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**British Airways response**  
**Irish Draft Performance Plan for Air Navigation Services**  
**Reference Period 3 (RP3) of the Single European Sky Regulation**

Thank you for the opportunity to respond to your latest consultation on the Irish Draft Performance Plan for Air Navigation Services; we set out below our views on Ireland's revised Reference Period 3 (RP3) Performance Plan proposals and implications for the wider policy environment.

### Executive Summary

We welcome the update to Ireland's original RP3 Performance Plan, which was consulted upon in 2019 in line with the provisions of Commission Implementing Regulation (EU) 2019/317 and the targets set out in Commission Implementing Decision (EU) 2019/903.

Covid-19 has had a severe impact on all aviation businesses, with a steep decline in traffic compounded by uncertainty over the speed and timing of any recovery of passenger numbers, which has impacted the financing of many companies and required balance sheet support in many cases to survive.

This recovery has been compounded by conflicting government restrictions that continue to limit flying between many international markets and has resulted in significant job losses across the sector; it is important therefore that everyone in the sector plays a role in supporting its recovery by ensuring that they operate an efficient cost base to safely meet anticipated demand, supported by further efficiency measures where appropriate, and reduce capital expenditure to minimum levels consistent with safety and delivery of service quality.

We recognise this is challenging to achieve in many circumstances, but without these efforts, consumers will be burdened with charges that are unaffordable, compromising the recovery and leading to a vicious circle of yet higher costs paid by fewer movements.

A summary of our key points is as follows:



- a) Overall we support the CAR's general position and economic approach to the RP3 revised performance plan; we have strong confidence in the CAR's approach to establishing the regulatory building blocks, with the foundations set out by the Steer report providing rational and evidenced approaches
- b) We would like greater clarification over the potential re-opening any revised performance plan particularly in relation to the basis for doing so; clarification would be welcome as to what the re-opening dead band is assessed against
- c) We would appreciate further clarity regarding the impact to service levels that has been specified by the IAA ANSP. Details of the 40,000 – 700,000 minutes of delay and the basis for these claims have been lacking for user's assessment and hampers our judgements against such claims.
- d) In regard to the Opex allowance for 2020 and 2021, we believe this should be reconsidered against the Scenario B as set out in the Steer report. This represents a still limited cost limitation level when compared to other comparator entities, even when making allowances for the nature of the IAA ANSP's business and is still extremely restricted compared to the reduction in revenue experienced as a result of the Covid-19 pandemic. Scenario A is fundamentally flawed through benchmarking against inefficient operators in the form of comparator ANSP's

## 1. Introduction

- 1.1. We **welcome the development of new inputs and forecasts for the regulatory building blocks of the revised Irish Performance Plan**, including deriving the full Regulatory Asset Base ("RAB"); this will ensure that the RP3 plan is thoroughly revised and receives appropriate scrutiny in advance of implementation
- 1.2. Nevertheless, **we believe that the IAA ANSP plan remains inefficient, both in terms of operating and capital expenditure**; in order for economic incentives to be effective, it is important that the building blocks represent only the efficient costs that are necessary to deliver a specified level of service
- 1.3. It is our view that the IAA ANSP has already comfortably provided service at 2019 levels, and it is **illogical that operating expense allowances need to be greater to achieve this same output in the future**; we expect operating costs to fall in real terms over time, representing greater efficiency being incorporated into the operation
- 1.4. En-route air navigation services in the Shannon Flight Information Region ("FIR") and Shannon Upper Information Region ("UIR") along with terminal services provided at Dublin, Shannon and Cork airports are **significantly less complex than airspace in many other ANSPs**; **we therefore expect this to be reflected in the operating expense allowances** established for RP3
- 1.5. This is further supported by the under-spend of allowances that was achieved in RP2 alongside significant surpluses built up within the IAA ANSP as a result; **economic regulation should not seek to over-reward the regulated entity, since this results in the**

**economic incentives having little effect in practice**, lowering the incentive to deliver ongoing productivity and efficiency improvements

- 1.6. Considering the historical performance levels delivered by the IAA ANSP, where the delay target and pivot value is close to zero, we support the adoption of a penalty only scheme in line with expectations for such scenarios as set out in Regulation 2019/317<sup>1</sup>

## 2. Inflation and traffic forecast assumptions

- 2.1. Inflation is determined by reference to the International Monetary Fund (“IMF”)’s forecasts of inflation<sup>2</sup>, and **where negative as in 2020, we note these are set to zero based upon the relevant Commission Implementing Regulation<sup>3</sup>**
- 2.2. We **question whether this is internally consistent with the treatment of inflation across the price control**, particularly in the treatment of elements of the cost of capital and inflation of the Regulatory Asset Base (“RAB”) in those years
- 2.3. We note that traffic levels are on a recovery trajectory at present, however we are not in a position to suggest any alternative traffic recovery scenarios due to the **complex traffic patterns across multiple carriers that support this analysis**
- 2.4. Due to the rapidly changing nature of the recovery profile, we **therefore believe it is prudent to update traffic forecasts later in 2021**, and support this process so long as the building blocks across the price control are updated as appropriate for consistency
- 2.5. It would be **prudent therefore for the CAR to establish the exact scope of any such review later in 2021**, ensuring the smooth and efficient update of the price control for the remaining years of RP3

## 3. Operational expenditure

- 3.1. Operating costs must represent efficient expenditure in order for the economic incentives to have any effect on the regulated company; therefore **in real terms, we would expect declining costs over time, which would represent productivity improvements coming into effect**, reinforcing an incentive for the regulated company to seek further cost efficiencies over time
- 3.2. We therefore remain **disappointed to see operating costs rise in real terms, being above 2019 levels by 2022** despite a traffic recovery that is not forecast to reach 2019 levels until 2024; this is particularly the case for en-route costs, which remain above our expectations of efficient costs
- 3.3. **Safety remains our overriding priority, and we will continue to prioritise safety-related investment where required**; nevertheless, the CAR must remain cautious of a regulated

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<sup>1</sup> Irish RP3 Draft Performance Plan consultation, para 13.15

<sup>2</sup> [International Monetary Fund: Ireland](#)

<sup>3</sup> [Commission Implementing Regulation \(EU\) 2019/317](#)

- entity describing swathes of spending as safety critical, particularly where this is neither clear nor fully described to customers
- 3.4. Otherwise, there is a **risk that a badge of safety might be applied arbitrarily to many cost items, which would be misleading and inappropriate**; the badge of safety should not detract from the priority to ensure that all operating expenditure allowances represent true efficiency
  - 3.5. Our interpretation of the relevant EU regulation 2017/373<sup>4</sup> is that it requires the establishment of best practice safety and regulatory oversight within ANSPs; since the **IAA ANSP was already considered one of the leading exponents of aviation safety, it does not appear logical to us that the IAA ANSP should require significant additional expenditure as a result** in order to comply
  - 3.6. Furthermore, we note the additional cost requirements as a result of the commencement of parallel runway operations at Dublin Airport in late 2022; nevertheless, we are **unclear why cost increases should be so significant given the likely recovery profile from the pandemic, along with the reduced operational complexity such a change will bring about** (compared to today's mixed mode runway operations)
  - 3.7. We welcome the IAA ANSP's delivery of reduced operating costs in 2020 and 2021 compared to 2019, which has been achieved through management measures as described<sup>5</sup>; however, **the level of savings achieved in 2020 at 9.1%<sup>6</sup>, is underwhelming considering the significant reduction in traffic levels experienced**, as compared to cost savings achieved by other ANSPs and savings made by others across the wider aviation industry
  - 3.8. Whilst we agree with the CAR position that "slightly higher savings could have been achieved by the IAA ANSP than were actually achieved"<sup>7</sup>, we **believe these cost savings could have been greater, as we see no requirement for greater non-staff costs in certain areas**
  - 3.9. Whilst many staff cost lines will be insensitive to traffic levels if they remain untouched, it is our view that **significant restructuring should have taken place, similar to that experienced by many airlines; this would have ensured that the IAA ANSP was in a position to better-support the recovery** of the industry
  - 3.10. We support the CAR position that the IAA ANSP is not at liberty to achieve the individual cost item targets or in fact the Opex target at all as the performance of the company is at managements discretion<sup>8</sup>. The **fundamental requirement is that CAR's judgement targets not only a balanced and achievable outcome, but one that is efficient**

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<sup>4</sup> [Commission Implementing Regulation \(EU\) 2017/373 of 1 March 2017 laying down common requirements for providers of air traffic management/air navigation services and other air traffic management network functions and their oversight](#)

<sup>5</sup> Irish RP3 Draft Performance Plan consultation, para 4.1

<sup>6</sup> Irish RP3 Draft Performance Plan consultation, para 4.4

<sup>7</sup> Ibid.

<sup>8</sup> Irish RP3 Draft Performance Plan consultation, para 4.43



- 3.11. **It has not necessarily been the case that ANSPs are unable to reduce Opex in line with traffic** as demonstrated by Slovakia where they were able to react in an appropriate way, in line with airlines and other industry actors, by adjusting its cost structure to traffic levels
- 3.12. Whilst **we agree that cost allowances for 2020 and 2021 should be assessed as efficient** and that a reasonable level of cost containment is assumed to have been achieved, **the assessment that higher levels of savings, at 10.1%, could have been achieved still appears to lack ambition and falls short of expectations that could be made of an efficient entity** facing competitive market pressures, even when considered without the benefit of hindsight
- 3.13. For the 'base year' savings comparison, **Scenarios A and C are flawed benchmarks against as they represent ANSPs that are inefficient to varying degrees**
- 3.14. The Steer Scenario B highlights the divergence in responses to the pandemic achieved by other Irish entities facing significant and comparable revenue reductions due to Covid-19. **The 12% reduction achieved by the IAA ANSP falls significantly short of the best performing reduction from the comparator group at 27%**
- 3.15. **Given the adjustments factored into Steer's Scenario B limiting the cost containment measures to 11.4% in 2020 and 19.0% in 2021, which still fall far short of the achievements made by the comparator group, we believe it is suitable to reconsider the adoption of Scenario B for this period.** If this is deemed to provide an inefficient outcome and CAR continue with their proposed adoption of Scenario A we would appreciate the basis of this decision being expanded upon
- 3.16. Given the significant underachievement of cost containment in 2020, the sustainability of the IAA's actions become a concern with the reduction in staff costs in 2020 primarily achieved through a reduction in overtime and adoption of the Irish EWSS ("employment wage subsidiary scheme"). With traffic levels forecast to remain depressed in 2022 compared to 2019 levels, the IAA ANSP must focus on attaining greater efficiency in its cost base
- 3.17. **We agree with Steer's bottom-up approach to creating its forecasting model for 2022 to 2024**
- 3.18. It is **concerning that there is the expectation that real term operating costs will rebound to above 2019 levels in 2022** despite the continued depression of traffic levels that will not recover to 2019 levels until 2024 according to the latest STATFOR traffic forecasts
- 3.19. We would question the suitability of forecasting cost containment related salary reductions being reversed in 2022 based on historic local market trends given the ongoing uncertainty in travel demand even as we approach the final quarter of 2021 and that STATFOR Scenario 2 traffic levels are significantly depressed compared to 2019 levels in 2022
- 3.20. It is heartening for the IAA to be recognised as having the lowest cost per composite flight hour within the comparator group but this should be considered against the complexity in the airspace managed, the interrelationship with adjoining airspace and ANSP's as well as the handled traffic profile ie high proportion of oceanic overflights. The efficiencies gained

over RP2 regarding ATCO cost increases against traffic growth is well received. With the forecast recovery of traffic over the RP3 period this is an area for continued improvements, and it is critical ATCO costs do not disproportionately increase

- 3.21. The growth of opex costs being primarily associated with the delivery of capital projects and the safety requirements imposed by EU Regulation 2017/373 is partially understandable as **safety remains the top priority for ANSPs and as such the adoption of EU regulation must be delivered. However, the growth of non-operational staff costs is an area of concern with the IAA assessed as the second highest in the comparator group**

#### 4. Cost of Capital

- 4.1. The cost of capital is a technically complex area of any price control settlement, yet the result of the calculation results in a relatively important part of the price control; we **seek to ensure that the cost of capital is just right, as any miscalibration can have important effects on the incentives** across the remainder of the price control package
- 4.2. In general, the Weighted Average Cost of Capital (“WACC”) has been decreasing in recent years, particularly as the cost of debt and **associated risk environment in global capital markets has been declining; it is therefore our expectation that this number should fall before any close analysis** of the WACC for the IAA ANSP
- 4.3. This is demonstrated by the Ofwat’s 2020 final determination of PR19 in the United Kingdom with a CPIH real vanilla WACC of 2.92%<sup>9</sup>, or 2.57% in RPI real terms; the **most applicable comparator has been the CAA’s RP3 determination for NATS En-route plc (“NERL”)** with the CAA calculating a RPI-real pre-tax WACC of 2.91%<sup>10</sup>
- 4.4. This was a substantial reduction from the 5.86% for RP2, and was **raised on appeal to 3.48% by the Competition and Markets Authority in the UK**<sup>11</sup> based upon a number of technical discussions of the elements of cost of debt, cost of equity and gearing as appropriate to NERL
- 4.5. We are therefore **pleased to see that the CAR has performed substantial analysis to determine its proposed WACC**, ensuring the IAA ANSP is compensated appropriately for its past stock of capital investment, and the incentive to invest is accordingly calibrated

#### Gearing

- 4.6. We **agree with the CAR that an appropriate notional gearing should be used to determine the WACC**, regardless of the actual debt held by the IAA ANSP; this ensures a financing incentive, allowing management to determine actual borrowing requirements and the actual and notional company financial models to diverge

<sup>9</sup> [UK Regulators Network, Cost of Capital Report 2020](#)

<sup>10</sup> Ibid.

<sup>11</sup> [CMA NERL RP3 Final Report, para 13.319](#)

- 4.7. Ultimately, as set out by the Performance Review Board<sup>12</sup>, this **optimal gearing minimises the cost of capital**; NERL's choice of 30% as determined by the CMA in its analysis of comparator companies was designed to help strengthen NERL's credit ratios, and that does not appear to be a consideration for IAA ANSP
- 4.8. CAR have considered a range of 40-60%, and a mid-point estimate of 50%, however it is **important to consider the effect that this has on the asset beta, alongside with the specific method towards re-levering** due to the significant difference between the notional and actual gearing; this follows the advice provided in the CMA report on NERL<sup>13</sup>
- 4.9. This is especially the case if the WACC in this case strictly increases in line with the gearing assumption, which would result in a higher WACC at a higher gearing; we **therefore ask the CAR whether this is might be the case**

#### Cost of equity

- 4.10. As per the PRB's proposals, we **note that the cost of equity could be set to zero, but that the CAR believe this may be inappropriate**; whilst setting a suboptimal incentive may result in difficulties in raising capital, we note that the IAA ANSP remains a state-owned entity
- 4.11. We therefore **ask the CAR if it has considered the treatment of similar entities in price control settlements** when coming to this determination, for example the UK's National Rail<sup>14</sup>, which is in a similar ownership situation

#### Risk free rate

- 4.12. We note that the CAR has selected Irish and German 10-year bonds, using 1-year, 2-year and 5-year average yields; we **ask whether the CAR considered whether index-linked government bonds were available as a cross-check** on the adjusted nominal gilt yields, and the justification for the chosen investment horizon
- 4.13. In addition, we ask **whether any cross check was performed on yields to ensure that no distortion existed in absolute terms**, which depending upon the averaging technique over the selected time periods might lock in short-term volatility over longer-term time horizons
- 4.14. It is important to ensure that if using nominal yields within the risk free rate calculation, **that this does result in a rate that compensates for inflation risk where the regulatory regime already incorporates substantial inflation protection** to revenues and regulatory capital values; it would be useful therefore to understand how the CAR has assessed this risk in using this methodology
- 4.15. We also note that the CAR used "forward rates [that] have been estimated using the ECB's Euro area yield curve"<sup>15</sup>, however **other regulators have taken the view that there is no**

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<sup>12</sup> [Performance Review Board of the Single European Sky](#)

<sup>13</sup> [CMA NERL RP3 Final Report, para 13.114](#)

<sup>14</sup> [2018 periodic review draft determination: Supplementary document: financial framework June 2018](#)

<sup>15</sup> Irish RP3 Draft Performance Plan consultation

evidence to suggest that forward rates represent robust predictors of future spot rates<sup>1617</sup>

- 4.16. It is therefore our view that **the resulting risk free rate of -1.0% to -1.5% may therefore be at risk of being marginally over-estimated** if certain aspects of its calculation diverge from developments at other regulators; this is particularly considering the -2.25% which the CAR notes was calculated for NERL in 2020

#### Beta

- 4.17. We agree with the CAR that **airport and ANSPs provide more appropriate comparators** for the IAA ANSP than those proposed by the PRB, since they operate in a more similar setting; furthermore, we agree with the CAR that Covid-19 “will not necessarily change these entities’ sensitivity to systemic risk, especially over the long term”<sup>18</sup>
- 4.18. We also agree that “ANSPs under the SES are slightly less sensitive to systemic risk than comparable airports given the environment in which they operate”<sup>19</sup>; this is **all the more given the Traffic Risk Sharing in effect at present, which allows IAA ANSP a level of protection** compared to its comparator set
- 4.19. Furthermore, it is **preferable to measure asset betas over a relatively long period of time**, particularly where there “is strong historical evidence that short-term shifts in volatility and correlations do not persist indefinitely”<sup>20</sup>; it therefore may be useful for the CAR to set out more detail in future as to its sampling and regression methodology, although an estimate of 0.45-0.5 does not appear at odds with other regulatory settlements at this stage

#### Total Market Returns

- 4.20. We agree with the CAR that Total Market Returns (“TMR”) appear to be better suited for measuring the equity risk premium and we note also the use of the Damodaran datasets<sup>21</sup> recommended by the PRB that result in a range of 3.4% to 5.2%; it is therefore **unfortunate that this output seems to have been set aside as being too low despite having been calculated from independent data** recommended by the PRB
- 4.21. Nevertheless, **it would be useful for the CAR to establish why this data used results in this calculated level of TMR**, and rather than disregard it in order to use alternative information from the cost of capital determination for Dublin Airport<sup>22</sup>, instead consider the source of any divergence from alternative datasets

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<sup>16</sup> [CAA CAP21039A: Appendix J – Weighted Average Cost of Capital - Economic regulation of Heathrow: Consultation on the Way Forward](#)

<sup>17</sup> [Competition and Markets Authority: Ofwat PR19 Price Determinations](#)

<sup>18</sup> Irish RP3 Draft Performance Plan consultation, para 5.24

<sup>19</sup> Irish RP3 Draft Performance Plan consultation, para 5.26

<sup>20</sup> [Wright et al \(2018\) Estimating the cost of capital for implementation of price controls](#)

<sup>21</sup> [Aswath Damodaran, Stern School of Business at New York University](#)

<sup>22</sup> [Dublin Airport Cost of Capital for 2019 Determination](#)



- 4.22. The **Dimson, Marsh and Staunton (“DMS”) dataset<sup>23</sup>** is used extensively in other **regulatory calculations**, including that produced by Swiss Economics for Dublin Airport<sup>24</sup>, and since this was performed on 2018 data, which is now three years out of date, we ask whether this might be updated to reflect more recent information
- 4.23. Furthermore, the use of DMS data in the Dublin Airport determination was based upon Blume’s method of averaging using a ten-year holding period, and **similar to our above comment relating to risk free rate, we ask what the justification is for the chosen investment horizon**, which by implication remains the same as that used for Dublin Airport, and where another timeframe may be more appropriate

#### Cost of debt

- 4.24. We note that the PRB suggests that “corporate debt costs of comparable entities should be used to estimate the cost of debt for ANSPs”<sup>25</sup>, and the **cost of the existing agreed (and not utilised) debt facility has been used to determine the cost of debt at the IAA ANSP**, resulting in a figure of 0.12%
- 4.25. Nevertheless, this figure does not appear unreasonable in comparison to other regulated entities, whose costs of debt have fallen into negative territory in recent years; the **CAR should consider how this is reflected in future should the cost of debt continue to fall, yet the agreed facility remain in place** as at present

#### Aiming up

- 4.26. We note the **CAR has justified the use of an “aiming up” allowance in order to mitigate estimation error**, and the potential adverse consequences on economic incentives than overestimation; this is justified on the basis of consistency with precedent and UKRN guidance<sup>26</sup>
- 4.27. Since the advent of this concept, “aiming up” has been subject to further regulatory review, particularly by the UK Competition and Markets Authority; whilst aiming up may be warranted in some cases, its **use in the UK reflects the particular circumstances and regulatory framework of the water sector<sup>27</sup>**
- 4.28. However, the **UK CAA has rejected its use for Heathrow’s H7 settlement, noting that the water industry has different characteristics**, and instead has a “need for specific investments that vary significantly over time required greater flexibility”<sup>28</sup>

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<sup>23</sup> [Global Investment Returns Yearbook 2021](#)

<sup>24</sup> [Dublin Airport Cost of Capital for 2019 Determination](#)

<sup>25</sup> Irish RP3 Draft Performance Plan consultation, para 5.33

<sup>26</sup> [Wright et al \(2018\) Estimating the cost of capital for implementation of price controls](#)

<sup>27</sup> [The argument for aiming up is set out in the CMA’s report on Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited PR19 price determinations, para 9.1269](#)

<sup>28</sup> [CAA CAP21039A: Appendix J – Weighted Average Cost of Capital - Economic regulation of Heathrow: Consultation on the Way Forward](#)

- 4.29. This is specifically as a result of the CAA’s assessment that “the Outcome Delivery Incentives (“ODI”) **framework applicable to water companies is materially negatively asymmetric and has been referred to extensively by the CMA as a justification for aiming up**”<sup>29</sup>
- 4.30. On the other hand, the IAA ANSP, whilst subject to asymmetric risk in respect of service units, **already has explicit protection through the application of a traffic risk sharing mechanism**; this mirrors the CAA’s justification not to apply any element of “aiming up” to Heathrow
- 4.31. It is therefore **our view that “aiming up” is not warranted by incentive package placed upon IAA ANSP as part of this RP3 price control**, and whilst is not warranted due to the incentive package on new investment, is in any case is certainly not warranted on existing assets
- 4.32. This is consistent with the UKRN paper, which states that “**once an investment is sunk, there is (obviously) no risk that investment will not occur if the RAR is set too low**”<sup>30</sup>, and “it is clear that the optimal RER for old (sunk) investment is therefore the expected WACC i.e., the mid-point of the estimated range”<sup>31</sup>

## 5. Capital expenditure

- 5.1. **We agree with the CAR decision that under the ‘User Pays’ principle that there is a benefit in aligning the recovery of capital costs with the useful life of the project** and we support the continuation of the IAA ANSP recovering capital costs in relation to capitalised assets in operation
- 5.2. **Where the CAR has identified uncertainty regarding the requirement to progress particular projects during the RP3 period**, we would be supportive of these projects being explored in more detail to ensure the programme consists of wholly fit for requirements projects and **crucially that these are not being prematurely delivered or existing assets being written down resulting in unnecessarily inflated charges to users**
- 5.3. Given the substantial impact of Covid-19 on users **we would advocate for continued, stringent cost control to be demonstrated by the IAA ANSP through the RP3 with non-critical project delivery re-evaluated** and ensuring maximal existing asset lifespans
- 5.4. The exclusion of the Dublin tower and CEROC projects from the downward Capex programme cost adjustment proposed by CAR is a logical position to pursue given the imminent capitalisation of the Dublin tower project and the 2020 capitalisation of the CEROC project. However, **we would encourage an ex-post review to determine the efficient costs associated to these projects given their significant cost levels and contribution to the RAB in conjunction with the inflated outturn costs for the Dublin tower by €7 million**

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<sup>29</sup> Ibid.

<sup>30</sup> [Wright et al \(2018\) Estimating the cost of capital for implementation of price controls](#)

<sup>31</sup> Ibid.



- 5.5. Given that **there was a significant underspend against the Determined cost levels in RP2, against assets that are adjudged to have likely warranted expenditure; it would be of interest to further understand the implication on costs to users in the RP3 determination** in regards to the catch-up in the proposed programme. Any incremental costs incurred by users in RP3 generated through delay of required work, in conjunction with a capex underspend, in RP2 should be considered and adjustments to allowances within the determination made accordingly. The cost of “catch up” should not be borne by users
- 5.6. We support the CAR in its monitoring and **reporting on actual efficient expenditure at a project level**. In its development of a reporting template we would point to the governance provided by NERL in its Long Term Investment Plan and Service and Investment Plan updates

Yours sincerely,

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