Summary of third party hearing with International Airlines Group held on 19 March 2013

Background

1. International Airlines Group (IAG) told us that it was an airline group which owned several airlines including British Airways (BA), Iberia and bmi.
2. It operated flights from Heathrow to Dublin.

Mergers and their effects in the airline industry

3. IAG saw a general trend of consolidation in the airline industry. This was most advanced in the USA where only three major airline carriers plus a couple of low-cost carriers and a couple of niche regional operators remained and a similar pattern was likely to emerge in Europe. To date the short-haul European market had not yet seen the same level of consolidation as European long-haul carriers had seen, but this would likely change in the future.
4. The growth of mergers led to an ability to fill capacity left by airlines no longer in operation. An example of this was the case of Malev Airlines whose capacity was filled within a couple of weeks after its closure.
5. Consolidation was likely due to economic factors. Returns were generally poor so airlines were constantly in need of capital injections and restructuring. In addition there were constant pressures to drive down costs and increase efficiencies, which could be achieved from the scale synergies and network effects associated with mergers in the airline industry.

The effect of mergers on IAG

6. IAG gave some examples of the economies of scale associated with consolidation with reference to the merger of BA and Iberia. It differentiated between two types of cost synergies—local synergies associated with an airline having larger operations at the same airport (for example, purchasing of ground handling services) and synergies associated with the scale of the total entity (for example, buying aircraft).
7. It also highlighted network effects—and in particular the range of routes offered to customers—as another benefit of consolidation. For example, IAG’s merger with BA and Iberia led BA to have increased presence in the Latin American market.
8. The acquisition of bmi had given BA access to slots at Heathrow allowing it to increase the breadth of its short-haul network, as well as allowing very material cost savings.
9. IAG had funded the merger of BA and Iberia solely through the issuance of shares while the acquisition of bmi (and the possible acquisition of Vueling) was a cash deal.
10. IAG distinguished between the revenue synergies and cost synergies associated with combinations between airlines. It said that revenue synergies—for example, combining networks—could be achieved via lighter forms of integration between
airlines such as code-shares or bilateral alliances, with the extent of the synergies depending on the depth of cooperation. Cost synergies—for instance, using common management information systems and merging sales forces—would require an extra level of commitment and would be more associated with full mergers.

11. IAG said that minority stakes could be useful for cementing a relationship with another airline—or as a waypoint in a journey towards full merger (as had taken place in the BA/Iberia merger).

Identifying an acquisition target

12. IAG identified three factors that would determine the attractiveness of a potential acquisition target. The first factor was the nature of the market in which the target airline operated and how it related to the market of the acquiring airline. The second was ensuring that the target airline was not a weak competitor within an important market. The third factor was whether the target airline had an attractive cost base.

13. When considering European airlines that could be potential acquisition targets (not necessarily for IAG), IAG said that Aer Lingus was not the weakest contender as it made money and had a good cost position.

14. The three main European groupings would probably not be interested in acquiring Aer Lingus at the moment because they were focusing on recent acquisitions. In addition, the major European network carriers primarily made their money on their long-haul rather than short-haul operations. Given that Aer Lingus’s long-haul route network was limited, this would limit the attractiveness of Aer Lingus relative to other possible acquisition targets.

15. Currently there was a short-term reduction in the level of consolidation due to recent rising fuel prices and the maximization of gains from recent mergers although this might change in the next two to three years once the majors had finished implementing and getting maximum value out of the recent deals in which they had been involved.

16.

17. Pension liabilities were a feature for IAG to consider when acquiring an airline; however, the assessment of these liabilities would depend on the structure of the pension scheme in question.

18.

Heathrow and Dublin airports

19. Since its acquisition of bmi, IAG had increased flights from Heathrow to Dublin from five to eight per day, which had exceeded its expectations. It had also introduced a business class cabin.

20. When looking at competition on the route between Dublin and Heathrow, IAG said that Aer Lingus would be its closest substitute and that it targeted the same type of customer. Although Ryanair operated from London Gatwick, IAG considered Ryanair to be a competitor due to the close distance between Heathrow and London Gatwick.

21. While it did not explicitly set fares with reference to those of Ryanair, IAG considered there to be a strong indirect mechanism linking the fares of the two airlines, because
BA’s fares would be set with respect to demand on the route, which would in turn be affected by Ryanair’s fares and capacity.

22. Due to the high level of costs at Heathrow a new entrant short-haul carrier would most likely not seek to fly from Heathrow but would try to fly from another London airport. This had resulted in reduced levels of demand from low-cost carriers to fly from Heathrow.

23. In relation to slot capacity and pricing at Heathrow IAG said that availability and pricing of slots at Heathrow would be dependent on when the slots were required, as there were times when slots were less in demand due to not being suitable for long-haul carriers. In addition IAG stated that a high frequency short-haul timetable from Heathrow could be difficult to achieve.

24. IAG stated that slot trading was becoming more common at Heathrow particularly by carriers that were operating less successfully and were becoming reliant on maximizing their assets.