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Sent by email to: economicregulation@caa.co.uk

30th April 2019

Re. Economic regulation at Heathrow airport from January 2020: proposals for interim arrangements (CAP 1769)

Dear Elly,

This response is made by International Consolidated Airlines Group SA (IAG) in response to the CAP 1769 consultation on interim arrangements for the economic regulation of Heathrow Airport Limited (HAL) from January 2020. It represents the views of IAG and its subsidiary airlines: British Airways, Iberia Airways, Vueling, Aer Lingus and LEVEL.

This response uses the questions from the CAA consultation document.

Do stakeholders agree with our initial conclusions that on balance the commercial deal for the iH7 price control period is in the interests of consumers?

IAG supports the commercial arrangements that have been agreed between airlines and HAL. The commercial arrangements retain the Q6 RPI -1.5% price path and have limited scope, so the majority of the existing regulatory framework continues throughout the iH7 (interim H7) 2020-2021 period leading into the upcoming H7 period.

The CAA's original indicative proposals would have seen the "out-performance" between the RPI -1.5% path versus HAL's actual underlying revenue requirement returned over the long-term through regulatory depreciation. The commercial arrangements return this "out-performance" over a much shorter period of 4 years than the CAA's proposals – this is much better for the consumer.

The commercial arrangements also provide for additional "out-performance" to be returned if passenger volumes increase over expected numbers. IAG therefore believes that the commercial arrangements are more advantageous than the CAA's original proposals which effectively allowed HAL to retain "out-performance" over a much longer period at the expense of airlines and consumers during that time with any eventual compensatory benefit being lost.

IAG's view is that the commercial arrangements enable benefits for consumers over the short-to-medium term, rather than the CAA's original approach where the return is done over a much longer period, that would include both the delivery and operation of an expanded Heathrow Airport. IAG has previously stated its opposition to pre-funding and the commercial arrangements come closest to ensuring that funding is returned to users in the present, avoiding pre-funding.

IAG notes CAA's assessment of CEPA's analysis of the HAL proposed iH7 business plan and the differential between the alternative regulatory scenarios. It is important to understand that the context of discussions between airlines and HAL was the CAA's original proposals from CAP 1658 which effectively formed the bounds of the commercial arrangement's discussion. If the CAA believe

circumstances have changed significantly since then it should take this into account in its assessment of the deal and, if necessary and in the consumer interest, adjust the iH7 price path whilst retaining the commercial deal on top of this.

In its assessment of the deal the CAA should also ensure that there are no unforeseen or unintended consequences of the deal to the detriment of the consumer (e.g. if the volume incentives are triggered there should be no impact on the k-factor).

Whilst the CAA cites the potential wider benefits of commercial arrangements at Heathrow Airport IAG would suggest that the circumstances in which this took place are unique. The commercial arrangements cover a very limited 2-year period at a time when the capacity at the airport is largely fixed. These circumstances coupled with the very weak CAA initial proposal – which we expected to be much stronger due to the limited 2-year period and HAL avoiding a full regulatory review - and our expectations of Heathrow Airport's likely performance meant that we were left with no alternative but to discuss and agree limited commercial arrangements. The CAA should therefore not bank on large benefits being delivered through further commercial arrangements being proposed in future and should not place great weight on this in its assessment of this deal. HAL remains a company with substantial market power. The CAA's focus should be on regulating HAL robustly and effectively.

The CAA cites the Gatwick Airport Limited "commitments" framework as evidence that commercial arrangements lead to more positive consumer outcomes. In IAG's view the jury is still out on the success of this approach – overall traffic growth is not primarily driven by such an approach and we would have anticipated service performance to improve regardless. It is also the case that elements such as airfield performance and capital expenditure have not met our expectations. A key test for this approach will be the ability of airlines to agree further commitments as they enter the G7 period – this is not a given.

IAG would strongly encourage the CAA to keep their options open when considering the response to a potential third iH7 extension year and to continue to monitor HAL progress on the expansion masterplan.

However, if the CAA chooses to progress with arrangements for iH7 it needs to recognise that the HAL-airline commercial arrangements are a product of the circumstances at that time and so was assessed against the alternatives available then. If the CAA wants to change any aspects of the commercial arrangements or its alternatives - for instance, by providing alternative "fallback" arrangements for airlines that don't wish to sign up to the commercial arrangements – then the CAA must ensure that all airlines should be able to re-consider their options and change their position as required.

Should we take any other steps to protect the interests of consumers over the period 2020 and 2021?

The CAA should look to amend the licence where necessary to facilitate the commercial arrangements. The iH7 arrangements should be primarily enforceable under the licence and IAG does not want the CAA to stand back from its regulatory duties during this period.

The commercial arrangements retain the Service Quality Rebate & Bonus scheme but IAG expect the CAA to continue their regulatory oversight as during Q6. As the H7 period will not be starting for at least a further 2 years and 8 months, with the potential for a further 12-month extension for 2022 the CAA should look to conduct a Service Quality audit as it has done during price control reviews throughout the scheme's operation. This will give airlines and consumers assurance that the scheme continues to be administered correctly over the 3-4 years leading up to the H7 control period.

The CAA originally put in place a Q6 trigger for the delivery of an automated security queue measurement during the control period. This was waived by the airline community in order to facilitate continued progress on a solution for this, however despite this proactive approach an airport-wide system, and the harmonisation of security queue measurement that the CAA specified for Q6, has still not been delivered. IAG would support the CAA re-instating a trigger to incentivise delivery of both a system and the harmonisation of queue measurement. This should have been done by now – it must be done before H7.

Further to the CAA's proposed licence changes IAG is strongly of the view that hold baggage screening should not be categorised as an "other regulated charge". Hold baggage screening charges, relating as they do to a process element of passenger security, should be designated as an airport charge. If they then qualify as being able to be funded through the Security allowance (Licence Condition C1.4) as a change in mandatory security requirements – in this case the DfT change from requiring airlines to have responsibility for HBS to HAL covering this – this should be applied. IAG would welcome the opportunity to discuss this further with the CAA.

Are there are any disadvantages with the commercial arrangements that we have not identified in this consultation?

The CAA proposes that alongside the commercial arrangements that it allows an opportunity for HAL to "shadow track" key parts of the Outcomes-Based Regulation framework that is currently being developed for the H7 business plan. IAG does not support the proposals to shadow-track as we are concerned that this could lead to perverse incentives where HAL performance during iH7 could be manipulated to influence eventual H7 thresholds and rates. Furthermore, this would pre-empt the eventual H7 price control decision – previous setting of the Service Quality scheme has always been subject to the full price control review process and Outcomes-Based Regulation should be introduced in the same manner.

Yours sincerely,



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