

## **CAP 1383: STRATEGIC THEMES FOR THE REVIEW OF HEATHROW AIRPORT LTD CHARGES (“H7”)**

### **A RESPONSE BY INTERNATIONAL CONSOLIDATED AIRLINES GROUP (IAG)**

#### **Background**

British Airways (BA), part of International Airlines Group, is one of the world's leading airlines and the largest international carrier in the UK.

The carrier has its home base at London Heathrow, the world's busiest international airport. It also has a significant presence at London Gatwick and its wholly owned subsidiary BA CityFlyer is now the biggest operator at London City Airport. The airline flies to more than 170 destination in 70 countries and is a founder member of the **oneworld** alliance.

BA employs approximately 40,000 people and has a fleet of more than 280 aircraft. The airline carries more than 40 million customers a year.

In 2010, BA completed its merger with Iberia of Spain to create the International Airlines Group (IAG). In April 2012 IAG completed its purchase of British Midland Limited (bmi) from Lufthansa. The bmi mainline business has been fully integrated into BA.

With the addition of Vueling in April 2013 and Aer Lingus in September 2015, IAG is one of the world's largest airline groups with 523 aircraft flying to 255 destinations and carrying 96.9 million passengers each year and over 600 thousand tonnes of cargo. It is the third largest group in Europe and the sixth largest in the world, based on revenue and tenth largest air freight carrier based on volume.

#### **Question 1: Do you agree that there has not been, or likely to be, a material change in circumstances to require a new MPD for HAL before January 2019?**

IAG agrees with the CAA that there has been no material change in circumstances since it conducted its MPD of Heathrow as part of the Q6 process. Consequently, we agree with the CAA's assessment for Q6 that HAL has significant market power.

In terms of looking forward, it is difficult to see any reasonable market development over the likely period of H7, which would lessen HAL's SMP. If anything, HAL's SMP is likely to grow. Should the Government announce an additional runway at Heathrow, then for the avoidance of doubt, IAG does not believe that this would constitute a material change in circumstance that would warrant a new MPD. There would certainly be no need for a new MPD before the new capacity was available, and in our view it is also debatable whether new capacity would affect HAL's SMP in such a way as to make economic regulation unnecessary.

#### **Question 2: How best can the CAA proceed with the H7 programme given the uncertainty about new runway capacity?**

In short, IAG believes that the CAA should not proceed with the H7 programme, and add a year to the Q6 settlement, to allow the uncertainty surrounding new runway capacity to resolve itself.

The last time that the CAA faced significant uncertainty at the beginning of the process to set a new price control was during Q5. That uncertainty was caused by the CMA's investigation into (the then) BAA Ltd, and the passage of the Civil Aviation Act (CA 2012). The CAA's response to dealing with this uncertainty was to add an extra year to the price control at Heathrow (Q5+1).

The Civil Aviation Act (2012) amended the CAA's duties and gave the CAA new powers. Given the uncertainty that was generated the CAA was correct to defer the Q6 control. It is our contention that the Government's decision on new runway has more far reaching and fundamental effects than the CA (2012). For Q6, the CAA set a RAB based control, yet it is not clear that a 5 year RAB based control would be appropriate in the light of a third runway at Heathrow. An R3 decision would fundamentally change the circumstances of H7, and force the CAA to reconsider what the correct model of economic regulation at LHR would be.

Consequently, we believe that the uncertainty surrounding the H7 process now, is far greater, and far more fundamental than that which faced the CAA when it was considering beginning the Q6 process. Consequently, we urge the CAA not to begin the H7 programme until there is more certainty regarding runway expansion in the South East. Furthermore, we propose, that as in Q5, the CAA extends the Q6 settlement by one year to allow sufficient time for the situation to resolve itself.

**Question 3: Is there a case for the CAA to consider extending the current Q6 arrangements until there is a higher level of certainty over runway developments?**

Absolutely – the CAA should extend the current Q6 arrangements for a period of 12 months.

Besides the obvious benefit of not beginning the H7 process until there is more certainty, we believe that a 12 month extension to Q6 would have a number of other benefits:

- i. Greater certainty on HAL's out-performance of Q6 – the CAA have shown that HAL are performing better than they expected when they set the Q6 controls. Our own modelling suggests that by the end of Q6 HAL will have outperformed the Q6 settlement by over £800m. This suggests that far from being 'draconian' as the HAL CEO stated when the CAA announced the Q6 settlement, the settlement was if anything not tight enough. An additional 12 months of data would give extra certainty about the degree to which HAL is outperforming Q6, and therefore a stronger basis on which to set an H7 control that facilitates lower prices;
- ii. not beginning the H7 process until there is certainty around new runway capacity will prevent potentially nugatory work for all parties;
- iii. the CAA's proposals for H7 do not appear to be fully thought through. For example the CAA's proposals for the Consumer Challenge Forum seem at present unfocused and unclear. A 12 month delay would allow the CAA to clarify and finalise its thinking, appoint the necessary members of the Forum, and ensure that they were well briefed and fully understood the aviation market;
- iv. the CAA has asked the airlines and HAL to begin discussions around a third runway at Heathrow in general and the financing of planning costs in particular. Such engagement is clearly very demanding of senior staff time and effort, and as a result

it is unlikely that neither HAL and in particular airlines would be in the position to devote the necessary management time to the H7 process whilst R3 engagement was ongoing. Having started the process, the CAA should allow it the space to reach a natural conclusion.

Whilst we believe that there are potentially large benefits to adding an additional year to the Q6 price control, we also believe that this can be done relatively easily and without harm. We believe that:

- i. There is no evidence that the WACC is too high – HAL have continued to invest during Q6, and have had no trouble issuing debt in the market. Whilst we believe this supports our contention that the Q6 WACC was too high, it clearly demonstrates that it is not too low, and that there is no risk of a capex strike;
- ii. in terms of capex, it is unlikely that HAL will complete the Q6 programme in Q6 and so an additional year would present no issues as HAL would simply work through the capex programme backlog. In addition, the airline community have already committed to beginning the process to move to HBS Standard 3 in 2019.

In short, whilst we continue to believe that the Q6 was too lax, and failed to address the problem of an over-rewarded, over-priced and inefficient HAL, we see that in the context of the significant uncertainty generated by the impending decision on runway capacity, that the damage to our passengers of continuing the Q6 settlement is far outweighed by the potential damage of beginning an H7 process in the current environment.

#### **Question 4: Do you agree with the proposed strategic themes for H7?**

IAG broadly agrees with the CAA's proposed strategic themes for H7. Without more detail on how the CAA will give effect to these themes in H7 it is difficult to comment further. We are particularly supportive of the CAA's proposals to put the passengers' interests at the heart of their deliberations for H7, and for their proposed focus on cost efficiency. In terms of the individual themes themselves:

- i. Empowering customers and furthering their interest- we strongly support this theme. As a business operating in a competitive environment, IAG is driving by understanding and delivering what the passenger wants at a price they are willing to pay. We are therefore supportive of the CAA's proposal to use the same lens as us in its H7 determination. We will comment in later questions of the detail of the CAA's proposals on the CCF. In determining what the passenger wants in H7, we would caution the CAA that simply putting together a wish list of perceived passenger wants will not be sufficient. The CAA must also understand, as commercial businesses in competitive markets do, what the passenger will pay for. We are concerned that the CAA's proposals in this area contain no proposals for dealing with this issue, and therefore exposes the airlines and their passengers to further spiralling costs at Heathrow;
- ii. Incentivising the right consumer outcomes – we support this theme. In our opinion, Service Quality Regime functions well, and is critical in ensuring that we can deliver our services to the passenger. We are fully supportive of building on the success of the SQR and enhancing it – especially by extending its reach into areas such as baggage, increasing the revenue at risk to sharpen incentives on HAL, and improving

governance by restoring the SQR Working Group as in Q5. We are open to the idea of introducing outcomes based measures, but these must be in addition to but not instead of the SQR;

- iii. Increasing airport resilience – airport resilience is an important issue for us and we are supportive of the CAAs interest in this area. However, unless a lack of resilience is caused by a failure to invest by HAL, this does not seem to us to be an issue for economic regulation. In our view, the key step in improving airport resilience at LHR should be an improvement in the management of airspace. The delivery of LAMP is a critical item in delivering this, and is the responsibility of NATS. As the CAA regulates NATS, it seems to us that the CAA’s focus should be on incentivising NATS to deliver the LAMP items that the airlines are paying for in the current control period. The CAA should also ensure that it makes the link between improved resilience and the scale of the adverse shock generator in its passenger forecasts and the WACC;
- iv. Promoting cost efficiency and financability – we strongly support this strategic theme. Heathrow is the most expensive airport of its type in the world, and its costs continue to spiral. In a world where fierce competition continues to drive airline ticket prices down, this is simply unsustainable. HAL’s prices at Heathrow must fall. It is what the passenger wants and deserves, and is the only sustainable path. At this stage, we would make a few further observations:
  - a. Cost efficiency comes from transparency of HAL and CAA data to airlines and for the airlines to have sufficient time to analyse it;
  - b. only the airlines operate in a highly competitive market, and so only the airlines have a real incentive to understand what the passenger wants and will pay for, and to deliver it in the most efficient way;
  - c. the Civil Aviation Act (2012) is very clear that the CAA’s primary duty is to further the interests of passengers. None of the secondary duties, including financing, can either individually or collectively can outweigh the primary duty. Therefore the CAA must deliver the settlement that the passenger deserves, regardless of its secondary duties;
  - d. to deliver c above, the CAA must focus on what a notionally efficient company would need to deliver the H7 programme, rather than what costs HAL can drive out. To do anything else, harms passenger welfare and leads to higher prices and less investment by the airlines at Heathrow. In Q6 the CAA focused on what savings HAL could deliver, and as a result the passenger will pay £1bn more for HALs opex than they would have done had the CAA set the Q6 control on the basis of a notionally efficient company.

**Question 5: How can consumer engagement throughout the H7 process be improved?**

Consumer engagement was a key theme throughout the Heathrow Q6 Constructive Engagement process. In Q6 the CAA recognised that airline interests and passenger interests aligned and adopted it as a rebuttable position. IAG continues to operate in a well-functioning, competitive market at Heathrow, across London and Europe, and globally as well. We firmly believe that we represent the interests of our customers and in this regard nothing has changed since Q6. Hence, the CAA should maintain the rebuttable position that airline and passenger interests are, and will be, aligned for H7. If this is not the case then the CAA should provide evidence as to why its position has changed.

BA and other airlines conduct extensive customer insight programmes and this combined with CAA research has provided an effective platform for ensuring that previous HAL plans have been based on the needs and willingness to pay of consumers. However, this does not mean that consumer engagement cannot be further improved to inform the development of H7 and IAG welcomes the CAA's approach to facilitate this.

It is difficult to comment on the Consumer Challenge Forum (CCF) in any detail, as the CAA's proposals do not seem well developed at this stage. However, in principle, IAG welcomes CAAs proposal to introduce the CCF. As a passenger focused business, we welcome any measure that helps the CAA and HAL focus on the passenger interest as much as we do.

We believe that the CCF can have a valuable role within the existing Constructive Engagement process. However we would be concerned if the introduction of the CCF fundamentally changed the CAA's Constructive Engagement process that has worked well and delivered positive results for customers, airlines and HAL over the last decade. The key to ensuring that the CCF is able to enhance the CE process, whilst avoiding lengthy and convoluted consultation, will be to clearly define at what points the CCF should become more deeply involved with the process and what HAL and the airline community need to provide, and when, for it to fulfil its business plan assurance role.

Whilst we are sympathetic to the need to make the CCF's participation in CE as effective as possible and avoid lengthy and convoluted consultation this should not be at the expense of giving the airlines the time and opportunity to engage in detailed work on HAL's Business Plans during the CE process. The fact of the matter is that airport regulation of Heathrow is complex and requires detailed scrutiny by both airlines and the CAA to ensure that the outcomes for the consumer have a proven grounding in what the consumer wants and is prepared to pay for.

IAG notes that in other sectors regulators are looking at how to further improve customer engagement beyond specific consumer research and have proposed using other sources as well as consumer challenge groups to understand consumer priorities, particularly in relation to operational day-to-day consumer interactions. Social media interactions or call centre contacts are good alternative sources of information about consumer priorities.

**Question 6: Are the CAA's proposed steps [box 2] sufficient to ensure that consumers' interests are at the heart of the H7 programme?**

IAG would contend that consumers' interests will be at the heart of the H7 programme regardless of the proposals for the CCF as airlines operating in a competitive market, as BA and other Heathrow airlines do, have an alignment of interests with their passenger and cargo consumers.

The proposal for an independent CCF could bolster the existing airline representation of consumer interests within the H7 programme. We stand ready to assist the CAA, CCF and Consumer Panel in the H7 process providing access to our consumer knowledge and understanding and experience of Heathrow and Constructive Engagement.

As it stands our view of the proposed CCF is that more detail is required on how it will work to allow airlines to take a view on whether it will be sufficiently able to perform the independent assurance

role proposed by the CAA. A greater level of definition is required on structure, composition, and operating protocols with the CAA, Consumer Panel, HAL, airlines and existing passenger and cargo groups. We do understand that the CAA is looking at all of these issues as a matter of urgency and that the April H7 workshops and appointment of a CCF chair will start to address these issues. It would be useful to have an emerging view on all of these areas ahead of the CAA appointing a CCF Chair.

We have the following comments in specific response to the steps outlined in Box 2 of the CAA's Strategic Themes document:

**i. Establish an independent CCF**

It will be important for the CCF to be truly independent particularly from HAL as the regulated body. This will be a challenge as it is likely that the CCF will be relying on HAL for information about their H7 plans and may even look to use HAL staff to fulfil a secretariat role. It may be that the airline community could provide some secretariat support as well as HAL. We would encourage the CAA to locate the CCF away from HAL at the airport. There is office accommodation at Heathrow that could fulfil this ensuring they are close to the airport but not based with HAL.

**ii. Consumer research leads to evidence-based regulatory outcomes**

We are happy to look at sharing our consumer research and intelligence with the CCF as we have done with the CAA and on occasion HAL in previous regulatory periods. Obviously as part of a competitive airline environment the CCF will need to be able to use this information in such a way that it does not compromise our or other airlines information. Overall we do not see this as a substantial change from previous Constructive Engagement periods. However a key issue for the CCF, as it is for airlines, will be identifying what consumers say they want versus what they are prepared to pay for.

**iii. HAL and airline plans deliver outcomes consumers value**

Throughout the H7 Constructive Engagement process it needs to be clear that Heathrow Airport is the regulated entity and not the airline community. Airlines operate in a competitive, commercial environment and are not subject to regulation. Airline customers have a choice. The benefits of competition are not available to those consumers in relation to services provided by HAL. The onus must specifically be on HAL to demonstrate that their plans take on-board the views of consumers whether they are derived from airlines or the CCF. That onus on HAL can be extended to airlines in as much as we help inform HAL develop their business plan for the H7 programme.

**iv. Cargo owner perspectives**

Together with our colleagues at IAG Cargo, we agree with the CAA that more work is needed to better understand the perspective of cargo owners who use Heathrow. This will need to be a key focus in order to ensure these stakeholders are properly represented by the CCF in H7. IAG and IAG Cargo are happy to assist and facilitate the CAA's and CCF's work in this area.

**v. CAA Consumer Panel**

As previously noted BA requires more definition on both the proposed CCF and how it interacts with the Consumer Panel to make a more informed judgment on how that empowers and further consumers interests in H7. In particular we are keen to understand the difference

between the scope of the Consumer Panel and the CCF. A key issue will be determining whether the CCF develops into a body that has a greater understanding of the Heathrow Constructive Engagement process which may supersede the Consumer Panel's role?

In order to ensure that consumers interests are placed at the heart of the H7 programme we strongly believe that engagement between the CCF, Consumer Panel and the CAA is open and transparent in line with the regulatory principles identified by the UKRN. HAL, airlines and consumers need to be able to understand, support, challenge and counter views expressed between the CCF, Consumer Panel and CAA in the same way that the CCF, Consumer Panel and CAA are able to do during Constructive Engagement between HAL and the airline community.

We are concerned that the CCF is being introduced as a new development for H7 with responsibility for delivering two fundamental key functions for H7: CE and the resulting H7 programme. Determining the process for developing evidence-based consumer-focused outcomes and establishing a framework to monitor their delivery throughout H7 will form the parameters for HAL and airlines business plan engagement. This places a significant burden on a new group that is likely to have, little or no prior experience of airport regulation or how the aviation industry, but whose output will be central to how HAL and the airline community can engage throughout the H7 process. We would like to understand how the CAA plan to ensure that the CCF is credible in this regard, and how the airline community in particular can help the CCF with this challenging start to their involvement in the H7 process?

When the CCF is considering the process for developing evidence-based, consumer-focused outcomes it needs to build upon the work done by HAL and the airline community in previous regulatory periods. Notwithstanding the opportunity to build upon existing work the task for the CCF in developing i) the process to determine those outcomes, and ii) the framework to monitor the delivery of those outcomes, is significant. The first of those two will need to be largely in place in advance of HAL's initial business plan in January 2017. BA has concerns about the CCF's ability to meet that timeline when the chair of the CCF is not assumed to be in place until Summer 2016 and with the remainder of the CCF to be appointed and in a position to start work. BA does not believe that any accommodation of the CCF's role at the outset should be at the expense of time afforded to HAL and the airline community to conduct the Constructive Engagement effectively.

We understand that the CCF is envisaged as playing more of an assurance role than a representative role as consumer challenge groups in other regulated sectors have done. Whereas Ofwat and Ofgem established multiple consumer challenge groups which, whilst being seen as very beneficial, did have varying degrees of good and bad performance. Unlike these areas where having multiple groups de-risked issues with the efficacy of these groups we understand the CAA is proposing to establish a single group so we need to ensure we get good performance from the proposed CCF.

Overall, we support the CAA's proposal to establish a CCF to augment the existing representation of passenger interests by BA and other airlines. More information is needed though to understand whether the arrangements to establish the CCF and deliver its workload allow it to sufficiently represent consumer interests in H7 alongside airlines.

**Question 7: Do you agree in principle that the CAA should look to move toward more outcomes-based regulation and to what extent should this complement or replace the existing SQRB scheme?**

If the CAA does decide to move towards outcomes-based regulation this would be complementary to the existing SQRB scheme. We strongly believe that the SQRB scheme, in an enhanced form, will be critical to effectively underpinning the H7 programme and that it could support outcomes-based measures if they are also in place.

The SQRB scheme is a critical element of the CAA's existing regulatory framework which has "delivered significant benefits" and therefore, we should look to "build on the(se) successes to date". To this end BA believes that a move towards outcomes-based measures is very likely to represent a logical extension of the existing SQRB scheme.

The SQRB scheme itself is predicated on outcomes that are currently expressed in an implicit fashion. A move towards outcomes-based measures would allow the assumptions behind SQRB elements to be made more explicit and demonstrated how they can deliver outcomes consumers would value in H7 – as they have done so in Q6, and Q5 before that.

The current SQRB measures are likely to fall into the category of secondary deliverables that enable the delivery of primary outputs within an outcomes-based regulatory model. BA believes that the current SQRB measures can all be clearly linked to implied outcomes such as safety & security, punctuality, full-service experience, and minimum queue times. It may well be that other additional outcomes would rely on existing SQRB elements or require new metrics to capture how these outcomes or primary outputs are delivered by the airport operator.

A key concern is that whilst a move to outcomes-based regulation and measures may seem appealing based on the experience of other regulators the context of airport regulation and how outcomes are delivered to end-users is far more complex. In the vast majority of instances end-users have their primary commercial relationship with airlines and cargo operators who in effect deliver the airport services to them within their own competitive environment, one-step removed from the airport operator itself. Additionally other key outcomes such as punctuality are not wholly the preserve of HAL or airlines. The additional complexity of NATS, NERL, and Eurocontrol performance can have a significant impact on the end-user experience delivered by HAL via airlines and cargo operators.

Regulated airports are not as self-contained a regulatory environment as the other utility sectors referenced by CAA in their thinking for the H7 Strategic Themes. These sectors may have important lessons that we can use to improve the H7 process but the CAA, HAL, airlines and the proposed CCF need to be cognisant that the airport environment is not as clear-cut and is far more complex.

In summary we are open to a move towards outcomes-based regulation and believe that the SQRB scheme will need to remain in place for H7 regardless of any moves toward this or not. The more complex context of how airport services and performance are perceived by end-users will need to be taken into account in any development of the existing CAA regulatory framework that has delivered significant benefits to consumers over the last three regulatory periods.



**Question 8: How can the licence regime improve airport operational resilience and mitigate disruption?**

Heathrow is a capacity-constrained airport with high user charges. We do not think our customers would support any measures to restrict capacity further, reducing choice of flights with a likely knock-on effect of even higher airport charges for the remaining passengers. There are better ways to improve resilience.

Airlines, Heathrow and NATS already work together to mitigate the effects of operational disruption. We are already progressing a number of initiatives to improve resilience. These include:

1. With an adverse European and UK ATC picture, IAG is always looking at mitigating ATC slot delays through reroutes and level caps. Both of these tactical mitigations result in a less fuel efficient flight profile but ultimately benefit the customer;
2. BA's Crisis Management Team (CMT) is set up to run in parallel with HAL Crisis Management Team in the event of any major disruption to our scheduled programme. At the appropriate times throughout the year we undertake two full blown corporate crisis management exercises;
3. since the winter weather disruption we experienced at the turn of the decade BA has invested heavily in equipment and training to bolster our winter resilience capability;
4. in anticipation of any disruption our primary driver is to provide information as soon as possible, and ideally before our customer is leaving for the airport. EU 261 dictates that airlines have a "duty of care" to the passenger regardless of the reason for delay;
5. we are investing heavily as an airport on Q6 projects that we can directly attribute to helping the resilience of Heathrow. Some £695m of a total Q6 capital spend of £3.3bn can be assigned to resilience capital work;
6. critical to a resilient Heathrow is a resilient baggage system and process. In Q6 we have developed auto Reflight allowing message exchange with baggage system, allowing us to process more bags, more quickly.

As we move through Q6 and into H7 we will place increased focus on the automation of the customer journey. This will provide additional touchpoints and enable more hosting of customers to improve their airport experience as well as aiding recovery in times of disruption. We have already seen how ATP gates have provided a better passenger flow. Projects such as BC18 with the development of the second T5 escalator and the introduction of parallel loading in the security lanes, have shown us how we can improve the resilience of the system.

In the event of disruption, there are further initiatives the airport could take to improve the speed of recovery, to the benefit of customers. One such is to allow more flexible use of runways to recover from disruption, including the ability to temporarily operate in 'mixed mode' to allow flight backlogs to be recovered more quickly.

**Question 9: Do you support our broad approach to approaching efficiency and financeability and do you agree that the specific issues raised (CPI v RPI, debt indexation etc) are relevant for this review?**

The CAA's own analysis for Q6 showed that Heathrow was the most expensive airport of its type in the world. In addition, the CAA's own data has also shown that charges at Heathrow have grown by over 100% in real terms over the last decade. Meanwhile the trend in average fares to airline passengers is downwards. This means two things:

- i. That airlines operating from Heathrow face a competitive disadvantage compared to airlines operating from other airports;
- ii. that the position is simply unsustainable – airport charges are a key part of an airline's cost base. Our passengers rightly demand lower prices, but this cannot be delivered indefinitely whilst HAL continue to put our costs up.

Consequently, we would be strongly supportive of CAA proposals to reduce costs and improve efficiency at HAL.

In terms of the detail on how the CAA would go about this, (Appendix 8) we have the following comments:

- i. generally the CAA is looking at the right elements of cost, but its approach is not robust. It seems to us that the proposed approach is to ask HAL for cost data, and then cross check against a top down benchmarking study. IAG contends that HAL's costs are largely irrelevant to the H7 process. The CAA should seek to understand what costs an efficient company would bear when running an airport like Heathrow, and set the charge appropriately;
- ii. we support the CAA's desire to find mechanisms to help HAL produce better quality business plans, and note the success that OFWAT and OFGEM have had in this regard. However, we also note that the aviation industry is very different in nature and structure to either of these industries and are sceptical that the quality of HAL Business Plans will be markedly different in H7 than Q6. Consequently, we urge the CAA to ensure it has sufficient resource and time to deal with HAL BPs of Q6 quality;
- iii. whilst we support the passenger interest theme that runs through CAP1383, we are concerned that it is only a partial presentation. It is one thing to understand what the passenger wants, it is another to understand what is commercially viable and what they will pay for. OFWAT has a sophisticated approach to dealing with this, linking cost benefit analysis and willingness to pay to capex plans. All of this architecture is missing in the CAA proposals, and there is the risk that HAL prices in H7 may continue to spiral whilst the airport chases dreams that no passenger will pay for;
- iv. we understand the need to look at downside risk in the financeability assessment, but this must also be balanced against an assessment of upside risk;
- v. we agree with the CAA that TOTEX and incentives around innovation are unlikely to be necessary or viable in an airport context;
- vi. we agree with the CAA that debt indexation and CPI v RPI are issues to examine;
- vii. we agree with the CAA that basing the allowed return on a notionally financed company is correct;
- viii. we agree that risk sharing mechanism should be examined. At present we do not feel that risk is appropriately allocated. In terms of passenger demand risk – HAL take only second order risk (airlines typically taking the first round risk by reducing prices to fill seats). HAL are paid to take downside risk (elements in the WACC and adverse shock generator), and take all the upside benefit. Airlines pay for the

downside risk but get no upside element. We believe that this is asymmetric. If airlines pay for downside risk then they should take the upside, and if HAL want the upside then they should pay for the downside (ie remove the adverse shock generator in forecasts and the lower the WACC).

- ix. Allowed Return – we note the CAA’s statement ‘...the allowed return for HAL, will be an estimation of the returns that investors in HAL will expect in order to attract, retain and remunerate investment...<sup>1</sup>’ with interest. For the avoidance of doubt, IAG does not believe that the allowed returns should be set according to the expectations of HAL’s existing shareholders. Rather the allowed return should be set according to the market, and specifically to the marginal investor.

**Question 10: Do you agree in principle with the continued use of Constructive Engagement and do you have any observations on how the process might be improved?**

IAG fully agrees with the continued use of Constructive Engagement (CE) and supports the CAA’s view that the Q6 CE operating principles, as outlined in Box 3 of the Strategic Themes document, remain valid for H7. The remainder of this answer covers 4 sections addressing proposals and options made by the CAA on CE in both the Strategic Themes document and the technical appendices.

Consumer Challenge Forum (CCF)

IAG will work with the CAA to facilitate the introduction of the CCF to the overall CE process. Given the CAA’s proposed timescales for the CCF to define the process for determining the high-level consumer outcomes that HAL’s initial business plan (January 2017) will reference, this work will need to be expedited at the earliest opportunity by the CAA, CCF, HAL and airlines. IAG agrees with the CAA that detailed scrutiny of the HAL’s business plan should remain between HAL and the airlines. There may well be opportunities here for the CCF to perform an assurance and observation role throughout or at designated times within the HAL-airline scrutiny CE phase.

CE airline engagement

On key discussions IAG agrees that senior airline representatives should represent and be able to commit their respective organisations to CE conclusions at a high-level. However it needs to be recognised that there is an asymmetry between airlines and the regulated airport in CE that should be addressed:

- HAL representatives sole focus is on the running of Heathrow as a regulated business
- Heathrow regulation is one of many competing priorities for airlines
- Scrutiny of HAL plans is needed for airlines to be able to commit to CE conclusions
- Without detailed scrutiny there is not a level playing field between HAL and airlines

We note the CAA option for terminal level CE in H7. We do not believe this would be appropriate as at this level airline management teams are focused on day-to-day operational issues rather than strategic and regulatory issues. Clearly some airlines, including IAG, have a greater level of resource and regulatory expertise that can be used within H7 CE. IAG would be happy to discuss this and the above points further with the CAA as we prepare for H7.

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<sup>1</sup> Para 31 of the discussion paper CAA produced for its April 20<sup>th</sup> seminar on Promoting Cost and Efficiency

### CE timelines

IAG believes that CE is extremely valuable both to ourselves and the wider airline community who are able to scrutinise HAL's business plans in order to refine and challenge them. Airline scrutiny in turn benefits the CAA, by allowing gaps to be narrowed and issues to be identified, and ultimately the consumer, by ensuring that business plans deliver developments and service offerings that they want. IAG has 2 concerns with the proposals for H7 CE:

1. Available time for business plan scrutiny – current CE proposals are for input prior to the initial business plan to be published in January 2017 and then for 6 months of CE from January to June. IAG believes that the time needed to input into the initial business plan is highly constrained and that the CE period is very limited in comparison with Q6 CE.
2. Provision for scrutiny of further business plans – the proposed H7 CE timeline does not allow for further CE scrutiny of updated business plans. IAG strongly believes that CE must be extended to allow for airline scrutiny of further HAL business plans.

Notwithstanding the above IAG is concerned about the timescales for HAL publishing their initial business plan, particularly in regard to interaction with the proposed CCF. If there were to be a delay this must not then be at the expense of the time afforded to the CE process which is fundamental to the H7 settlement. IAG would contend that an even shorter CE period would significantly diminish the capability of IAG, airlines and the CCF to perform our roles effectively.

### Other comments

IAG has the following comments on other CAA proposals for H7 CE:

- We support the CAA's position that all of the regulatory building blocks should be within the scope of CE. Without CE running across all elements of the HAL regulated business it would not be possible to make informed judgments in the round about the business plan. HAL should make available all the financial assumptions they are making for H7 in order to inform this work as well.
- IAG is happy to discuss resilience measures with HAL as part of CE. We do note that airport resilience relies on airspace resilience too. A lack of progress in airspace regulation, for example LAMP delays, should not simply be transferred over as an even larger challenge to be addressed within airport regulation. We are happy to work with the CAA further on this in H7.
- We would like to understand more about the CAA's emerging thinking in the area of Heathrow's environmental impacts and its role in the local community.

### **Question 11: Do you agree with the proposed timetable for the review?**

Leaving aside the issue of whether the H7 process should be deferred for 12 months, we are broadly comfortable with most aspects of the review timetable. We are supportive of the idea of moving some of the early study work and the baseline benchmarking to the period before CE begins. Like

the CAA, we hope that HAL may use the emerging data from these studies as part of the basis of a more pragmatic initial business plan.

However, we are uncomfortable with the proposed shortening of Constructive Engagement. We believe that CE is particularly useful both for identifying areas of agreement and difference between the airline community and HAL, and also for ensuring transparency of data. We are however, supportive of the CAA's revised timetable for CE, issued in its paperwork for the 20 April informal seminar on H7, which proposed two phases of CE: one to inform HAL's initial BP; and one to scrutinise it. However, the CAA currently proposes that more time be spent pre-HAL's BP rather than scrutinising it. IAG disagrees with this element of the revised proposal, and insists that the CAA back-end loads the CE timetable so that there is sufficient time to effectively scrutinise HAL's proposals.

As businesses operating in highly competitive markets, airlines have a strong incentive to cut their costs whilst delivering what their passengers want. Many airlines have been successful at cutting their costs, and those that do not typically go out of business. Consequently, the airline community has a particular skill in cost reduction and passenger delivery which we are keen to apply to HAL in general, and their cost base in particular. We are keen to ensure that we have full and transparent access to HAL and CAA data, and enough time to conduct proper analysis. If such transparency and time is available, we are confident that we will be able to deliver robust proposals to deliver what the passenger wants – lower prices at Heathrow whilst maintaining the standards they have come to expect of us.

We are concerned that the proposed shortening of CE will make it difficult for us to conduct a proper analysis and audit of HAL costs, and that this can only be to the detriment of our passengers.