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by Harry Bush CB

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'The development of competition in the UK airport market'[1]

Introduction

1. There can have been few times since the privatisation of BAA in the late 1980s when there has been so much change – and attendant uncertainty – around the UK airports market. In addition to the impact of the most significant economic reverse in the aviation market since the War we await the Government's decision on its Review of Economic Regulation (although we had a taster announcement a few weeks ago on financing); there appears to be a significant political divide over the future growth of capacity in the South East which is unlikely to begin to be resolved until next year; and there is discussion about whether and how far high speed rail may substitute for and/or complement airport capacity.

2. There is also some uncertainty around future ownership structures in the market given BAA's appeal of the Competition Commission's (CC's)

[1] I would like to thank CAA colleagues, and in particular Chris Hemsley, for assistance in preparing this lecture.

divestment remedies to the CAT, on which judgement is awaited. However, the recent announcement of the sale of Gatwick itself represents a significant potential injection of competition into the UK airport market around London. And there is the clear possibility of more to follow in the South East and Scotland.

3. Against that background, this year's Beesley lectures provide a timely occasion both to review the current position of the market and, looking to the future, to consider the role that the regulator and Government can play in seizing the opportunity to foster competition presented by the most significant restructuring of the industry since BAA was privatised in 1987.

4. I will therefore be focussing on competition within the airports market rather than the other developments that are in prospect (or contention). However, they will be touched upon in the course of this talk as:

- regulatory reforms may affect the role the regulator can play by, for example, broadening the currently restricted range of regulatory tools available under the Airports Act; and

- policies on capacity development will influence the landscape in which competition will play out and could in turn affect regulatory or government responses to capacity scarcity.

5. This audience is likely to take it for granted that increased airport competition <u>will</u> benefit consumers going forward. It is unnecessary to hypothesise about how events might have played out in the past, without BAA, or to trawl for evidence of its supposed past misdemeanours. Instead, we have in our regional markets enough evidence of airport competition working to suggest that there are significant benefits to be had even if competition is likely to play out rather differently in the unique circumstances of London. However, those benefits cannot be assumed to flow automatically given the current starting point whereby economic regulation applies to all three BAA London airports. Such regulation could impede the development of competition. Ownership restructuring is therefore only the beginning of the process. Once the CC has completed its task, it will fall to the CAA and, in different guises, Government to complete the work.

6. Indeed, the CC referred to this in its report on BAA, stating that:

> *"Proportionality and the avoidance of over-regulation are principles of better regulation that are particularly appropriate for a marketplace where competition is expected to become increasingly workable over time. Faced with just such a marketplace, it will be the task of the regulator of airports to modify regulation appropriately to promote competition and as competition develops.*"[2]

7. This seems an appropriate starting point for regulatory consideration and I will argue that:

   - first, while economic regulation can be a justified response to the risk of abuse of substantial market power, applied inappropriately it can inhibit the development of competition between airports and ultimately harm consumers. The potential for greater competition stemming from BAA break-up seems likely therefore to change the economic regulation applied to airports;

[2] Paragraph 10.340, CC Final Report

- second, competition will be encouraged by ensuring that there is clarity about how the boundary between regulation and competition will operate. This will necessitate work to demonstrate how decisions will be made about where, and to what extent, regulation will be applied;
- third, reform of the statutory framework for regulation could play a useful role in supporting the transition to a more competitive market, by providing a more flexible set of tools to regulate different levels of market power and clarity about the roles and responsibilities of airports, the regulator and Government. Hence the importance of Government proposals for change to the framework of economic regulation but also of recognising that the existing Airports Act regime could be operated – although somewhat more clunkily – to encourage competition should it remain in force.

Looking back: what has been achieved?

8. Before considering the future of the airports market it is instructive to look back and reflect upon what has been achieved in the last quarter century across the UK aviation sector; what this has meant for consumers; and how it has impacted on the airports market. Whilst BAA's dominant position has remained, much has

been changing around it.

9. In the 1980s, competition between airlines in the UK looked rather different from today. There were efforts to develop a “second force” airline, British Caledonian, at Gatwick. And by the second half of the decade Virgin Atlantic had emerged, and British Midland had begun adding European routes to its domestic network from Heathrow. But, generally speaking, British Airways still had a big hold over the market. Choice was limited and, even on the shortest routes, business practices such as the “Saturday night” rule – crude price discrimination between passengers travelling mid-week and those staying over a weekend – were common. In August 1986, Heathrow and Gatwick served directly 202 and 117 international scheduled destinations respectively[3], dwarfing Manchester’s 46 or Birmingham’s 18, and requiring many passengers from other UK regions to fly through the London airports to connect to international networks.

10. Air services were tied up in a morass of restrictive bilateral agreements between governments that set maximum frequencies, encouraged airlines to set prices

[3] Source: July 1986 ABC World Airways Guide

jointly through industry conferences, and generally ensured that incumbent state-owned flag carriers were not subject to “too much” competition. Of course, the market sought ways around these restrictions on scheduled flights. Charter carriers – which could be seen as the original “low cost” carriers – continued to grow and opened up major leisure destinations to mass international leisure travel. Unofficial discounting of air fares through third-party consolidators – bucket shops – was common. And booking phantom accommodation might allow you to get a seat at cheaper inclusive tour rates. In some cases, the best chance of securing a cheap deal would be to wait in the airport lounge for hours in the hope of securing a stand-by seat.

11. Prices were, by today’s standards, high, especially within Europe. But when you could afford to fly the airlines provided food, transported bags for free and, for the most part, took good care of you when things went wrong.

12. The idea that an unknown Irish airline would grow to become one of the largest airlines in Europe and be allowed to establish its largest base in London, or that a new UK airline which started out with two borrowed aircraft would overtake all

other airlines at Gatwick whilst operating domestic services in France would have been fanciful.

13. So what prompted this transformation? The single largest change came in 1993 with the entry into force of the so-called “Third package” of EU legislation governing air services, and the resulting transition to a single aviation market in the EU from 1997. This allowed any EU airline to fly any route between two points in the EU and, following the example set by the USA, swept away the restrictions that acted to protect national flag carriers from competition. The rise of easyJet and Ryanair (and other no-frills carriers) – assisted by internet distribution and a fierce focus on cost efficiency – followed.

14. This combination of liberalisation and new business models led to significant gains for passengers. Choice of destination and service quality has increased; costs and fares have fallen. The ONS’s International Passenger Survey suggests that the average one-way fare paid by the UK passenger travelling to the EU25 countries fell by about a third in real terms between 1993 and 2007. However, the drivers of these desirable developments have themselves raised a number of

other issues. There has been extensive unbundling and resulting payment for services that were previously offered with the headline fare. Regulators – seeking to keep pace with changing business models and pricing – have intervened to help ensure that consumers receive the information that they need to participate in a more complex market. Overall, developments have been overwhelmingly positive. But the pressure that liberalisation and competition can put on consumer protection is a lesson that could resonate as competition intensifies in the airports sector.

15. More liberal airline markets also coincided with – and to an extent drove – the increasing commercialisation of UK airports. Following the privatisation of BAA, other airports moved to a more commercial footing. Whilst local authorities retained an ownership interest in the two largest non-BAA airports, Manchester and Birmingham, these airports undoubtedly became more commercial. And, increasingly, there was a transfer of airport assets from local authorities to the private sector and between private sector groups. The sector attracted home grown operators, such as the Peel Airports Group – operators of Liverpool John Lennon, Durham Tees Valley and Robin Hood Doncaster Sheffield – overseas

operators and financial groups. The result of this market in airport assets and the pressure from airline operators was a sharper focus on cost and commercial revenues, and on the need to attract and retain airlines, with charges often tied to multi-year contracts rather than a set published tariff as in the past.

16. It is perhaps worth noting here the contribution that the data published by the CAA makes to the functioning of this market. Regular airline and airport statistics give breakdowns of the number of passengers and flights by route, and the CAA’s passenger survey (interviewing some 175,000 passengers a year) shows airports and airlines where passengers live, where they fly to and for what purpose, and therefore the markets that are available to be captured from competitors. The results in the airport market are apparent in keen rivalry and the significant growth of many regional airports. To give one example of an airport which competes with London airports as well as its South West neighbours, Bristol, served just over 2m passengers in 2000 and offered frequent scheduled services to 11 destinations. By 2008 it had 38 such routes, with many more offered at lower frequencies, and served over 6m passengers.

17. So, to sum up, a heady mix of EU liberalisation; the consequent emergence of no-frills airlines looking for opportunities for rapid expansion; and the more commercial outlook of regional airports looking to build up a network of air services gave rise to a more dynamic, competitive airports market alongside and complementary to the changing airline market.

18. Which left the elephant in the room, BAA, which had been one of the early privatisations largely unaccompanied by structural reform. (Indeed, after privatisation, BAA was allowed to expand its airport interests, through the acquisition of Southampton in 1990.) And while later privatisations involved such reform, and British Gas (another early privatisation) was restructured, there seemed greater reluctance to contemplate structural reform of the airport market than of other sectors. A Government review in 2000 left BAA's position intact. Only with the Enterprise Act were regulators – the OFT and CC – given powers that would enable thorough consideration of the ownership structure and the decision to break up BAA.

Where we are now

19. The CC's report caught the headlines for the break-up of BAA, but it is helpful to consider some of the areas that attracted less attention and where the CC's thinking evolved significantly over the course of its investigation.

20. First, as mentioned earlier, there is a clear recognition in the CC's final report of the logical link between break-up, increased competition and a reduction in the intensity of regulation. Indeed, a reduction in the intensity of regulation is a potential benefit from break-up.

21. In particular, the CC concluded that:

> "…….. *we expect competition between London airports to develop such that we would no longer expect Stansted and Gatwick to hold substantial market power … we strongly support the reduction and in due course, the removal of regulation, as competition develops.*"[4]

[4] Paragraph 10.344 of 'BAA airports market investigation', Competition Commission, 19 March 2009

22. In any transition the CC also contemplated the scope for alternatives to the traditional regulatory approach:

> "*Should, however, a need for regulation of Gatwick and Stansted persist even under separate ownership, we consider that it may well be appropriate in due course to use an alternative to the current RAB-based methodology*"[5]

23. Second, the CC agreed with a point made to it by the CAA that there was a need for the regulatory framework to establish credibility that as competition develops, regulation will withdraw, otherwise "*if airports expect price caps to be reintroduced whenever capacity starts to tighten they are unlikely to have adequate incentive to invest*".[6]

24. In taking this line, the CC went some way to clarifying the role of capacity scarcity in competitive airports markets, although there remained some ambiguity, with parts of the CC's final report still linking deregulation to the introduction of new capacity and a consequent reduction in levels of scarcity in line with earlier

[5] Paragraph 10.343, CC Final Report
[6] Paragraph 10.343, CC Final Report

reasoning in the CC's findings.[7] I deal in more detail with the issue of scarcity and its consequences for competition later.

25. Third, the CC was clear about the potential impact of Government policy on the development of competition. It recognised that aviation externalities and planning requirements conferred responsibilities on Government that could significantly affect airport development, and that the way in which such policy was articulated and implemented could impact competition. The CC was critical of the extent to which the 2003 Aviation White Paper prescribed the location of airport development.

26. These issues are critical to the challenges the regulator will need to meet over the coming years. I want now to say more about them.

27. The most significant challenge is how regulation should respond to emerging competition. This issue is often characterised as identifying the appropriate pace

[7] "Clearly a decision on whether or not to lift price caps *as new capacity comes on stream* will require the balancing of risks based on the consideration of a number of factors, including the nature and intensity of competition that develops in the period following divestiture of Gatwick and Stansted.", para 10.344, CC Final Report [*emphasis added*]

for regulatory withdrawal: how fast and how far should economic regulation retreat? But it is equally – if not more – important to understand how economic regulation should be modified to avoid restricting or distorting the development of competition in the first place.

Assessing the prospects for further competition

28. A key element in the analysis expected of a regulator in these circumstances is the assessment of market power. There are two important points to recognise here. First, any assessment will involve significant elements of judgment, not least where the focus is on prospective market power in a changing competitive landscape and where resulting decisions on regulation also feed back into the development of competition. Second, the analysis must be firmly rooted in the particular economics of airport markets. The CAA has therefore today launched a project to develop in consultation with industry stakeholders a better understanding of how airport market power can best be analysed. We are currently inviting views on the issues that should be considered by this review, but here are some for starters.

29. First, I have already mentioned the importance of understanding the role of scarcity in airports markets and how this relates to market power. Scarcity is an essential feature of markets but the issue is particularly pertinent for airports given the nature of airport investment and some of the constraints on it.

30. Much airport investment can be, and is, incremental. But step changes are sometimes required – possibly, but not only, a new runway – which can create alternating periods of scarcity and surplus. Airports need to earn returns across this investment cycle as a whole. If the consequences of scarcity – higher prices flowing from higher demand – are prevented there will be muted incentives to invest and competition may not be sustainable. This is a difficult message. Break-up and competition do not necessarily mean that prices will fall. At times of tightening capacity and demand for new investment, prices will tend to rise. Competition may, of course, still bring benefits in terms of price, putting downward pressure on prices (both in the short term and long term) so that they are lower than they might otherwise be. But – relative to the current airport offering – the benefits of the competitive market may be more apparent in other dimensions, in particular greater innovation and responsiveness on investment

and service to customers' varying requirements.

31. In this model, some degree of scarcity – and its pricing results – are part of the competitive dynamic which delivers appropriate investment. However, to airline customers – with shorter-term commercial horizons – it may not be easy to accept that scarcity (and its pricing implications) is a natural adjunct of the airport rivalry that will deliver the better all-round investment and service that they and their passengers want – including the possibility that competition will over time work on airport cost structures (as well as levels), with airports aligning them better with changes in demand as a means of securing competitive advantage.

32. However, to the extent that there remains lumpiness in airport investment, it behoves regulators to seek to distinguish pricing power that arises due to high demand relative to underlying supply from pricing power that arises from an artificial restriction of capacity, the former being a signal of a well-functioning market, the latter a sign of abuse of market power. This raises the practical question as to how these two can be distinguished from each other.

33. The answer to this question lies in assessing evidence in the round, that is not only any change in prices but also the circumstances in which this occurs. For example, attempting to evaluate short term prices against short run costs is unlikely to tell us much about whether market power has been abused. Assessment needs instead to consider whether short term prices substantially exceed the long run competitive price level (which might be estimated by the long run incremental costs of supplying airport capacity) and how far – and for how long – such pricing is reasonable given the degree of scarcity in the market.

34. In practice, of course, there will be constraints on the ability of the regulator to gauge the extent to which pricing conduct might be ‘excused’ by conditions of scarcity. Even after examining the facts around the historical relationship between price and scarcity, there is inevitably a residual degree of uncertainty about this relationship. It follows that the regulator should consider other means of assessing whether abuse of market power has taken place. One such might be to examine whether, as part of a strategy to maintain prices above the competitive level, there is any evidence of restricting supply, or of under-investment. This is arguably more tractable, as it may be possible to show that

there are value-enhancing investments that are not being actively pursued. But judgements will need to take account of uncertainties, for instance around future volumes or levels of competition, of alternative investment options and, potentially, financing constraints.

35. This is not any easy area, and so how – and how far – pricing power due to scarcity can be distinguished from the abuse of airport market power will, therefore, be an important feature of our competition project.

36. A second possible issue is that in order to analyse airports properly, it is necessary to appreciate the nature of the modern airport business, including the variety of services provided, and the variations between airports. This variety – and these variations – can have a significant impact on airport operators' incentives.

37. Airports generate aeronautical and non-aeronautical revenues, such as income from parking and the rental of terminal space to shops. Airports can thus be said to operate in multi-sided markets with different but interconnected customer

groups. Analysis of airport profitability needs to take into account the way in which an airport will seek to optimise across its income streams with losses on aeronautical activities potentially offset by the commercial income that passengers bring. This multi-sided nature of airports also affects market definition and the assessment of market power: an airport can be disciplined by passengers *and* by airlines, but most powerfully by the switching of both away from an airport – an issue that I will return to shortly.

38. Analysis of airport competition also needs to take account of differences in airport characteristics: Heathrow cannot easily be compared in terms of complexity, infrastructure, investment, cost or pricing with Glasgow Prestwick; and the similar size of Aberdeen and London City masks the presence of a huge helicopter operation at the former and the particular niche business travel characteristics of the latter.[8] Many airports will have more in common than these disparate examples but will nevertheless demonstrate significant differences which need to be recognised in order to gain a rounded appreciation of the

[8] Passenger numbers in 2008: Aberdeen, 3,390,000; London City, 3,260,000. Source: CAA airport statistics.

extent, and nature, of rivalry between airports.

39. A third possible issue for our project is the nature of airport competition in the liberalised European aviation market. In its inquiry, the CC focused on competition between neighbouring airports – an issue that was at the heart of determining whether BAA's ownership of several airports around London and in central Scotland was restricting competition. However, the removal of all administrative restrictions on airlines' freedom to operate between any two points in Europe has had a significant impact on the European airline market, and that in turn has affected the nature and extent of airport competition.

40. The major no-frills airlines operate a business model involving, in contrast to classical network airlines, multiple bases and point to point operations. Rather than seeking to maintain a share of any specific market through a network structure they are extremely mobile in their pursuit of profit opportunities. They are genuinely pan-European businesses; Ryanair established its largest base at Stansted, rather than in Ireland. And, similarly, more than a quarter of easyJet's passengers now fly on non-UK routes, rather than on routes to or from the UK.

These developments have impacted negotiations between airlines and airports. UK airports now compete for a proportion of their services in a pan-European context. If its airport charges or service offering are uncompetitive, Manchester Airport would increasingly be as likely to lose a service to Lisbon or Lubeck as to Liverpool or Leeds Bradford.

41. The CC tended to downplay the extent to which these developments represented a constraint on airport market power as – in the context of the recent periodic review of Stansted airport charges – did some airlines. However, over this summer, we have seen easyJet and Ryanair withdraw capacity from UK airports and expand elsewhere in Europe, demonstrating that this form of switching is a reality:

> *"Ryanair's big expansion in the Canary Islands is due to "zero" tourist taxes in Spain and the 100% discount on airport charges this winter. This contrasts with the route cutbacks Ryanair has announced in the UK and Ireland where airport charges at Dublin and Stansted are increasing and the Irish and UK*

Governments have imposed suicidal tourist taxes of €10 and £10 respectively."[9]

And:

"easyJet today announced proposals to reduce its flying programme at Luton by 20% and to close its East Midlands base. The airline will move this capacity to more profitable airports and expects that most of the aircraft will be redeployed to continental European bases."[10]

42. Such statements should not cause surprise: the oddity would be if liberalisation of an industry with the most mobile of assets – an aeroplane – did not affect the market power of suppliers with the most fixed of assets – airport infrastructure. The question to be determined is how far such developments have affected the market power of individual airports. This will vary. Hub airports serving airline networks with a high proportion of connecting traffic are likely to be less affected (though they may face other more hub specific competition forces) than those with a predominance of point to point services; and airports serving long haul should be less affected than those serving European short haul.

[9] Ryanair press release, 29 July 2009
[10] easyJet press release, 3 September, 2009

43. Assessment of the extent and effect of pan-European competitive pressures will need to complement other forms of analysis which bear more on competition between neighbouring airports. These should seek to assess not only current overlaps between airport catchment areas but also, through analysis of isochrones derived from journey times, how they might change in the future – in other words prospective as well as current competitive pressures. Of course, the CAA will need to be mindful of the strengths and weaknesses of these approaches. Current catchment areas are likely to understate the potential for competition between airports (because they are based on existing patterns of business and may not capture the dynamic benefits of competition); whilst isochrone analysis may tend to overstate the strength of competition, as it involves assuming that airlines would be prepared to offer routes that allow passengers to use alternative airports (whereas, in practice, such routes may not actually be viable).

44. As a regulator the CAA will need to be in a position to weigh up the contribution that can be made by the different types of analysis. But if we are to get a

rounded picture it would be helpful to have greater access to the data held by airlines that is relevant to the assessment of airport market power, in particular on switching costs and airfares. This will enable better understanding of cost structures and strategic decision-making.

45. Access to such comprehensive data is all the more important when the arguments presented by airlines and airports often differ depending upon the audience being addressed. An airline may argue to a regulator considering deregulation of an airport that switching costs are high, whilst stressing to investors – and to airports in pricing negotiations – the flexible way its network allows it to move capacity between airports in response to increases in charges. Indeed, the CAA was on the receiving end of characteristically forthright criticism from no-frills airlines for suggesting that some – but not all – passengers using Stansted Airport might find airports such as Birmingham and East Midlands to be reasonable substitutes. Now that the dust has settled on the Stansted price control we find ourselves listening to Ryanair's chief executive recently telling the BBC that:

"...we already know from our own statistics that lots of passengers from [the region served by Leeds/Bradford airport] are travelling across to Manchester, up to Prestwick or down to Stansted to get Ryanair's low fares."[11]

46. Robust empirical analysis will therefore be needed to assess some of the arguments that circulate within the aviation sector. Airports are repeatedly referred to as local monopolies, often by airlines with very strong market positions at these airports. Such airlines typically argue that they are operating in a fiercely competitive market. But how consistent is this story? In such circumstances, would not the airlines concerned also share in the market power offered by the supposed monopoly? If, alternatively, the airline market is so competitive how secure can the airport's position be?

47. We do not need definitive answers to these questions now. But the CAA would like to establish greater understanding of the issues and relevant evidence so as to assist in the decisions that will be needed in the coming years. And I

[11] Michael O'Leary, BBC, 11 August 2009, http://news.bbc.co.uk/1/hi/business/8194996.stm.

encourage airlines, airports and other stakeholders to participate in the project we have launched.

Understanding the impact of regulation on the development of competition

48. Turning now to the issue of the impact of regulation on the development of competition, there is a risk of a regulatory ‘Catch 22’. In some circumstances – for example, where the costs of new entry happen to be below those of the incumbent – regulation might permit competition to develop without a significant change in the approach to regulating the incumbent supplier; efficient new entrants can compete effectively with the price-controlled incumbent. This is perhaps the ideal situation for a regulator holding the fort until competition develops. When there is sufficient evidence, deregulation can follow. The approach is low risk: deregulation follows the demonstration that competition *is* working.

49. However, the UK airports sector may not provide such an easy route to deregulation for a number of reasons. First, where prices have been capped on the basis of the indexation of capital costs, they may be below replacement cost

(and also far from reflecting capacity scarcity). Retaining them at such a level is – other things being equal – unlikely to stimulate commercial investment in airports. However, the alternative of rising prices can be expected to meet opposition from airlines and passengers. The distinction between economic value and the existing regulatory value is likely to be lost amid concern about the potential for higher airport profits. Yet without this uncomfortable debate, will investors believe that regulators will allow prices to respond normally to supply and demand?

50. This is made all the more important by the highly capital intensive nature of airports – accentuated by the way opex is to a greater or lesser extent offset by commercial revenues – leaving cost structures heavily capital-dominated and therefore more exposed to revenue volatility.

51. This presents policy makers with a choice. Is it sufficient to continue regulating airport businesses, encouraging them to invest and reassuring them that future returns will be unregulated? Or, is some start to deregulation required in order to establish sufficient credibility that future returns will be commercially driven,

thereby providing the certainty needed to support competition?

52. At the very least the regulator needs to assess whether its regulatory approach is likely to harm the development of competition, and to explore alternatives. The CAA has already had to make such calls in the last decade. In 2003, it rejected the CC's recommended tightening of price caps at Manchester on the grounds that it would inhibit local competition. Five years later the market had moved on sufficiently for the Government to accept the CAA's advice to free the airport from price control.

53. In relation to Stansted, the CAA's decision in 2003 to adopt stand-alone pricing – ending the practice of cross-subsidisation between BAA's airports – and its subsequent adherence to that – laid an essential foundation for a more competitive London market. And in its decision on Stansted price controls earlier this year the CAA sought again to ensure that development of competition was safeguarded. The CAA identified the potential for the expectation of a continued RAB-based approach to setting price controls to provide perverse incentives for both the airport and airlines, with the airport facing an incentive to bring forward

investment given the positive effect on the price derived from existing assets (whilst the incumbent airlines faced a strong financial incentive in the opposite direction). Such regulatory incentives could impact on the broader market, for example affecting rival unregulated airports' expectations about future price levels and the timing of investment with a consequent impact on the incentives faced by those non-regulated airports to invest in commercial projects.

54. The CAA's decision was therefore driven as much by an assessment of the potential effects of the Stansted price cap on the future development of effective airport competition as by the detailed cost analysis which had been undertaken by the CC in its advisory role to us. The clear message was that there should be no presumption that future price controls at Stansted would be RAB-based. All parties – the airport, its airline customers and potential competitors – should therefore expect that, even if price controls are maintained, a mechanistic link between the level of the price cap and the airport's investment programme cannot be relied upon. The intent is that this should have a significant impact on behaviours now, by better aligning the airport's and airlines' incentives at Stansted, while also signalling the CAA's approach to potential airport

competitors who might otherwise be constrained by the price capping at Stansted derived from historic costs.

55. Indeed, the CAA has stressed more generally the importance of examining alternative forms of regulation to RAB-based price cap regulation, launching today – alongside the competition project – work to identify regulatory approaches that are consistent with a more competitive airport market. Given that the UK airport market cannot be characterised as a natural monopoly, regulatory approaches designed for such monopolies cannot be assumed to be appropriate, particularly as the potential for distorted investment incentives at price regulated airports will affect the development of competition over a long period given the long-lived nature of airport assets.

56. However, under the current airport regulatory framework, any change to the basis of regulation would need to be examined by the Competition Commission, in its next mandatory price control investigation. There are some promising signs: in the CC's final report, it welcomed the CAA's announcement of a work programme to investigate alternative forms of regulation although the same report also

criticised the CAA for considering alternative forms of regulation which were "wholly contrary to the views of the Stansted user airlines."[12]

57. However, for a competition-enhancing regulatory regime to succeed airport or airline opposition cannot be sufficient to dismiss alternative ways of regulating – let alone their consideration in the first place. As I have already argued, regulatory reform might involve unpopular and difficult choices, but these are the choices that need to be debated - and possibly faced - if we are to make the best of the opportunity presented by ownership change. Of course, any changes will only be made following due consultation and against the CAA's then statutory duties, recognising all the costs and benefits of making such changes and the importance of frameworks which encourages investment and service quality to the benefit of consumers and airlines.

Role of Government

58. My discussion so far has focussed on what the CAA can do in terms of its own evidence gathering and decision making. But that activity takes place within a

[12] Paragraph 6.53, CC, Final Report

regulatory framework and planning context established by Government. If reform to the framework of economic regulation proceeds in line with Government proposals so far, the CAA should have a more flexible set of regulatory powers – based around a system of airport licences – which could better support the development of competition by enabling greater tailoring of regulation to changing circumstances than does the one-size-fits-all price capping regime embodied in the Airports Act. The ability to remove price controls but to continue price and service quality surveillance – backed by transparency conditions better to inform consumers about service standards and the extension of the CAA's Competition Act powers to cover airports – would complement the CAA's powers under consumer legislation and reduce the actual or perceived risks associated with removing price caps.

59. Other changes would also be useful in this context. The removal of the automatic regulatory second guessing embodied in the mandatory reference of price control decisions to the CC would (subject to appropriate alternative appeal procedures) improve regulatory consistency and credibility. And a primary duty to consumers could provide a useful compass to steer a way through the issues of scarcity and

appropriate pricing in a more competitive market. However, it is worth emphasising now, as we have done before, that we do not see a primary duty to consumers sidelining airlines. Rather, it will provide a clearer focus to the regulatory debate, sharpening all stakeholders' – airports' and airlines' – focus on what their proposals will do for the end consumer. We would anticipate a continuing significant role for the airlines in the regulatory process. The way in which they can test consumers' interest in routes and services and price them accordingly puts them in a good position to judge what consumers are willing to pay for, and therefore to interpret consumers' interest in airport investment and service. It is just that they cannot *always* be assumed to represent consumers. But airlines competing to deliver valuable services to their passengers, and wanting airport infrastructure that supports this endeavour, have absolutely nothing to fear from a primary CAA duty to the consumer.

60. We would, for example, anticipate retaining Constructive Engagement, a form of airport-airline negotiation which was introduced by the CAA in an effort to reduce what might be termed 'regulatory dependency' whereby parties look to the regulator more than they need to for solutions and support. It sought to introduce

a commercial dimension into the regulatory process and, for all its difficulties, led to significant agreement on large swathes of investment and service quality at Heathrow and Gatwick. It provided a sounder basis for regulatory decision making by articulating more clearly where there was agreement and, as importantly, disagreement – and why. With lessons appropriately learned from experience last time, Constructive Engagement can no doubt play a part in reformed regulation in the future just as it has under the Airports Act.

61. There is likely therefore to be some continuity between the existing and any revised regulatory framework. Similarly, while regulatory reform offers the prospect of improved powers and decision making, particularly in managing the interface between competition and regulation, its absence or delay need not be a bar to progress. The decision – and preceding analysis – on deregulation of Manchester and the scope to modify the nature of price caps demonstrated at Manchester and Stansted shows that the Airports Act can be made to work, although the interfaces with Government and the CC add to complexity and the on/off switch implied by designation for price control makes transitional

arrangements more difficult.

62. The second key contribution from Government is in setting the overall planning framework for airport development. Substantively, this was last done in the 2003 Air Transport White Paper which, while neither authorising nor precluding any particular airport development, explicitly supported a second runway at Stansted as soon as possible (by 2011/12) and a third runway at Heathrow.

63. This set of issues will emerge again with the drafting of a Government National Policy Statement which it is intended should guide decisions on major infrastructure by the newly created Infrastructure Planning Commission. Such a document, of its nature, is bound to limit the options for airport development – to do otherwise would be to offer no guidance at all. The issue is one of balance and the extent to which prescription of airport location risks creating the adverse effects on competition identified by the CC.

64. Of course, at one end of the spectrum of possible approaches, a ban on major airport development around London, could very significantly constrain the

potential for competition. There would still be scope for greater differentiation of services to airlines and passengers but gains from competition around future investment would obviously be much more limited. Capacity scarcity would become less a phenomenon of the airport investment cycle and more of an enduring feature with implications for regulation and Government policy. It is very difficult to be precise about such implications without a full policy background. But a number of possibilities stand out.

65. To the extent that enduring capacity shortage puts upward pressure on airport pricing, the reluctance to abandon or modify price caps is likely to be strengthened. But would that be the right response? To the extent that a policy of proscribing London runway development embodies a preference for non-London airport locations or alternative transport modes, price restrictions at the London airports could hinder these developments by suppressing to some extent the necessary price signals, particularly given the significant capital costs and risks involved in alternative propositions and the associated difficulties in adequately remunerating investment.

66. On the other hand, unfettered price increases could in principle go beyond what is required to stimulate alternative investment and create significant rents for London and other airport operators. That is not attractive. Nor, however, is leaving such rents with airlines through over-aggressive price capping of airports. Amongst other things, that could complicate airline competition. The issue may become one not of economic regulation dealing with potential abuse of market power but of Government tapping into rents created by the scarcity it is mandating – with, of course, the resulting potential decision-making distortions entailed in government having a fiscal interest in maintaining scarcity.

67. Without clarity around such policy issues the task of economic regulation may become progressively more difficult as it becomes harder in practice to distinguish potential abuse from legitimate pricing responses to scarcity. In particular, the scope to use withholding of investment as an indicator of abuse becomes more difficult in the context of a relatively comprehensive ban on major investment.

68. So the planning and policy framework set by Government will be a major determinant of how airport competition plays out. But even with the fairest of winds – policy and regulatory – it is necessary to be realistic about the pace of change and some of the accompanying risks.

69. Airport development is a long term game. Today's service is significantly determined by yesterday's investment – as the users of Heathrow's T5 will appreciate. Of course, there is a good deal that can be done to improve the management and efficiency of airport services but infrastructure significantly constrains what can be achieved. It might therefore take many years for the *full* impact of ownership change to feed through. But even within such constraints competition is likely to lead to innovation in product, service and pricing, and in doing so to help reveal the value that passengers and airlines place on particular services, and to result in prices that reflect these differences in value – which may go to the structure as well as the level of charges.

70. There should also be improved commercial interchange between airports and airlines, with both more mindful of the end-consumer. This should bear on shorter term service issues, from ensuring joint plans are in place to increase

resilience of passenger service throughout the airport to differentiation in service quality that better matches different airline business models, but also the longer term requirements of investment in a changing and uncertain market. Airports in a more competitive market are unlikely to want to hold all of the risk associated with investment in new facilities. And airlines, for their part, may wish to avoid price perturbations deriving from changes in scarcity. The result could be greater use of long-term contracts which share risk, better align airport and airline incentives and reduce the need for short-term prices to vary.

71. These all have significant potential to benefit consumers: improving efficiency; increasing choice; and aligning the commercial interests of airports and airlines when it comes to delivering investment that consumers value. However, explaining the gains that are likely to accrue from greater airport competition will require considerable care. If policy makers create unreasonable expectations about what competition will deliver there is a risk that its successes will be ignored. They will also need, as in the airline case explained earlier, to ensure that valuable innovation is not accompanied by practices that misinform or mislead consumers, or restrict competition in airline markets. Greater

competition may therefore require more resources for consumer enforcement.

The European dimension

72. Which brings me to my final point: the implications of European regulation for UK airport competition and the increasing importance of the CAA's work in Europe intended to influence the design of EC regulation.

73. The EC has a strong record on aviation. As I have already argued, the creation of a single European aviation market has led to significant gains for consumers, in terms of price and choice. More recently, European regulations that require airlines to provide assistance to passengers and, at times, financial compensation when flights are delayed or cancelled, and to ensure that all non-discretionary charges are at least disclosed alongside the advertised price of the ticket, have had a clear focus on protecting consumers in the more complex commercial environment that this single market has helped to create. The strengthening of general consumer rights, and the resulting extension of the CAA's powers, also provides increased protection for air passengers.

74. Recently, European initiatives have started to focus more and more on airports. This is understandable as regulatory frameworks in much of Europe are substantially less developed than in the UK. There is a risk, however, that EC regulation will fail to appreciate fully the nature of the UK airports market. The recent Airport Charges Directive in its early drafts risked doing so, although the recent legitimisation of secondary slot trading was a welcome recognition of market realities.

75. As the UK moves increasingly towards a model where competition – backed by competition and consumer law – protects consumers, the importance of ensuring that future EC regulation is fit for purpose will increase. In practical terms, this means that the CAA will – with Government – need to be increasingly active in Europe and engage in an intelligent manner with proposals that may be designed for less competitive airport markets than we have in the UK.

Summary

76. Which takes me back to where I started tonight. It is an interesting time for the UK aviation sector. It seems likely that, irrespective of the outcome of the

forthcoming appeal of the CC's remedies package, there will be a significant change in the structure of the UK airports market. At the very least, Gatwick looks to have a new owner.

77. This structural shift presents an opportunity to deliver better outcomes for consumers both directly and through airlines being better able to deliver value to their own customers. But break-up needs to be supported by other developments if it is to maximise consumer benefits. First, regulation must facilitate the development of competition, which is why the CAA is launching its work on developing regulatory approaches that facilitate competition. Second, airports will need greater clarity about how the boundary between regulated and non-regulated airports will be defined, something that the CAA's competition project should support. Third, Government, will need to be mindful, whatever its approach to airport development, of the competition consequences of the precise planning and other arrangements it makes. Finally, the CAA's wider role – be it enforcing competition and consumer law, or engaging in European debate – will be important to ensuring that the potential benefits to consumers are both realised and sustained.