

BAA AIRPORTS MARKET INVESTIGATION

American Airlines: summary of hearing, 14 June 2007

Background

1. American Airlines (American) is a member of the **oneworld** alliance. It told us that it operated from three UK airports: Heathrow, Gatwick and Manchester. The configuration of its business between the three airports was to some extent determined by the number of slots at Heathrow. It was as yet unclear what effect the Open Skies agreement would have on its operations from Heathrow and Gatwick.

BAA's management of Heathrow

2. American said that there were severe capacity constraints at Heathrow, but these constraints were not responsible for malfunctioning air-conditioning, leaking roofs, traffic tailbacks etc. These were due to poor management by BAA.
3. A specific example of poor management involved the availability of aviation fuel at Heathrow, both before and after the fire at the Buncefield oil storage depot in December 2005. Even before the fire there had been concerns about the amount of fuel available at Heathrow because of storage problems. BAA had met the base carriers at the airport to discuss how fuel should be allocated if there was a shortage. The base carriers proposed a higher allocation for themselves than for visiting carriers. A document was circulated for comment just before the Buncefield fire, but following the fire the proposal was portrayed as a cross-airline agreed plan and BAA implemented it, with severe financial effects for non-base carriers such as American. IATA then took the lead in a number of further meetings and eventually a non-discriminatory allocation was agreed, based on a long-haul, medium-haul and short-haul categorization.
4. Nineteen months after the Buncefield fire fuel was still being rationed (and still is today). BAA maintained that this was an oil company problem and had put little resource into helping to solve it. American would have expected BAA to exert stronger leadership and put pressure on the oil companies and the DTI. Instead, most of the pressure had come from the IATA Steering Committee, which had instigated meetings with the DTI. American said that this demonstrated BAA's lack of responsiveness to customers' needs. It was also the case that more fuel storage capacity was needed at Heathrow; there was an aircraft standing area where tanks could be located but BAA had resisted this on the grounds that it would disrupt its construction schedule.
5. American was also unhappy with the way airport security had been managed at Heathrow. The problem existed as far back as February 2006, when queues at Central Search in Terminal 3 (T3) stretched out of the terminal into the car park. At a series of meetings with the airlines, BAA admitted that it was short of staff, did not have enough staff at the right times of day and did not have enough machines. It was apparent to the airlines that rostering of staff was very poor: there might be 11 machines open in the middle of the day, when T3 was not busy, but only two at 6 am, when hundreds of passengers wanted to go through. American suspected that industrial relations problems were a contributory factor to the slowing of passenger

flows as well as more stringent requirements from the DfT. It was noticeable that the security process at Heathrow was slower than at airports in the USA and elsewhere in Europe. BAA promised to have Central Search operating efficiently by Easter 2006 but failed to do so, with many flights being delayed as a result. There had been some increase in staffing and usable machines, but queues continued. American speculated that BAA was still making poor use of staff or that its hiring regime did not match attrition. It observed that greater engagement and pro-activity by the security staff would help to speed up the flow through of passengers.

6. BAA shared monitoring information with the airlines and there had been regular security briefings. The airlines had assisted by supplying BAA with transfer and check-in information and expected load factors. BAA had made some attempt to deal with the security failings, but not as fast or as robustly as American would have wished. Costly delays to flights, up to 4 per cent of American's flights, were still occurring because of congestion at Central Search and delays to flight crew at the control post for access to the airfield. These delays had knock-on effects for the rest of the airport as they could slow the arrival and departure of other flights. American commented that the situation illustrated the mismatch of airlines' interests (getting passengers etc in and out of the airport efficiently and on time) and those of BAA (large construction projects on which it made a lot of money). American would not be surprised if the proportion of operational security space to retail space was weighted more towards retail at Heathrow than at other airports.
7. American believed that the shift away from an operational focus could not be attributed solely to the new owners, although access to senior BAA executives was much less than it had previously been. It seemed clear that the new management did not want to talk to airlines about airport operations. One example of loss of operational focus was an occasion when one of American's employees found that 358 lights were not working in the cargo tunnel, which was a serious safety hazard. It was also the case that standard maintenance of air-conditioning, elevators and escalators was not being done.

Airport charges

8. American said that the cost of a 767-300 aircraft with a typical turnaround of three hours would be £3,900 at Heathrow, in terms of landing, parking, jet bridge and passenger fees, compared with £2,700 at Manchester, £2,900 at Paris, and £1,200 at Rome. Aviation was an industry of such marginal profits that the difference in charges could have a devastating effect and could only stifle Heathrow's ability to compete with other hub airports. American believed that charges were high at Heathrow because BAA had a monopoly and because its location had made it highly desirable.

Terminal 3

9. American pointed out that—as of end-May 2007—in the development plans for Heathrow the only improvement planned for Terminal 3 (T3) was a new forecourt. American is still unsatisfied with the revised CIP. As part of the **oneworld** alliance, and together with other occupants of T3, it had been working with BAA to look at major improvements to the terminal, such as linear check-in and segregation on the piers. However, the various improvement plans had been postponed, because of the airline moves following the opening of T5 and the Heathrow East project; the expected vacant space at T3, which would have allowed large projects to take place, would not materialize. Consequently T3 was going to be busier between 2007 and 2012. The things that were then being considered for T3 were repair and

maintenance items such as replacing carpets and keeping the air-conditioning in working order, but BAA was presenting them to the airlines as if they were improvements. American said that if BAA had managed the airport efficiently, there might be an argument for higher airport charges than were currently planned in order to upgrade facilities, but in fact there had been poor management and there was scope for BAA to run the business more efficiently without increased charges.

Constructive engagement

10. American said that there had been little engagement with BAA, which seemed to have its own agenda and to present the airlines with a fait accompli. By way of illustration, American had been in discussions for some months with BAA about the location of a premium check-in facility in the T3 forecourt, only to be presented with plans showing a coffee shop in the prime location and to be told that BAA had already signed an agreement with the retailer. American commented that constructive engagement seemed to be a high level principle which did not go down to the level of the airline operator. It was fighting for a segregated Pier 7, and a documented trial it had conducted five years ago had shown that horizontal segregation would not work all the time. There should have been constructive engagement on what would work by the DfT deadline of 31 December 2008, but there had been no engagement and the time constraints meant that BAA was going to opt for horizontal segregation, which would have a lower capital cost than vertical segregation but would not be as effective.
11. American was particularly concerned about baggage transfer, especially as it lost more bags at Heathrow than at any other airport. The original plan, dating back some years, was for a baggage tunnel between terminals. BAA dragged its feet on this and then decided to transfer baggage by road instead, which was bad for the environment and would require recruitment of 250 people to drive the vans. It was a significantly worse product, the only advantage being the lower capital cost. American wanted, as quickly as possible, an automated baggage tunnel between T5 and T3 and to the other terminals, and was prepared to pay for it. The heart of the problem was that BAA was not keen on this project and was therefore using the opposition of one airline to it as a reason for not going ahead, whereas if BAA wanted a particular project it would carry it out regardless of how many airlines were opposed.

Traffic forecasts

12. American shared BAA's pessimism about future traffic, given that it was the UK Government's stated aim to dampen demand for air travel through taxation. The Open Skies agreement might be a counterbalance; whereas Heathrow was not going to experience any quantum change in air traffic movements, more flights to the USA would mean greater numbers of larger aircraft, thus increasing throughput of passengers. However, the new departure tax was likely to encourage connecting traffic to use other European airports instead of Heathrow. Also, with more efficient aircraft point-to-point flights from the USA to cities in mainland Europe were becoming possible. These factors raised doubts about Heathrow's future as a connecting hub.
13. American did not believe that Gatwick would lose a great amount of traffic even if some carriers moved to Heathrow as a result of the Open Skies agreement. Any voids would quickly be filled by low-cost and charter airlines. American said that as long as BAA owned all three main London airports it had no incentive to make Gatwick or Stansted an attractive alternative to Heathrow. It could afford to take

losses at Gatwick because of the money flowing in from carriers at Heathrow, whereas a separate owner of Gatwick would have to try to win back the long-haul carriers.

Cost of capital

14. American said that the cost of capital proposed by the CAA seemed too high, given that there was a fairly low level of risk. It had observed that every capital project that BAA put on the table had a large percentage of risk associated with it, which was added on throughout the calculations. It seemed that between 20 and 30 per cent contingency was added for every project, which was unacceptable, especially when a contingency was largely on things that BAA supplied in-house. American believed that BAA should be limited to 5 per cent contingency, which was what most airlines worked with.
15. American said that airlines' exposure to unforeseen major events such as 11 September 2001 was much greater than BAA's exposure. Each airline had its own geographic market and was affected by events within that market, whereas BAA served many airlines flying to many parts of the world and was therefore able to spread risk much more widely. For the most part, airlines would continue flying and paying charges to airports. In the USA the airlines, not the airports, had been going bankrupt. It appeared that the airlines were being asked to pay for BAA's risk as well as their own, which was unacceptable given that the airports would not exist without the airlines' flights.

Operating expenditure

16. American believed that BAA had many opportunities to increase the efficiency of its operations and recoup a significant amount of costs. Outsourcing, particularly of security functions and IT operations, was one solution that BAA should be considering. American commented that it and other airlines had gone through the process of finding efficiency savings. It would be willing to share ideas with the airports if they were ready to engage and were sufficiently motivated to look for savings. It mentioned Manchester as an example of an airport body that was more engaged and efficient than BAA, and said that in certain respects, including security and facilities for passengers of reduced mobility, it was ahead of Heathrow and Gatwick.
17. As regards security staff, BAA was paying at the upper quartile. American was able to recruit sufficient staff (about 100 a year) at lower rates of pay, but ran the risk of having its staff poached by BAA. The cost of this was then charged back to airlines on the basis that BAA was recouping the cost of heightened security. American believed that BAA could recruit the numbers it needed at lower cost if it tried harder.
18. American found it hard to believe that BAA was suggesting an improvement to the security queuing standard, from 95 per cent of passengers not queuing for more than ten minutes to 95 per cent not queuing for more than five minutes, given that it was failing to meet the 10-minute standard and the SQR had been suspended. American suggested that there should be different standards for different times of day and year but with an absolute ceiling of 20 minutes' waiting time.
19. American suggested that the SQR needed to include some operator-type measures, such as the functioning of the air-conditioning in the offices (sometimes very poor), lighting in the cargo tunnel and cleanliness of the jet bridges, both the public access and the airline access parts. The ramp environment at Heathrow was a particular

concern; it was often dirty and strewn with debris, which was dangerous because it could be sucked through aircraft engines, causing costly damage. Cleanliness of the ramp should also be measured in the SQR.

20. With regard to the amount at risk in the SQR, American said it would rather have improved service than a rebate but it recognized the need for a penalty and suggested that it be set at half of BAA's profit margin. It did not agree that BAA should receive a bonus payment if it outperformed the standards, which did not accord with normal commercial practice. It was required to provide an agreed adequate standard of service and should not expect additional payment for going beyond what was agreed.

BAA market inquiry

21. American told us that it was concerned about cross-subsidy from Heathrow to the other BAA London airports. In support of this it said that charges at Heathrow were considerably higher than at Gatwick, and it suspected that BAA gave incentives to airlines to use Stansted, which was under capacity for much of the day. It was therefore taking fees from airlines at Heathrow that gave it a large margin which it then used to encourage other airlines to enter Stansted, which then competed against the Heathrow carriers. American believed that BAA saw Heathrow as a cash cow and used the money it generated to improve other things. It believed that this was a result of common ownership of the three airports which made them not totally distinct in terms of where the money flowed.
22. Under separate ownership, Stansted would have to thrive or fail on its own merits. Heathrow carriers would no longer subsidize new entry at Stansted. In addition, there would be a real incentive for Gatwick and Stansted to work to attract traffic away from Heathrow. They could do this through competitive pricing, but also by marketing aggressively to airlines on factors like the demographics of the catchment area, potential for growth, onward rail connections etc. American recognized, however, that there were costs and difficulties involved in switching from one airport to another, which led to inertia, plus the fact that Heathrow had the best location and onward connections.
23. American said that there were not many examples of competition between airports in the USA because they were owned by public entities that did not have the same incentives as a private company. All three airports serving New York were controlled by the Port Authority and in Los Angeles the City controlled most of the large airports. American was aware of one example of competition, between Miami and Fort Lauderdale airports which had been good for airlines and service. The two were separately owned, although both by public entities.
24. American did not believe that separate ownership of the London airports would affect their ability to raise capital. It knew of no major airport that had ever had difficulty raising capital.
25. American was doubtful whether competition between terminals would be feasible at Heathrow, or even at Gatwick, because of the capacity constraints, and also because there was a lot of shared infrastructure. It would be hard to have separate operators and connecting traffic, and to attract incoming airlines to different terminals.
26. Even if Heathrow and Gatwick were separately owned, American would want them to be regulated, at least initially, because the airports' market power was unlikely to be eliminated completely given the difficulties of airlines switching between airports. It

believed that the best way to improve regulation would be to make it focus on operational issues and bring the incentives into line with the needs of customers.

27. American agreed that decisions on major new investment were driven by the planning system and environmental considerations rather than by the airport operator and that this restricted competition between airports. However, this was less true of smaller projects.