

Business review continued

Principal risks and uncertainties

The operational complexities inherent in our business, together with the highly regulated and commercially competitive environment of the airline industry, leave us exposed to a number of risks. Many of these risks – for example, changes in governmental regulation, acts of terrorism and the availability of finance – can be mitigated to a certain degree but remain outside of our control.

The directors of the Group believe that the risks and uncertainties described below are the ones that could have the most significant impact on the long term value of British Airways. The list (presented in alphabetical order) is not intended to be exhaustive.

Brand reputation

Our brand is of significant commercial value. Erosion of the brand, through either a single event, or series of events, could adversely impact our leadership position with customers and ultimately affect our future revenue and profitability.

Capital investment

A wrong decision in respect of our planned fleet growth, in terms of timing, aircraft numbers or fleet type, could have a material adverse impact on our future performance.

Competition

The markets in which we operate are highly competitive. We face competition from other airlines on our routes, as well as from indirect flights, charter services and from other modes of transport. Some competitors have cost structures that are lower than ours or have other competitive advantages. Fare discounting by competitors has historically had a negative effect on our results because we are generally required to respond to competitors' fares to maintain passenger traffic.

Consolidation/Deregulation

Mergers and acquisitions amongst competitors have the potential to adversely affect our market position and revenue. Certain markets in which we operate remain regulated by governments, in some instances controlling capacity and/or restricting market entry. Relaxation of such restrictions, whilst creating growth opportunities for us, may negatively impact margins.

Environment

Failure to adopt an integrated environmental strategy could lead to a deterioration in our reputation and consequential loss of revenue. An increased focus on corporate responsibility and a published emissions reduction target will help deliver the refocused strategy.

Financial commitments

We carry substantial debt which will need to be repaid or refinanced. Our ability to finance ongoing operations, committed aircraft orders and future fleet growth plans may be affected by various factors including financial market conditions. Although most of our debt is currently asset-related, there can be no assurance that aircraft will continue to provide attractive security for lenders in the future.

Fuel price

We use approximately six million tonnes of jet fuel a year. Volatility in the price of oil and petroleum products can have a material impact on our operating results. This price risk is partially hedged through the purchase of oil and petroleum derivatives in forward markets, which can generate a profit or a loss.

Global economic slowdown/Credit crunch

Our revenue is highly sensitive to economic conditions in the markets in which we operate. The financial services sector is one of our key customer segments and recent difficulties in the banking industry represent a significant risk to our revenue.

Government intervention

The airline industry is becoming increasingly regulated. The scope of such regulation ranges from infrastructure issues relating to slot capacity and route flying rights, through to new environmental and security requirements. Our ability to both comply with, and influence any changes in, these regulations is key to maintaining our operational and financial performance.

In February 2008, public consultation ended on the UK Government's conclusion that its environmental conditions on Heathrow expansion could now be satisfied and allow full utilisation of Heathrow's two runways and the construction of a short third runway to go ahead.



Heathrow and Gatwick airports and economic regulation

Our main operating bases, Heathrow and Gatwick, are subject to economic regulation by the UK CAA. The CAA sets the maximum level of airport charges, the airport's capital investment programme and service quality standards for five-yearly periods. A new five-yearly settlement came into force on April 1, 2008. Significant benefits of the settlement include:

- Major new capital investment that would be of benefit to our business for example Terminal 5's Satellite C, an automated transfer baggage link to Terminal 3 where our other Heathrow services and **oneworld** partners are due to operate, and allowance for 'mixed mode' use of Heathrow's existing two runways and investment in a third;
- A major cut in the cost of capital allowance for the airports – which reduces our airport charges; and
- Raising and extending service quality standards, which benefits our operations and customer service.

But the settlement also includes a large rise in allowed airport operating costs – which adds to our airport charges.

It is unclear if this settlement will stay in place as some other airlines are considering instigating a judicial review in 2008 which may lead to changes. We will seek to protect our interests should such a review take place.

In parallel, the UK Competition Commission is holding an inquiry into the UK airports market – notably BAA's airports in SE England and Scotland.

This inquiry is expected to issue its formal report in 2008 and must do so no later than March 2009. The report may lead to wide-ranging structural changes to the regulatory arrangements and to the ownership of airports. It may also involve a period of uncertainty during implementation if the Commission's recommendation is contested by the parties.

We will continue to put the case for a strengthened regulatory structure (with licence requirements on the regulated airports). We will also campaign for the right regulatory or ownership structure to make sure neither prevents urgent attention being given to expanding Heathrow and transforming it into a modern and globally-competitive hub.

Heathrow operational constraints

Heathrow has no spare runway capacity and operates on the same two runways it had when it opened 60 years ago. As a result, we are vulnerable to short-term operational disruption and there is little we can do to mitigate against this. In February 2008 public consultation ended on the UK Government's conclusion that its environmental conditions on Heathrow expansion could now be satisfied and allow full utilisation of Heathrow's two runways and the construction of a short third runway to go ahead. This would create extra capacity and reduce delays, enabling Heathrow to compete more effectively against European hubs like Paris, Amsterdam and Frankfurt.

Industrial relations

We have a large unionised workforce. Collective bargaining takes place on a regular basis and a breakdown in the bargaining process could disrupt operations and adversely affect business performance. Our continued effort to reduce employment costs, through increased productivity and competitive wage awards, increases the risk in this area.

Pandemics

Epidemics, pandemics and other health risks that may occur, can adversely affect demand for air travel. For example, in the Spring of 2003, the SARS epidemic caused concerns among many travellers and resulted in a decline in demand for certain of our routes, most notably those to/from the Far East. Infectious disease experts consider that there is currently a serious risk of a global influenza pandemic.

Safety/Security incident

The safety and security of our customers and employees are fundamental values of ours. Failure to prevent a major safety or security incident could adversely impact our operations and financial performance. One of our Boeing 777 aircraft was involved in a landing accident in January 2008. Investigations by the UK AAIB are ongoing but at this stage the cause does not appear to be related to either the operation or maintenance of the aircraft.