

BATA and IATA Airlines views on the Principles of Future Airport Regulation in the UK

July 2008

Summary

This paper reflects the views of airlines operating in the UK, represented by BATA and IATA. We have consistently said that in our view the current system of airport economic regulation is not fit for purpose. We therefore welcome and fully support the Competition Commission (CC) and Department for Transport (DfT) Reviews into the UK Airports market and economic regulation of the UK airports.

We believe reform of the regulatory framework and a fundamental review of the role of the regulator are absolutely necessary, and that regulatory reform is just as important as structural and ownership remedies.

We recognise that the precise form of economic regulation will depend to some extent on the Competition Commission's conclusions on the BAA market study, and on the remedies imposed. At this stage we are therefore proposing seven key principles for airport regulation as an initial contribution to both the Reviews that are complementary to the more general UK "Better Regulation" principles of proportionality, accountability, consistency, transparency and targeting:

- 1). Regulation will still be needed if the London airports are broken up due to the lack of effective competition between airports and the significant switching costs for airlines.
- 2). Where possible regulation needs to encourage and incentivise market-driven outcomes - this requires regulation to be tailored to the needs of each airport.
- 3). Obligations need to be placed on airport providers through statutory duties and a licensing regime, which can vary to ensure proportionality.
- 4). Regulatory discipline and accountability needs strengthening together with appropriate checks and balances.
- 5). The CC's role in airport inquiries has proved to be indispensable under the current framework and could only be reduced to that of an appeal body provided key safeguards are included in the new framework.
- 6). Important elements of the current regime should be retained, in particular the single till, separate regulation of each airport, statutory objectives towards all users not just consumers, and Government control over airport designation for price control decisions.
- 7). Transition to the new regulatory system needs to be carefully planned so that it does not disrupt the ongoing activities of airports or agreed investment plans.

BACKGROUND

The three London airports Heathrow, Gatwick and Stansted are currently subject to price cap regulation. All are owned by BAA and, together with Southampton, account for 91% of passengers in South East England. There is widespread dissatisfaction with the current approach to airport regulation particularly amongst airlines.

The Competition Commission's (CC) "Emerging Thinking" (April 2008) on the inquiry into the UK airports owned by BAA has also criticised the economic regulation framework and the way it is applied and operated. Recommendations are expected to flow from the CC's Provisional Findings. In parallel with the CC's inquiry, the DfT has initiated a review of airport regulation that will be advised by a panel of experts chaired by Professor Sir Martin Cave.

THE INTRODUCTION OF COMPETITION AND ITS IMPLICATIONS FOR REGULATORY REFORM

The CC currently believes that the common ownership by BAA of the London airports has an adverse effect on competition (an AEC) and we fully support this view. If confirmed, the CC will secure remedies. It is now widely expected that significant structural change will follow the CC investigation, including the likely break-up of BAA's three London airports.

We also recognise that it may be possible and beneficial to introduce an element of competition into each airport's operation. We believe that more of the airport's monopoly services could potentially be provided by third parties and should at least be subjected to market testing to ensure that the airport provides good value for money. Obvious examples include security services and information technology that have established external suppliers.

The scope for increased competition for airport services, especially the scope for terminal competition, is likely to vary at different airports. Key factors will include the degree of operational complexity and inter-dependence across terminals and the extent to which airlines need to move between terminals to reduce congestion and make the most efficient use of scarce capacity. Market-driven solutions will therefore be needed rather than a "one-size-fits-all" approach.

Depending on the different potential remedies, we accept that regulatory oversight will be presented with challenges to ensure that the benefits of newly created competition are maximised.

While any remedies proposed by the CC will change the structure of economic regulation, price control regulation will continue to be required at all the regulated airports, whatever their ownership structure. The lack of any significant spare capacity across South East England airports in particular will continue to place significant constraints on the extent to which airports can compete.

However, reform of the regulatory framework and a fundamental review of the role of the regulator are absolutely necessary. We firmly believe that regulatory reform is even more important than structural or ownership remedies.

PRINCIPLES OF AIRPORT ECONOMIC REGULATION

The precise form of economic regulation will depend to some extent on the CC's conclusions and on the remedies proposed. At this stage we therefore propose seven key principles for airport regulation. These are complementary to the more general "Better Regulation" principles of proportionality, accountability, consistency, transparency and targeting. The principles are as follows:

Principle 1: Regulation will still be needed if the London airports are broken up

1.1 The CC "Emerging Thinking" on their UK Airports Market Review saw some scope for competition between airports based on demand substitutability by both passengers and airlines. However, there is a continued need for economic regulation due to:

- a). Lack of effective competition between the airports
 - The lack of significant spare capacity across South East airports means that airports cannot effectively compete whatever their ownership structure.
 - The planning system confers a degree of market power on the London airports because capacity lags behind demand, denying choice to many airlines.
 - If two or more of the London airports are owned by the same company, BAA or a new owner, the regulatory system must remove the risk that investment at one airport could be held back to encourage use of another airport;
 - Under separate ownership, and in the absence of additional capacity, each of the London airports would retain a position of market power in certain market segments. Even when some "spare" capacity exists across the market, it will not be available in practice to all airlines. Differences in airline business models are a necessary consideration and the costs of splitting an operation across airports, or even across terminals, can be a significant factor.
 - Heathrow has a unique role in the UK as a transfer hub airport
- b). Airlines face significant switching costs across airports:
 - Airline switching costs further limit the extent to which airports can compete for airline business. Switching costs will vary significantly among airlines and can be very high. This is not just for foreign airlines but also particularly for UK airlines with their major operating bases at the London airports. Some airlines also operate engineering bases, cargo bases and/or operational headquarters at these airports, whereas others will choose to subcontract many services or locate them away from the airports. These differences, as well as the size of the airline, can affect the degree of choice available to airlines.
 - Freighters are prevented by the Traffic Distribution Rules from operating new services from Heathrow or Gatwick however good the "deal" or incentives on offer.

Principle 2: Regulation needs to encourage and incentivise market-driven outcomes. This also requires regulation to be tailored to the needs of each airport.

2.1 Where possible regulation should provide a framework within which airports and airlines can reach real commercial outcomes. This will require the regulator to

incorporate measures that correct for airport market power and ensure that balanced outcomes can be achieved.

2.2 For the 2008-13 price control period (Q5) the CAA encouraged a commercial dialogue through constructive engagement (CE). Although this resulted in some improvements to the consultation process, significant weaknesses undermined the process that then failed to deliver commercial outcomes. The main problems were:

- Its limited scope with operational expenditure and retail revenues both excluded and reserved to the CAA.
A time and resource intensive process that was not funded.
Failure to recognise that the airport maintained market power and would only reach agreements that took advantage of this.
- Asymmetry of information and a “drip-feed” of information to airlines and the regulator.
- A “hands-off” approach from the CAA that encourages the airport not to concede any significant points and does not ensure an intensive scrutiny of investment or expenditure plans.
- The timing resulted in a number of loose ends on service quality and capital expenditure “triggers” which have yet to be agreed.

2.3 Airlines understand and appreciate the need for long-term certainty about the funding of major infrastructure. The CAA has used a RAB based approach, with pre-funding, revenue advancement and price smoothing to encourage investment. Recent use of triggers tries to ensure that projects are delivered. However, significant weaknesses in this approach have emerged, including the fact that the incentive to spend capital is relatively unrestrained and that pre-funding reduces the commercial risks that would normally incentivise the airport to make sure developments are tailored to the needs of the market and commercially viable. It is right that the airport should bear the long term commercial risks, but it is also essential that they are not deterred from investing in market driven projects. This may require explicit longer-term agreements to be negotiated between airports and airlines to address the funding of long-term projects that extend beyond the normal five-year regulatory cycle. Such agreements need to be incorporated into the new regulatory framework.

2.4 Economic regulation needs to be evaluated from time to time to ensure that regulatory mechanisms deliver market driven outcomes, and not just rely on the five-yearly reviews.

2.5 A “one size fits all” framework is not appropriate for the regulated airports. Each one has its own requirements and regulation needs to be built around the conditions at each airport. Each of the airports is at a different stage of development and also caters for different airline models. Regulation needs to be sufficiently flexible to ensure that airports do not impede competition among airlines by imposing a single view of market needs.

Principle 3: Obligations need to be placed on airport providers through statutory duties and a licensing regime, which can vary to ensure proportionality.

3.1 Our understanding is that all other UK regulated utilities operate under a licence regime. Presumably because it was written early in the evolution of

privatisation the Airports Act has no such License requirements. The absence of a licence and statutory duties is a clear anomaly that needs to be corrected.

3.2 In the absence of any obligations the regulator can only use very blunt tools to achieve legitimate regulatory objectives. Incentives built into regulation tend to require disproportionate benefits for the airport to persuade it to act.

3.3 The benefit of statutory duties and licence obligations is that they are both clear and fair and can be tailored to ensure particular outcomes and objectives are achieved appropriate to the requirements of each airport taking account of the scope for competition.

3.4 Statutory duties and a licence should create a more stable regulatory regime by establishing a long-term framework to protect the public interest. The current approach using Public Interest Findings to address problems as they arise has been criticised by the airports for creating an uncertain regulatory environment. The accompanying enforcement mechanisms of both a licence and statutory duties will provide stronger incentives for the company to address the public interest than at present where, for example, BAA can threaten to refuse to invest in new capacity.

3.5 All other regulated utilities operate under a licensing system, including NATS, which also has statutory duties to ensure safety, efficiency and to plan ahead to meet future demand. The statutory duties for NATS would also appear to provide a good starting point for airports.

3.6 The use of statutory duties alongside a more detailed licence reduces the risks of “regulatory capture”.

3.7 Licence obligations should address elements including financial structure, service quality, regulated asset disposals, reporting, consultation and provision of information, and also incorporating existing Public Interest findings. Airports play a critical role in the delivery of air transport, and license powers can enable the regulator and the Government to ensure that key airport services continue to be provided in the event a regulated airport faces some form of financial distress.

Principle 4: Regulatory discipline and accountability needs strengthening.

4.1 It is essential that economic regulation be applied in a determined and disciplined manner by a regulator that remains sufficiently resourced and who reports on the outcomes of the regulatory process

4.2 The CAA’s “light touch” approach, and its regression to economic theorising, rather than regulating in accordance with outcomes in reality, has been criticised by the CC as well as by airlines.

4.3 Existing checks and balances have been used to overturn key CAA policy proposals in the past, underlining the importance of accountability measures. In our view examples of poor CAA judgements include the “dual till” (proposed in Q4) and the more recent proposal to de-designate Stansted. Easyjet is currently bringing a judicial review against the Q5 price control decisions at Gatwick for failing to scrutinise operational costs adequately and all airlines have strongly voiced the view that Q5 price caps are excessive and that other elements, such as service quality bonuses, are inappropriate. The absence of an appeal mechanism gives the CAA freedom without accountability.

4.4 Checks and balances therefore need to be built in to ensure that the independent regulator is properly accountable and that poor decisions can be overturned on appeal.

4.5 The regulator should also be required to report on the outcomes of their decisions in terms of prices, quality, investment and airport efficiency. This would help to move away from the theoretical approach employed at present to one based more solidly on evidence and outcomes.

Principle 5: The CC's role in airport inquiries has proved to be indispensable under the current framework and could only be reduced to that of an appeal body providing key safeguards are included in the new framework.

5.1 The CC's role in airport inquiries has proved to be indispensable under the current framework, in particular by providing a reality check against the CAA's interpretation of its statutory duties, by providing solid and strong advice on key issues and by imposing Public Interest obligations.

5.2 We believe The CC's role should only be reduced to that of an appeal body providing key safeguards are included in the new framework. These include clear statutory duties, specific licence requirements and a dual right of appeal for both airport and airlines. An airport regulator is just as likely to err in favour of the airport as to err on the side of users and therefore natural justice demands that an appeal to the CC is possible by both sides. In addition, unlike other regulated sectors, where there are thousands or millions of direct customers, there are relatively few direct customers of airports, the airlines. Airline views, while not always identical, are generally clearly voiced and common positions are articulated through the user organisations and representative bodies. Airlines therefore, unlike the customers of utilities, have the ability and commercial incentive to engage directly in airport regulation and in appeals, to ensure that their own interests as customers and the requirements of their own passenger customers are met. As such a closer direct involvement by airlines in the process, and right to appeal, is fully justified.

Principle 6: Key aspects of the current regime should be retained, including the single till; separate regulation of each airport; statutory objectives towards all users (not just consumers) and Government control over airport designation decisions.

6.1 The single till is a fundamental part of airport economics. Airports that have to compete with others will develop retail revenues as a means of providing services to passengers and offsetting airport charges, as recognised by the CC in both the Q4 and Q5 reviews. Airports with market power generally try to develop this as a separate revenue stream. Regulation has addressed this through the single till.

6.2 Each airport should be separately regulated to avoid competitive distortions, cross subsidies and gaming.

6.3 Airlines purchase airport services and the objectives of regulation must reflect this. The interests of passengers and shippers are paramount and should be satisfied by the outcome of regulation, but they are indirect customers of airports whose interests can be met only if airline interests are met. We do not agree that the Reviews should consider whether the regulator's current duty towards users should be amended to give greater weight to passengers or consumers. The competitiveness of airline markets provides the required protection for consumers, as airlines will be commercially driven to deliver the requirements of passengers. We do

not believe the regulator is best placed to understand passenger needs, which are complex and variable. Furthermore we note that the CAA has not provided any evidence of significant differences between airline and passenger interests. In practice, the loss of a reference to airline interests would substantially weaken the CAA's accountability for its decision-making since passengers are unable to articulate their requirements or to ascertain the results of the CAA's decisions, and rely on airlines to protect their interests.

6.4 The Government, not the regulator, should continue to designate and de-designate particular airports based on objective criteria and following consultation with CAA and industry. The fact that neither the Government nor the airlines agreed with the CAA's recent conclusions regarding the proposed de-designation of Stansted for price control purposes demonstrates that the new criteria are open to very wide differences of interpretation and judgement. The involvement by Government, while potentially adding a political dimension, ensures regulatory accountability.

Principle 7: Transition needs to be planned carefully so that it does not disrupt the ongoing activities of airports or their agreed investment plans

7.1 Any change to the regulatory framework needs to be consistent with the agreed investment plans at airports and their ongoing activities.

CONCLUSION

We have welcomed and fully supported both the Competition Commission's investigation into the UK Airports market and the DfT's review of airport regulation. It is important that these reviews facilitate a commercial approach to the development of the UK airport market that responds to the needs of both passengers and airlines. We believe reform of the regulatory framework and a fundamental review of the role of the regulator are absolutely necessary, and that regulatory reform is just as important as structural and ownership remedies. We believe our seven key high-level principles should guide the new approach, alongside the more general UK Better Regulation principles.

25th July 2008