

Ms Julie Hawes,
Competition Commission.

15 August 07

Dear Ms Hawes,

BAA Airport Enquiries.

May I submit the enclosed further note in connection with your recently published interim report.

Yours sincerely.

A.J. Lucking F.R.Ae.S MILT

13 Aug 2007

BAA Market Investigation.

A note by A.J. Lucking.

The writer was concerned to see in para 52(g) of the Commission's paper of 9 August that it was unclear whether the allocation of capacity to regional services from Heathrow would be affected by any of the matters it has to consider. The first consequence of failure to invest in Heathrow runway capacity was loss of 12 regional connections – to be followed in the mid 1990s by fares rising rapidly, as the airlines exploited the scarcity value of slots (CAA report on "Open skies").

When considering the case for revision of the regulatory regime, the writer believes that the Commission should evaluate the restoration of the regional connections to the national global gateway. According to a BAA survey, Heathrow users are willing to pay £10 extra each, merely to end the hassle due to inadequate facilities. This should be verified by carrying out an impartial survey of all passengers. But even £5 each would probably be enough to make construction of a third runway acceptable as an investment by a privately financed company. Currently, much of the allowed "ration" of profit probably can be generated with lower capital investment in ancillary activities. As then BAA Director Michael Maine (correctly) responded in accordance with his duty as a Company Director when questioned by Mrs Dunwoody MP, "Shareholders have to be our number one priority".

The Eddington report (para 2.54, main report, p.33) states "Businesses, capital investment and labour are becoming globally mobile. Although there is a lack of quantitative evidence on the relationship between transport and globally mobile activity, the survey evidence suggests that good transport links, both internationally and domestically, can be important in attracting, retaining, and expanding such business activity in the UK". The study found only one work that attempts to answer this question – a Delhi university study by Kumar on "Infrastructure availability, foreign direct investment inflows, and their export orientation....."

Eddington also reported (summary report, p.49): "However, new high-speed rail networks in the UK would not significantly change the level of economic connectivity between most parts of the UK, given existing aviation and rail links. Even if a transformation in connectivity could be achieved, the evidence is very quiet on the scale of resulting economic benefit, *and in France business use of the high speed network is low*".

The French have 28 overland regional connections from the Paris airports, 13 of which are the subject of "Public Service obligations", and some are subsidised – in addition to their extensive high speed rail network. The Germans have told the R. Aeronautical Society how an attempt to substitute trains for planes on the 98 mile Stuttgart – Frankfurt route failed, and 6 daily air services were restored. The Japanese have 61 daily air services on the Tokyo – Osaka route, in parallel with seven high speed trains per hour. Yet, here, during the RUCATSE work in the early 1990s, the Civil servants asked the writer, who represented the AUC, BCC and CBI, "Why are you making such a fuss about these domestic air services? Why can't they go by train, just like we always do?" Both modes are needed, notably on routes of up to 400 Km.

A bar chart in the 28 July 07 "Economist" (attd) shows how the most important foreign visitors, from the USA have abandoned the railway train – "If we can't fly there, we can't get there". Who does not have a US primary operating system in their computer? And the ten leading US software companies are within 30 minutes of Heathrow, not Kings Cross. The US filed 49,500 patents in 2006, vs our 5,000, and Japan's 27,000.

The economic consequences of being cut off from the nation's global gateway should be assessed by Oxford Economic Forecasting or some similar body rather than continuing the present policies based on the assumption that they are negligible. The current response to Liverpool's claim that it lost 40,000 jobs with the Heathrow link is that it is wrong, "because they are working somewhere else". Yet nobody doubts for a moment that the Channel Tunnel Rail Link will generate 100,000 jobs at Ebbsfleet, Stratford, and Kings Cross.

Work done by the writer during the 1990s casts some light on this problem. The 1990 AUC/LBS study found that each export sales trip generated on average the turnover to support 2 jobs for a year. So it is not good news that only 16% of British business travellers enjoy their work trips – compared with 53% of Germans (research by Wyndham group). The writer's experience, even before the present security problems, was that veteran sales staff in particular would evade trips that should have been made.

The 120 employee Putney company that the writer managed "struck oil" in the 1970s – in Australia. Previously, the company had only had limited business outside the UK, all in Europe. Subsequently, the business spread to South Africa, Japan and the USA, involving considerable travel, not unduly tedious then, as most of the staff lived within easy reach of Heathrow. The company is now at Merton, but manual factory work has had to be contracted out to Slovakia and Shenzhen, involving further travel. Engineering, marketing and finance etc remains in the UK. In contrast, a company run by a former colleague in Inverness, with customers mainly in India and South Africa, closed down in the period when the Heathrow connecting flights were suspended. A company unable to access Heathrow, directly or via a connecting service, will be hampered at the least. The number of business passengers originating in the regions and going to the less popular destinations is not sufficient to make direct flights economic, eg failure of services from Manchester to Australia and South Africa..

The writer concludes that the basic causes of the present situation are:

1. Failure to assess the economic value of air transport services, notably in the 2003 White Paper. Though its text ranked Heathrow more important than Stansted, the annex and supporting documents valued Stansted at £9Bn by 2060, and Heathrow at only £5.5Bn. Hence the priority for stag parties in East Europe, rather than business services at Heathrow? Oxford Economic Forecasting's figures for overall economic impact in 2030 were: mixed mode at Heathrow £4.2Bn *per annum*; the third runway, £7.2Bn pa: and a Stansted runway, £2.3Bn pa. In 1993, RUCATSE came to a similar conclusion –

Heathrow, £48.6Bn by 2040, Stansted £14.4Bn. The Americans value Chicago O'Hare's eighth runway and associated re-alignments at \$18Bn per annum.

Mrs Dunwoody MP told the Civil Engineers' airport conference that compensation for houses demolished to make way for Atlanta's fifth runway was five times value – compared with the pre-blight value + 10% + removal costs that BAA offers. As Norman Mineta, a transport academic, said when US Secretary of Transportation “We invest in airports to-day, to ensure jobs and prosperity to-morrow”. The USA has added 12 runways recently, and six are under construction. Any centre more than 70 driving miles from a hub airport can apply for an “Essential Service Order”. 104 of those in force currently are subsidised.

2. Failure to reform the Regulatory Regime, so that less investment in ancillary activities generates the allowed “ration” of profit, rather than encouraging the timely provision of operational assets.

The writer believes that the Commission could make a significant contribution to the present problem, and enable more competition, by revising the regulatory regime to incentivise private owners to invest in operational assets. Without more runway capacity, more effective competition cannot be achieved

Figure 15: The case for new very High Speed Lines (HSLs)

Significant momentum has built behind the case for a new network of very high-speed rail lines in the UK. This is often associated with new technologies, such as magnetic levitation devices, currently in very limited use in China. The business case is often argued to rest on the transformational impact of such a network on the UK's economic geography.

However, new high-speed rail networks in the UK would not significantly change the level of economic connectivity between most parts of the UK, given existing aviation and rail links. Even if a transformation in connectivity could be achieved, the evidence is very quiet on the scale of resulting economic benefit, and in France business use of the high speed train network is low.

Faced with such arguments, supporters of HSLs point to the capacity increases such new lines would deliver in London and selected urban areas by removing some or all interurban trains from commuter and freight lines.

Such benefits are likely to be both real and substantial. Crucially though, these goals could be achieved by other solutions, and perhaps at much lower cost. The range of policy measures would include fares pricing policy, signal-based methods of achieving more capacity on the existing network, and conventional solutions to capacity problems e.g. longer trains. Indeed, in keeping with a non-modal approach, the measures assessed should include improvements to other modes that support these journeys (e.g. motorway, bus, and urban access improvements).

New lines – including new very high-speed lines – should take their place within this range of policy measures, and each should be assessed on their merits before selecting the option that offers the greatest returns on investment.

An alternative argument is sometimes made on environmental grounds because a very high speed line from London to Scotland could attract modal shift from air. Such arguments must be made with care given that total domestic aviation emissions, including flight between other cities, account for 1.2 per cent of the UK's annual carbon emissions (CO₂ equivalent), including allowance for the the climate change impacts of non-carbon emissions from aviation. Furthermore, rail's energy consumption and carbon emissions increase with speed and this would erode rail's environmental advantage and so it is important to consider the costs involved in reducing carbon emissions in this way.

A set of policies based on these principles would deliver greatly enhanced economic returns

1.143 What is clear from this analysis is that the economic case for transport is compelling but that there is no single answer to the UK's long term transport needs. To sustain the UK's productivity and competitiveness, whilst meeting the environmental challenge, demands a sophisticated policy mix, combining better pricing of transport, other better use measures and sustained infrastructure investment. Without such action the costs to the economy will be substantial. Having set out the challenge, and identified the key strategic priorities, option generation must now focus on bringing forward and comparing the full range of pricing and investment options in these areas so that resources can be focused on the schemes which will best sustain the UK's productivity and competitiveness, whilst respecting its environmental obligations.

4.173 Interventions to significantly increase rail journey times are sometimes claimed to provide a step-change in economic performance. The literature suggests that in most cases, the returns are likely to be modest relative to other smaller-scale options. For example, the evidence on the costs and benefits of new North-South high speed rail lines available to this study suggests returns at the lower end of the distribution compared to the returns available from other policy options. These relatively modest returns are likely to be driven by several factors including the following:

- the UK's compact economic geography means that most major urban areas are already close together when compared to many European and international competitors;
- for those economically important connections that are more distant, such as London to Edinburgh and Glasgow, air services already provide fast, frequent connections serving business needs and other markets at relatively low cost. The new rail link, therefore, would not be a step change as the link is already there and there is very little evidence that high-speed rail links help regional performance;
- the benefits accruing to intercity business and non-work/leisure travellers in the UK from this new link are likely to be subject to significant uncertainty and speculation because the demand for the link has not been tested and proven;
- history has shown that for large-scale infrastructure projects that rely on emerging technological solutions, costs tend to increase by an order of magnitude against original estimates; and
- in addition, where new rail lines are added and speeds greatly increase, there are likely to be very significant environmental implications from the need for land take, plus emissions and noise.

4.174 Given the distinction made above about the types of high-speed rail interventions, it is important to recognise that not all high-speed rail line options would be subject to the same issues. For those that do not involve relying on untested technologies and are targeted at solving proven congestion and overcrowding problems, higher and more certain returns are likely than for high-risk options on new links where demands are speculative. There are several areas of the network where congestion and overcrowding have already been identified and are projected to worsen over coming decades without appropriate policies or responses, for example on commuter links into London and perhaps other cities. New infrastructure options are one potential solution, but they should be assessed alongside other options designed to meet the same objective.

4.175 When considering significant improvements to inter-urban links between agglomerations, on any mode, it is useful to recognise that commuters are generally prepared to do a 40-50 minute commute, and measures to improve the speed of connection between neighbouring agglomerations bring more people within this threshold, therefore widening the labour market. Agglomeration benefits are likely to drop off over longer distances.

4.176 Step-change measures to deliver a transformation of the transport system are therefore generally unlikely to be a priority, given fixed funding resources. The scale of wider transformational benefits is uncertain and is extremely unlikely to be enough on its own to justify very large amounts of public spending involved. Those that are able to tackle a particular and already demonstrated problem on the other hand, are generally more likely to be cost-effective, but should of course be assessed on their own merits relative to other options such as pricing, variable infrastructure options and line upgrades.

2.50 However it is not just international gateways that matter. The quality of the domestic transport network is essential to allow the final transportation of goods and services to consumers and firms.

2.51 Despite significant reductions in costs over recent decades, transport costs continues to remain a significant hindrance to the level of trade,⁴² which further reductions in transport costs and/or increases in the speed of transport may help overcome. Half of all international trade (by tonnage) takes place between countries located within 3000 km of each other.⁴³

2.52 For some urban areas and their catchments, international links may be important. This is likely to be the case for urban areas trading globally and competing for foreign investment. Historically, this may have meant access to ports but for today's service economy, access to international airports is also important.

Domestic trade **2.53** There are also benefits to domestic trade. So, for many areas, domestic links between urban areas and their catchments are important. Specialisation supported by trade links is particularly strong for some urban areas and supports their economic success (e.g. Manchester, Leeds, Liverpool). In some cases, links to the economic capital (London) are important to benefit from gains to trade. For example, although there are direct productivity effects where financial services are clustered, effects on demand for ancillary services may be felt in selected urban areas well away from London, such as financial services in Leeds.⁴⁴

(vii) Globally mobile activity

Business, capital and labour increasingly mobile **2.54** Businesses, capital investment and labour are becoming globally mobile. Although there is a lack of quantitative evidence on the relationship between transport and globally mobile activity,⁴⁵ the survey evidence suggests that good transport links, both internationally and domestically, can be important in attracting, retaining and expanding such business activity in the UK. Surveys show that much commonality exists between the transport requirements of domestic and global firms.⁴⁶

2.55 Figure 2.7 below points to the particular importance of access to markets, international connectivity, skilled labour, and transport within urban areas, as key factors influencing business investment.⁴⁷ It can be argued that transport plays a role in all these areas.

⁴² By the 1990s distance was a 24 per cent greater obstacle to trade than it had been in the 1960s, see: *The puzzling persistence of the distance effect on bilateral trade*, Disdier and Head, 2004, cited in Crafts and Leunig, 2005.

⁴³ *Transport and International Trade, Conclusion Of Round Table 131*, European Conference of Ministers of Transport, 2005. This is supported in the economic literature through gravity trade models, which show that doubling distances between trading areas halves the volume of trade.

⁴⁴ *Economic linkages across space, report for ODPM*, Coombes, Duranton, Overman and Venables, 2005.

⁴⁵ The Study found only one work that attempts to answer this question. *Infrastructure availability, foreign direct investment inflows, and their export-orientation: A cross-country exploration*, Kumar, 2001, shows that efficient physical infrastructure facilities, including transport, can improve the investment climate for foreign direct investment from multi-national corporations.

⁴⁶ UK Trade and Industry survey evidence – various presented to the Eddington Study.

⁴⁷ Good air transport links have been important in positioning London as the best city in Europe for business location for the last twelve consecutive years, with one quarter of Europe's largest companies basing their headquarters in the city.

Railway reform

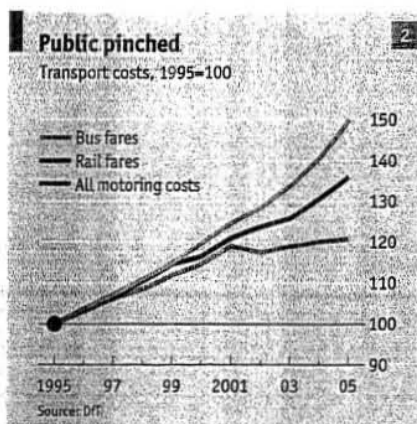
The age of the train

Modest improvements to the railways will be financed by higher fares

DESPITE the received wisdom that privatisation was an unmitigated disaster, Britain's railways have prospered over the past ten years. Passenger numbers have risen by 40%, and trains now carry more people than they have in 50 years. Such popularity is causing problems: commuter routes are intolerably crowded and some sections of line are running out of capacity. On July 24th the government published detailed plans for the railways until 2014, and a vaguer set of ambitions for the next three decades.

Ruth Kelly, the new boss of the Department for Transport (DfT), trumpeted its planned programme of investment. Some £5.5 billion is to be spent by 2015 upgrading London's Thameslink route; 1,300 new carriages will be ordered (mostly for use near London); and hundreds of millions of pounds are to go on improving capacity at overcrowded stations in Birmingham and Reading (for example, by lengthening platforms). The DfT wants capacity across the network to double over the next 30 years.

But it was not all good news for train-spotters. Grand plans for European-style double-decker trains were rejected as impractical, as were schemes for a high-speed rail route (run, in the wildest of dreams, on magnetic-levitation technology) connecting London to the north. A de-



cision on Crossrail—a railway across London—was delayed once again.

More controversial is how trains will be paid for in future. Rail subsidies have averaged £4.5 billion in recent years, with a similar amount coming from fares. The DfT proposes to shift some of the burden from taxpayers to ticket-holders, slashing its contribution to £3.2 billion a year by 2009 and hoping that a combination of more passengers and pricier tickets will boost fare revenue to £6.7 billion.

The change has been in the wind for months. Many train firms have won their franchises recently by making bold (some would say foolhardy) promises to cut the amount of public support they need. Passengers are already feeling the heat. Fares on all parts of the network have risen far faster than inflation. Some firms have been more creative. Alongside above-inflation fare increases, South West Trains has instructed its guards to show no mercy when issuing penalty fares to ticketless passengers, even if they have a good excuse.

The white paper allows this to continue: firms are free to raise unregulated ticket prices (typically, those bought just before travel) as much as they want. It even leaves open the possibility of removing price caps on regulated fares, such as season tickets. Network Rail, which owns the track, is expected to cut its costs by a third.

It is hard to know what to make of the government's proposals without a firm notion of what the railways are meant to be for. Despite their relative unpopularity (see chart 1), Britain's trains are part of its national identity, particularly among the less reformed bits of the Labour Party. This reverence has hampered a serious discussion about what they should do. Some

claim they provide a social service for the poor (although passengers are in fact overwhelmingly middle-class). Others such as Sir Rod Eddington, a former boss of British Airways and the author of a government-sponsored report on transport, focus on their impact on the economy, mainly as a means of moving large numbers of commuters in and out of cities. This week's paper seems more sympathetic to the latter view than the former. Optimists take that to mean that the government is forming a clear idea of the railways' role.

Sadly, the rest of its transport policy remains contradictory. Under Labour the cost of rail travel has risen more than the cost of motoring (see chart 2), encouraging people to ignore advice about the virtues of rail and switch from trains to cars. Ministers have said they want to shake up road travel (through a national road-pricing scheme) and aviation (by forcing air travellers to bear the environmental costs of their trip). Both policies would have a big impact on the relative competitiveness of the railways, but there is little detailed discussion of this in the white paper. David Begg, a former boss of the Commission for Integrated Transport, argues that the government needs to look at pricing across the entire transport system: "until we do that, transport policy will never make sense." ■

Housing policy

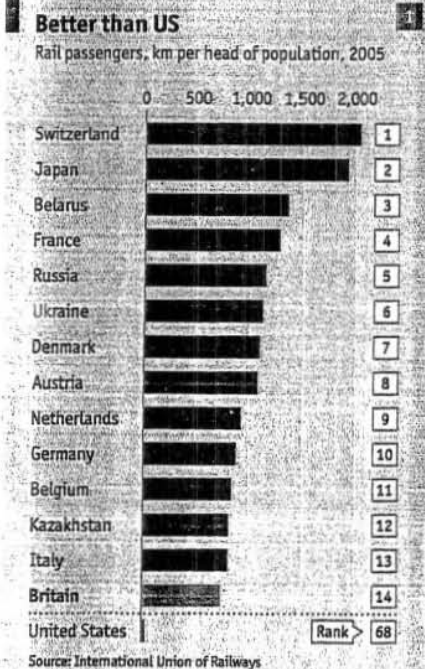
Build more or else

New plans are less ambitious than they seem but will still be hard to achieve

THE timing could hardly have been less propitious. A delay in publishing the Labour government's proposals for more housebuilding meant that they came out on July 23rd when the floods in central and southern England were at their worst. Not only did this deflect attention from the initiative; it also gave critics the chance to point out that many of the new homes envisaged would be built on flood plains.

The plan, drawn up by Yvette Cooper, the housing minister, sets out how the government intends to meet its new goal of 3m new homes in England by 2020. That may sound a lot but is in fact only around 250,000 more than previously planned. The government wants the homebuilding rate to rise to 240,000 a year by the middle of the next decade, compared with its previous target of 200,000. That higher rate will then continue until 2020.

Launching the proposals, Ms Cooper told MPs that "strong action" was essential because demand for housing was outstripping supply and making homes less af-

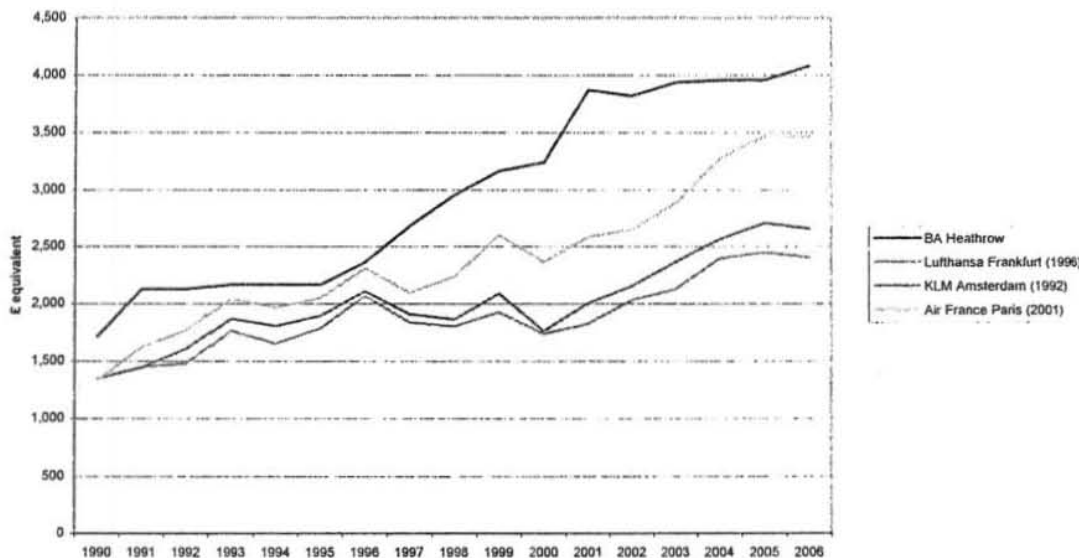


CAA study re "Open Skies"

Pricing on London-US markets

39. High demand for business class traffic combined with the relatively constrained nature of the market and a competitive advantage from a high quality product would be expected to confer significant pricing power on UK carriers. The relative fare levels for US fares from London compared to other long haul destinations are examined below. Chart 3 shows the published, fully flexible business fares for a return fare from London to the US.

Chart 3: Comparison of flexible business class fares to New York (JFK)



Source: Airline Tariff Publishing Company database

40. The chart shows the gap in fares widening considerably over time (NB: the date of any Open Skies deal with the US is shown in the key) so that there is now a 40 per cent difference in fares between the Lufthansa fare and that offered by BA. Such high fares suggest that BA has significantly greater pricing power at Heathrow compared to the other hub operators. It might be questioned whether this is a reflection of the additional scarcity rents at Heathrow compared to other European hubs. However, it should be borne in mind that these figures do not take into account any corporate discounts, which may be significant and are explored in more detail below. Pricing may also reflect factors such as quality of product and the underlying – and growing – strength of the London business market.

41. Chart 4 below, compares long-haul published fares (economy, premium economy, business and first) across all of BA's long-haul network to assess how US fares compare.

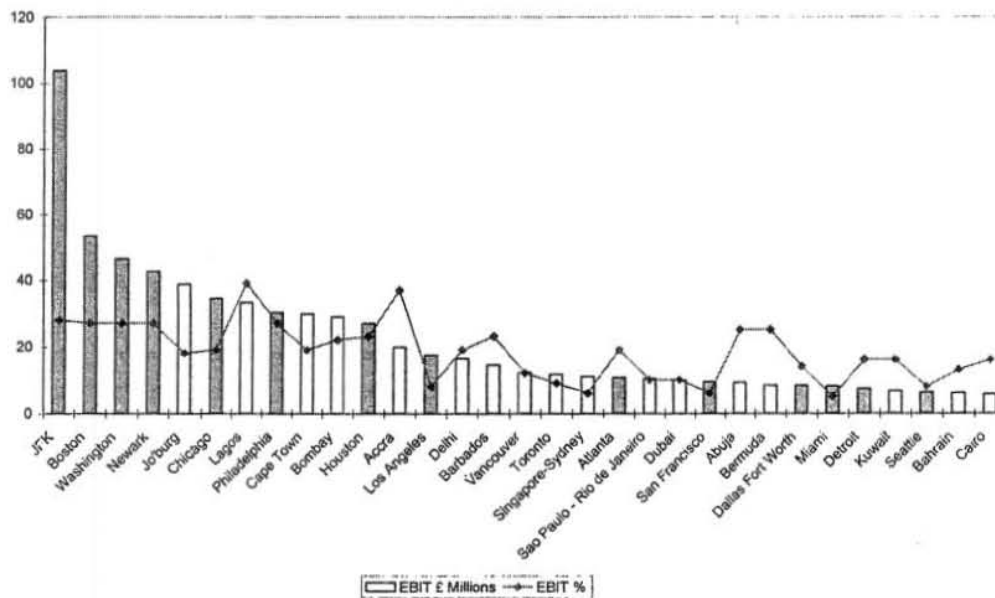
market for UK carriers would suggest that significant benefits might be obtained from liberalisation. High published business fares and high profit margins on transatlantic services suggest a degree of incumbent airline market power.

- Conversely, some characteristics of the market would suggest a reasonable degree of competition: low leisure fares and a reasonable level of competitors on a number of the major city pair routes. A closer look at the market is therefore necessary to understand the nature of competition from London to the US. The following areas are examined:

Profitability on London-US aviation markets

- Analysis by ABN Amro published July 2005 suggested that North America was responsible for generating seventy per cent of BA's profits. Similarly, six of the top ten most profitable city pair routes in their network were to the US (the other four being Johannesburg, Lagos, Cape Town and Bombay, all at the time of the assessment, highly restricted markets).
- Chart 1 showing the thirty most profitable routes in BA's network is shown below. The bars represent the profit (EBIT, £ million) generated by each route, with the line representing the percentage margin (EBIT %) for the point. US points have been highlighted. It is interesting to note that the east coast destinations are the most profitable of the US routes, with the more distant US points (e.g. Atlanta, Houston, Los Angeles, etc) less profitable in both relative and absolute terms. This may reflect BA's relative weakness in operating to these more distant hubs and the alternative routings that are available to travellers wishing to travel to Asia.

Chart 1: BA profitability by route



Source: ABNAmro

- The relative profitability of the US points is explained partly by the size of the US market, which dwarfs other long-haul destinations in terms of traffic (see Chart 2 below). However, not all of the added profitability is explained by the capacity

Chart 4: BA flexible fares per km for intercontinental routes

(Source: Airline Tariff Publishing database)

