

American Airlines®

Jeffrey A. Ogar
Attorney

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VIA ELECTRONIC MAIL:
Julie.hawes@cc.gsi.gov.uk

Ms. Julie Hawes
Inquiry Coordinator
Competition Commission
Victoria House, Southampton Row
London WC1B 4AD
United Kingdom

*Re: Market Inquiry Into The Supply Of Airport Services By BAA Within The UK;
Heathrow And Gatwick Quinquennial Review*

Dear Ms. Hawes:

On behalf of American Airlines, Inc., thank you for the opportunity to provide comments to the Competition Commission regarding the Office of Fair Trading's referral of a market inquiry into the supply of airport services by BAA within the UK, as well as the Civil Aviation Authority's quinquennial referral of airport charges at London's Heathrow and Gatwick airports. Since these two issues are intertwined, American has combined its comments, which follow, into this single document.

American is proud to serve London from the United States. We fly to Heathrow from Boston, Chicago, Los Angeles, Miami and New York, and Gatwick from Dallas/Fort Worth and Raleigh-Durham. Heathrow is the primary connecting hub for the oneworld Alliance, as it is served by seven of American's nine oneworld partners. Simply stated, both London generally and Heathrow specifically are vital and important gateways for American's European service.



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Unfortunately, BAA's mismanagement of its London airports has cost American millions of dollars in higher landing fees, reduced operational performance and lost revenue as passengers choose to connect through other European hubs. We believe that these problems stem in large part from the conclusion reached by the OFT in its study of UK airports – lack of competition has led to lower quality services and higher prices. Any frequent traveller comparing Heathrow and Gatwick to other major European hub airports would likely echo the sentiment that the BAA owned London airports are poorly maintained, equipment is often inoperable, and the customer experience is simply unacceptable. As such, we strongly supported the OFT's referral of its investigation and report to the Competition Commission.

I. American Airlines Has Significant Concerns Regarding BAA's Ownership Of London Airports

American has three primary concerns with BAA's ownership and management of its London airports. First, BAA's joint ownership of Heathrow, Gatwick and Stansted has created an inefficient and unfair incentive for BAA to subsidize Stansted at the expense of Heathrow and Gatwick. Second, BAA's mismanagement of Heathrow has made it an inferior connecting hub when compared to Frankfurt, Paris or Amsterdam. Third, BAA is so consumed with building new facilities – such as Terminal 5 and Heathrow East Terminal – that it ignores Terminal 3, allowing it to decay to the detriment of BAA's customers – consumers and the airlines they fly. Each of these concerns is discussed in turn.

A. BAA Uses Heathrow And Gatwick To Cross-Subsidize Its Development Of Stansted

BAA's joint ownership of Heathrow, Gatwick and Stansted allows it to cross subsidize Stansted's growth at the expense of the other two airports. For example, the OFT study cited concerns by certain carriers that "increased airport charges at Stansted to fund development could not simply be passed through to air travellers," and that if "a low cost airline's costs rose to the point at which a particular service no longer achieved the required rate of return, then the service would simply be withdrawn."¹ While this may not suggest that BAA should raise landing fees at Stansted, neither does it suggest that other carriers should subsidize that development through higher landing fees at Heathrow and Gatwick.

For example, if Stansted were owned separate and apart from Heathrow and Gatwick, its owner would develop the airport based on its ability to generate revenue from improving Stansted – whether through higher fees or increased throughput. Stansted would have an incentive to compete with Heathrow and Gatwick, as the "[f]ailure to invest, where a rival airport is expanding, can lead to a loss of business from airlines."² With common ownership, however, BAA is able to funnel revenue from Heathrow and Gatwick into Stansted, effectively cross-

¹ Office of Fair Trading, UK airports: Report on the market study and proposed decision to make a market investigation reference, p. 83-84 (December 2006).

² Id. at 36.

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subsidizing its development with fees paid by airlines that do not ever use Stansted. Since the rival airports are under common ownership, there is no “loss” of business – and thus fewer incentives to investment. As the OFT study notes, BAA has “an incentive to delay Heathrow investment while upgrading Stansted, as this would reduce the investment risk at Stansted.”³ Such cross-subsidization is unfair to those airlines paying high airport fees at Heathrow and Gatwick (and to their customers), only to see that money invested elsewhere.⁴

B. BAA’s Mismanagement Of Heathrow Has Made It A High-Cost Low-Quality European Hub

1. BAA’s Airport Fees Have Skyrocketed While The Quality Of Its Service Has Plummeted

The OFT study notes that price increases at BAA’s airports are capped – but American questions whether these caps reflect anything more than a government sanctioned extraction of monopoly profits from the airline industry. As the study notes, the CAA limits fee increases at Heathrow to the rate of inflation plus 6.5%, while increases at Gatwick and Stansted are limited to the rate of inflation plus 5.0%.⁵ As a result, fees at Heathrow have jumped more than 20% in just the past two years.⁶ These never-ending fee increases might be more palatable if they led to better service and more efficient operations at BAA airports. Unfortunately, precisely the opposite has been true.

The OFT study notes that “[w]hile airports do not directly charge passengers to enter the airport, the costs borne by airlines in passenger and landing charges are, to some extent, passed on in higher airfares.”⁷ To the extent that networks based at Heathrow bear costs that are higher than those incurred by networks based in Paris, Amsterdam or Frankfurt, a competitive imbalance results. Airlines at the more expensive hub airport are thus forced to decide between: (a) recovering their costs while being uncompetitive on price; and (b) being competitive on price but not recovering their costs. Since airlines generally cannot switch airports in the short-run, such an imbalance leads to market failure.

³ Id. at 83.

⁴ This subsidy to carriers serving Stansted is particularly unfair given the fact that many of those carriers posted record profits for 2006. See Press Release, Ryanair Announces Record Q3 Results – Net Profit Rises 30% to

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BAA's argument that "countervailing buyer power of airlines may reduce the market power of BAA" is simply unsupported by the evidence.⁸ The OFT correctly notes that "the fact that [airlines] are unable to [negotiate discounts off BAA's charges] at Heathrow and Gatwick demonstrates that competition is restricted."⁹ If even British Airways is unable to negotiate with BAA, carriers with a far smaller presence at BAA airports (like American) have absolutely no hope of doing so.

2. Examples Of BAA's Inadequate Planning For Operational Disruptions

No better reflection of BAA's inadequate planning for operational disruptions at Heathrow and Gatwick can be found than the Airports Council International survey of passenger satisfaction cited in the OFT study – Gatwick ranked 49th and Heathrow 56th out of 58 total airports.¹⁰ Two specific examples of BAA's failure to adequately plan or to demonstrate leadership in responding to operational disruptions are the 2005 Buncefield fire and the 2006 security scare – each of which created costly disruptions for airlines and passengers. In both cases BAA's response to the crisis was inadequate, as capital allocations to airside infrastructure investment was not made a high enough priority.

a. Buncefield

A prime example of BAA's failure to adequately plan and provide leadership at Heathrow (despite hiking fees more than 20% over the past two years) is its response to the fire at the Buncefield fuel depot on 11 December 2005. Buncefield supplied 30% of the jet fuel used by airlines at Heathrow, and the fire severely disrupted the already delicate balance between supply and demand. The disruption persists to this day, and had an extremely disruptive impact on the Summer 2006 scheduling season. Non-UK carriers (including American) were discriminated against in fuel allocations, forcing them to incur the cost of ferrying fuel into Heathrow while their UK rivals were favored by preferential allocations.¹¹ While fuel supplies were later distributed in a more equitable fashion, BAA failed to exercise any leadership on this issue. The solution in place today exists in spite of – not because of – BAA's efforts.

⁸ *Id.* at p. 79.

⁹ *Id.* at pp. 79-80.

¹⁰ *Id.* at p. 93.

¹¹ For American alone, this added over \$4 million in costs to its Heathrow operations.

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Nor has BAA provided any leadership by creating a plan to avoid or minimize anticipated fuel shortages in 2007 and beyond, particularly during the heavy summer season. Nearly eighteen months after the Buncefield fire, and BAA has still done little to create an adequate long-term solution to address the current demand for fuel at Heathrow. While BAA saw fit to tender £750 million to shareholders in an attempt to stave off the Ferrovial takeover,¹² that money would have been better invested in improving fuel facilities at Heathrow. Long after the fire, BAA is still rationing fuel at Heathrow going into the Summer 2007 scheduling season.

b. August 2006 Terrorism Alert

While the security threat of 10 August 2006 was significant and unprecedented, it highlighted the fact that BAA has for years failed to adequately invest in security infrastructure at Heathrow and Gatwick. For example, rather than utilizing existing terminal space to create additional checkpoints and other security measures, BAA instead invested in retail outlets. The same is true for the security control posts used by airport personnel and vendors on airport property – BAA has failed to provide adequate investment to ensure a smooth yet secure flow of people and goods on and off airport property.

As a result, the two airports were completely unable to handle a shock to the system. By comparison, other international airports in Europe saw far fewer disruptions and returned to normal far more quickly than those operated by BAA. As the OFT study notes, “other airports in the UK suffered less disruption due to a more cooperative and efficient handling of the situation as it arose.”¹³ American estimates that it lost millions of dollars as a result of BAA’s having inadequate contingency planning or infrastructure to respond to the threat. Even today – nine months after the security scare – the security screening process at Heathrow and Gatwick is simply unacceptable. Yet this result is not inevitable. In fact, despite being forced to handle the same threats, American’s other gateway airports in Europe (including privately-owned Manchester Airport in the UK) have provided far better customer service.

C. BAA’s Development Of Terminal 5 And Heathrow East Terminal Have Left Terminal 3 As An Inferior Facility

BAA has been so distracted by the construction of Terminal 5 that those airlines consigned to Terminals 1, 2 and 3 have suffered from the neglect of their facilities for years. For those currently located in Terminals 1 and 2, the situation will get better as they migrate into Terminal 4 and the planned Heathrow East Terminal. In contrast, the situation stands to get worse over the next decade for those carriers in Terminal 3, as BAA turns its attention from Terminal 5 to Heathrow East Terminal. For example:

¹² *Id.* at p. 74.

¹³ *Id.* at p. 94.

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- BAA has failed to upgrade Terminal 3's baggage systems, leading to consumer frustration over baggage delivery performance;
- BAA has failed to upgrade Terminal 3's customer facing areas, leading to consumer frustration over the facility's appearance (and even operability); and
- BAA has failed to invest in adequate security segregation at Pier 7, leading to potential operational disruptions and further consumer inconvenience.

In response to concerns that Terminal 3 is being ignored, BAA committed to members of oneworld that it planned to invest in Terminal 3 infrastructure, including customer-facing and baggage facilities, by 2011. Unfortunately, this appears to have been an empty promise:

- BAA's mid-April Capital Investment Programme ("CIP") does not include funding for upgrades to the Terminal 3 baggage system upgrade during Q5, leaving American with an outdated 18 year old system while its competitors enjoy new state of the art equipment. Rather, American and other occupants of Terminal 3 may have to wait until Q6 to see the improvements to a baggage system that is already unreliable;
- The CIP does not include funding for upgrades to customer facing areas in Terminal 3 during Q5, and some projects are not proposed for completion until 2016;¹⁴ and
- Adding insult to injury for those airlines in Terminal 3, BAA is dedicating resources to upgrading the much newer, much cleaner and much more efficient *Terminal 4* in order to encourage non-alliance carriers to move into that facility.

¹⁴ BAA is promoting its "Making Heathrow Great by 2012" campaign even though work on the most important parts of these Terminal 3 improvements will likely not have begun by that date. Thus, while BAA may plan to make Heathrow great by 2012 for everyone *not* relegated to Terminal 3, it is little solace to those carriers – like American – that may continue to suffer from the existing infrastructure problems at its facilities for years after the flame has been extinguished at the London Olympics.

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At Heathrow, the lack of competitive equivalence would operate to the detriment of both American and interalliance competition, because BAA has planned to organize terminals by alliance affiliation.¹⁵ As a result, BAA's mismanagement of Terminal 3 will mean that American is relegated to Heathrow's worst terminal, while its competitors enjoy the fruits of BAA's inflated airport charges at their new facilities. This stands in stark contrast to the principle of competitive equivalency, which aims to allow consumers to choose between airlines based on their product offerings as opposed to the disparate quality of facilities provided by airport authorities.

Because this restructuring of Heathrow's terminals around alliances would place oneworld at a significant competitive disadvantage given the neglect of Terminal 3, the alliance informed BAA in December 2005 that:

Our support for closing Terminal 2 assumes that the current Terminal 3 facility and baggage system refurbishment proceed as planned. Additionally, we do not want a situation where funds and BAA focus shifts to the expected new Heathrow East Terminal, thereby resulting in a diminished attention on Terminal 3. Completion of an upgraded Terminal 3 is essential to the competitive equivalency principle on which we have all agreed. A refurbished Terminal 3 is essential to the oneworld alliance – and to BAA as well.

Unfortunately, BAA continues to appear less interested in maintaining its current facilities than it is in its more high profile construction projects. Such a situation is unfair to those airlines relegated to Terminal 3, as we have little competitive recourse against BAA that would force them to provide substantially equivalent services to all carriers serving Heathrow.

¹⁵ Once construction of Heathrow East Terminal is complete, the competitive landscape at Heathrow will be as follows:

- Heathrow East Terminal: Star Alliance carriers
- Terminal 5: British Airways
- Terminal 4: SkyTeam carriers
- Terminal 3: oneworld carriers and Virgin Atlantic

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II. The Competition Commission Should Impose Remedies Upon BAA Designed To Eliminate Cross-Subsidization, Create Incentives To Improve Heathrow As A Connecting Hub On Par With Other Major European Airports And Ensure Competitive Equivalency Across Terminals

The Competition Commission has two issues before it: (1) the CAA's referral of BAA airport charges; and (2) the OFT's referral regarding the need for more competition among UK airports. American requests that the Competition Commission consider the following remedies in its inquiries:

- Bringing BAA airport charges more in line with those of comparable European airports, and obtaining assurances that increases in those charges will be efficiently invested in airport improvements;
- Separating – whether by divestiture or some other remedy – the economic interests controlling Heathrow, Gatwick and Stansted in order to ensure that airlines serving one airport are not forced to cross-subsidize the development of another;
- Imposing higher service standards on BAA airports so that airlines and consumers do not have to needlessly suffer due to poorly maintained infrastructure and a lack of leadership; and
- Demanding competitive equivalence at BAA airports for all users, so that airlines can compete for customers on a level playing field, rather than handing modern new facilities to members of the Star and SkyTeam alliances, British Airways and other airlines, while forcing American and others to wait up to a decade for improvements to Terminal 3.

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Again, American appreciates the Competition Commission's invitation to comment on its inquiry into BAA's management of its London airports. We would welcome the opportunity to provide any further information, to answer questions, or to meet with your staff on this very important issue.

Very truly yours,

Jeffrey A. Ogar
Attorney
American Airlines, Inc.

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