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Civil Aviation Authority
Westferry Circus
Canary Wharf
London EH14 4HD

cc: economicregulation@caa.co.uk

28th July 2023

IAG response to Civil Aviation Authority (CAA)
CAP 2554 – Economic Regulation of Gatwick Airport Limited (GAL)

Thank you for the opportunity to respond to your consultation on the economic regulation of GAL. We set out our views below, having assessed your request with our Group companies, including Aer Lingus, British Airways, Iberia and Vueling, along with all their subsidiary companies.

1. Executive Summary

1.1 We cautiously welcome GAL's revised proposals in the context of the existing regulatory framework. Given the circumstances following the pandemic and before work begins on moving Gatwick's Northern runway, it seems appropriate to consider an extension to the existing arrangements.

1.2 We recognise a successful Development Consent Order ("DCO") will necessitate a significantly different profile of capital expenditure which may affect the final year or two of this proposal. The CAA must therefore ensure that the framework in place following this proposed extension, for future expansionary expenditure under a successful DCO remains appropriate and protects consumers.

1.3 Within the specifics of the proposal, we welcome the replacement of RPI with CPI as an appropriate metric for inflation, now RPI has been retired as a National Statistic. A price profile that delivers an initial negative, real price path reflects ongoing productivity gains that would be expected in competitive markets.

1.4 The proposed capital commitment does not appear unreasonable where GAL has identified a broad envelope of investment projects that are required both to resume maintenance of assets and develop some further capacity whilst raising service quality standards to levels consistent with those expected by airlines and their consumers, catching up for investment commitments that were not able to be made during the pandemic

1.5 An extension does not appear unreasonable in the context of catching up the investment commitments, though the CAA should balance the length of any extension against the significantly different capital expenditure profile that would be required once expansionary work begins, both to ensure consumer outcomes are supported and that the benefits of expansion are shared appropriately with consumers.

1.6 Service quality standards would benefit from research on passenger outcomes, which would allow GAL to get ahead of the curve of passenger requirements, and demonstrating to the CAA that it is responsive to passenger needs. This is the case where certain standards might not capture the entire picture or are measured incorrectly, though this must always be framed in the context of operational priorities and expenditure required by GAL to deliver these operational service standards.

1.7 Overall, GAL's proposal does not appear unreasonable in the circumstances. In relative terms, GAL would continue to operate as it has been to date, with the investment that was curtailed during the pandemic delivered in later years. Nevertheless, it is ultimately for the CAA to consider the details to ensure that this does indeed deliver the best value and service for consumers in the light of analysis conducted by the CAA.

2. Background and GAL's proposal

2.1 We note that the CAA's economic regulation of GAL is based on a set of "commitments" that include a cap on the average level of airport charges, a minimum level of investment and a system of rebates if GAL misses certain service quality targets.

2.2 An extension to the current commitments were introduced in 2021 and cover the four-year period to 31 March 2025 – they included a cap of Retail Prices Index (RPI) + 0% on GAL's published charges and a minimum investment requirement of £120 million per year in real terms, on average, over the six years from 2019/2020 to 2024/25.

2.3 A lengthy regulatory review that creates significant, long-term uncertainty for consumers, airlines and GAL does not appear to be necessary at this stage, where GAL has made significant effort to engage with airlines in developing its proposals for this extension. We welcome the strong recovery of passenger volumes at Gatwick, which has reduced a degree of uncertainty that may have existed when considering the proposals in 2022.

2.4 We agree with GAL that "commitments need to be robust to a wide range of economic scenarios, including downside cases", though also highlight that this needs to be the case also for upsides to protect consumers in certain scenarios, where regulation is ultimately a tool to prevent consumer harm from arising – though not to push all risk inappropriately to consumers.

2.5 GAL has submitted a proposal to **extend the term** of the current commitments for four years from 1 April 2025 to 31 March 2029. Key features of the proposal include:

I. **Price commitment** - a revised price cap for the extension period being CPI -1% for the first two years, followed by CPI + 0% for the final two years;

II. **Service commitment** - a review of service quality metrics and targets (whilst already scheduled) GAL has now identified two new measures (a new metric on air traffic control performance at Gatwick and financial incentives for the Special Assistance passenger satisfaction measure (which is monitored at present but without financial incentives); and

III. **Investment commitment** - the investment commitment is unchanged at an average of at least £120 million per year; though the average will not be assessed over the ten years from 2019/2020 to 2028/2029.

3. GAL's proposal – our views

3.1 Extension of the commitments term

3.2 It is relevant to consider that the original commitments period was for seven years, yet the current extension period only has a four-year duration. Whilst this may have a certain logic and align to any DCO process, the pandemic has presented an issue with capital investment undertakings that GAL has clearly sought to address with its proposed extension.

3.3 It is also worth considering that if seeking alignment of the end of the proposed period with the DCO process, the DCO may also be subject to delay or uncertainty. It is therefore relevant to consider whether the commitments period should ever be aligned to the DCO process, and how to accommodate the significantly different risk profile, passenger growth and capital expenditure levels that would result under expansion scenarios.

3.4 Furthermore, it may be relevant to consider whether there are alternative commitments for a DCO and non-DCO scenario, particularly where there are greater capital commitments required under a DCO scenario, but also that service standards may change markedly during and as a result of construction activity.

3.5 Ultimately, GAL have proposed a four-year extension for it to manage its business, though we are flexible as to the most appropriate solution, so long as it is demonstrably in the interests of consumers. As a result, we are not averse to GAL's proposal if it can provide appropriate stability and value for airlines and consumers during the period in question.

3.6 Overall, we recognise the logic that the extension above might appear to offer. In relative terms, Gatwick would continue to operate as it has been to date, with the investment that was curtailed during the pandemic delivered in later years.

3.7 However, it is important to consider the details to ensure that this does indeed deliver the best value and service for consumers in the light of the analysis conducted by the CAA at the previous periodic review of the framework.

3.8 Price commitment

3.9 The proposal includes a price cap of:

a. CPI - 1% for the first two years of the extension (2025/26 and 2026/27) and CPI + 0% for the final two years of the extension (2027/28 and 2028/2029)

b. GAL's original proposal to airlines included a price cap of RPI + 0% for all four years. GAL states that it modified this proposal in response to airline feedback that RPI was no longer an appropriate metric.

3.10 We welcome GAL's modified proposal outlined above as it would be reasonable to suggest that the starting point for flat prices in real terms would be CPI as opposed to RPI.

3.11 This is particularly relevant in today's high inflationary environment, and particularly so where RPI measure of inflation has been widely recognised as "a very poor measure of general inflation, at times greatly overestimating and at other times underestimating changes in prices and how these changes are experienced"[1].

3.12 Consumers using Gatwick are highly price sensitive yet have high expectations for service standards, making the task for GAL and airlines particularly challenging in the present market environment.

3.13 Whilst we have previously held the position that the net yield price path was an important feature of the first commitment framework, it is clear that GAL found management around that particular metric challenging due to the nature of its contracts with individual airlines along with varying out-turn traffic volumes that led to fluctuations over which it had no control.

3.14 It is also important that GAL is incentivised to continue to drive cost efficiencies over time, ensuring that it becomes operationally more efficient and capitalises on restructuring it has undertaken during the pandemic. The absence of direct competition mutes some incentives to drive greater productivity, therefore the regulatory regime should reflect ongoing efficiency gains where feasible and achievable.

3.15 Service commitment

3.16 GAL had already committed to consult airlines and the PAG on the structure and content of the service commitments, to ensure they remain appropriate and relevant and to present passenger research and evidence to inform this consultation. It is important that service standards focus not only upon core service requirements but also areas of emerging issues, and that measurement is realistic to ensure it delivers actual, positive consumer outcomes.

3.17 To this end, we are keen to look beyond the measured metrics specifically to understand where emerging issues might exist, and where the measurement of the present metrics might be modified to better reflect the consumer's direct and indirect experience, both within the terminal and within critical areas of the wider operation.

3.18 We do not believe that service metrics should create an excessive industry of reporting and complexity, but that this discussion around the extension offers an opportunity to realign measurement of service outcomes to the changed circumstances that airlines and consumers have experienced post-pandemic.

3.19 We therefore welcome GAL's perspective on this, particularly where its "approach to service means considering Core Service Standards in the broader context by looking at each element of the passenger journey through the airport, understanding the connections between them and seeing where improvements can be made that would enhance the overall passenger experience".

3.20 In addition, we welcome GAL's continued commitment to the 2023 consultation with the ACC and Passenger Advisory Group ("PAG") to ensure that service standards remain appropriate in support of delivering a strong service outcome for consumers. This should

[1] Office for National Statistics, "Shortcomings of the Retail Prices Index as a measure of inflation"

offer the appropriate level of scrutiny of the Core Service Standards, allowing them to be refreshed in line with GAL's commitments.

3.21 Investment commitment

3.22 GAL proposes to maintain the existing investment commitment, which requires it to invest a minimum of £120 million (in 2018/2019) per year, on average. Under this proposal, the average will now be assessed over ten years from 2019/20 to 2028/2029. GAL states that it invested £430 million during the first four years of this period and the commitment will require it to invest a further £1 billion (in 2022 prices) over the remaining six years of the extended period.

3.23 Maintaining a real terms commitment to investment over any extension period appears to be appropriate to ensure that capital investment missed during the pandemic is caught up, and that consumers continue to benefit from ongoing improvements to service standards for the remainder of the commitments period.

3.24 We appreciate GAL's approach comes despite the effect of the pandemic and note that this is in line with the decisions that many airlines have been forced to make, funding new aircraft deliveries previously committed. No business in a competitive market can hope to recover revenues not earned during the pandemic, and GAL's approach is a mature perspective that is in keeping with the spirit of the UK regulatory framework.

3.25 Passenger volumes outcomes could result in both significant upside and downside potential scenarios for GAL and consumers. We agree the framework should neither "disadvantage consumers or adversely affect the airport in ways that make it impossible for it to meet its service obligations and invest", and we recognise that the commitments framework should allow GAL and airlines to avoid zero sum discussions.

3.26 It may therefore be useful to consider how commitments might evolve in the event of a successful DCO, ensuring consumers are protected in either a successful or unsuccessful DCO scenario. This would ensure that both the capital commitment and the gross yield price path adapt appropriately, ensuring the CAA's metrics that assess the framework to deliver an appropriate outcome in either case. The CAA must therefore review this, and hold GAL accountable, subject to the DCO outcome.

3.27 We will continue to engage with GAL in the Capital Investment Consultation process to help define the most appropriate investment priorities for the future. We are committed to ensuring that these discussions are productive and deliver the best outcomes for consumers.

4. Conclusion

4.1 We welcome the introduction of CPI as an appropriate price path, with such a reduction reflecting ongoing productivity gains that should be expected in competitive markets.

4.2 GAL's proposed capital commitment does not appear unreasonable where it has identified a broad envelope of investment projects that are required both to resume maintenance of assets and develop further capacity whilst raising service quality standards to levels consistent with those airlines and their consumers.

4.3 Service quality would benefit from updates based on passenger research, which would allow GAL to get ahead of the curve, demonstrating to the CAA that it is responsive to passenger needs. This is the case where certain standards might not capture the entire picture or a measured incorrectly.

4.4 It is important that GAL note IAG priorities over the coming years, which are focussed on more efficient operations, incorporating automation and technology solutions, and driving greater resilience into our ground operations across our network. We are committed to discussing our initiatives with our key partner airports and would be keen to ensure that GAL is a core partner in this process.

4.5 We remain available for further consultation, and we look forward to hearing from you at your earliest convenience.

Yours sincerely,

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Alexander Dawe
Group Head of Economics and Regulation
International Airlines Group, S.A.

Copy: Raghbir S. Pattar, Group Director of Airports