

The Supply of Airport Services by BAA within the UK Competition Commission Market Inquiry

Evidence on behalf of The Department for Transport

Introduction

On 30 March 2007 the Office of Fair Trading (OFT) referred the supply of airport services by BAA within the UK to the Competition Commission (CC) for further investigation. This followed an initial investigation by the OFT where they found potential adverse effects stemming from a combination of market features.

Whilst the Department for Transport (DfT) does not own or operate any airports, we do have a responsibility for ensuring a sustainable aviation sector in the UK that balances the needs of the UK economy and the environment, and protects the interests of consumers. Some of these responsibilities are discharged on behalf of the Secretary of State by the Civil Aviation Authority (CAA), the industry's independent regulator. We welcome the opportunity to present evidence to the Competition Commission.

Background

The DfT's policy on aviation was laid out in the *Future of Air Transport White Paper* (2003)¹ (the ATWP), and more recently in *The Future of Air Transport Progress Report*² (2006). In the ATWP Progress Report we outlined the policy context as follows:

'In December 2003, the Government set out a sustainable long-term strategy for the development of air travel out to 2030. It balanced the growing aspirations we have to travel and the needs of our economy with the need to protect our environment. It rejected a 'predict and provide' approach and instead proposed a comprehensive strategy that:

*** committed the Government to ensuring that aviation reflects the full costs of its climate change emissions**, which will influence the amount of traffic growth that will occur. This is the same approach Sir Nicholas Stern³ recommended right across our economy;

*** put in place tough local environmental conditions for our most environmentally sensitive airport**, London Heathrow. Further expansion in flights would not be allowed unless limits on noise and air quality could be met;

*** recognised that aviation brings real benefits** to the lives of ordinary people and to business. It connects people and places

¹ *The Future of Air Transport* Department for Transport (2003)

² *The Future of Air Transport Progress Report* Department for Transport (2006)

³ Stern Review on the Economics of Climate Change (2006)

in ways that many people value highly and is also critical for a successful economy. Since publication of *The Future of Air Transport* White Paper in 2003, the number of passengers using our airports has risen by 14%;⁴

*** rejected proposals for new capacity at several airports and at new Greenfield locations, and instead promoted making much better use of existing airport capacity.** The strategy supported the development of regional airports mostly within existing capacity, as well as the construction of a further runway at Stansted and at Heathrow, and measures to make better use of existing runways at those airports.

The Government remains committed to the strategy set out in the White Paper: it strikes the right balance between economic, social and environmental goals.'

The OFT Reference

The Office of Fair Trading (OFT) decided to make a reference to the Competition Commission (CC) under section 131 of the Enterprise Act 2002 (the Act) for an investigation into the supply of airport services by BAA within the UK. This confirmed the OFT's proposed decision which was published on 12 December 2006 and on which the OFT publicly consulted.

The OFT concluded it has reasonable grounds to suspect that BAA's high regional market shares in the South East of England and Lowland Scotland, the system of economic regulation of airports, and capacity constraints combine to prevent, restrict or distort competition.

In their reference to the CC, the OFT have summarised the features which in their view form the basis for a reference and meet the section 131 test in terms of features that could have an adverse effect on competition. They are:

- The joint ownership of airports by BAA
- The regulatory regime applied to BAA's airports
- The existence of development restrictions and capacity constraints

Although not all of these issues are in the direct competence of the DfT, the following sets out our evidence on each of these areas under the headings of joint ownership and regulation.

⁴ CAA Airport Statistics (2005), www.caa.co.uk

Joint Ownership

The DfT does not see the ownership of an airport or group of airports as a barrier to competition *per se*. We recognise the national interest in delivering new capacity, as set out in the Air Transport White Paper.

We are clear that the additional runway capacity in the South East is central to Government policy. As stated in the "Future of Air Transport Progress Report"⁵:

"...while making best use of existing runways in the South East and supporting increased routes and services in other regions could reduce pressure on the major South East airports, this would fall short of a sustainable long-term solution if trends continued. The Government therefore supported the development of two new runways in the South East: at Stansted and at Heathrow if environmental conditions could be met".

This in turn is consistent with the CAA's duty as set out in the Airports Act 1986 Section 39 which is:

"(c) to encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports;"

We recognise the vital role that competition, wherever practical, plays in both protecting the consumer, and ensuring the continued development of an efficient and sustainable aviation industry in the UK.

The Government accepts that there are several factors which mean there is a potential risk of abuse of market power stemming from joint ownership of a group of airports. For example, situations where there is excess demand and limited ability to increase supply could confer market power to incumbent firms. Also, we accept that in the short run, airline operators are effectively locked in to operating from a particular airport.

However, the DfT believes that there are a number of market features which may mitigate this risk.

First there is the rapid growth in regional airports which increasingly provide alternatives for both airlines and passengers. The Air Transport White Paper Progress Report⁶ set out that regional airports now serve a wide range of international destinations. In addition, the Government issued policy guidelines in October 2005 to encourage international airlines to fly direct to, and through, UK regional airports. Regional airports are therefore in some circumstances able to compete for passengers.

⁵ Future of Air Transport Progress Report, DfT, December 2006 (page 42)

⁶ Future of Air Transport Progress Report, DfT, December 2006 (page 50)

Second, BAA sells its services to informed customers who are sophisticated purchasers with a drive to minimise costs. At airports such as Stansted and Heathrow, a high percentage of slots are used by a small number of airlines, which may introduce an element of airline countervailing power that could serve to limit the degree of market power that can be exercised by the airport.

In considering the implications of common ownership we would encourage the Competition Commission to consider the financeability of the significant programme of investment as supported by the Government in the Air Transport White Paper.

In summary, the Government's view is that, wherever practical, competition is preferable to economic regulation. And we are keen to promote a sustainable industry, which is capable of delivering the increases in capacity outlined in the ATWP, in the interests of consumers. We accept that there are market features that could distort the market, but argue that there may also be mitigating factors. It is outside of the DfT's competence to judge whether mitigating factors are strong enough to counterbalance any market distortion that stems from BAA's ownership of airports in the South-East of England and Scotland, and we look forward to the Competition Commission's judgement on this.

Regulation

The Department most recently laid out the system of economic regulation at airports in its recently published Consultation on Proposed Designation and De-designation for Airports⁷. Economic regulation at UK airports falls into three categories:

- airports not subject to any sector-specific economic regulation. These airports have an annual turnover, measured over each of the previous three years, of less than £1m;
- airports that require a permission to levy airport charges. Any airport with an annual turnover in excess of £1m requires permission to levy airport charges. These airports are required to submit financial information to the CAA. In addition, the CAA has powers to attach conditions to remedy or prevent certain courses of conduct; and
- airports additionally designated by the Secretary of State for price cap regulation. The CAA must attach conditions relating to the information in the accounts and the maximum amount raised from airport charges for these airports.

DfT takes the recommendations of the OFT and other bodies like CAA very seriously. Hence we decided to consult on new designation criteria, and

⁷ Consultation on Proposed Designation and De-designation Criteria for Airports, DfT , February 2007

shortly will consult on the application of designation criteria to Manchester and Stansted.

As we made clear in our consultation on designation criteria, our view is that wherever practical, competition is preferable to economic regulation, which may distort market decisions and stifle innovation. Even where there is inadequate competition, regulation should only be preferred if it can be expected to deliver a clear net benefit. So economic regulation needs to be appropriate and proportionate.

Where market failures, for example the abuse of market power, lead to an adverse effect on competition, there are risks that there may be an impact on prices and investment that may not be in the best interests of consumers. Where the circumstances exist to merit consideration of price cap regulation, it should only be preferred if it can be expected to deliver a clear incremental benefit, taking account of the benefits of competition law, and also the costs of regulation⁸. If these conditions are met, however, economic regulation should act to restore the appropriate incentives to invest.

The Department recognises that airports were one of the early sectors subject to economic regulation and the CAA does not have similar powers to those of most other regulators. However, we believe that regulation should be proportionate to the market failure that it is designed to address. Consequently, part of the answer to what form regulation in the airports sector should take in the future will depend on the degree of competition. That in turn depends upon the CC's deliberations and future actions. We will examine the powers and duties of the CAA once your deliberations are complete. Whilst we cannot predict the outcome of this work, we can say that it will be guided by the principles of better regulation, and a belief that wherever practical, competition is preferable to regulation.

Further Information

The DfT would be happy to discuss any of the information contained in this paper, and to support the CC by answering any further questions that you may have. Further enquiries should be addressed to Jonathan Moor, the Director of Airports Strategy at Jonathan.Moor@dft.gsi.gov.uk, or to David Hart, Head of International Networks Analysis and Support at David.Hart@dft.gsi.gov.uk.

Department for Transport
May 2007

⁸ Consultation on Proposed Designation and De-designation Criteria for Airports, DfT, February 2007