

NON CONFIDENTIAL VERSION



Supply of airport services in the UK by BAA

Overview submission by British Airways to the Competition Commission

11 June 2007

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Supply of airport services in the UK by BAA Overview submission by British Airways

1. INTRODUCTION

- 1.1 British Airways (BA) welcomes the opportunity to submit views to the Competition Commission (CC) investigation into the supply of airport services in the UK by BAA.
- 1.2 This submission sets out the key issues for BA at this point. BA is looking forward to engaging further on the issues raised here and all other aspects of the CC's investigation.
- 1.3 Heathrow is strategically important to BA. It is BA's international hub and main base. BA is Heathrow's biggest customer, each year paying around £250m in airport charges and around £90m in non regulated charges. BA also has a significant base at Gatwick and operates services to Stansted (mainly cargo).¹
- 1.4 As the OFT notes, all of BAA's airports in the South East are operating at capacity at peak times of the day.² The constraints at Heathrow are particularly severe: it operates at capacity at most times of the day most days of the year.³
- 1.5 The chronic shortage of capacity at Heathrow is extremely damaging to the competitive position of BA in the principal markets in which it operates. These are:
- (i) hub and spoke operations, where BA is competitively disadvantaged in consequence of capacity constraints and attendant service level shortfalls at Heathrow relative to those airlines operating hubs at Frankfurt, Paris, Amsterdam and (in the near future) the Middle East.
 - (ii) point to point operations (especially short haul) where BA is in competition with many other airline operators (including low cost carriers (LCCs)), at Heathrow and other airports (like Gatwick and Stansted) serving customers from and to London and the South East.
- 1.6 Heathrow is in a zero sum game, which severely restricts BA's chance to grow its operations.
- 1.7 In consequence a major strategic pre-occupation of BA continues to be (as it has been for a number of years) to secure that BAA undertakes adequate investment at Heathrow

¹ BA also operates services to Glasgow and Edinburgh.

² BA broadly agrees with the OFT's preliminary views on geographic market definition (see section 2 below). In this submission BA uses the term "South East" to refer to BAA's airports in the South East and East Anglia.

³ BAA – The OFT's reference to the Competition Commission (April 2007); paragraph 5.12.

to relieve the current chronic congestion and expand capacity at Heathrow to meet foreseeable future demand and to permit BA to grow its business in the competitive environment in which it operates. This means the building of a third runway. No other alternative (including mixed mode operation on the existing runways) will suffice.

1.8 BAA's record in working to influence Government and public opinion, and to overcome the planning and other obstacles that are associated with major capacity expansion and a third runway at Heathrow, has been lamentable. In BA's view, this results from a combination of factors which include:

- (i) BAA's ownership not only of Heathrow but also of its principal competitors in the South East, namely Gatwick and Stansted. This blunts the incentive to expand capacity at Heathrow. Instead, BAA has an incentive to secure full capacity utilisation and to develop new capacity at Stansted, in the knowledge that some passenger demand (including future passenger growth) will be 'spilt' from Heathrow to Stansted to utilise that capacity. This thereby benefits BAA, even though it is at the cost of damaging the long-term position of Heathrow as a hub airport.
- (ii) The current regulatory regime, which imposes no statutory obligation on BAA to seek to ensure all reasonable demands for airport services at its key airports are met, including through investment in new capacity; and instead incentivises BAA to undertake investment (much of it pre-funded) which will increase the regulated asset base (RAB) on which its permitted revenues are calculated. This encourages BAA to invest generally. However, it does not necessarily ensure that the investment projects undertaken are those best suited to meet the needs of airport users, including airlines. At Heathrow, the regime has resulted in extensive terminal investment, much of it essential (Terminal 5) or highly desirable, but has manifestly failed to bring forward investment to relieve chronic runway and airfield congestion through capacity expansion, notwithstanding the move away from overall 'system' regulation at the three South East airports to separate regulation of each airport, during Q4.

1.9 These factors, singly and in combination, result in the restriction and distortion of competition at the levels of airline operations and the provision of airport services to airlines in the markets for hub and spoke operations at Heathrow and elsewhere⁴, and in point to point operations at airports in the South East and East Anglia, in all cases for the purposes of Part 4 of the Enterprise Act ('EA').

1.10 In terms of remedies:

⁴ For the purpose of Part 4 of the EA, the term 'market in the United Kingdom' includes a market which operates in the United Kingdom and in another country or territory: see EA, s.131(6)(a).

- (i) The blunting of incentives to invest in new runway capacity at Heathrow resulting from joint ownership of Heathrow, Gatwick and Stansted may ultimately be dealt with by ownership separation of Heathrow and Stansted. But very considerable timing delays would inevitably ensue in achieving ownership separation and thereafter letting investment incentives work, and immediate action needs to be taken and pursued if a new runway is to be built at Heathrow to meet the Government target of 2015-2020.
- (ii) It is to be hoped that BAA will publicly adopt as soon as possible a clearly thought through strategy aimed at delivering the investment in a third runway at Heathrow in timely fashion. If BAA were to satisfy its critics as to the seriousness of its commitment, and if steps were taken through the regulatory regime to underpin that commitment, then this would serve somewhat to reduce many of BA's current concerns over distortion of investment incentives. In terms of speed and effectiveness, this is preferable to ownership separation in remedying the lack of investment in runway capacity at Heathrow.
- (iii) The current regulatory regime has over the years delivered a number of benefits, especially following the quinquennial reviews by the CC: BA would point to 'single till' price control, separate price caps for each of BAA's three London airports and the quality standards regime introduced in Q4 in particular. However, the regime does not correspond with modern regulatory best practice, and in particular the effect of the current regulatory regime in distorting investment incentives needs to be remedied by updating the regulatory regime. In addition to the current duties imposed on the CAA (which may need updating)⁵, BA considers that the regime should incorporate the elements of:
- imposing appropriate statutory duties and obligations on the owners/operators of key airports. These may (by analogy to precedent) include taking all reasonable steps to ensure that current and reasonably foreseeable demand from users for airport services at key airports are met; to promote competition between airports; and to meet service standard requirements.
 - a requirement for owner/operators of key airports to be licensed. This provides the means of specifying in greater detail how the statutory duties imposed on both the CAA as regulator and the owners/operators as licensees are to be discharged, and permitting flexible on-going regulation of the licensees. The licence regime would contain the charge control, but the imposition of statutory duties on the owner/operator will permit greater regulatory oversight and control over

⁵ Though BA thinks the current involvement of the CC in the quinquennial review process works well.

investment and its remuneration under the charge control, and permit the current imbalance in favour of BAA to be corrected. Other licence provisions should include financial ring-fencing (designed to avoid the risk that financial stress on the airport business will affect investment to the detriment of airport users and competition), and appropriate service standard requirements, capable of fine-tuning as required (and more frequently than once every five years).

- (iv) BA sees no circumstances in which ownership separation (and the resulting promotion of competition between airports) will obviate the need for on-going economic regulation, including in particular charge control based on the single till and separate price caps for each London airport. Otherwise, the airport operator would be able to levy charges higher than would be the case in a fully competitive environment since even large airline operators like BA face insurmountable barriers to switching in consequence of a combination of their sunk costs of investment at the airport, and the nature of their operations (Heathrow as a hub and spoke airport). At most, competition in consequence of ownership separation may enable a 'lighter touch' regime to be put in place.

2. THE RELEVANT MARKETS

Introduction

- 2.1 This section sets out BA's views on the product and geographic market definitions appropriate for assessing the potential for competitive constraints to operate in the supply of airport services, though BA recognises that the appropriate market definition will depend on the specific competition concerns being analysed.⁶
- 2.2 Airports have two sets of users which potentially they compete to serve, namely airlines and airline users (passengers and for cargo). Insofar as concerns airlines, airports supply services (such as runways, terminals and equipment, security control) which enable airlines to compete with one another; and in so doing also stimulate competition as between airports to supply those services.
- 2.3 For the purposes of assessing whether there are features of the overall market which result in the prevention or distortion of competition, BA considers that it is appropriate to consider separately the provision by airports of services which enable airlines to provide:
- (i) 'hub and spoke' operations involving an integrated network of airline services;
 - (ii) point to point airline services on both short-haul and long-haul routes;
 - (iii) cargo services.
- 2.4 Any restriction or distortion of competition may take effect both at the level of the provision of airport services and at the level of provision of the corresponding airline services.

'Hub and spoke' services

- 2.5 Hub and spoke services involve the operation of integrated services and enable passengers (and their luggage) and air cargo to inter-connect and transfer from one flight to another. To attract network airlines, an airport needs to offer a combination of services and facilities enabling hub and spoke operation. The key features are:
- (i) connectivity: airlines must be able to provide efficient flight connections
 - (ii) capacity: a large number of arriving and departing flights need to be able to inter connect efficiently and space is needed to allow the network to grow

⁶ BAA – The OFT's reference to the Competition Commission (April 2007); paragraph 4.72.

- (iii) convenience: to local passengers, close to a large market with good roads and public transport
 - (iv) cost-effectiveness: the cost of building the runways, terminals and necessary access links must be affordable.
- 2.6 Hub and spoke operations connect both long haul and short haul services. Because the services interconnect they sustain bigger aircraft, particularly on long haul routes, and a wider density of routes than would otherwise exist. Long thinner routes in particular can be operated efficiently and profitably. This benefits transfer passengers who can fly to a wide range of destinations by connecting at the hub. It also benefits the local market, as the density of traffic is increased and more destinations and frequencies can be offered. Airports (and airlines) are thus able to obtain important economies of scale and scope in the combination of transfer and point to point traffic through hub and spoke operation. At Heathrow, about 35% of passengers are currently carried in transit and 65% are using Heathrow as a point of entry or departure. (For BA, the percentage of transfer passengers at Heathrow is higher).
- 2.7 The minimum requirement for a hub and spoke operation has been at least two runways. Now to be competitive globally a third runway is needed⁷. The government has recognised this and plans a third runway at Heathrow.
- 2.8 This is because hub and spoke airlines must be able to coordinate convenient timings of incoming and outgoing flights, with waves of incoming long haul flights (e.g. in the early morning) connecting with waves of short haul flights departing shortly afterwards. The pattern continues through the day, with a second major peak with short haul early evening arrivals connecting with evening long haul departures. This requires a much greater density of flights, to allow different connections across the long haul and short haul services.
- 2.9 Runway length is also an issue. As noted above, hub and spoke operations use bigger aircraft. These are the most demanding in terms of runway length to enable safe departures with a full payload and fuel load. Heathrow has the longest runways, and is best able to meet these needs, followed by Gatwick. The existing and proposed runways at Stansted and the runways at the other airports in the South East, in particular Luton, are too short for the largest aircraft (at full payload-range capability) and for the longest-range long-haul aircraft, to be suitable for a full hub and spoke operation.
- 2.10 Therefore, Heathrow is the only airport in the South East that can provide a viable hub infrastructure for network airlines based in the South East. In recognition of the difficulty

⁷ The airport under construction in Dubai will have six runways. See further Table 3.1 at paragraph 3.27 below.

in splitting network operations of airlines across more than one airport, and the incumbency advantage of Heathrow as a hub and spoke operation, the 2003 white paper ruled out developing Stansted (or any other airport in the South East) as a second international hub to compete with Heathrow.⁸

- 2.11 In any event, it is not possible for an airline efficiently to base network operations on two adjacent airports. BA was forced to try to do so at Heathrow and Gatwick in consequence of capacity constraints at Heathrow, but the increased costs of a split hub operation (assessed at around £450m per year in 2000) and the loss of economies of scale and scope (Heathrow and Gatwick overlapping for local passengers) led to the decision of BA to 'de-hub' Gatwick.
- 2.12 Heathrow's main hub and spoke competitors for those passengers making use of hub and spoke services to transfer to onward destinations are in Europe (Frankfurt, Amsterdam and Paris) and increasingly, the Middle East. In this connection, two points are relevant:
- (i) For the purposes of Part 4 of the EA, in considering whether any feature of a market in the United Kingdom affects competition, it is appropriate to have regard to any market operating in the United Kingdom and in another country or territory⁹. Thus, the CC may consider features affecting both competition between Heathrow and overseas airports providing hub and spoke services, and competition as between BA as a network operator and other network airlines based on hub airports located outside the UK.
 - (ii) As described more fully in section 3 below, capacity constraints at Heathrow do prevent or restrict competition in various ways: there are constraints on the number of flights and thus destinations BA can serve as a network operator; capacity constraints impede operational efficiencies, exacerbate the consequences of any delays (however caused) and result in lower service levels, all of which impair the competitiveness of Heathrow and of BA as the network carrier using Heathrow as a hub, relative to competing hub airports and their network airlines.
- 2.13 Once an airline is committed to a particular airport as the centre of its hub and spoke operation, the barriers to relocating elsewhere become very high. BA is not aware of any airline ever moving its main hub and spoke operation to another airport except where the existing airport has closed.

⁸ The Future of Air Transport, Department for Transport (December 2003); paragraph 11.17.

⁹ EA, section 131(6)(a).

- 2.14 Airlines make long-term investments in their airport bases, which makes wholesale relocation to another hub airport extremely expensive. BA's main base is at Heathrow, and it has substantial investments in its HQ, World Cargo Centre, and in its maintenance operations. Working arrangements of crew and other staff are predicated on the fact that BA is based at Heathrow. In practice, the barriers to exit from Heathrow are insurmountable.

Point to point services

- 2.15 Airlines compete to serve passengers travelling to or from particular airport destinations. The key factor thus becomes the catchment area over which passengers can be attracted to travel from a given airport (or are prepared to use as the point of arrival).
- 2.16 BA agrees with the OFT that passenger demand for an airport depends on a variety of factors, including:¹⁰
- (i) the destinations served by airlines operating at the airport, frequency of service, price and availability;
 - (ii) convenience of the airport in terms of distance from journey start point and availability of surface access links; and
 - (iii) possibly the quality and price of airport services, including car parking and retailing.
- 2.17 BA also agrees with the OFT that the geographic market for the provision of point to point services extends to the South East and East Anglia. This is in consequence of a combination of factors which include:
- (i) substantial overlaps as between airports in the South East (notably Heathrow, Gatwick and Stansted) when viewed in terms of the postcode areas from which they attract passenger traffic (and correspondingly, the importance of London as an eventual destination for incoming passengers);
 - (ii) significant overlaps in the route-pair destinations served from those airports (particularly when account is taken of the fact that destination areas may themselves be served by several airports¹¹)

¹⁰ BAA – The OFT's reference to the Competition Commission (April 2007); paragraph 4.12.

¹¹ By way of example, Milan and its surrounds are served by Linate, Malpensa and Milan-Bergamo.

- 2.18 A similar view has on occasion been taken by the EU Commission when considering competition as between airlines on route pairs.¹²
- 2.19 There is some limited scope for airlines to switch point to point services as between different airports in the South East. However, their willingness and ability to do so may be constrained by a variety of factors which may include significant investment in assets and personnel to support a substantial operational base at a given airport, or their desire to avail themselves of network benefits (for example, airline alliance partners operating at Heathrow). However, this does not mean that airlines do not consider that the different airports in the South East form part of the same competitive set, given the readiness of airline passengers to switch airports and airlines.
- 2.20 In its reference decision, the OFT defined the relevant product market as being for 'airport services' generally, while leaving open the possibility that in relation to long-haul services a higher specification of infrastructure might be required. It is true that long-haul services require more highly specified infrastructure (longer runways, larger stands and wider taxi-ways to deal with larger aircraft, as well as greater terminal space to deal with larger passenger groups at check-in and departure gate). However, each of Heathrow, Gatwick and Stansted (and to a lesser extent Luton) can cater for point to point long haul services (as they tend to use smaller aircraft than hub and spoke long haul operations). In those circumstances, little purpose is served in the context of the present enquiry in segmenting short and long-haul point to point services.
- 2.21 Joint ownership by BAA of the three largest airports in the South East has resulted in very severe restrictions of competition at the level of provision of airport services: BAA has no incentive to promote vigorous intra-group competition, but instead has sought to manage the airports on a 'system basis'. As recently as May 2005 BAA proposed a levy of £0.50-£1 per passenger at all of its airports in the South East in order to cross subsidise the further development of Stansted: this would equate to a subsidy of about £4 per Stansted passenger by passengers at Heathrow and Gatwick. The system of economic regulation in place is not apt to overcome these difficulties, and in particular does not provide accurate investment signals. This in turn produces considerable distortions of competition in the provision of point to point airline services: by way of example, costs of operation and capacity constraints at Heathrow mean operators based there have no ability to adopt the highly successful low cost carrier business model deployed notably by operators at Stansted.

¹² BA notes that the European Commission is market testing remedies on the London-Dublin route in Ryanair/Aer Lingus (Case M.4439) where Ryanair serves Dublin-Stansted and Aer Lingus serves Dublin-Heathrow.

Cargo

- 2.22 Cargo is either carried in dedicated 'all cargo' planes or as 'belly cargo' in the hold of - typically long haul - passenger planes. Around 70% of UK air cargo is carried as 'belly cargo'. Insofar as concerns service requirements at the airport for cargo traffic, these principally require sophisticated IT systems for picking and 'track and trace', as well as provision of suitable storage facilities (e.g. refrigeration). For 'belly cargo', much of which is transferred, facilities for rapid and efficient transfer are needed.
- 2.23 The current Traffic Distribution Rules¹³ which were introduced by the DfT in the mid-1980s, exclude 'all cargo' operators (and small ad hoc aircraft movements of general aviation and business jets) from Heathrow and Gatwick at peak times (which cover most of the operating day). Some 'all-cargo' operators use Luton, but the runway is too short for fully laden large aircraft (as noted above, see paragraph 2.9). Stansted is thus the only option in the South East for adding new long-haul 'all cargo' operations.

¹³ Airports Act, 1986, section 31.

3. THE THEORY OF COMPETITIVE HARM

- 3.1 BAA has neglected investment in increased runway capacity at Heathrow. The incentives to expand runway capacity at Heathrow are blunted by the fact that BAA owns not only Heathrow but its principal competitors in the South East - Stansted and Gatwick - as well. The current regulatory regime does not correct these distorted incentives. The result is the distortion and restriction of competition at the levels of airline operations and the provision of airport services to airlines in the markets for hub and spoke operations at Heathrow and elsewhere, and in point to point operations in the South East.
- 3.2 Competition between 'all-cargo' operators is distorted by the Traffic Distribution Rules.
- 3.3 Each of these factors is considered in further detail below.

Neglect of investment in runway capacity at Heathrow

Prior to 2003

- 3.4 At no time over the last 25 years has BAA actively campaigned to influence government policy to allow increases in Heathrow's runway capacity, despite the fact of Heathrow being capacity constrained.
- 3.5 For much of the consultation period preceding publication of the 2003 white paper, BAA produced no work on, and did not lobby for, increasing Heathrow's runway capacity, concentrating instead on options for additional runways at Stansted and Gatwick (and Glasgow and Edinburgh). There were many opportunities to influence government policy, including the 1998 white paper¹⁴ and the government's consultation on future development of air transport in the South East in 2002.¹⁵
- 3.6 Indeed, at the second inquiry into Terminal 5 (which took place between 1995 and 1999) BAA invited the inspector to rule out both mixed mode operations on the two existing Heathrow runways and a third runway. BA strongly opposed this move. BAA had not even conducted a cost/benefit analysis on the Heathrow runway options. BA understands that securing planning approval can involve compromise, but a decision by the planning applicant voluntarily to fetter long term capacity expansion opportunities should not be taken without full knowledge of the possible consequences.

¹⁴ A New Deal for Transport: Better for Everyone; Department for Transport (1998).

¹⁵ The Future Development of Air Transport in the United Kingdom: South East; Department for Transport (July 2002).

- 3.7 BAA has suggested that it was not possible to do any work on Heathrow runway options whilst the T5 decision was pending due to the sensitivities involved. BA does not (and did not at the time) accept this explanation. As noted above, the government had already made clear that it was committed to a wide-ranging national consultative exercise on airport policy (which ultimately led to the 2003 white paper) by the time BAA invited the T5 inspector to rule out mixed mode and a third runway at Heathrow.
- 3.8 The T5 planning decision explicitly stated that it did not fetter consideration by the government of future runway options for Heathrow. Yet still BAA did not begin work to create the Heathrow runway options, let alone lobby for them. In contrast, BA began work on options to increase runway capacity at Heathrow immediately after the conclusion of the second T5 inquiry and shared the results with government policy makers. It was only during the last months of the process, once BA had secured Heathrow's place on the government's agenda, that BAA began some work on the options for expanding runway capacity at Heathrow.
- 3.9 BAA's neglect of the Heathrow runway options is all the more surprising given that for many years prior to the publication of the 2003 white paper Heathrow was the only BAA airport in the South East where government policy was not *against* expanding runway capacity: a 1979 planning agreement prevents BAA from promoting a new runway at Gatwick until 2019 and the 1985 white paper had ruled out a second runway at Stansted. Contrast the proactive campaigning by other airports for capacity expansion: Manchester Airport Group campaigned successfully in the 1990s for a second runway at Manchester airport; similarly the owners of Luton airport campaigned for a second runway prior to publication of the 2003 white paper which they continue to promote.

No significant progress since 2003

- 3.10 Despite the conclusion in the 2003 white paper that a new runway should be built at Heathrow between 2015 and 2020 (albeit second in priority to a new runway at Stansted and conditional on compliance with air quality limits and noise restrictions and improved public transport access), BAA has continued to neglect runway expansion at Heathrow.
- 3.11 The addition of a new runway at Heathrow within 12 to 17 years of publication of the white paper is a challenging task: it will be 23 years from publication of the white paper supporting Heathrow Terminal 5 in 1985 by the time it opens in March 2008. Determined action by BAA was required from the outset.¹⁶ Yet BAA committed just two

¹⁶ This was recognised by the government: "...We will therefore institute immediately, with the airport operator and relevant bodies and agencies, a programme of action to consider how these conditions can be met in a way as to make the most of Heathrow's two existing runways and to enable the addition of a third runway as soon as practicable after a new runway at Stansted...". The Future of Air Transport; Department of Transport (December 2003); paragraph 11.63.

full time members of staff to the project for the first two years after publication of the White Paper in 2003 and spent about £2m¹⁷. This is a fraction of the resource BAA has devoted to Stansted where BAA set up a large team and spent £74.5m between January 2004 and June 2006 to develop the second runway project¹⁸. By March 2007 this had risen to £103m¹⁹. BAA's failure to commit sufficient resources to the Heathrow project has jeopardised delivery of the new runway within the ambitious timeframe set by the government.

- 3.12 Contrast BAA's willingness to make significant investment in facilities which suit its commercial interests but which are not of the highest priority for airlines. The Heathrow East terminal (HET) is the planned replacement for the existing Terminals 1 and 2. It which was conceived entirely by BAA, without input from users, and has a team of more than 60 full time staff. BAA plans to spend £60m on developing it before March 2008 (funding which was not scrutinised or approved by airlines).²⁰
- 3.13 Had BAA been committed to adding a third runway at Heathrow BA would have expected it to:
- (i) Immediately after publication of the white paper in 2003 announce a pro-Heathrow runway development position, rather than remain passive and non-committal.
 - (ii) Create a fully resourced team to work on all aspects of the options for development.
 - (iii) In particular, resourced a high-powered team to work on air quality issues, to inform and assist the government led work and to prepare plans.
 - (iv) Led a communications and lobbying strategy with local and regional authorities (as it has done with HET) to inform and broaden the positive climate of opinion already held by businesses, trade unions, airlines and many local people to further expansion at Heathrow.
 - (v) Abandoned efforts to justify cross subsidy of Stansted.

¹⁷ BAA (Tabitha Stebbings) (8 June 2007).

¹⁸ BAA Stansted Generation 2 - Quarterly Expenditure Update: 1st Qtr 06/07 (July 06).

¹⁹ BAA Stansted Generation 2 - Quarter Expenditure Update: Jan to March 07 (April 07).

²⁰ BAA capital programme (2007).

- (vi) Created a plan and vision for the area and region in which Heathrow lies to show how the benefits of expanding the airport could be best captured.
- (vii) Entered into a long term agreement with NATS that would ensure that resources for taking forward the airspace planning and development necessary for Heathrow's runway expansion would be fully allocated with secure long term funding.

Reasons for neglect of Heathrow

Joint ownership

- 3.14 BAA's incentive to expand runway capacity at Heathrow is distorted by the fact that it also owns Heathrow's principal competitors in the South East, namely Heathrow and Gatwick. As owner of all three, BAA would effectively be the beneficiary of any major expansion of airport capacity in the South East such as results from a new runway. So it is in a position to take investment decisions which suit its commercial aspirations as owner of Heathrow, Stansted and Gatwick, rather than those which are in the best interests of any particular one of those airports (and its users).
- 3.15 BAA has an incentive to secure full capacity utilisation and to develop new capacity at Stansted, in the knowledge that passenger demand (including future passenger growth) will be "spilt" from Heathrow to Stansted to utilise that capacity. BAA has frequently argued that traffic volumes at Stansted (as well as Luton and Gatwick) are driven by capacity shortages at Heathrow.²¹ And it claims that investment at Stansted is not justified on the basis of demand from Stansted users, but instead on spilt demand from Heathrow and as such users at Heathrow should fund expansion at Stansted.²²

Regulatory regime

- 3.16 The current regulatory regime incentivises BAA to undertake investment (much of it pre-funded) which will increase the RAB on which its permitted revenues are calculated. This encourages BAA to invest generally. However, it does not necessarily ensure that the investment projects undertaken are those best suited to meet the needs of airport users, including airlines. At Heathrow, the regime has resulted in extensive terminal investment, much of it essential (Terminal 5) or highly desirable, but has manifestly failed to bring forward investment to relieve chronic runway and airfield congestion through capacity expansion, notwithstanding the move away from overall 'system'

²¹ See BA's submission to the OFT (4 October 2006).

²² This was a principal argument at the time of the Q4 review, when BA campaigned for maintenance of the integrated 'system' approach to its three South East Airports. In the event, the current regulatory system provides for separate regulation of airports which prevents cross subsidisation.

regulation at the three South East airports to separate regulation of each airport, during Q4.²³

- 3.17 A particular feature of the current airports regime is that it imposes no statutory (or other) duties on BAA to seek to ensure that all reasonable demands for airport services at its key airports are met, including through investment in new capacity. As the OFT notes in its reference decision BAA will only commit to investment if it obtains a satisfactory return²⁴. The consequence is an asymmetric regulatory regime where the CAA can persuade BAA to invest only by use of a carrot, and without recourse to a stick.
- 3.18 In this respect the regulatory regime for airports is at odds with more modern regimes applicable in respect of other regulated entities which are the subject of regulatory duties. For example, National Air Traffic control services (NATS) is required under s.8 of the Transport Act 2000 to take all reasonable steps to ensure that the air traffic control system is efficient and co-ordinated, to secure that demand for ATC services is met, and to have regard in providing, developing and maintaining the system, to the demands which are likely to be placed on it in the future. Appropriate statutory duties are also imposed on undertakings in the water, electricity and gas industries, and under the licence regime on National Rail: see Annex 1.

Planning regime

- 3.19 Planning restrictions make new entry into airport provision highly unlikely.²⁵ Any increase in airport capacity must therefore be delivered through more efficient use of existing runways (e.g. mixed mode operations) or the addition of new runways at existing airports.
- 3.20 Clearly the delays and complexities involved in the planning regime exert some constraint on increasing airport runway capacity. But they cannot be taken to explain or justify BAA's neglect of runway capacity expansion at Heathrow over the last 25 years.

²³ It has also failed to bring forward investment in other critical areas at Heathrow, such as pier service both at Heathrow generally and at T5 in particular, aircraft stand provision and the Eastern Maintenance Area and Apron redevelopment. See paragraphs 2.36 to 2.40 and 3.7 to 3.14 of BA's submission to the CC on the Q5 review (submitted 10 May 2007).

²⁴ BAA - The OFT's reference to the Competition Commission at paragraph 1.7 (capacity expansion) and 5.39 (the HET terminal investment).

²⁵ BAA – The OFT's reference to the Competition Commission (April 2007); paragraph 5.4.

- 3.21 In any event, the government's 2007 white paper proposals for reform of the planning process in relation to large infrastructure projects may alleviate to some degree the constraints imposed by the planning regime.²⁶

Harm to competition

- 3.22 As the OFT notes, all of the runways at BAA's airports in the South East are operating at capacity at peak times of the day.²⁷ The constraints are particularly severe at Heathrow which operates at capacity at most times of the day most days of the year.²⁸
- 3.23 This results in the restriction and distortion of competition at the levels of airline operations and the provision of airport services to airlines in the markets for hub and spoke operations at Heathrow and elsewhere, and in point to point operations at airports in the South East.

Hub and spoke

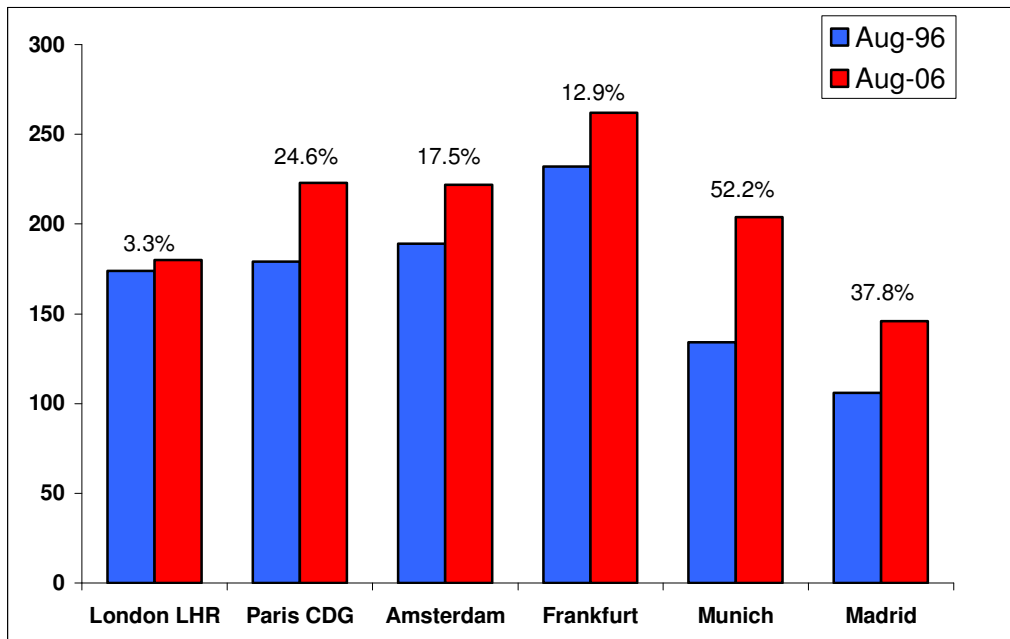
- 3.24 Despite considerable growth in the air transport industry over the last decade, Heathrow has barely moved in terms of the route network it can offer. As shown in Figure 3.1, since 1996 Heathrow's total of destinations served non-stop has increased by about 3% (but its total route network (including stopping services) has fallen by 5%). But Heathrow now offers barely two-thirds the reach of Frankfurt and trails Amsterdam and Paris by nearly 25%. And the spectacular growth of Munich means that Heathrow now lies fifth in the European table of airports serving destinations non-stop, though even fifth position appears under threat from Madrid.

²⁶ Planning for a Sustainable Future; Department for Communities and Local Government and others (May 2007).

²⁷ There are also capacity constraints in relation to pier service, aircraft stands, baggage systems. This submission concentrates on runway capacity constraints, since this is the key issue affecting the growth of the air transport industry in the South East.

²⁸ BAA – The OFT's reference to the Competition Commission (April 2007); paragraph 5.12.

Figure 3.1
Destinations served non-stop from European hub airports (1996 v 2006)



Source: Official Airline Guide.

3.25 This is a serious decline. A static or declining Heathrow makes the airport a less attractive hub for transfer passengers. As noted above, transfer passengers have a choice of airport. And they are willing to use it: the additional security measures introduced in the UK in August 2006 resulted in significant numbers of transfer passengers using hub airports elsewhere in Europe. As shown in Figure 3.2, (≈). Permanent shifts of transfer passengers away from Heathrow of this magnitude would be likely to result in further shrinkage of Heathrow's network as against those offered by other European hubs and in absolute terms.

Figure 3.2
BA Transfer Passengers - August 2006 Security Disruption

(≈)

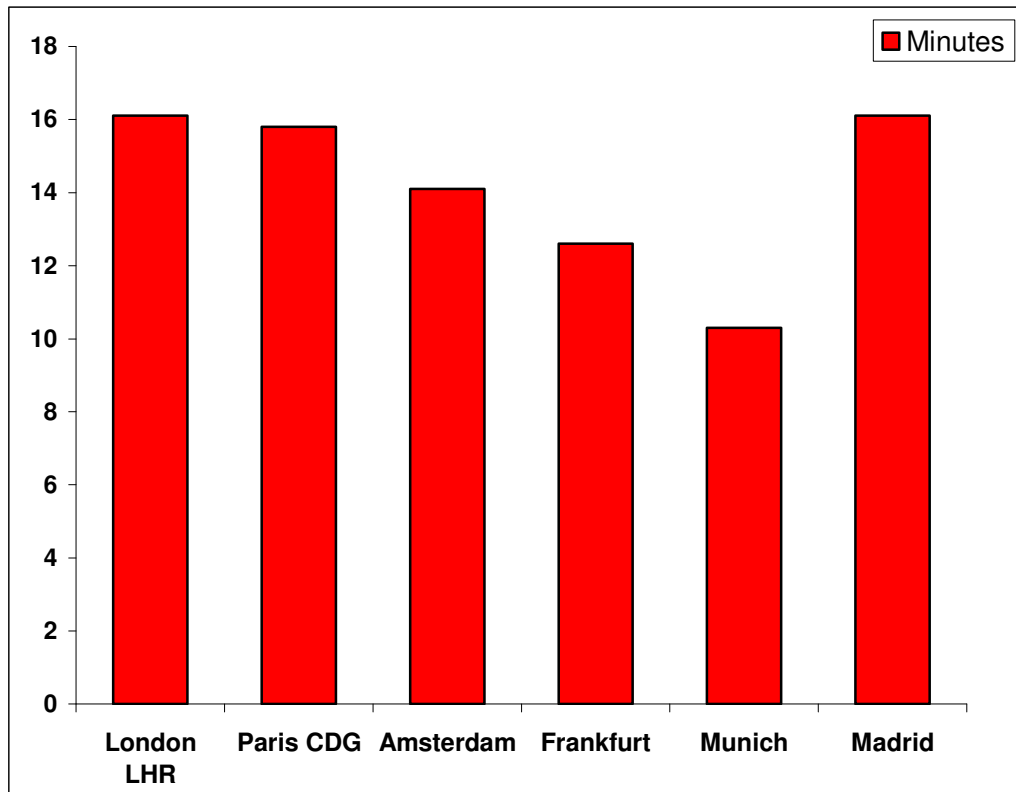
Source: BA.

3.26 Delays are an increasingly serious problem at Heathrow. Around one-third of Heathrow departures take off more than 15 minutes late²⁹. This is the worst record of any airport

²⁹ Association of European Airlines.

in the UK, and significantly worse than any other major European hub. Data from Eurocontrol (2006) show that the average delay for departures and arrivals at Heathrow is 40% worse than the German hubs at Frankfurt and Munich (see Figure 3.3)³⁰. Congested runways mean extra minutes spent stacking in the air, being held at taxiway points on the ground or waiting for stands to clear. Late inbound aircraft result in late outbound aircraft. With no slack in the system delays can multiply out of control, forcing airlines to cancel services.

Figure 3.3
Delays at European hubs 2006



Source: *Eurocontrol: Digest - Annual 2006 - Delays to Air Transport in Europe, p.15.*

3.27 All of Heathrow's hub competitors are better placed in terms of runway capacity (see Table 3.1). Paris, Madrid and Amsterdam already have capacity for 120 movements per hour, nearly 50% more than Heathrow's current limit of 85. Frankfurt and Munich will reach 120 long before the earliest date for delivery of a third runway at Heathrow (2015)

³⁰ Performance at Madrid is set to improve with the opening of two new runways in March 2006.

with new runways planned to open in 2010 and 2011 respectively. And with its six full length runways and lack of night flight restrictions, the new Dubai World Central airport will also represent a significant threat to Heathrow.

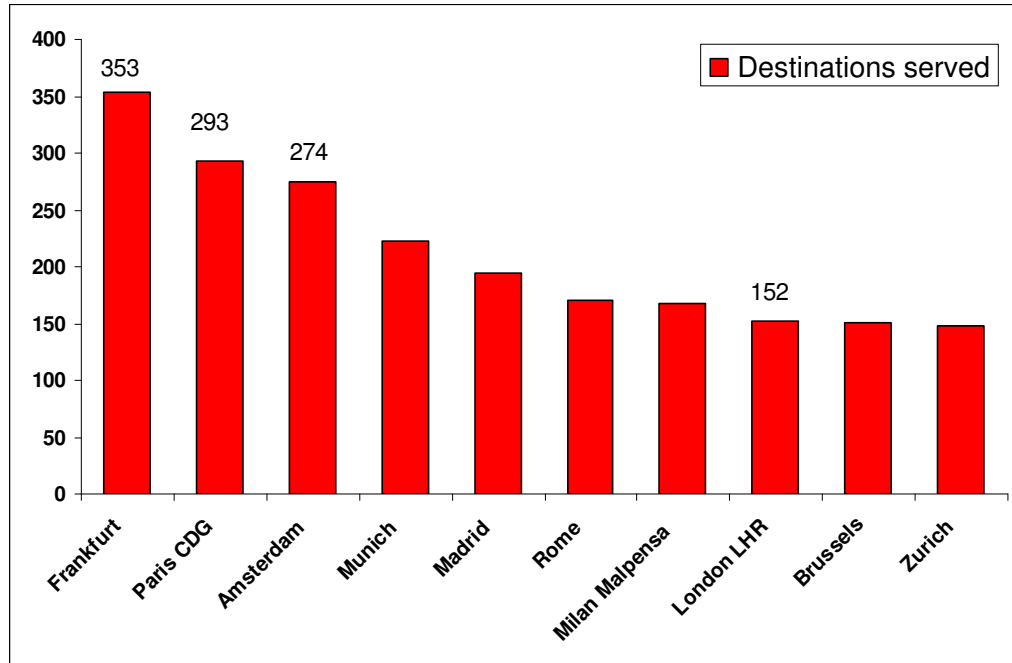
Table 3.1
Maximum movements per hour

Airport	Runways	Max movements per hour
Paris CDG	4	120
Madrid	4	120
Amsterdam	5	120
Frankfurt	3/4 ^[1]	100/120
Munich	2/3 ^[2]	89/120
Heathrow	2	85

Notes: [1] New runway planned to open in 2010
[2] New runway planned to open in 2011

- 3.28 There will be further serious erosion of the ability of Heathrow and BA to compete against other European hubs and their network airlines (not to mention Dubai) if nothing is done to increase runway capacity at Heathrow by 2015. BA projects that the squeeze on slots would lead to the loss of almost thirty destinations compared with today, leaving Heathrow in eighth place in terms of airports serving destinations non-stop (see Figure 3.4). With continued growth elsewhere, Heathrow's network would be only 43% the size of that offered by Frankfurt and barely half that offered by Paris and Amsterdam.

Figure 3.4
Destinations served projected to 2015 without
extra runway capacity at Heathrow



Source: BA.

- 3.29 Such a drastic erosion of Heathrow's competitive position as a hub airport is likely to impact outside of the air transport industry. The 2003 white paper notes that:

*"...[Heathrow] competes...primarily with the major continental airports of Northern Europe, such as those at Amsterdam, Frankfurt and Paris. And in doing so it helps London and the South East compete for business investment and economic growth with those cities and their surrounding regions. This in turn produces economic benefits – direct and indirect – for the rest of the UK. The airport directly or indirectly supports nearly 100,000 jobs..."*³¹

- 3.30 Unless Heathrow keeps pace with the competition, London and the South East will lose out to hubs located elsewhere on business investment and the economic growth that results. Estimates by Oxford Economic Forecasting (see report at Annex 2) suggest

³¹ The Future of Air Transport; Department for Transport (December 2003); paragraph 11.49.

that in net present value terms a third runway at Heathrow will generate increased GDP of £27 billion over the period to 2030 (2005 prices)³².

- 3.31 There has also been a decline in domestic routes served from Heathrow. The scarcity of slots has resulted in the disappearance of connecting flights to parts of Scotland, and to the North and South West of England. Since 1995 the number of regional airports in the UK served from Heathrow has fallen from 21 to 9: services between Heathrow and Dundee, Carlisle, Humberside, the Isle of Man, Plymouth, Newquay and many others have all been forced out. All of these are areas where connectivity to London and the South East is important in attracting investment.

Point to point

- 3.32 The scarcity of capacity at Heathrow also hampers its ability and that of its airlines to compete for point to point traffic with other airports in the South East such as Gatwick and Stansted. As noted above, there is evidence of passenger switching away from Heathrow. That is likely to increase if the Heathrow capacity constraints and the resulting decline in the number of routes served by Heathrow, increased delays and other service quality failures (which already place Heathrow near the bottom of the table of service quality measured at international airports³³) continue.
- 3.33 Switching of point to point traffic away from Heathrow also adversely impacts on BA's hub and spoke operation. As noted above, network connectivity is important, and a combination of transfer and point to point traffic enables economies of scale and scope to be captured.

Cargo

- 3.34 The Traffic Distribution Rules (TDRs) distort the cargo market by effectively limiting "all-cargo" operators (other than those with long standing historic slots³⁴) to Stansted.
- 3.35 The current TDRs were put in place in 1985, at a time when Stansted was markedly less full than Heathrow or Gatwick.³⁵ It is not clear why the TDRs should continue to exclude all-cargo operators from Gatwick since capacity constraints are similar at

³² The Economic Contribution of the Aviation Industry in the UK; Oxford Economic Forecasting (Autumn 2006); paragraph 9.3.

³³ BAA – The OFT's reference to the Competition Commission (April 2007); paragraphs 5.118 et seq.

³⁴ Though BA notes that in 2005 BAA consulted on restricting existing all-cargo operations at Heathrow and Gatwick.

³⁵ In 1991 most Traffic Distribution Rules were removed. The only ones that were retained were the rules that related to all-cargo services and small ad hoc aircraft movements (general aviation and business jets).

Gatwick and Stansted. The recent announcement of EU/US "Open Skies" should free up some capacity at Gatwick as carriers take the opportunity to move to Heathrow.

4. REMEDIES

Neglect of investment in runway capacity at Heathrow

Ownership separation

- 4.1 The blunting of incentives to invest in new runway capacity at Heathrow resulting from joint ownership of Heathrow, Gatwick and Stansted may ultimately be dealt with by ownership separation of Heathrow and Stansted. But very considerable timing delays would inevitably ensue in achieving ownership separation. The timescale for the enquiry is up to two years, and it is possible that BAA would seek to mount a legal challenge to any adverse findings. Settlement of the terms of remedies would follow thereafter, and BAA would be given a reasonable period of time to restructure and undertake a sale process. In all, a delay of three to five years from now appears plausible. Thereafter, it may take several years for investment incentives to work. Yet immediate action needs to be taken and pursued if a new runway is to be built at Heathrow to meet the Government target of 2015-2020.

Public commitment by BAA

- 4.2 BA therefore believes that a more immediate remedy would be for BAA publicly to adopt a clearly thought through strategy aimed at delivering the investment in mixed mode (initially to improve operational robustness) and a third runway at Heathrow in timely fashion. BA recognises that since summer 2006 BAA has committed further resources to the Heathrow runway project³⁶ and notes recent press reports³⁷ that BAA is joining the 'Future Heathrow' interest group. But remains to be convinced that this represents a definitive shift in BAA's attitude and commitment to capacity expansion at Heathrow.
- 4.3 As part of the government 2007-2008 consultation on mixed mode operations and a third runway at Heathrow, BAA needs to commit to:
- (i) An objective of reducing average delays at Heathrow to no more than 5 minutes, to be implemented as soon as the result of the consultation allows.

³⁶ Though the level of resource invested by BAA still falls some considerable way short of the level that BA would expect on a project of this magnitude (as noted in paragraph 1.13 above). In particular, there is no sign that BAA is planning to set up a full team to develop the planning application for a third runway and/or mixed mode immediately after a favourable outcome of the consultation on the Heathrow runway options in 2008 (before the white paper was published in 2003 BAA made plans for a fully resourced team to be set to work on a second Stansted runway and announced them within a few weeks of publication).

³⁷ Sunday Times, 10 June 2007.

- (ii) The objective of opening the first phase of runway 3 as soon as possible, with a published target of 2015. This will enable users, businesses, local authorities and local residents to plan and prepare with a greater degree of certainty and in the knowledge of BAA's set purpose.
- (iii) Including funding for the planning application and inquiry for runway 3 and mixed mode in the 2008-13 capital plan (to be withdrawn if agreed by the airlines and regulator only if the public consultation is not successful). This is likely to involve some £100m capital expenditure.
- (iv) To agreeing capital expenditure triggers for runway 3 initial building as well as for potential mixed mode investment in the Q5 settlement.

4.4 BA would expect BAA to proceed on the assumption that the consultation recommends development of a third runway at Heathrow at its conclusion in 2008. For this purpose, it needs to develop a clear project plan designed to achieve the milestones set out in Table 4.1.

Table 4.1
Actions required by BAA to deliver third runway at Heathrow by 2015

Action	Timeframe
Preparation of planning case, including pre-application discussions and negotiations with Hillingdon local authority.	2008-2010
Detailed airspace design and approval.	2008-2012
Planning inquiry	2010-2012 ^[1]
Planning approval	2012-2013 ^[2]
Build and open phase 1 of the third runway (including taxiways, airfield links to existing terminals)	2013-2015 ^[3]
Phased opening of Terminal 6 capacity, and surface access	2015-2018 ^[3]

Notes: [1] Likely to be in 2010 if the Independent Planning Commission (IPC) is in operation.³⁸
 [2] Likely to be in 2011 if the IPC is in operation.
 [3] May be earlier if the IPC is in operation.

4.5 If BAA were to satisfy BA and other critics as to the seriousness of its commitment to Heathrow, and if steps were taken through the regulatory regime to underpin that commitment, then this would serve somewhat to reduce many of BA's current concerns

³⁸ See Planning for a Sustainable Future; Department for Communities and Local Government (and others) (May 2007); paragraph 1.46.

over distortion of investment incentives. In terms of speed and effectiveness, this is preferable to ownership separation in remedying the lack of investment in runway capacity at Heathrow.

Regulatory regime

- 4.6 While the current regulatory regime has over the years delivered a number of benefits ('single till' price control with separate caps for each of the London Airports and the quality standards regime), the effect of the current regulatory regime in distorting investment incentives needs to be remedied by updating the regulatory regime. In addition to the current duties imposed on the CAA (which may need updating)³⁹, BA considers that the regime should incorporate the elements of:
- (i) Imposing appropriate statutory duties and obligations on the owners/operators of key airports. These may (by analogy to precedent) include taking all reasonable steps to ensure that current and reasonably anticipated future demand from users for airport services at key airports are met. It is also frequently the case that the statute foresees a licence containing conditions imposing on the licensee obligations to meet service standards and to promote competition as between users.
 - (ii) A requirement for owner/operators of key airports to be licensed. This provides the means of specifying in greater detail how the statutory duties imposed on both the CAA as regulator and the owners/operators as licensees are to be discharged, and permitting flexible on-going regulation of the licensees. The licence regime would contain the charge control, but the imposition of statutory duties on the owner/operator will permit greater regulatory oversight and control over investment and its remuneration under the charge control, and permit the current imbalance in favour of BAA to be corrected. Other licence provisions should include financial ring-fencing (designed to avoid the risk that financial stress on the airport business will affect investment to the detriment of airport users and competition), and appropriate service standard requirements, capable of fine-tuning as required (and more frequently than once every five years).
- 4.7 BA sees no circumstances in which ownership separation (and the resulting promotion of competition between airports) will obviate the need for on-going economic regulation, including in particular charge control (based on 'single till' price caps set for each London airport separately). Otherwise, the airport operator would be able to levy charges higher than would be the case in a perfectly competitive environment since even large airline operators like BA face insurmountable barriers to switching in consequence of a combination of their sunk costs of investment at the airport, and the

³⁹ Though BA thinks the current involvement of the CC in the quinquennial review process works well.

nature of their operations (Heathrow as a hub and spoke airport): see generally section 2 above. At most, competition in consequence of ownership separation may enable a 'lighter touch' regime to be put in place.

Cargo

- 4.8 BA believes that the TDRs should be amended so as to allow all-cargo operators to access Gatwick. Of course, if sufficient runway capacity was made available at Heathrow, there may be no continuing requirement for TDRs at all.

ANNEX 1

BA sets out below key features of the regulatory regimes affecting air traffic control, water, electricity, gas and rail.

1. Air Traffic Control (“ATC”)

Statutory duties on licence holder

1.1 The Transport Act 2000 requires the holder of an air traffic control licence to:

- Provide, develop and maintain a safe system for the provision of ATC services.
- Take all reasonable steps to secure that the system is efficient and co-ordinated.
- Take all reasonable steps to secure that demand for ATC services is met.
- Have regard, in providing, developing and maintaining the system, to the demands which are likely to be placed on it in the future⁴⁰.

Statutory duties of CAA as economic regulator

1.2 The Transport Act 2000 requires that, in addition to its paramount duty in relation to safety, the CAA must exercise its functions as regulator in the manner it thinks best calculated:

- To further the interests of operators and owners of aircraft, owners and managers of aerodromes, persons travelling in aircraft and persons owning property carried in aircraft. The interests to be considered are interests regarding the range, availability, continuity, cost and quality of air traffic services⁴¹.
- To promote efficiency and economy on the part of licence holders.
- To secure that licence holders will not find it unduly difficult to finance activities authorised by their licences.⁴²

⁴⁰ Section 8.

⁴¹ Section 2(3) Transport Act 2000. Section 2(4) requires the CAA to promote competition in the provision of air traffic services where it thinks that appropriate.

⁴² Section 2(2) Transport Act 2000. This subsection also includes duties to take account of the UK's international obligations and environmental objectives.

Licence conditions on licence holder

1.3 NATS (En Route) Plc (“NATS”) holds an ATC licence granted by the CAA. The licence contains a variety of obligations. The major service level obligations are as follows:

- NATS must make available certain core ATC services “so as to be capable of meeting on a continuing basis any reasonable level of demand for such services.”⁴³ In determining what is reasonable for the purposes of the above obligation regard shall be had to:
 - The level of overall demand reasonably expected to be met at the relevant time on the basis of the Service and Investment Plan provided by NATS.
 - The effect on overall demand of changes in legal or regulatory requirements made subsequent to the Service and Investment Plan (provided that NATS has taken all reasonable steps to meet the subsequent changed demand).⁴⁴
- NATS must meet each request for the provision of core ATC services reasonably made by any person⁴⁵.

1.4 In providing ATC services NATS must not discriminate against or give preferential treatment to any persons in the operation of its systems⁴⁶. In addition, NATS must not discriminate against or give preferential treatment to any persons in respect of the terms on which the service is provided, where such terms are likely to have the effect of preventing, restricting or distorting competition⁴⁷.

1.5 NATS must agree with the CAA:

- Measures against which its performance and quality of service may reasonably be assessed.
- Indicators of performance based on the abovementioned measures.

⁴³ Condition 2(1)(a) NATS Licence. In addition to the generally defined core services, NATS is required to provide a number of specific services – condition 2(1)(b) NATS Licence.

⁴⁴ Condition 2(4) NATS Licence.

⁴⁵ Condition 2(5) NATS Licence.

⁴⁶ Condition 2(7) NATS Licence.

⁴⁷ Condition 2(8) NATS Licence.

- Standards of services to be met⁴⁸.

1.6 NATS is required to conduct its business in the manner best calculated to achieve the standards of service specified⁴⁹.

1.7 NATS is also required to comply with several financial ring-fencing restrictions⁵⁰.

2. Water

Statutory duties of water undertakings

2.1 The Water Industry Act 1991 and related subordinate legislation impose multiple duties on a water undertaker. There is a general duty to develop and maintain an efficient and economical system of water supply in the relevant area. As part of the general duty the undertaker must ensure that all such arrangements have been made:

- for providing supplies to premises and making supplies available to persons who demand them; and
- for maintaining, improving and extending the water undertaker's water mains and other pipes;

as are necessary for securing that the undertaker is and continues to be able to meet its specific obligations under the Act⁵¹.

2.2 The specific obligations include:

- A duty to provide to domestic premises such a supply of water as is sufficient for domestic purposes⁵².
- A duty to provide non-domestic supply except to the extent that Ofwat considers it reasonable to limit that duty⁵³.

⁴⁸ Condition 11 NATS Licence.

⁴⁹ Condition 11(3) NATS Licence.

⁵⁰ Condition 5 NATS Licence.

⁵¹ Section 37(1) Water Industry Act 1991.

⁵² Section 52 Water Industry Act 1991.

⁵³ Section 55(2) and 56 Water Industry Act 1991.

- A qualified duty to meet new requests for non-domestic supply⁵⁴.

Statutory duties on OFWAT as economic regulator

2.3 Ofwat is required to exercise its powers and perform its duties as regulator in the manner which it considers is best calculated, inter alia, to:

- Further the consumer objective. The consumer objective is to protect the interests of consumers by promoting effective competition in the provision of water services wherever appropriate⁵⁵.
- Secure that the functions of a water undertaker are properly carried out as respects every area of England and Wales.
- Secure that companies holding appointments are able to finance the proper carrying out of their functions.⁵⁶

2.4 Subject to the above requirements, Ofwat is also required to exercise its powers and perform its duties in the manner which it considers best calculated, inter alia, to:

- Promote economy and efficiency on the part of the relevant undertaker.
- Secure that no undue preference is shown, and that there is no undue discrimination in the fixing of charges by the relevant undertaker⁵⁷.

Conditions in appointment of water undertakings

2.5 Ofwat is authorised to attach such conditions to a company's appointment as a water or sewerage undertaker as it considers expedient in light of its statutory duties⁵⁸. Such conditions typically include:

- A detailed form of price control (including mechanisms to penalise water undertakings if investment programmes are not adhered to)⁵⁹.

⁵⁴ Section 55(3) Water Industry Act 1991.

⁵⁵ Section 2B Water Industry Act 1991.

⁵⁶ Section 2A Water Industry Act 1991.

⁵⁷ Section 2(3) Water Industry Act 1991. This subsection also imposes various duties in relation to disposals, financial ring fencing and sustainable development.

⁵⁸ Section 11 Water Industry Act 1991.

- A prohibition on undue preference or discrimination in charging⁶⁰.
- Provisions for financial ring fencing⁶¹.
- Provisions for setting and attaining service targets⁶².

3. Electricity

Statutory duties of electricity supply and transmission companies.

3.1 Under section 9 of the Electricity Act 1989, a statutory duty is imposed on an electricity distributor to:

- Develop and maintain an efficient, co-ordinated and economical system of electricity supply.
- Facilitate competition in the supply and generation of electricity.

3.2 Section 9(2) imposes on the holder of a transmission licence the duty to:

- Develop and maintain an efficient, co-ordinated and economical system of electricity transmission.
- Facilitate competition in the supply and generation of electricity.

3.3 The Electricity Act 1989 also requires each electricity distributor to conduct its business in a such a way that it can reasonably be expected to meet overall performance standards set by Ofgem⁶³.

Statutory duties on OFGEM as economic regulator

3.4 Ofgem's principal statutory objective as regulator is to protect the interests of consumers and, where appropriate, to do so by promoting effective competition in the generation, transmission, distribution or supply of electricity⁶⁴.

⁵⁹ For example, conditions B to D Instrument of Appointment in respect of Wessex Water Services Limited.

⁶⁰ For example, condition E Instrument of Appointment in respect of Wessex Water Services Limited

⁶¹ For example, condition K Instrument of Appointment in respect of Wessex Water Services Limited.

⁶² For example, condition J Instrument of Appointment in respect of Wessex Water Services Limited.

⁶³ Section 40A(3) Electricity Act 1989.

3.5 In carrying out its functions Ofgem must have regard to:

- The need to secure that all reasonable demands for electricity are met.
- The need to secure that licence holders are able to finance their activities⁶⁵.

3.6 Subject to the above duty, Ofgem is also required to carry out its functions in the manner it considers best calculated, inter alia, to:

- Promote efficiency and economy on the part of licensees and the efficient use of electricity.
- Secure a diverse and viable long-term energy supply⁶⁶.

Licence conditions on licence holder

3.7 A transmission licence⁶⁷ will typically contain provisions imposing:

- Charge control, including provisions preventing charges which would restrict, distort or prevent competition⁶⁸.
- Financial ring-fencing⁶⁹.
- A qualified obligation to enter connection agreements with those wanting to use the system⁷⁰.

⁶⁴ Section 3A(1) Electricity Act 1989.

⁶⁵ Section 3A(2) Electricity Act 1989.

⁶⁶ Section 3A(5) Electricity Act 1989. This subsection also includes requirements in respect of safety and sustainable development.

⁶⁷ Distribution licences will typically contain equivalent terms, see the Electricity Distribution Licence: Standard Conditions.

⁶⁸ For example, condition C7 National Grid Electricity Transmission Plc's Licence. Condition C4 provides for a general charging methodology.

⁶⁹ For example, condition B6 National Grid Electricity Transmission Plc's Licence.

⁷⁰ For example, condition C8 National Grid Electricity Transmission Plc's Licence.

4. Gas

Obligations of gas transporter

4.1 The Gas Act 1986 provides that it is the duty of a gas transporter as respects its authorised area:

- To develop and maintain an efficient and economic pipeline system.
- So far as it is economical to do so, comply with any reasonable request to connect to his system any premises or any other authorised system⁷¹.

4.2 This general obligation is buttressed by several specific supply obligations. First, a gas transporter may be obliged to supply any premises which are situated within 23 metres of a relevant main, or which could be supplied by a pipe provided by the owner or occupier of the premises⁷². Second, a person can request that Ofgem make a ruling that the transporter should upgrade a section of its system. Such a ruling will specify a sum which should be paid to the transporter for the cost of such an upgrade and a reasonable element of profit⁷³.

4.3 It is also the duty of a gas transporter to facilitate competition⁷⁴ and to avoid any undue preference or discrimination⁷⁵.

4.4 The Gas Act also requires each electricity distributor to conduct its business in a such a way that it can reasonably be expected to meet overall performance standards set by Ofgem⁷⁶.

Obligations of OFGEM as economic regulator

4.5 Ofgem's principal statutory objective as regulator is to protect the interests of consumers and, where appropriate, to do so by promoting effective competition in the shipping, transportation or supply of gas⁷⁷.

⁷¹ Section 9(1) Gas Act 1986.

⁷² Section 10 Gas Act 1986.

⁷³ Section 21 Gas Act 1986.

⁷⁴ Section 9(1)A Gas Act 1986.

⁷⁵ Section 9(2) Gas Act 1986.

⁷⁶ Section 33BA Gas Act 1986.

4.6 In carrying out its functions Ofgem must have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands for gas in Great Britain are met.
- The need to secure that licence holders are able to finance their activities⁷⁸.

4.7 Subject to the above duty, Ofgem is also required to carry out its functions in the manner it considers best calculated, inter alia, to:

- Promote efficiency and economy on the part of licensees and the efficient use of gas.
- Secure a diverse and viable long-term energy supply⁷⁹.

Licence conditions on gas transporter

4.8 In addition to the extensive obligations set out in the Gas Act 1986, the standard transporter licence includes obligations in respect of:

- Forecasts of system capacity and development to assist persons seeking connection⁸⁰.
- Charge control and monitoring⁸¹.
- Financial ring-fencing⁸².

5. Rail network

Duties of the Office of Rail Regulation

5.1 The Office of Rail Regulation's statutory duties include promoting:

⁷⁷ Section 4AA Gas Act 1986.

⁷⁸ Section 4AA(2) Gas Act 1986.

⁷⁹ Section 4AA(5) Gas Act 1986. This subsection also includes requirements in respect of safety and sustainable development.

⁸⁰ Condition 25 Gas Transporter Licence: Standard Conditions.

⁸¹ Conditions 4 and 4A Gas Transporter Licence: Standard Conditions.

⁸² Condition 45 Gas Transporter Licence: Standard Conditions.

- Improvements in railway service performance and otherwise protecting the interests of users of railway services⁸³.
- Use of the rail network and development of the network to the greatest extent considered practicable⁸⁴.
- Efficiency and economy on the part of persons providing railway services⁸⁵.
- Competition in the provision of railway services⁸⁶.

5.2 The Office of Rail Regulation must set the terms of rail licence in accordance with the above duties⁸⁷.

Duties imposed under a rail network licence

5.3 Network Rail Infrastructure Plc (“Network Rail”) holds a network licence. Condition 7 of that licence requires Network Rail to secure:

- The operation and maintenance of the network.
- The renewal and replacement of the network.
- The improvement, enhancement and development of the network.

5.4 In securing the above objectives Network Rail is obliged to act in accordance with best practice and in a timely, efficient and economic manner so as to satisfy the reasonable requirements of rail service providers and funders in respect of (i) the quality and capability of the network and, (ii) the facilitation of rail service performance⁸⁸.

⁸³ Section 4(1)(zb) and (b) Railways Act 1993.

⁸⁴ Section 4(1)(b) Railways Act 1993.

⁸⁵ Section 4(1)(c) Railways Act 1993.

⁸⁶ Section 4(1)(d) Railways Act 1993.

⁸⁷ Section 9 Railways Act 1993.

⁸⁸ Condition 7.1 Network Rail Licence.

- 5.5 Network Rail is obliged to take such steps as are necessary or expedient so as to achieve the above objectives to the greatest extent practicable (having regard to all relevant circumstances, including Network Rail's finances)⁸⁹.
- 5.6 Network Rail has, as required by its licence⁹⁰, published the criteria by which it evaluates new projects for the purpose of fulfilling the above obligations. It assesses any scheme against three sets of criteria: (i) financial impact, (ii) compatibility with existing commitments, and (iii) deliverability. It will consider the reasonableness of a train operator's requirements in light of the government's national performance targets⁹¹.
- 5.7 Network Rail is prohibited from unduly discriminating against any person in carrying out its functions⁹².
- 5.8 Network Rail's licence requires financial ring-fencing⁹³.

⁸⁹ Condition 7.2 Network Rail Licence.

⁹⁰ Condition 7.3 Network Rail Licence.

⁹¹ Paragraph 1.3 Network Rail Business Planning Criteria (March 2006).

⁹² Condition 10 Network Rail Licence.

⁹³ Condition 12 Network Rail Licence.

ANNEX 2

The Economic Contribution of the Aviation Industry in the UK
Oxford Economic Forecasting (Autumn 2006)⁹⁴

⁹⁴ Available in hard copy only.