

# Business review continued

## The markets we operate in

### Regulation

The international airline industry is subject to a high degree of global, European and UK Government regulation covering both commercial activity and operational standards.

UK airlines are regulated by the Secretary of State for Transport and the Civil Aviation Authority (CAA), an independent statutory body. Under the UK Civil Aviation Act 1982, the CAA is responsible for supervising many aspects of an airline's financial condition, management and operations. European airlines are also subject to EU regulations, drawn up under the provisions of the European Treaty (chiefly Article 71). Responsibility for enforcement is shared between the European Commission and the Member States.

International regulation of airline operations derives from the Chicago Convention of 1944, which established the International Civil Aviation Organization (ICAO). This is a specialist agency of the United Nations, which fosters the planning and development of international air transport. Under the auspices of ICAO, rules establishing minimum operational standards are normally agreed on a multilateral basis. Airlines' rights to fly over, or make stops in, foreign countries for technical reasons are generally derived from the International Air Services Transit Agreement of 1944. Rights to carry traffic between countries and the regulation of fares are normally agreed on a bilateral basis between governments.

### Route flying rights

Our rights to carry scheduled passengers and cargo on international routes outside Europe generally derive from air services agreements between the UK Government and the governments of the foreign states concerned. Under these agreements, each government grants to the other the right to designate an airline or airlines of its state to operate scheduled services between specified points in their respective countries, and sometimes to or from points in third countries, although this also requires the agreement of the third country's government.

Once an agreement has been reached, the UK Government designates the airlines that will operate the agreed services. We must also obtain the necessary operating permits from the foreign governments concerned. These are unlikely to be withheld so long as our operations meet the required

international safety standards. A government may have the right to prevent an airline from operating the agreed services if it is not satisfied that it is substantially owned and effectively controlled by the other government or its nationals (commonly referred to as the 'nationality clause'). For this reason, our Memorandum and Articles of Association contain provisions that could be used to limit the rights of non-UK and non-European nationals who own shares in British Airways Plc.

In order to comply with EU law, all new or revised bilateral agreements signed by EU countries must contain a Community designation clause in place of the nationality clause. This clause allows any EU airline to apply for available traffic rights between that EU Member State and the third country on a non-discriminatory basis. Currently, most UK agreements still reserve traffic rights to UK airlines, but this is changing gradually as the agreements are renegotiated.

In 2003, EU Member States granted the European Commission a mandate to negotiate changes to existing bilateral agreements between Member States and third countries, to comply with EU law. A general framework was also agreed covering the processes whereby Member States may continue to negotiate bilaterally with third countries.

Within the EU there is a single internal market for air transportation. The most significant elements of this are a liberal pricing regime, free access to all routes within the EU for airlines and a carrier licensing procedure. EU single market policies extend to the European Economic Area (EEA) comprising the EU, European Free Trade Area countries and Switzerland.

Under the UK Civil Aviation Act 1982, the CAA must balance a number of objectives in making air transport or route licensing decisions where applications to operate a particular route are contested. These include encouraging British airlines to provide air services at the lowest fares consistent with safety; an economic return to efficient operators and the sound development of the UK air transport industry; furthering the reasonable interests of users; ensuring that British airlines compete as effectively as possible on international routes; and making the most effective use of UK airports. The CAA grants global route licences for scheduled and charter air services. The absence of the necessary bilateral rights will not result in refusal to grant a licence application.

**A new multilateral agreement covering air services between the EU and the US signed March 22, 2007, has enabled us to launch our new OpenSkies subsidiary.**



Charter operations are not generally covered by air services agreements. The CAA adopts a broadly liberal policy towards applications from British airlines for charter flying rights. It is then for the airline to seek the consent of the other government. Within the EEA no distinction is drawn between charter and scheduled operations.

### EU – US Open Skies

A new multilateral agreement covering air services between the EU and the US was signed on March 22, 2007. This first stage agreement, which came into effect on March 30, 2008, removes all restrictions on transatlantic flights by EU and US airlines. It also grants rights for EU airlines to carry passengers and freight from the US to third countries on services that originate in the EU, and, in turn, for US airlines to carry passengers and freight from EU to third countries (both within and beyond the EU) on services that originate in the US. Talks on a second stage agreement, which will aim to achieve further liberalisation, commenced in May 2008.

### Airport slots

Our ability to obtain slots at airports is critical to producing schedules that are attractive to our customers. Allocation of slots at a significant number of airports where we operate, including Heathrow and Gatwick, is decided by the Airport Coordinator, who acts in accordance with guidelines laid down by the International Air Transport Association (IATA). These guidelines give priority to the historic rights of existing users. Airport Coordinators advise their slot allocations at the biannual IATA Schedule Coordination Conference. These allocations provide the basis for slot negotiations with the Airport Coordinators and other airlines.

Regulations governing the allocation of slots in the US are different, but the US has stated that it is committed by its international obligations to treat all carriers in a non-discriminatory manner.

We believe that we have sufficient slots to operate our existing routes and generally we have been able to obtain slots to cover previous route changes and expansions.

### Fare setting

The CAA no longer regulates fares of UK carriers. But some foreign governments still require all airlines to file and seek approval of their fares. It is a widespread practice among airlines to sell a substantial proportion of seats and cargo space in many parts of the world at tariffs lower than the approved levels or on other unapproved special terms. We respond competitively to such market conditions and accordingly a large proportion of our revenue is derived from such sales.

We continue to offer our customers interline passenger and cargo services with other IATA airlines but we no longer participate in IATA tariff conferences. Multilateral interline passenger tariffs for scheduled journeys and tariffs for cargo interline services are now determined through the IATA e-tariff and Flex Fare mechanism.

### Safety

Safety standards are generally agreed on a multilateral basis under the auspices of ICAO. The country of registration of an aircraft is generally responsible for ensuring that the aircraft and its crew meet these guidelines, leading to variations and differences on specific requirements between States. European countries first attempted to harmonise their safety requirements through the Joint Aviation Authorities (JAA) and non-binding Joint Aviation Requirements. Certification of compliance by the state of registry is normally recognised by all other members of ICAO.

In September 2003, airworthiness and maintenance standards, based largely on ICAO and JAA standards, were adopted into EU law and a new independent European Aviation Safety Agency (EASA) was set up to advise the European Commission and Member States on safety matters. The new safety framework is consistent with ICAO requirements. Member States are still responsible for supervision and compliance, but they can no longer unilaterally vary standards in these areas except to respond to an immediate safety problem or to meet a short-term operational need without compromising safety.

In December 2006, EU-OPS 1 was published as Regulation 1899/2006. EU-OPS 1 basically transfers the operational requirements and procedures from non-binding JAA requirements into European law. It is anticipated that these will form the basis

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of EASA regulations when competence for operations and licensing is given to EASA. EU-OPS 1 comes into effect on July 16, 2008.

British airlines are still required, except in limited circumstances, to operate British registered aircraft. All British airlines are required to hold a UK Air Operator's Certificate (AOC) currently issued by the CAA, acting as a member of the JAA. The AOC will continue to be issued by the CAA on behalf of the European Commission or EASA. The AOC confirms the competence of the holder to operate and maintain its aircraft safely. Each aircraft operated under an AOC may only be flown if it has a certificate of airworthiness confirming compliance with the EU regulations. All flight crew and certain maintenance staff must be licensed.

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**Maintaining our high safety standards is a key priority. All departments, especially engineering, flight operations and ground operations, pay continual attention to operational safety and the health and safety of employees. Specific responsibility for advising on safety matters rests with a separate department under the Head of Safety and Security. We have a formal safety management system in place, and we operate a comprehensive monitoring system to ensure that incidents are reported and action is taken whenever appropriate.**

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### Security

In the UK, the Secretary of State for Transport has the power to direct the aviation industry to take measures to prevent acts of criminal violence. These measures often exceed both the international standards developed by ICAO and EU regulations. Responsibility for implementing the measures and meeting their costs falls on both airlines and airport authorities. A number of foreign countries have also developed aviation security programmes, which require us to meet specific security standards.

Our security department continuously assesses the threats to our business, develops policies for the protection of our operations and assets, directs our staff or agents to implement appropriate countermeasures and monitors their effectiveness. There are also circumstances in which governments may seek to prevent airlines from flying to or from various destinations or otherwise hinder their operation. Changes in customs, immigration or other regulation may have the same effect.

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**Widespread passenger disclosure requirements and enhanced security measures exist and continue to be introduced by the EU and various governments to help control terrorism and illegal immigration. We engage actively with the European Commission, the UK and other governments and airports to try to minimise inconvenience to our customers while maintaining the necessary level of security.**

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**We maintain commercial arrangements with other airlines covering scheduled passenger and cargo services on a small number of our international routes.**



### Environmental regulation

Our activities are covered by a comprehensive network of regulations at local, national and international levels. These cover emissions to the local and global atmosphere, disposal of solid waste and aqueous effluents, noise and other relevant factors. In managing our environmental performance we aim to comply with these regulations as a minimum, but to exceed them in a number of key areas. For further detail see the environment section on corporate responsibility on pages 48 and 49.

### Competition

Most of the markets in which we operate are highly competitive. We face competition from other airlines on the same city-pair routes, from indirect flights, from charter services and from other modes of transport.

The intensity of the competition varies from route to route, depending on the number and nature of the competitors, particularly whether or not they are state-owned or state-supported, and on the regulatory environment and other factors. At one extreme, there are a few international routes on which competition is limited to the other state's designated airline and fares are regulated. At the other extreme, there is a free market for internal flights within the whole of Europe allowing any European airline to operate on any route, setting whatever fares they wish, subject only to infrastructure constraints and competition law.

On many of the routes with multiple carriers, our pricing decisions are affected by competition from other airlines, some of which have cost structures that are lower than ours or other competitive advantages allowing them to operate at lower fare levels.

It is UK Government policy to liberalise markets progressively and to encourage fair and equal competition wherever possible. The presence of state aid, in all its forms, and in several different markets, distorts competition and is generally incompatible with policies and regulations designed to open up markets.

### Commercial arrangements

We maintain commercial arrangements with other airlines covering scheduled passenger and cargo services on a small number of our international routes. Commercial arrangements can govern, among other things, capacity offered by each airline, how revenue is shared between airlines and how schedules are coordinated. In very few cases, some commercial arrangements between ourselves and other airlines are required under the relevant air services agreements. For further details on some of our key commercial arrangements see the key alliances section on pages 28 and 29.

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### The economic landscape

There has historically been a strong correlation between our revenue performance and the health of the major economies of the UK and US. This relationship has continued throughout 2007/08 as both these markets began to show signs of weakness.

The long awaited softening in the UK economy, which the Bank of England had been trying to engineer through higher interest rates, failed to materialise in 2007. Indeed, real GDP growth accelerated to 3.1 per cent from 2.9 per cent in 2006.

But during the latter part of 2007, there was growing evidence that the UK economy was approaching a turning point. The financial market crisis had intensified, while high interest rates, high household debts, and reduced credit availability were finally starting to affect housing demand and prices. Against this background, there were also signs that the long expected slowdown in consumer spending had finally begun.

Economic slowdown really began to bite in the early part of 2008. The credit crunch has started to affect the real economy, with households and businesses finding access to credit materially reduced. Growth in the housing market has stalled, and house prices have started to edge down. Rising fuel and food prices have further squeezed real disposable incomes, although retail sales have remained remarkably resilient. The downside risks have increased, and growth is expected to slow.

The US economy experienced a clear softening in 2007, largely as a consequence of problems in the residential housing sector, which culminated in the sub-prime crisis. Conditions have continued to deteriorate and at a faster pace, with consumers hit by higher unemployment, rising energy prices, continued problems in the housing market, and falling wealth. There are also signs of weakness in the business sector.

The Federal Reserve has so far responded with aggressive cuts in interest rates contributing to a further weakening of the US dollar, particularly against the euro and yen. In addition, the US Government has responded with significant tax cuts.

### The competitor landscape

The airline industry remains highly competitive, with more competition than ever before in a number of our market segments.

#### Domestic and shorthaul

We face competition on the ground and in the air. There is a clear relationship between shorter rail journey times and the ability of train operators to capture a bigger share of the total air/rail travel market. For example, between 2004 and 2007, rail journey times between London and Manchester decreased by 17 per cent and the train's share of the total market grew by 20 per cent.

The development of Eurostar services has had a significant impact on air travel. With Eurostar now based at St. Pancras International and journey times cut by up to 25 minutes, customers will experience greater benefits from travelling into city centre terminals by train.

Furthermore, increased awareness of the environment is affecting demand in this market.

In the air, competition in shorthaul is mostly coming from the budget airlines, who will soon account for more than half of the London market. These carriers are now planning to increase their fleets significantly, but only a small proportion of this growth seems destined for the London markets, with focus shifting towards intra-European services.

Traditionally, full service airlines have had two cabins, with a premium and an economy cabin. In recent years, there has been a move away from this configuration, with some airlines removing premium cabins and others shifting to a hybrid three class offer.

#### Private jets

Demand for private charter airlines meeting the needs of business travellers is increasing. These services are premium/luxury standard and entirely flexible, offering a fast and efficient service from smaller airports.

People are searching for products and services that make their lives less complex and challenging. They are also looking to punctuate their busy lifestyles by taking time out to escape their hectic routines or to reward themselves for dealing with the pressures of the day.



## Longhaul

The quality and number of competitors has grown in the last five years. Competition will continue to increase.

**While our traditional markets such as the UK and the US will continue to be strong, new ones, particularly India and China, look likely to grow. The rise of the Gulf, as a destination and as the home of key competitors, is expected to intensify. We are also starting to see the first successful steps towards airline consolidation in Europe with the mergers of Air France/KLM and Lufthansa/Swiss.**

Mainstream competitors have begun to invest in their products, focusing on inflight entertainment and new seat technology. New aircraft, in particular the Airbus A380, will offer opportunities for further product upgrades.

Full service carriers continue to invest in special facilities for premium passengers, in some cases creating dedicated premium terminals.

### Premium-only carriers

The operation of premium-only services became a high profile activity in 2005 with the almost simultaneous launch of the US carriers Eos and MAXjet with a focus predominantly on the London-US market, especially London-New York.

Despite their appeal to consumers, these carriers have not proven commercially sustainable and have both collapsed in recent months.

### Low cost longhaul carriers

Dedicated low cost airlines still remain a rarity in the longhaul segment, and most are linked to charter or tour companies. Indeed, it could be argued that existing charter airlines have already been serving the low cost longhaul segment for some years.

## The consumer landscape

Consumer expectations and spending power continue to rise. Consumers are leading increasingly complex and busy lives. As pressure on their time grows, leisure time will become increasingly precious to them. An ageing population also means that there will be a greater number of older people with the wealth and health to travel more. There will also be growth in the affluent, younger segment.

**An increasing proportion of our customers are e-literate. The development of broadband and mobile technologies will make it easier for them to access information quickly and change the way they buy goods and services. Social networks will become increasingly important with consumers relying more on peer advice than traditional advertising when making purchase decisions. Environmental concerns are moving higher up the agenda, with consumers expecting brands to be environmentally responsible.**

### Consumer travel and purchase behaviour

People are taking more holidays. Short breaks – many arranged independently – are growing particularly strongly. Although the package holiday is not dead, there has been a significant increase in the number of consumers creating trips and holidays for themselves.

The value of trips booked online shows the strongest growth. The internet has undoubtedly been the single biggest influence on changing the way we research and buy products, goods and services.

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### Changing consumer trends

Consumers are living increasingly fast, full and flexible lives. The boundaries between work and leisure are blurring and, for many people, time and personal energy have become the most valuable resources in daily life. Many of our products and services are designed to help customers make the best use of their time – whether on the ground or in the air. For example, we have smooth and fast check-in processes for all, and fastrack departures and lounges for premium customers.

Consumers are looking for ways to control their energy levels and to save time by doing tasks more quickly or by outsourcing them. That's why, in our lounges at Heathrow and New York JFK we now offer a concierge service for customers to help them while they are on the move.

People are searching for products and services that make their lives less complex and challenging. They are also looking to punctuate their busy lifestyles by taking time out to escape their hectic routines or to reward themselves for dealing with the pressures of the day.

Award-winning ba.com allows customers to research, book and manage their travel whenever they need – while at home or when travelling. We are constantly developing and adapting our site to respond to the changing needs of our customers.

### Health and wellbeing

There is a growing interest in health and wellbeing, a trend strongly associated with increasing affluence and with an ageing population. Good health underpins personal freedom, and is naturally a big priority as people get older.

Alongside health, people are concerned about individual safety and international security. For travellers these fears include the threat of global conflicts, terrorism, the impact of climate change, environmental disasters like the tsunami or the New Orleans floods and health threats such as bird flu and SARS.

Many people are now focusing on developing their emotional-wellbeing, contentment and quality of life. Consumers increasingly expect more basic needs to be fulfilled and thus have higher expectations of their overall wellbeing than previous generations.

Our 'Well Being in the Air' programme provides customers with information to help them reach their destination feeling healthy, refreshed and relaxed. We also offer a series of podcasts from our resident sleep expert 'Dr Sleep' to help people manage the effects of jetlag. Our wellbeing information is available on both ba.com and onboard through our inflight entertainment programme, Highlife.

### Professional consumers

Consumers are becoming more demanding and sophisticated in their shopping patterns. As markets become more competitive and spending power increases, the balance of power is shifting from supply to demand, giving consumers the upper hand.

We offer a range of products and services to meet the differing demands of our customers. This ranges from different cabins, to choices on how customers book and manage their travel, to the service offered on board.

Despite the increasing affluence of consumers, value remains a critically important factor in their choices. Equally they are prepared to 'trade up' and pay a premium price for better quality products. Many brands are responding to this by offering more luxurious and more expensive versions of everyday commodities. For customers who want to treat themselves, we have recently introduced attractive and popular Club Europe upgrade prices for a range of leisure destinations and will continue to look at options to extend this further.

### Communication channels

The overload of available information is forcing consumers to think about the communications and the information sources they use. Increasingly they are choosing for themselves what media and communications tools suit them. Digital technology has made it easier for them to be creative in developing their own content, and in sharing their ideas with others, for instance by turning to peer networks for word-of-mouth recommendations. We are experimenting with our own 'Google gadget' so that customers can have the latest flight and operational news and offers built into their Google homepage. We continue to look at other ways that we can harness the knowledge and experience of our customers and staff for social networking and blogging.