

BAA AIRPORTS MARKET INVESTIGATION

Points from hearing with the British Air Transport Association on 11 July 2007

Background

1. The British Air Transport Association (BATA) is the trade association for the UK registered airlines. It has 15 members: three airlines operating scheduled flights (British Airways, bmi and Virgin); two low-cost operators (Flybe and Jet2); a number of charter airlines; and two freight operators. The majority of its members operate from Gatwick airport and only the three providing scheduled services fly from Heathrow. BATA represents its members to the Government, the CAA and other bodies, and occasionally the media, on a wide range of aviation-related matters.

BAA management

2. BATA told us that it had no direct relationship with BAA, nor did it represent its members to BAA. It was too early to comment on the effects of the change of ownership, although BATA had noticed that the attitude to the strategic development of Heathrow had recently become more positive.
3. BATA said that the BAA airports tended not to respond flexibly to operational problems, possibly because they were very full. Other UK airports, for example London City and Manchester, had shown greater resilience to events like the heightened security introduced in August 2006. The problems at the BAA airports in south-east England suggested that BAA had not thought through its business continuity plans.

Constructive engagement

4. BATA told us that it had not been directly involved in constructive engagement but had supported the idea when it was first mooted by the CAA and had kept in touch with those of its members that were taking part. Members saw the benefits of the process, although it demanded a great deal of their time. BATA understood (at the time of the hearing) that progress was being made on three areas of disagreement: pier service at Heathrow, the eastern apron at Heathrow and the Gatwick capital investment plan. On the third of these points, BATA said that the airlines were concerned that the current regulatory regime encouraged capital investment, but not necessarily the most efficient investment, because of the returns associated with it. BAA had been broadly transparent in the constructive engagement process, but its plans had changed quite rapidly over the previous two or three years, as had its passenger forecasts, and it was difficult to keep track of the changes. For example, BAA had announced its intentions for the Heathrow East Terminal (HET) almost before any consultation with the airlines, and it had taken some effort to recover from that and reach agreement about the strategy. On balance, BATA would like constructive engagement to continue as part of the economic regulatory regime.

Cost of capital

5. The cost of capital proposed by the CAA was too high. It supported British Airways' evidence on this matter. With regard to BAA's argument that the CAA had some responsibility to maintain consistency across regulatory regimes, another objective of the regime was to try and reflect reality and simulate competition. It was clear from the price paid by Ferrovial that BAA was extremely valuable to a purchaser. BATA believed that a part of the premium paid could be attributed to what was seen as a generous regulatory incentive. Heathrow, for example, made a great deal of money for the BAA group and the incentive would remain even at a significantly lower cost of capital. BAA's threats to abandon the HET development if the cost of capital was low should not be taken seriously.

Capital expenditure

6. BATA recognized that following the Currie and Brown study of capital cost BAA had agreed that there was some scope for reducing project costs. There had been some progress towards this, but it would have to be kept under review because airlines were operating in a highly competitive environment and needed facilities that could be developed cost-effectively. BATA suggested that BAA's costs should not exceed those of the construction industry generally.

Operating costs

7. The potential for savings on operating costs was rather greater than the CAA had allowed. The 1 per cent a year improvement target was far too low and 3 per cent a year would be a more appropriate and reasonably challenging target, especially as it related to developments and growth at an existing site, which should provide scope for economies of scale.
8. Security staff were not deployed with maximum efficiency; there was some anecdotal evidence of rather generous rostering rules and a number of local arrangements. It seemed likely that BAA had been reluctant to take a tough line in areas like rostering and absenteeism because of the risk of industrial action. It thought that the regulatory regime, which allowed pass-through of most of the security costs, had not helped BAA to face up to some of these issues.
9. BAA's payment of its security staff at the upper quartile was not inappropriate for a demanding and high profile job. It commented that efficiencies could often be secured by contracting out specific activities, which might include security, because the people managing the staff concerned had a dedicated focus on a particular activity instead of covering a wide range. Specialization and focus could lead to better performance in terms of quality and efficiency.
10. It was possible that security queuing times might be reduced in the future through new technology, but it was difficult to keep pace with the changing security requirements. Investment in new technology would be a good business investment compared with employing large numbers of staff, but at present more facilities were needed—additional gates and staff to man them fully at all peak times.

Traffic forecasts

11. BATA believed that BAA had been too pessimistic in its passenger forecasts for Q5. It had underestimated the load factor; its model and assumptions were dated in that respect and looked back to a time when airlines starting a new route, or increasing

frequency on a route, would expect to need two or three years before the route was operating with the optimum load factor. Nowadays, airlines could not afford to wait two or three years. They had to achieve a high load factor from day one and would compete on price to achieve this. When BAA was considering the effect of the Open Skies agreement at Heathrow, it had assumed that when a new long-haul service started from Heathrow its load factor would be in the region of 60 per cent, whereas BATA would expect it to be around 70 per cent.

12. BAA's assumptions overstated the effect on passenger numbers of economic factors such as air passenger duty, higher interest rates or exchange rate fluctuations. When there was a change in the economy, any airline that had a schedule would not want to reduce it, particularly at major airports, so it would drop prices in order to fill its aircraft. This meant that the number of passengers flowing through an airport would largely remain the same despite the changed circumstances. Sudden events like worldwide epidemics or terrorist attacks could have an effect on passenger numbers, but experience had shown that this tended to be short-lived.
13. As regards Open Skies, BATA said that there was a strong demand for long-haul operations at Heathrow from US carriers that were currently flying from Gatwick. The likely outcome was that short-haul services from Heathrow would be sacrificed to provide space for long-haul services, with domestic routes either being lost or switching to other airports in the South-East. More crucially for Heathrow, larger numbers of passengers might fly from regional airports to other European hubs such as Amsterdam or Paris to connect with long-haul services. This could endanger Heathrow's future, and damage the airlines operating there and the UK economy, unless the airport was further developed.

Service quality

14. In BATA's view, the appropriate standard for queuing at central search was an average of five minutes and no passenger waiting for more than ten minutes. As regards the amount at risk under the SQR, BATA believed that at Heathrow it should be higher than the current 3 per cent and that additional aspects of the airport's operation should be brought into the scheme, in particular airside services such as availability of stands, guidance systems on stands, and piers.

BAA airports market inquiry

15. BATA believed it would be beneficial if all three BAA London airports were separately owned. In particular competition would stimulate the delivery of additional capacity. It said that independent regulation of the airports imperfectly simulated competition, as evidenced by the fact that BAA, in the run-up to the air transport White Paper, was lobbying for its own agenda, which focused on Stansted where it believed it had an opportunity to develop additional capacity. It had been loath to support development at Heathrow, which was by far the most important of its airports to the UK economy and also to the airlines, and had already limited what could be done at Gatwick by agreeing to no further development until 2019. So BAA had been able to work to make best use of its assets in a way that was not in the best interests of the industry or consumers. In the White Paper consultations BATA had supported development at Gatwick as the second priority after Heathrow, and no airline company put Stansted ahead of Gatwick. BATA told us that BAA had a corporate objective to make proposals that were as acceptable as possible to opponents of airport expansion, and so they opted for the one that seemed easiest to get through the planning process rather than the one with the best economic payback.

16. Even under current conditions there would be some opportunity for an independent owner of Stansted to compete for customers, as there was a little runway capacity still available, but the more important benefit of separate ownership would be the scope to compete for future developments.
17. At Heathrow and Gatwick, however, BATA reported that airport capacity was fully used and independent ownership would only allow competition for future capacity. There was an active market in slots at Heathrow, which allowed airlines that did not mind operating at Gatwick to transfer some or all of their operations from Heathrow. The choice of airport would depend on whether it could serve the airline's particular markets and, in the case of a network carrier, provide the opportunities for it to operate an effective 'hub'. Heathrow was the airport of choice for much of the premium business travel market in south-east England.
18. Transfers between Heathrow and Stansted seemed less likely; the low cost and charter airlines did not want to operate from Heathrow and preferred to make best use of capacity at Gatwick and Stansted. In general, short-haul operators with smaller aircraft would find it easier to switch between airports. Long-haul operators had difficulty moving because they tended to have large fixed investments in hangars and other facilities and would usually depend on a good range of connecting short-haul services that another airport may not be able to offer. However, it was possible to envisage a long-haul airline operating a different model in the future and being prepared to operate from Gatwick in competition with services from Heathrow.
19. There was real competition between regional airports in the UK. An airline planning to start a new service would have discussions with a number of airports and take into account the facilities on offer and access to the airport. Airports with spare capacity were well-placed to attract a variety of airlines, depending on the markets that were available, whereas BAA wanted to encourage only the larger aircraft to use Heathrow because of the shortage of slots.
20. BATA thought that there was potential for competition between airport terminals. Separate ownership of terminals had been tried in other parts of the world and had been successful. It would be essential to ensure that there was good interconnectivity between terminals, especially at Heathrow.
21. The regulatory regime had been proved to be necessary, but in the airlines' view it did not go far enough. BAA had an easier ride than it should have, and generated shareholder profit that should be shared among the wider stakeholder group, including the airlines. BATA believed that regulation of prices would still be required if Heathrow, Gatwick and Stansted were separately owned, because, although separate ownership would deliver competition at the strategic level, capacity constraints would restrict competition at the operational level.
22. BATA had some sympathy with BAA over planning constraints. It hoped that current proposals would lead to a nationally agreed plan for airport development which would help to speed up the planning application process. It recognized the need for local planning inquiries, but said that it was important that the first year of an inquiry was not spent arguing about basic principles, as had happened in the T5 inquiry.
23. BATA was concerned about BAA's relative dominance in Scotland, although not as exercised as about the airports in south-east England. There was still spare capacity at both Edinburgh and Glasgow airports, and some competition to Glasgow from Prestwick. There was some segmentation of the market, with Edinburgh serving a growing business market while Glasgow served a wider range of leisure destinations. BATA thought it would be a good thing for the development of Scotland in the longer

term if Edinburgh and Glasgow were separately owned, so that a single company would not have strategic influence over crucial infrastructure.