

Potential distortions from the interaction between price-capped and unregulated airports

1. In this appendix, we consider potential distortions between a price-capped airport and a substitute unregulated¹ airport under different ownership.²
2. The CAA argued that limiting prices at price-capped airports to historical costs may dampen incentives to invest at other airports (notwithstanding the fact that airports regulation overall continued to operate reasonably effectively as an incentive-based regime for airports holding a position of market dominance). The CAA said such an effect would arise if the price-capped airport expects that, at some point in the future, price caps based on historical cost might be below the marginal willingness to pay of its users. The CAA suggested that the airport would then have an incentive to raise the price cap to the level of users' marginal willingness to pay. Under a RAB-based price control the airport operator can achieve this—and increase its regulated revenues—by investing. This investment could still be brought forward by the airport even if it were less efficient than investment at substitute unregulated airports and therefore have the effect of crowding out investment at other airports.
3. Any such distortion already exists under the present ownership and regulatory structure as Luton and London City are unregulated and are substitutes for BAA's price-capped airports. We noted in our provisional findings that we had not seen clear evidence of price caps having adverse effects on investment at other airports. We noted in our recent Stansted report that a regulated price cap at Stansted, at or above existing levels, should not cause any distortion to the investment decisions of any other airport.

¹Here this means an airport without a price cap.

4. We do not consider that the position would be likely to be different if the number of price-capped airports is reduced and the number of unregulated airports is increased. If, following divestiture by BAA, Stansted ceases to be price-capped, a potential distortion between price-capped Stansted and unregulated Luton is removed, albeit a potential distortion between price-capped Heathrow and an unregulated Stansted arises. As set out in our provisional findings, there are in any case other factors (including planning and government policy) which would act against any tendency for BAA to over-invest at Heathrow.

5. Moreover, as the CAA accepted, any potentially distorting effect on the efficient allocation of runway slots in the short term would be mitigated by the fact that airlines can sell their slots to other airlines. As we also noted in our provisional findings, it is the combination of RAB-based prices and slot prices that provides the signal to the market. The CAA nevertheless argued that there would be a distorting effect on runway investment: if a price-capped and unregulated airport were both trying to secure airline support for expansion, an equally-efficient project would get more airline support at the price-capped airport because expansion at the price-capped airport would result in higher airline slot rents than an equivalent expansion at a non-regulated airport (as airport charges are capped at the regulated airport but slots are allocated for free). We do not agree with this argument for the following reasons. First, the CAA's own analysis suggested that, as output expands, slot rentals would fall not increase,³ implying that existing airlines would not necessarily prefer investment in expanding capacity at price-capped airports. Second, for there to be over-investment at a price-capped airport, the cost of expanding capacity must be greater than the current price and this is a further reason why slot rentals would fall,

²We also considered the potential distortion arising from a price-capped Heathrow and unregulated Southampton remaining under common ownership and concluded that Heathrow was so much larger than, and so different to, Southampton that any distortion was likely to be small.

³Capacity and output expansion tends to cause slot rentals to fall if there is a downward sloping demand curve and no price discrimination by airlines at the price-capped airport.

not increase.⁴ Third, under the existing rules, half of all new slots are available to airlines classified as new entrants rather than to existing airlines, representing a further reason why existing airlines would not necessarily support expansion at a price-capped airport (although it could also imply that new entrant airlines prefer expansion at a price-capped airport, it is not clear why new entrants' views would carry special weight).

6. In conclusion, we accept that any regulatory arrangements must necessarily be less than perfect but we do not consider that competition between price-capped and unregulated airports will lead to significant distortion of investment decisions with adverse effects on consumers. We have not seen clear evidence that significant distortions have occurred up to now (with three BAA price-capped airports plus Southampton competing with smaller unregulated airports) nor are we persuaded they are likely to occur under a possible future situation where BAA owns a price-capped Heathrow and competes with larger unregulated airports under separate ownership, including potentially Stansted and Gatwick.

⁴If the cost of expanding capacity is greater than the current price, slot rentals fall even if airlines are able to perfectly price discriminate.