RPI Conference: Merton College: 12-13th September 2016

25 Years of Competition and Regulation: A Note on Airports

Introduction

If there was a Golden Age of privatised utilities and of the privatised state industries more generally, it is likely to be around the turn of the 80s decade. Optimism was strong, Regulators were still independent and government was inclined to let them get on with it. But there were exceptions, even then. The point of this note is to suggest that the airport industry has never been free of detailed interference and that the initial, post-privatisation structure and policy framework, was designed to facilitate intervention and a centrally planned outcome, although there was no agreed central plan. The effects of the removal of economic regulation from the downstream airline market linked with the privatisation of BAA in early 1987, placed over time, however, major counter-veiling pressure on both airports and government. The note is selective providing only a resume of most main developments and issues relating to airport competition and regulation.

BAA Privatisation

It is 30 years since the enabling Bill was passed, leading to the privatisation, in 1987, of the British Airports Authority, the then owner of 7 airports in Scotland and southern England. At that time it was one of the largest privatisations, its nominal proceeds exceeded only by BT, British Gas and Rolls Royce.

The Government decided to privatise BAA as a whole, for speed of implementation (BAA, was strongly opposed to breakup) but also because: "separate ownership would introduce undesirable rigidity into the administration of government policy for route licensing and traffic distribution and for airport development"[1]. Traffic distribution rules were to direct different types of traffic to different airports in response to future capacity and environmental problems. In this context, Heathrow, Gatwick and Stansted: "constitute together an integrated airport system for London and the south-east"[2]. Luton appeared not to be on the radar.

This concept of an integrated airport system was to lead to all sorts of mischief as anticipated by myself and David Thompson[3]. In an Institute for Fiscal Studies Report, we strongly challenged the proposal to keep BAA intact; regrettably at the time, it was one of the very few studies to do so. The advantages of having a competitive structure for privatised industries in general had still to be made in 1985 and, in the case of airports, the government thought that competition at best was a weak influence on outcomes; cross-elasticities were considered "very small"[4] because the effect of airport charges on airline costs "is relatively unimportant".

Economic Regulation

[1] Airports Policy, Cmnd 9542, June 1985, para 9.10
[2] Ibid.
[3] IFS Research Report #16, *Privatising London's Airports*, 1985.
[4] Airports Policy, 9.10

There were to be regulatory safeguards but:"the Government does not consider that a system of continuous and detailed regulation of [airport] charges is either necessary or appropriate for airports in the private sector"[5]. More than three decades later, we still have an element of both continuous and detailed regulation although the number of airports so affected is fewer and the procedures are now different and much improved (see below). Unlike other major privatised industries, airports were not given to a new regulatory body but handed to the existing Civil Aviation Authority. At the time, four airports, Heathrow, Gatwick, Stansted and Manchester, were 'designated' for price controls following Part IV of the 1986 Act and subjected to price cap regulation of the RPI+/- variety. There were anomalies in this selection.

Manchester was the first subject to a price review, with Stephen Littlechild on the MMC Panel (airports unusually were subject to a reference from the CAA to the MMC, later CC, before the CAA made a decision). Manchester was different from the BAA airports: it was (and still is) a public sector body possibly motivated by the 'public interest' (albeit of a regional variety) which raises the point: does incentive regulation work efficiently in circumstances when the firm might not be profit maximising, but seeking other objectives (see below)?

The price control imposed on Stansted was absurd. At the time it had around half a million annual passengers, a tiny fraction of numbers at Heathrow or Gatwick and many fewer than numbers at Luton which was not subject to price controls. It had no market power (other than a very local one), but the former nationalised BAA had large ambitions for the airport. Following a public inquiry, planning permission to expand it to accommodate 15mppa was given in the 1985 White Paper, on the eve of privatisation: a development which the nationalised Board immediately committed to. The method in the madness was that expansion of the airport was to be cross-subsidised in effect by Heathrow (contrary to assurances given by Ministers in the lead-up to the 1986 Act).

Heathrow had the highest capacity utilisation in Europe. A landing/takeoff slot mechanism allocated the capacity available. Following IATA procedures, slots had been 'grandfathered' to incumbent airlines and slot values were rising. Thus, airport charges did not and do not play an allocative function. This reality was worsened by the fact that traditional price capping tended to imply falling real charges at Heathrow (Gatwick and Manchester) unless there was major investment, e.g. Terminal 5.

All the major Scottish airports were owned by the BAA: Glasgow, Edinburgh, Aberdeen and Prestwick and between them totally dominated Scottish aviation, in spite of which there were no price controls. The Government argued against separating these Scottish airports from each other and the rest of BAA (shared overheads, rotation of skilled staff etc.).

Overall, the selection and justification of airports for price capping was riddled with inconsistencies. The particular object seemed to be to allow BAA to dominate the London market, to enable government to more easily influence outcomes in accordance with government policy on airport development. Paradoxically, one of the first policy developments in the early 1990s was to set aside most of the Traffic Distribution Rules, the intended operation of which was one reason given for not dividing BAA five years before.

[5] Airports Policy, 10.10

Early Competition Issues

In June 1993, Luton airport complained to the CAA that Stansted was pursuing a course of conduct as described in S.41(3)(c) of the 1986 Airports Act; it was argued that it was levying charges that were too low and materially harming Luton; there had been a transfer of traffic from Luton to Stansted. S.41(3)(c) was a curious provision in the Airports Act; it dealt with predatory conduct in spite of the government's presumption that airports were not a competitive industry. In response to the complaint, Stansted accepted that it was not making a return on capital employed or even a profit on book cost; but its revenues exceeded avoidable costs. The CAA responded: given the state of Stansted's balance sheet, it was thought "improbable" that the borrowings for expansion could have been obtained except from members of the BAA Group. The CAA conceded that the scale and timing of Stansted's expansion had been premature and it was this excess capacity that was at the root of the problem. Net charges after discounts clearly failed the sufficiency test and Stansted's pricing policy was causing Luton material harm. S.41(3)(c) tests were met. The CAA went on to conclude that no remedy was appropriate because it was the Government's decision to expand Stansted!

At a similar time, Manchester also appeared to be borrowing at a rate that could not be justified in the commercial market. The, then, Group Director of Economic Regulation at the CAA, Cliff Paice, commented that the airport "was proposing a remarkable investment programme [and] gross capital formation in the last year of the quinquennium was 56[%] of the forecast turnover, which is a truly astonishing figure". It is possible that this CAPEX was aimed at pre-empting the development of near-by Liverpool. Liverpool airport had been bought by the Peel Group which negotiated a (very) long term contract in 1998 with easyJet (then a relatively new airline), one of the first airport-airline contracts. The following decade the airport expanded rapidly taking traffic from Manchester. Manchester had been subject consistently to a large(ish) minus X over a number of control periods (-5 in 2002 for example) but, in later years at least, without too much protest. It was also charging below the price cap (see OFT, 2006), all which might suggest that it was competition driving performance and not the price cap. On the other hand, it had not sought to compete in the low cost carrier market through low cost contracts, partly because, it was said, price caps on a five year cycle got in the way of long term 'deals' (personal communication). Manchester was finally de-designated by the Secretary of State in 2009, on the advice of the CAA; it has since taken market share from Liverpool.

Abolition of the 'system approach'

In 2000, the Regulatory Group of the CAA (then under Doug Andrew) undertook a 'Fundamental Review of Regulation' with George Yarrow and David Starkie as advisers. A number of different ideas were put forward including: price path commitments (beyond the forthcoming control period); price profiling; a default price cap and a dual till where-by the focus was on aeronautical revenues (excluding terminal-produced commercial revenues from the regulatory till). There was strong opposition to these proposals by the airlines. The only major change for the 2003 settlement was to abolish the 'system approach' so that each airport was a separate cost and profit centre with its own asset base for the purposes of the price cap. The CAA had maintained its position on this point in spite of considerable opposition from the CC, Department of Transport and, of course, the BAA. This outcome had a profound impact because it ruled-out future cross-subsidies, principally from Heathrow to Stansted. Arguably, it represented the first step towards the break-up of the BAA – a step which the, then, CC implicitly opposed.

Later in 2003, the Government released a White Paper setting out a strategic framework for the development of airport capacity over 30 years. Its publication was preceded by extensive studies undertaken by consultants on behalf of the Department, including regional studies of site options and detailed airfield layouts. Airports were expected to bring forward proposals within this framework to be considered through the planning process and to pay for these proposals. In spite of this acknowledgement to a commercially driven industry, the government gave some steer on what it wanted built including support for Stansted as the first new runway to be developed in the south east despite the lack of a clear stand-alone business case for doing so; (The government was unenthusiastic about the development of Luton, once again treated as a Cinderella). BAA claimed that absent the 'system approach' they could not develop Stansted in a major way on a stand-alone basis: the implied increased charges necessary would not be viable. The Government pointedly drew attention to the CAAs statutory duties towards promoting investment in new facilities. Meanwhile, Heathrow airlines supported expansion of Stansted, Stansted airlines opposed it. In the end neither of the developments – additional runways at Stansted and Heathrow – desired by the 2003 White Paper, came to pass.

Aviation Developments

At this stage the aviation world was changing rapidly, principally through the advent in Europe of the low cost airline 'innovation,' but there were two associated factors of importance: liberalisation of European aviation and the introduction of the internet; the latter made the customer search process much easier and new markets more accessible to airlines. The now footloose LCC's strategy was to base a tranche of capacity at an airport in return for negotiated terms (just as easyJet had done at Liverpool in 1998). The airport, for its part, had the security of a base customer which Justice Davis (2009) described as the equivalent of the retail developers anchor tenant. Ryanair and easyjet were the major exponents of the negotiated approach and they rolled-out the concept among Britain's regional airports (which subsequently grew rapidly prior to the Recession). Stansted, with plenty of capacity and a desire to fill it, suited this approach and also expanded rapidly after deals were done.

When Harry Bush came to the CAA from the Treasury (as economic regulator) in 2003, Stephen Littlechild became adviser. They saw the need to move the regulated airports in a similar direction and the outcome was the introduction of 'constructive engagement', to promote dialogue between the regulated airports and their airline customers. The CAA's aim was to encourage the maximum agreement between the parties so that the regulatory process became more akin to a commercial negotiation. The process had some success. There was consensus in some areas but it fell some way short of overall agreement, particularly at Stansted (where to the annoyance of the low cost carriers, charge discounts introduced in the previous decade, were withdrawn in 2006), but also at Heathrow and Gatwick. This was due to a number of factors, including the long-standing mistrust between airports and airlines (it would take more than one regulatory review to break this down); the back-stop presence of the regulator which reduced incentives to reach an agreement, and the overhang of very substantial charge increases at Heathrow (and to a much lesser extent Gatwick) to pay for both substantial investment and enhanced security required by Government following the liquids scare of 2006.

EU Rules on the Free Movement of Capital and their Consequences

In parallel with the introduction of 'constructive engagement' there were other important developments opening-up the industry. To protect certain companies on public interest grounds from undesirable future ownership, at privatisation special shares were introduced into the Articles of Association of a number of companies. However this was an arguable provision under Article 223 of the Treaty of Rome. The British government's 'golden share' in BAA was ruled illegal by European courts in 2003, when it was deemed contradictory to the principle of free circulation of capital within the EU.

In 2006 Ferrovial, the Spanish construction conglomerate, bid successfully, in excess of £10bn., for BAA which was then de-listed from the London Stock Exchange. Although the government professed to be relaxed over the takeover, it was most unlikely that this was the case in view of the Department's former role as sponsoring department of the nationalised industry. In 2002, the Chief Executive of BAA had been quoted in *The Guardian* saying:

"*We are the builder of airports on behalf of the government… It is the Government's responsibility to decide how airports develop and where airports develop*."[6] (italics added)

A new senior management at BAA threatened this relationship. Before the Ferrovial bid had been finalised the OFT launched a study of the airport market leading to a market investigation reference to the CC.

The Market Reference Inquiry

A formal reference was made by the OFT in March 2007. The CC's final report in March 2009 found that there was evidence of significant competition between some non-BAA airports and that BAA's common ownership gave rise to an AEC in the south east and Scotland[7]. The CC required divestment of Stansted *and* Gatwick to different purchasers, (BAA had announced the sale of Gatwick during the inquiry) and the divestment of Glasgow *or* Edinburgh (together with undertakings in relation to Aberdeen, which was considered to have significant market power). The CC expected benefits in the capacity constraining south east to flow partly as a result of independent airports competing for planning and capacity developments. It also made recommendations to the Department of Transport in relation to altering economic regulation to a licensed-based approach in line with other utilities.

En passant, the CC made a significant comment regarding government policy on airports and the framework set out in the 2003 White Paper. It said: "…there are specific aspects of the White Paper, notably its support for a specific location and in some cases for a specific timing of investment, which, we have found, overly constrain the ability of airport operators to bring forth new projects in response to changes in the market, particularly in the South-East; accordingly we conclude that these specific aspects of government policy are features which restrict or distort competition between airports" (Final Report para 14).

---

[6] Guardian Newspaper 30 April 2002.

[7] *BAA airports market investigation: A report on the supply of airport services by BAA in the UK*, March 2009.

Edinburgh was sold by BAA to Global Infrastructure Partners (the new owner of Gatwick) in 2012 and in January 2013, Heathrow Airport Holdings Limited (owning the remaining assets of what had been BAA plc) announced the sale of Stansted to the Manchester Airports Group (MAG). Thus, the three airports which continued to be price-capped (Heathrow, Gatwick and Stansted) were now under different ownership and trading in rather different circumstances. Long neglected within BAA, Gatwick in particular carved out a distinct and more visible identity and has campaigned vigorously to be able to expand, competing with Heathrow in the process.

2012 Civil Aviation Act

The government, to its credit, did act upon the CC basic recommendation of changing the basis of economic regulation of airports, passing the 2012 Civil Aviation Act. By this time not only had the ownership structure of UK airports been transformed (and not just those of the former BAA plc airports), but also the European aviation market had changed to an extent that airports were now subject to competitive constraints from a number of sources[8]. The principal elements of the Act came into effect from April 2014 and applied to airport operators: having more than 5mppa and with substantial market power (Test A); where the benefits of regulation exceed the costs (Test B); and where competition law alone does not provide sufficient protection against the risk of abuse of substantial market power (Test C). The CAA licences airport operators that meet the market power test. The issue was complicated by the European Charges Directive, 2011. This European law applies only to airports meeting a 5mppa criterion and is incorporated into UK law by the 2012 Act, but the Act establishes the primacy of competition law under S.46.

The next price-cap review (Q6) for the three airports, Heathrow, Gatwick and Stansted, was underway when the UK legislation was passed and its procedures were broadly adopted. Heathrow met the tests and continued with price controls; Gatwick (advised by Stephen Littlechild) was an arguable case for price controls which was resolved essentially by agreement to a form of price monitoring. The CAA also chose to argue the case for continued control at Stansted, even though when Harry Bush was Economic Regulator, it supported its de-designation (and that of Manchester). (De-designation was then down to the Secretary of State who did not agree to accept the CAA's recommendation in the case of Stansted,). MAG, the new owner of Stansted was determined to press its case, a case that had been helped by the sharp, adverse reaction of Ryanair (accounting for about two-thirds of Stansted's traffic) to a hike in charges announced just prior to the take-over[9]. The result was that price controls were removed for aeronautical charges applied to Stansted's passenger aircraft. It was approaching three decade since the airport had been first designated, at that time with the negligible prospect of gaining significant market power, but forming part of a wider aviation strategy, a strategy that subsequently was to fail. Removing unnecessary economic regulation can prove exceedingly difficult.

---

[8] Harry Bush and David Starkie, Competition Drivers towards Improved Airport/Airline Relationships, *Journal of Air Transport Management*, 41, 45-49.

[9] See David Starkie and George Yarrow, Why airports can face price-elastic demands: margins, lumpiness and leverage passenger losses, *Letters and Notes on Regulation*, 2.4, December 2013, Regulatory Policy Institute, Oxford. This (and other) work was done at the time for Stansted and argued that elasticities were anything but "very small" as suggested by the government in 1985 (see page 1).

The Airports Commission

Notwithstanding the CC's comments in 2009 (see above), in September 2012, the government announced the establishment of an Airports Commission (AC), to identify and recommend options for:"…maintaining the UK's status as an international hub for aviation" (Interim Report, para. 1.1). Its independent Commissioners came largely from without the aviation industry but much of its Secretariat from the Department for Transport. In many respects it was a case of 'back to the future'. Similar planning exercises had been carried out in 2003, 1993 (the RUCATSE or Runway Capacity in the South East study) and, of course, in the early 1970s with the Roskill Commission. In spite of the AC recognising "… the UK has a competitive and substantially privatised airports sector…" (1.5) its approach was to assess the structure of the UK airports sector considering "how well the UK's economy and society are being served by its current airport infrastructure" (1.27). In the process it engaged in an evaluation methodology which overall was complex, utilising not only CBA but CGEM and generally not entirely consistent with a competitive, commercially driven industry.

The Interim Report, in December 2013, "…demonstrates a clear case for at least one net additional runway in London and the South East by 2030" (page 172) leaving open the possibility of there being two or more runways, albeit drawn from a restricted number of site options. By the Final Report in July 2015, the Commission had decided to choose Heathrow Airport Ltd's proposal (for a 'full-length' runway to maximise the 'connectivity gain') in preference to Gatwick and an alternative Heathrow design; it might be argued that the die had been cast at the outset with the government's emphasis on the need to maintain the UKs international aviation hub status. The alternative Heathrow design was an innovative scheme for extending the current northern runway to an extent that allowed for simultaneous use of the same runway by arriving and departing aircraft. Unfortunately it would appear that the company advancing the idea, Heathrow Hub, had an agreement, if chosen, to sell its scheme to HAL thus reducing an opportunity to provide the Regulator with some comparative performance measures.

Subsequent delays to a final decision by the Government led to a ramping up of the rent-seeking lobbying by all three short listed contenders. . Also lobbying on Heathrow's behalf were regional interests seeking increased connectivity to the world via Heathrow, together with preferential long term allocation of runway slots at this prime hub.

The rents sought by Heathrow in particular are a consequence of the RAB based approach to price controls and the difficulty of ensuring efficient levels of investment in these circumstances. The runway of 3,500m, proposed by HAL, exceeded the airport's earlier proposal for a 2,800m runway, thereby adding only 6 per cent to total runway capacity but significant costs at the margin. The longer runway requires the M25 to be placed in a tunnel (and a strategically important waste-heat power plant to be moved), increasing the construction timetable by at least a year. It remains to be seen whether the Regulator challenges the degree of spending proposed. The principal incumbent airline at Heathrow, BA, seeking to protect its scarcity rents has certainly done so arguing that "the price tag for the third runway is excessive and cannot be justified on any basis"

The delay by the Government in resolving the runway issue has serious welfare cost consequences but perhaps not quite as serious as the various interest groups contend. At congested airports, there is operating a fairly efficient market in slots, enabling airlines (subject to some constraints) to buy and sell slots. This slot market helps to ensure that slots are generally used by airlines able to make best use of them. If a commercial opportunity to open a new route to a developing market arises, it is in principle possible for the airlines to do so; a useful palliative for government indecision.

Acknowledgements: I am very grateful to Harry Bush, Doug Andrew and Stephen Littlechild for comments on early drafts. They of course bear no responsibility for the outcomes.