

Ref: JB / MM

Tel: 0161 489 3798

Fax: 0161 489 3812

Mail: jonathan.bailey@manairport.co.uk

Date: 17th March 2008

Ms Susie Talbot
Economic Regulation Group
CAA
4th Floor
CAA House
45-59 Kingsway
London WC2B 6TE

Dear Ms Talbot

CONSULTATION ON THE FRAMEWORK AND OPTIONS FOR THE ECONOMIC REGULATION OF STANSTED AIRPORT

This letter sets out a response on behalf of the Manchester Airport Group Plc (MAG) to the CAA's consultation on the framework and options for the economic regulation of Stansted Airport.

MAG owns and operates Manchester, East Midlands, Humberside and Bournemouth airports. MAG is, therefore, interested in the regulation of Stansted by virtue of its ownership of East Midlands (EMA) since there is a degree of overlap in the passenger catchment areas between the two airports. There is also a degree of competition between most airports in the UK (and beyond) to attract airlines to operate services and/or to establish a base of operations, for both passenger and freight services.

However, given that MAG's interest is indirect – since the consultation is in respect of Stansted Airport – we do not intend to address each question posed in the CAA's consultation document but instead to provide our views where relevant to some of the overall issues raised.

As MAG has argued in previous submissions in respect of the de-designation of Manchester Airport we believe that there is a very competitive market for airport services in much of the UK. However, we have no objection to the imposition of price control regulation on airports in areas where a clear monopoly exists and there is a significant risk of anti-competitive behaviour to the detriment of passengers, airlines or competing airports.

Economic regulation is generally designed to replicate as far as possible the working of a competitive market. Such a competitive market has proved to be the best regulator in the case of airports such as Manchester. There are, however, degrees of competition at different airports and the extent to which an airport is subject to regulation should – as much as possible – reflect that degree (as well as taking into

account the costs of regulation). The recent consideration of the possible de-designation of Stansted highlighted the particular position of that airport in relation to competitive constraints. The different interpretations of the data by the various parties involved only served to emphasise that the competitive position of Stansted is not the same as that of Heathrow or Gatwick, and that notwithstanding its common ownership with those airports, Stansted's current market power is limited. (MAG notes that the Secretary of State determined that it is the potential of future abuse of a dominant market share and the common ownership of BAA airports that justifies economic regulation of Stansted. It should be noted that the issue of common ownership will not be solved by adopting any of the price cap options. The ability to add capacity in the South East market is also a key factor in ensuring future competition.)

Although Stansted is a competitor of EMA, and to some extent other airports in our Group by virtue of the competition for airline services, the degree of competition is limited. MAG believes that the regulatory approach adopted for Stansted should reflect this reality and, while acting to prevent possible abuses of Stansted's remaining degree of market power, adopt a system that replicates as far as possible the workings of the airport market in the rest of the UK.

In adopting a new approach it is right that sound principles are followed in determining the form of a price cap to ensure it is applied in a targeted, proportional and cost efficient manner.

One of the key risks with the current structure for price control review is that the price cap may be set too low, forcing competing airports to reduce prices below a commercial level. This could result in weakened profitability and/or degraded customer service and have an impact on competitor airports.

Given that currently Stansted is pricing below the cap set by the CAA and that the degree of market power could be described as marginal, the likelihood of this risk impacting on EMA to a significant degree is small. MAG is also of the view that while price is now the major determinant of choice of airport, this is not the only competitive factor and there is also competition on service quality. Due to the competitive interaction between the airports EMA would have to follow prices down to a certain extent due in a scenario where the cap is set too low, but it would expect to compete effectively to attract airlines and passengers through better service standards. MAG sees the provision of high service standards at airports as one of the key issues in the industry today and is likely to be a competitive factor for the foreseeable future.

One principle of the structure adopted should be that the determination of a price cap should not incur unnecessary levels of cost so as to distort the working of the market. By its existence, economic regulation adds cost to the operation of an industry that is already subject to significant current and potential future external costs including Air Passenger Duty (soon to become Aviation Duty), and policing or security costs incurred in detecting and preventing terrorist attacks. In principle a "light touch" regime would be expected to impose lower costs on the sector and the regulatory regime chosen for Stansted should reflect this. A more intensive form of price cap such as the existing building block approach or the CAA's proposed development of "an augmented building block" approach would only be appropriate where the risk of abuse of a dominant position is high.

One of the features of the current regulatory approach is the adversarial nature of the relationship between airlines and airport operator that can exist during each review. Such uncooperative or even hostile relationships at one airport can have a

detrimental affect on the relationships at other airports – since the same airlines operate at MAG’s airports as at others, at the very least it would likely that the experience of one operator could condition their expectations of another. In principle the chosen regulatory regime should avoid a structure where the CAA is effectively the referee between the two sides. Ultimately this is of no benefit to the aviation industry but only results in additional costs being incurred for legal and technical advice to the parties.

Given current and anticipated market conditions, and the potential negative impacts of the building block approach we do not believe that the Augmented Building Block approach set out in Option 1 is likely to be appropriate.

MAG is also concerned that any regulatory structure for Stansted should recognise the principle that the management of airports is the responsibility of the airport operator. The selected regulatory structure must allow airports to manage their own businesses led by customer needs. Indeed, MAG can only determine the appropriate form of airport development and identify the appropriate products and service standards required by involving airlines closely in effective consultation. This is good business practice but the Stansted price control structure should avoid setting any precedent whereby an airport is obliged to go beyond this normal commercial relationship.

Airport operators are responsible to a wide range of customers now and in the future, they – and their shareholders – must take a long-term view since airport assets are constructed and paid for over an extensive period. Airports must cater for different airline customers with different operating models and these requirements will change over time. By contrast, due to the nature of the market, airlines cannot often be sure of their requirements or their fleet composition for the short term. Judgements as to the appropriate infrastructure for the next 10 – 30 years must therefore be left to the operator.

Similarly, it is not desirable for the regulator to specify the design of terminals or other infrastructure. This would also not be in line with the light touch approach we support and it would almost certainly increase the costs of the process.

Another principle we wish to see recognised is that an airport must be managed as a whole. An airport’s business is made up of a combination of aeronautical and non-aeronautical activities and these should not be separated. The “single till” exists as a commercial reality for MAG’s airports. Equally, in MAG’s view dividing the business into legacy and new infrastructure or specifying terminal development in a way that does not take account of the entirety of the business would also fail to recognise the nature and complexity of the airports business. Just as competition between terminals at an airport would lead to a significant risk of operational difficulties, so tendering for new development with decisions made by different bodies, is also to be avoided. MAG has made these and similar points earlier as part of the initial OFT market study in 2006.

MAG is opposed to any precedent that divides the management of an airport either by infrastructure or by having airlines specify development of infrastructure. For these reasons, the options in the CAA’s consultation paper on Legacy price caps (Option 2) or Terminal Development Tendering (Option 3) should be rejected.

In principle, MAG would also wish to see the regulatory regime rely as much as possible on the existing body of competition law. The airport sector should be treated, as much as is possible, in the same manner as other industries. The need

for any structure that entails more than a light touch regulatory regime is harder to justify given the extension of legislation over recent years that acts to prevent or remedy abuses of competition. MAG believes that airlines and consumers have sufficient protection from the general provisions of competition law and from the CAA's existing powers. Competition law has been strengthened since price cap regulation was implemented through the Competition Act 1998, the Enterprise Act 2002 and the existing provisions in Articles 81 and 82 of the EC Treaty. The CAA's ability to investigate public interest complaints and to set conditions in under Section 41 of the Airports Act is already a departure from the law affecting other industries and is an important additional factor making up part of the regulatory framework. MAG would expect to make use of these legal instruments if it believed that competing airports were acting unfairly and to its detriment.

In the light of the considerations above, MAG is of the view that the Market Led Price Cap (CAA Option 4) or the precautionary price cap (Option 5) are the most appropriate in the case of Stansted. A degree of market power does remain with Stansted, although in the case of EMA this is marginal, partly by virtue of Stansted's proximity to the strong underlying demand of the London market (in comparison with other regional airports with overlapping passenger catchment areas). Therefore, MAG would in principle support the more restrictive of these two options, that of the Market Led Price Cap. This option appears to balance the competitive pressures in the market without restricting the development of the industry. It would also be in line with the Government's Better Regulation agenda providing a proportionate response to the particular challenges in the airport sector.

Yours sincerely

Jonathan Bailey
GROUP DIRECTOR OF EXTERNAL AFFAIRS