

BAA AIRPORTS MARKET INVESTIGATION

Points arising from the hearing with the DfT held on 5 June 2007

The aviation industry

1. In respect of aviation, the DfT's main responsibility was to create an environment in which a sustainable aviation industry could develop in the UK accounting for environmental costs and social inclusion. It saw the supply of airport services as a key component in ensuring an effective and internationally competitive aviation industry that supported economic growth. Aviation played a very important role in the UK economy. In 2003 it was responsible for about £11 billion of GDP, about 1 per cent annually; it directly supported about 200,000 jobs and indirectly many more than that. Growth in demand for air travel placed increasing pressure on some of the key airports in the UK. This pressure was creating significant problems in terms of reliability and increasing delays for passengers and freight.
2. The 2003 White Paper, *The Future of Air Transport*, outlined the DfT's strategy for sustainable aviation and looked at both the impact of climate change globally and the impact on the local environment in terms of noise and air quality. It also set out the Government's commitment to ensuring that the price of air travel reflected its environmental and social impacts. The Government was currently taking work forward on the inclusion of aviation within the European Emissions Trading Scheme as soon as was practicable and was consulting on an emissions cost assessment to inform future decisions on major increases in airport capacity.
3. As stated in the White Paper, the DfT strongly supported two additional runways in the South-East of England; this was based on the balance of all costs and benefits, including environmental impacts. The DfT's view was that wherever practical, competition was preferable to economic regulation, which might distort market decisions and stifle innovation. Even where there was inadequate competition, regulation should only be preferred if it could be expected to deliver a clear net benefit. So economic regulation needed to be appropriate and proportionate.
4. The White Paper sets out a 30-year framework, within which the DfT would expect individual airport operators to bring schemes forward for the development of their own airport. There was nothing to stop any operator across the country bringing forward a scheme, even if it was not in the White Paper. As part of the planning inquiry, local environmental impacts would need to be examined, such as noise and air quality, along with surface access issues.
5. The CAA's role with respect to regulation and the duties it carried out on behalf of the Secretary of State are laid out in Section 39 of the 1986 Airports Act. The Secretary of State for Transport decided which airports should be designated for the purposes of price control, but did not determine the way in which price caps were set, or what the price cap would be. That is for the CAA to decide. The CAA has an obligation to set price caps as set out in Section 39 of the Airports Act 1986 which includes to encourage investment in new facilities at airports in time to satisfy anticipated demands by airport users. As far as the CAA's international obligations were concerned, there were two elements. First were the ICAO guidelines, which were set out on the basis of charging for airport use, and they were fairly high-level guidelines

based on principles such as cost-related fairness, equity etc. The other aspect of this was about the international air service agreements—there were responsibilities under the bilateral agreements between different countries for access to the airports and the charges to those airports. The EU-US air service agreement was to be introduced in March 2008 which would open up significant new possibilities for transatlantic services to and from Heathrow. Terminal 5 was due to open at the same time as the new EU-US agreement came into force. This would not provide more capacity for carriers to enter Heathrow but would make it easier to handle increased numbers of passengers and new airlines resulting from the opening up of the transatlantic market.

Slot allocation

6. The DfT explained that slots at the 3 main London airports and Manchester were allocated by an independent body, Airport Coordination Limited (ACL). Under EU slot allocation regulations, slots were allocated on the basis of grandfather rights, so any airline which already used a slot and did so for more than 80 per cent of a season would continue to have a right to use it. If it failed to do so, the slots were returned to a pool. Slots in the pool (including newly created slots) were allocated on the basis of 50 per cent priority to new entrants to the market and 50 per cent to existing users of the airport in question. One of the problems at Heathrow was that there were very few spare slots, which made it difficult for new carriers to enter the market or for existing carriers to expand.
7. Because of this, a secondary market has emerged at Heathrow, where airlines exchanged slots with each other with some financial consideration attached to that swap. The European Commission had argued that EU slot allocation regulations did not allow for a secondary market for these slots. It was difficult for airlines to expand and some companies might be unwilling to pay for slots on the secondary market. The lack of available slots at Heathrow was a key reason for seeking to expand capacity at the airport.

Additional runways

8. In the DfT's view, two new runways were required in the South-East of England before 2030. The White Paper strategy for additional runways in the South-East resulted from extensive consultation and economic forecasting, particularly a project known as the South East Regional Airspace Study (SERAS). Stansted and Heathrow were chosen as the sites for the runways because they were the two best candidates having assessed all the costs and benefits. In the event that building an extra runway at either of these airports proved not to be feasible, DfT would need to revisit the White Paper policy on airport expansion in the South-East.
9. The White Paper stated that Government did not see any subsidy going in to the construction of the second runway at Stansted and therefore the timing of any decision had to be a commercial one, based on revenue forecasts and risks. Also, however, the CAA had responsibilities to set price caps to encourage investment at a time which was beneficial to consumers.
10. The DfT had stated that the Government would support a third runway at Heathrow, but only within noise and air quality constraints. It was currently conducting a project to forecast how those two constraints might be met and a timescale. A planning constraint is in place which means that another runway at Gatwick airport could not be constructed before 2019 and therefore in the White Paper, the Government had

said that, taking all relevant factors into account, it would keep the option for a wide spaced runway after 2019.

Mixed mode

11. The White Paper encouraged the maximum use of existing capacity and said one way to achieve that at Heathrow might be through mixed mode operations. The White Paper did not actually approve mixed mode—that was not Government policy at present. Later this year, the DfT would be consulting on both mixed mode and also a third runway and a sixth terminal at Heathrow. Although the policy was set out saying a short third runway was supported, there was not any indication in the Air Transport White Paper that it would meet the noise and the other environmental restraints. Mixed mode would provide up to 10 to 15 per cent additional capacity on the existing runways. Besides consultation, it would involve seeking two separate approval processes: it would require planning permission because it would require raising the current cap of 480,000 air traffic movements; and it would also potentially require an airspace change process. A policy decision could, however, be taken to allow some mixed mode within the existing cap or to make other minor improvements in capacity. However, mixed mode on the existing runways was not possible with a third runway. This was due to airspace issues. Mixed mode was therefore, considered to be a way of bridging a gap between the current situation and the creation of a third runway.
12. The DfT policy was that any additional capacity had to fall within the noise and air quality constraints. The noise constraint meant sticking within the size of the 57 decibel noise contour. With extra movements, unless further action was taken, the size of the current decibel contour could increase; and the Government had a very clear policy against increasing the size of the contour. The DfT was therefore looking carefully at the operation of mixed mode and runway 3 with the latest technology and fleet mix assumptions. Noise impacts on residents in the area were a very significant factor that would be reviewed during the consultation period. Airspace was also becoming an issue across the whole of the South-East of England on which the DfT had been working very closely with the CAA and with NATS.

Stansted (including planning regulations)

13. The Stansted Generation 2 application would be progressed under the regulations of the *2004 Planning and Compulsory Purchase Act*. The DfT believed that while the airport was currently being used mainly for short-haul traffic, potentially in ten years' time it might be very different. One of the issues for airports operators was to have sufficient flexibility in the design and operation of an airport to respond to changes in travel behaviour. It was a matter of concern, for example, that there was little spare capacity at Heathrow to allow flights from new destinations. The CAA had presented a range of analysis, which showed that Stansted competed with airports like Birmingham and Luton, and that the markets were similar enough for there to be competitive pressure between those airports which acted as a brake on Stansted's potential market power. The DfT did not have a view on this.

Forecasting

14. The DfT's modelling estimated the relationship between passenger air travel demand and its key drivers. This had shown that both incomes and air fares drove air travel demand. The modelling suggested that while a one-off rise in APD would have some effect on demand, the overall forecast of strong growth in demand would not be

significantly changed because this was more strongly driven by the forecast of growing incomes. The DfT and BAA employed forecasting methodologies which had both similarities and differences, but generated broadly similar forecasts.

Security

15. The Department's primary responsibility was the safety of passengers. This was also transport security's (TRANSEC) main concern and TRANSEC was the main forum for promoting airport security. The DfT had asked the airports and the airlines for evidence of their costs from the 10 August security changes. This would be submitted to the Secretary of State. One of the advantages of having a larger company, like BAA, owning several airports was that they had a team that could actively contribute to the security debate at a more strategic level. Some of the smaller airports did not have that capability.
16. The DfT constantly reviewed security requirements at airports since the threat was constantly changing. The Department set and regulated the standards of security arrangements within the airports and gave its full support to current research that sought to improve these standards. How airlines or airports chose to apply the standards set was entirely up to them. The security services were regulated in exactly the same way regardless of whether they were contracted out or provided in-house. A number of airports were looking at different methods and technologies which could help them speed up the overall security process. Any proposed advancement in technology would be considered by TRANSEC. There were various levels of security: ICAO, EU and UK. The threat level in the UK was higher than most of mainland Europe; hence airport security was tighter in the UK.

De-designation

17. In response to the OFT and following a formal consultation process, the DfT had published revised designation and de-designation criteria. There were three criteria which would be applied. The DfT had also received requests from the CAA, Manchester Airport Group and the Transport Select Committee to consider the designated status of Manchester and Stansted Airports. It would be consulting on the status of these airports over the Summer after which the Secretary of State would make a decision before the end of the year. This timing would help the CAA be in a position to work out what they did in terms of a price cap for those airports if required.
18. De-designation of an airport could open the way for the signing of longer-term contracts, especially between airports and airlines, which might be of benefit and interest to both parties. However, airport de-designation had not previously occurred and there was a degree of nervousness among interested parties as to how it would work out.
19. For some airlines there might be a perception that price control was a sort of low-cost insurance policy. Most of the compliance and price control costs were borne initially by the airport operator but this was then spread across airport users. For a small airline the cost might be low, but for larger airlines the costs of regulation, including Constructive Engagement and negotiations with the airport operator, could be high. It was important to ensure that there were incentives on the operator to deliver value for money and be efficient and effective.
20. Airport owners also needed to have a sufficiently robust financial structure to maintain operations in a climate of uncertainty and to invest in line with the Air Transport White Paper and to improve customer services. Very large investments

were going to be required so any owner or operator of an airport in the UK would need to be able to have a financial ability to actually fund those significant investments.

Market issues

21. The DfT had advocated stand-alone regulation for designated airports. One of the major problems that all regulators faced was incentivizing investment at the appropriate time. One of the key features of UK economic activity was that it was less important who owned the companies in the market than that the markets were competitive and, in the case of the owners of UK airports, that they were financially strong enough to provide the investment as laid out in the White Paper. The White Paper also supported the development of regional airports as the Government was conscious of the congestion in the south-east airports, so would not encourage people to travel into the South-East if there were perfectly good airports to fly from in the regions. The growth of regional airports in recent years had outstripped BAA's main south-east airports.

Relations between BAA and airlines at Stansted

22. It was a disappointment that relationships were poor between BAA and the airlines at Stansted. One of the problems at Stansted was the concentration on the very short term at the expense of planning for the future. In addition a major issue between BAA and the airlines was the design of a new runway and whether new all-purpose terminals were needed or something simpler and cheaper. The aviation market was developing in Asia and BAA would want to target that as a growth area. Stansted was the only BAA location in the London area where there was spare capacity. For the airport to take these extra flights, the terminal and runway structure would need to be adapted.

Scotland

23. The Scottish Executive was very focused on communications between England and Scotland and would be concerned if it felt that the frequency of services between Edinburgh or Glasgow and Heathrow might be threatened. It also had policies that we did not have such as PSO and/or route development funds which helped subsidize some of the routes.

Competition

24. The Scottish airports currently had spare capacity, whereas the south-east airports had very little. An operator with spare capacity would want to fill it and would compete with others to do so. However, if an operator had no spare capacity, one might question why it would compete. One should also distinguish between short-run responses and long-run responses. In the short run the scope for additional capacity might be relatively small. In the long run, the capacity issues were different.