

KEY POLICY ISSUE

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PREPARING FOR A MORE COMPETITIVE AIRPORTS SECTOR

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Introduction

There are few times since the privatisation of the British Airports Authority (BAA) in the late 1980s when there has been so much change and uncertainty surrounding the UK airports sector. In addition to the impact of the most significant economic downturn in the aviation industry since the War, the UK Government's Review of Economic Regulation (RER) has proposed changes to the way the UK Civil Aviation Authority (CAA) operates. This review has proposed a more flexible licence-based approach to regulation, allowing the intensity of regulation to be better linked to the degree of airport market power. It has also proposed that the CAA's powers to enforce competition law be widened to include airports.¹

There has also been a major change in the structure of the airport sector in the South East of England following the recent sale of Gatwick airport by BAA to Global Infrastructure Partners. This change in the ownership structure, which will significantly reduce BAA's majority share of passengers in the South East, represents a significant potential injection of competition into the airport market around London.

Furthermore, following an investigation into the UK airports market and, more specifically, BAA, the UK Competition Commission (CC) decided in March 2009 that BAA's ownership of airports in the South East and in lowland Scotland was a feature of the market that had an adverse effect on competition in the UK and that BAA should be required, in addition to Gatwick, to sell Stansted and one of Edinburgh or Glasgow airports. There is therefore the clear possibility of further sales by BAA in the South East of England, depending on the eventual outcome of the successful appeal of the CC's recent market investigation.

Many of these developments reflect a change in the way that airports are viewed by policy makers. Whereas previously it was generally accepted that airports constituted something akin to natural monopolies, it is now evident that, to varying degrees, airports can and do compete with each other for both passengers and airlines. It is this insight that led the CC to make the decision to break up BAA in an attempt to stimulate effective competition between airports, and which underpins the benefits that have already been gained from regional airport competition in the UK.

¹ 'Reforming the Framework for the Economic Regulation of Airports: Decision Document', Department for Transport, December 2009

In order to respond to these developments and ensure that this likely increase in competition benefits airport users, in November last year, the CAA launched two related projects. These two projects will aim:

- to consider and identify, in principle, how best to assess the degree of competition faced by airports; and
- to consider and identify the ways in which regulation can distort competition, and the implications for the form of regulation that the CAA might adopt in future. This project will likely look at the potential effects of retaining RAB-based regulation, as well as the effects of adopting alternative regulatory approaches.

The remainder of this article provides more detail on these projects, and presents the CAA's initial thinking on how they will be managed. (It should be noted, however, that the CAA has yet to confirm its objectives and approach to these projects. This will follow in March 2010, once the CAA has carefully considered the responses it received to the November consultation.)

Assessing airport competition

The CAA needs to develop an approach for assessing the degree of competitive pressure faced by an airport both to ensure its analysis supporting any consideration of regulatory withdrawal is robust and to deal with any competition law cases that may arise. This project should also provide greater transparency for airport operators and airlines on the CAA's methodology in these circumstances

Competition and regulatory authorities have developed standard guidelines on assessing market power, which provide a useful starting point for this project. However, there are particular features of the aviation industry that will have an impact on the assessment of market power.

For example it is important to understand the role of scarcity in the airports sector and how this relates to market power. Scarcity is an essential feature of markets, but the issue is particularly pertinent for airports given the periodically lumpy nature of airport investment and some of the policy and environmental constraints upon it.

It is also necessary to appreciate the nature of the modern airport business, including the variety of services provided to different customer groups, and the variations between airports. This variety can have a significant impact on airport operators' incentives and how they compete.

Lastly, the liberalisation of the EU aviation market must be taken into account. 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 this in turn has had an impact on the nature and extent of airport competition which now takes place across borders.

The purpose of this project will be to decide how each of the above factors – and others raised by interested parties – should be taken into account in assessing airport market power.

Understanding the impact of regulation on the development of competition

In its final report on BAA, the CC stated its expectation that the break-up of BAA would increase competition among the London airports, reducing the market power of Gatwick and Stansted and therefore lessening the need for regulation at these airports. This link between the degree of competition and the need for economic regulation is well established, and has been recently illustrated by the decision to remove price cap regulation from Manchester Airport due to the constraint posed by competition on the airport's conduct.

However, the emergence of additional competition may not remove the need for continuing regulatory oversight entirely, or justify a simultaneous reduction in regulation at each of the three major South East airports. Competition may take a little time to develop fully, arguably providing a potential rationale for

some form of continuing economic regulation to protect airport users during a transitional period. Further, there may be an ongoing need for the current form of price control regulation of Heathrow for the foreseeable future.

The CAA recognises the potential for a regulatory asset base (RAB) approach to price regulation to distort investment incentives and competition. The principal purpose of this project is therefore to consider ways to improve the current approach and identify alternatives to the current RAB based method for setting price controls.

Expectations regarding regulation can have a significant effect on the behaviour of market participants, perhaps prejudicing nascent competition, or distorting investment decisions. As part of this project, the CAA therefore intends to take into account the effect of expectations about future regulation, including how to introduce greater clarity and transparency as to the future nature of regulation.

Process

The CAA is proposing to examine evidence on the relationship between competition and regulation, consider experience in other regulated industries and in airport sectors in other jurisdictions and analyse evidence submitted to the CAA. The CAA proposes to use this analysis to develop guidelines as to how the CAA would expect to assess competition faced by airports and to identify alternative methods of regulation that may be less distorting to competition and investment.

The CAA recognises the importance of engaging stakeholders in this process. By working closely with industry stakeholders – airports, airlines and others – the CAA can ensure that its work is fully informed about industry practice and that its decisions and decision making process is transparent. The CAA therefore intends to encourage participation by arranging bilateral and multilateral meetings with stakeholders throughout the projects and by hosting stakeholder forums to discuss issues as they arise.

Conclusion

In summary, it is an interesting time for the UK aviation sector. It seems likely that, irrespective of the implications of BAA's successful appeal on the CC's remedies package, the change in the structure of the UK airports market will have significant consequences.

This structural shift presents an opportunity to deliver better outcomes for users. However, 'break-up' needs to be supported by other developments if it is to maximise these benefits: regulation should not unduly hinder the development of competition. One way to ensure that regulation does not do so is to provide greater certainty to industry about how competition faced by airports will be assessed. Another is to spell out more clearly how regulation might be adapted to take account of the existence, and prospect, of effective competition.

This is why the CAA has launched these projects. And why the CAA is interested in your views on the issues to which they give rise.

The views expressed in this article are the author's and not necessarily those of IATA.