

BAA AIRPORTS MARKET INVESTIGATION

IATA: summary of hearing, 29 May 2007

Background

1. The International Air Transport Association (IATA) represents over 250 airlines whose services comprise some 94 per cent of international scheduled air traffic. IATA represents the views of its member airlines to airport and ATC providers governments, civil aviation authorities, and transport ministries.
2. IATA noted that while European airlines had reduced their non-fuel costs by about 15 per cent since 2001, airport charges had continued to rise. It told us that since 2001 aeronautical charges at Heathrow and Paris-Charles de Gaulle had increased by 40 per cent.
3. IATA did not perceive a great difference between the increase in charges at Heathrow and at non-regulated airports, mainly because the two sets of airports had started from different positions, but it believed that unregulated airports had greater leeway to increase prices without justification. IATA said that a viable regulatory environment could provide greater transparency for industry participants.
4. Comparing the business opportunities offered at BAA's London airports, IATA said that Heathrow in particular could generate higher fares than some of the other airports in the region, perhaps slightly stronger than Paris and Frankfurt. IATA welcomed the Civil Aviation Authority's (CAA's) statement that that the airport regulatory system was a separate issue from ownership, in the light of BAA's takeover by Ferrovial in 2006. Since the takeover there was perceived to be a lack of consistency in operations, with staff turnover being a contributing factor. Part of this problem, IATA believed, was that Gatwick acted as a 'feeder' for airport staff to Heathrow, making it harder to retain experienced staff.

Issues relating to the quinquennial review

5. On regulation, IATA told us that the overall process is worthwhile, but while the UK regulatory model was well understood it was too complex, costly and time-consuming. It contrasted it with the quicker model operating in Ireland. IATA also suggested that if the CAA could encourage a longer-term view for investment planning rather than the current focus within each quinquennial review, then airport development would occur in a more coherent and planned fashion. At the moment, the regulatory framework provided for investment, but not necessarily where investment was most needed by the airport users.
6. IATA told us that the regulatory incentives for BAA to achieve higher standards of service needed to be strengthened if BAA's airports were to attain world-class status. While increased penalties would not fully compensate airlines for delays or lost passengers, IATA argued that a tougher regime of penalties would be the best way to encourage BAA to improve its performance.
7. IATA said that regulatory processes needed to take more account of systemic risks and add-on costs. IATA provided the example of a report by consultants on capital expenditure, which looked closely at base costs but did not delve into risks and add-

on costs, which comprised 30 per cent of the total Heathrow East Terminal (HET) project.

8. IATA also suggested that the Regulatory Asset Base (RAB) approach to regulation could encourage BAA to make inappropriate investment decisions.
9. IATA endorsed the theory behind BAA's constructive engagement programme, and described it as a productive and positive development. It was, however, in its infancy and greater transparency was still required from BAA. IATA suspected that in the longer term a more formal rules-based approach to constructive engagement might be required to achieve this desired level of transparency.
10. One example of the character of the working relationship given by IATA was BAA's announcement of the HET project. The announcement took place after a 'strategic choices' consultation process, in which airlines assigned priorities to a list of airport projects that did not include HET. IATA told us that this announcement led them to question the effectiveness of the constructive engagement process.
11. As regards capital expenditure, IATA pointed out that the HET project was currently priced at £1.7 billion by BAA, but IATA had had little indication of the breakdown of costs and so could not determine whether the project was good value for money. BAA did originally consult with airlines on their priorities for major projects and was told that alliance clustering (where groups of airlines operating in cooperative alliances sought to be co-located in airports) was the highest priority. HET was not identified by BAA as their preferred option during these discussions. Subsequently BAA allocated the HET project the largest share of capital expenditure in the next five years.
12. IATA also raised its concerns about the ongoing lack of an upgrade at Heathrow Terminal 3. The completion of the new Terminal 5 (T5) would lead to uneven service quality arrangements for airlines at Heathrow, depending on which terminal they were located in.
13. Part of IATA's concerns were focused on so-called 'gold-plating' by BAA, by which it spent more than the airlines believed was necessary on capital projects. IATA told us that if airport projects were not agreed to by airlines, then they should not be funded by airline charges.
14. On cost of capital, IATA argued that the CAA's proposal of 6.2 per cent was too high. IATA said that the risk allowance component seemed unnecessarily large, and that BAA and the CAA were being overly cautious. IATA indicated that the requirement to compete on prices led airlines to restructure to achieve lower cost structures, particularly after serious market shocks such as 11 September 2001 and the SARS epidemic. But IATA did not believe the same dynamic operated in the airports market. One possible solution IATA identified was to provide for different cost of capital figures at different stages of airport development projects. IATA thought the idea had some merit, but acknowledged that it would need to be properly ring-fenced in terms of the old and new asset bases. IATA also discussed possible trigger mechanisms that could be used as project gateways.
15. IATA told us that BAA's debt leverage could potentially go higher than the 60 per cent allowed, but would welcome further views on the topic.
16. In discussing operating expenditure, IATA disagreed with the CAA's proposed 1 per cent efficiency gains, and argued that a figure of at least 2 per cent would be appropriate. It believed that BAA needed to make greater efficiencies in its

manpower costs, particularly in security services. IATA said that it understood BAA's lack of willingness to tackle the trade unions, but said that it was something that the airline industry itself had to deal with. IATA acknowledged that airlines' security tasks were different from those carried out by airports, but pointed out that airlines achieved cost-effective outcomes by outsourcing security tasks.

17. IATA also hoped that the new airport facilities being constructed by BAA, such as T5, would lead to an overall reduction in airport operating costs.
18. On BAA's price increases, IATA told us that BAA's response to Ferrovial's takeover bid revealed a 'sweetener' offer of £750 million, which equated to an increase in dividends of 40 per cent. IATA said that this led it to believe that there were insufficient incentives for BAA to set charges at a fair and efficient level.
19. On BAA's queue waiting target of no more than five minutes of waiting for 95 per cent of passengers, IATA said that the revised proposal was initially made by CAA to BAA and BAA then presented the revised target to the Service Quality Work stream in the Constructive Engagement process. Up to that point there had been no involvement of the community on setting the revised target, but BAA has subsequently consulted. IATA regarded this 95 per cent target as an improvement on previous targets, but it still fell short of its own preference, which was for a 10 minute maximum queue time.
20. With regard to BAA's traffic forecasting, IATA did not endorse the methodology used to calculate the lower-than-expected traffic forecasts. IATA said BAA's modelling took some temporary factors and treated them as permanent features. IATA also claimed that BAA's modelling of average aircraft size was inaccurate, skewing the traffic predictions.
21. IATA said that levels of service at Heathrow and Gatwick were far lower than at airports in the Far East, the Middle East and Australia. IATA said that BAA needed to set its sights higher, and that the regulatory environment was part of the problem. IATA told us that BAA were going to get a guaranteed return and it might not necessarily be encouraging appropriate spending; nor was the spending necessarily in line with IATA's objectives, despite the constructive engagement process.
22. IATA said that the entire travel industry was affected by unforeseen events such as 11 September 2001 and the SARS epidemic, but airlines invariably experienced the strongest effects from shocks, because sharp reductions in demand for air travel affected their cashflow immediately. The strong competition among airlines meant that carriers responded to such shocks by strong discounting to restore passenger numbers, which cut into airline profit margins.

Issues relating to the market inquiry

23. IATA said that regulation was always second best to competition, but even if the BAA airports were owned separately, they would still mostly operate as local monopolies and some regulation would still be required. IATA argued that in London, Heathrow and Gatwick did not compete on price, service quality, facilities, future investment or capacity. It cited the example of Moscow's two separately-owned airports, where competition had benefited both airlines and consumers.
24. IATA disagreed with the proposition that combined ownership produced lower overall risk. It argued that separate ownership would mean more responsive and sensible business decisions.

25. IATA told us that New York JFK Airport operated with its eight terminals in separate ownership. IATA estimated that there was relatively little potential for this sort of competition among the terminals of London's airports. IATA was also concerned that separate ownership of terminals might lead to fragmentation of services and unnecessary duplication of costs.
26. IATA told us that the Open Skies agreement would have a positive effect on passenger numbers, with a flow-on effect of requiring use of landing slots by larger aircraft. Open Skies would also make it easier for airline alliances to co-locate their operations, particularly at Heathrow.
27. On planning issues, IATA said that BAA should be actively lobbying to put their case forward and had a responsibility as one of the UK's largest businesses to lead public opinion rather than be a victim of it.
28. As regards BAA's Scottish airports, IATA acknowledged that they were not as high profile as the London airports, but it nevertheless believed that separate ownership would be more efficient than joint ownership, as there was little or no competition between Glasgow and Edinburgh airports. IATA said that Prestwick airport (40 km south-west of Glasgow) might provide some limited competition for Glasgow airport, particularly from low-cost carriers.