

# **Annex C – Department for Transport’s Draft Impact Assessment on the Regulatory Status of Manchester Airport**

## **Introduction**

The Secretary of State for Transport is currently considering whether the regulatory status of Manchester airport under Section 40 of the Airports Act 1986 should be changed. In particular, the Secretary of State is considering whether Manchester airport meets the criteria established to assess whether airports should be designated or de-designated. Further information about the process and the consultations and decisions in the process so far can be found on the Department for Transport’s (DfT) website at [www.dft.gov.uk](http://www.dft.gov.uk).

A change to the regulatory status of Manchester airport may have implications for a number of stakeholders, including the airport operators, the airlines and passengers. An IA represents an important mechanism to assist the Secretary of State with making her policy decision. The information presented here is work in progress because the IA is only a draft at this stage of the consultation process. It explains the approach the DfT is taking to the IA, including how it proposes to assess potential costs and benefits, and represents an opportunity for interested parties to express their views and provide information to the DfT to inform a final IA.

The DfT will not reach a view on the balance of the potential costs and benefits until it has considered responses to the consultation about the CAA’s advice and this draft IA. In this draft IA, the DfT has not provided a quantification of the costs and benefits of potential de-designation of Manchester airport. Indeed, it is likely that it will not be feasible to quantify the relevant incremental costs and benefits individually because of the practical constraints created by the limited availability of information. The DfT will consider the extent to which it is possible to quantify costs and benefits after considering responses to this consultation, and in particular, whether interested parties are able to identify robust ways to quantify costs and benefits, and the information that would be used to do so. The Secretary of State will consider the net incremental benefit or cost in making her decision about the designation status of an airport through the criteria used as part of the process.

It is important to note that the third criterion used by the Secretary of State to determine whether airports should be designated or de-designated considers whether designation would deliver incremental benefits. Given the link between the third criterion and the IA, the Secretary of State will take account of responses that consider the third criterion to inform the IA. Therefore, in responding to questions within this IA, interested parties should seek to provide any information in addition to that provided in response to criterion 3.

The subsequent sections of the IA:

- Describe the proposed approach to the IA.
- Explain the main costs of potential de-designation of Manchester airport that the DfT has identified, provide some initial thoughts about how these might be estimated and seek views to inform a final estimate of the costs.
- Explain the main benefits of potential de-designation of Manchester airport that the DfT has identified, provide some initial thoughts about how these might be estimated and seek views to inform a final estimate of the benefits.
- Consider the other important issues required to inform an IA.
- Summarise the draft IA and the questions on which we would welcome respondents' views. Although the DfT is seeking interested parties' views on a number of specific questions, if interested parties have views about any other issues relating to the IA, these should be included within their response.

## **Approach**

In this section we discuss three issues that are important in our approach to the draft IA:

- The policy options being considered.
- Key assumptions for assessing costs and benefits.
- The role of qualitative and quantitative costs and benefits.

### *Policy options*

The legal framework provided by the Airports Act 1986 means that the Secretary of State has only two options regarding the status of airports under Section 40 of the Act - either an airport is designated or it is not designated. It is not possible for the Secretary of State to impose conditions or requirements on a designated airport as a consequence of it being designated or de-designated. Given this legal framework, we have only considered the two options that are open to the Secretary of State - the continued designation or the de-designation of Manchester airport.

There are a number of common regulatory provisions that apply to designated and non-designated airports, including:

- UK and EC competition law, enforced by the Office of Fair Trading (OFT), by the European Commission or by affected parties through UK or European courts;
- Section 41 of the Airports Act 1986, under which complaints about various courses of conduct by airports can be made to the CAA for investigation; and

- Certain powers available to the CAA under the Airports Act 1986, under which it can impose additional accounting requirements. The CAA stated in its advice to the Secretary of State that it would propose to reapply these requirements to Manchester airport if it was de-designated by the Secretary of State.

In addition to these powers, a de-designated airport faces the possibility of re-designation if the Secretary of State's criteria were met at some point in the future.

The effect of designation is that the CAA has to impose certain mandatory conditions on the airport concerned that:

- Set price caps on airport charges, generally for periods of five years, following a mandatory reference to the Competition Commission;
- Address any public interest findings made by the Competition Commission at the five yearly review; and
- Specify information that has to be published in the airport's statutory accounts<sup>1</sup>.

The precise form of the future price caps that would apply at Manchester airport if it continued to be designated will depend on the assessment of the CAA, against its statutory duties, and taking account of the recommendations made by the Competition Commission. It is not for the DfT to take a view on the form of any future price caps at Manchester airport. In carrying out this IA, the DfT will consider whether the form of price cap assumed would be likely to have a material effect on the assessment of costs and benefits. The advice provided by the CAA indicates that the form of the potential price cap in Q5 might not have a significant impact upon the costs and benefits, i.e. all forms of potential price cap have significant shortcomings in the view of the CAA.

- **Question 1 – Do respondents believe that the form of price cap assumed is likely to materially alter the assessment of costs and benefits?**
- **Question 2 - Can respondents quantify any potential differences between the costs and benefits for different forms of price regulation? If yes, please explain the information and assumptions.**

*Key assumptions for assessing costs and benefits*

The objective for the DfT in IAs is to assess the overall costs and benefits arising directly from a change in policy.

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<sup>1</sup> Although the CAA has stated that it would propose to reapply these requirements to Manchester airport if it was de-designated by the Secretary of State.

In assessing the potential costs and benefits of de-designation, the DfT has sought to identify costs and benefits that arise as a result of a change in regulatory status of the airport. Further, the assessment is based on an evaluation of the likelihood of achieving the outcomes that might be expected in a reasonably competitive market. In principle, the level of prices, investment and efficiency should, therefore, be compared to the levels that might be expected to occur in a reasonably competitive market over time. In addition, costs and benefits should be measured from the perspective of society, rather than for a particular subset of consumers or suppliers.

The CAA's advice to the Secretary of State notes the importance of considering forward looking efficient costs as a potential measure of whether price levels indicate cause for concern. The CAA also notes that price increases in markets can be an important signal of capacity scarcity, and therefore, provide an incentive for new investment in additional capacity. Therefore, price increases are not necessarily indicative of excessive pricing.

- **Question 3 – Do respondents agree with how the DfT proposes to decide what constitutes costs and benefits for the draft IA?**

*Qualitative and quantitative costs and benefits*

Consistent with the Government's approach to developing IAs, in the final IA, the DfT wishes to quantify the potential costs and benefits as far as is possible. However, it is not always possible to attach robust numeric values to costs and benefits where there is only limited information and a significant range of possible values. Examples of costs and benefits that are difficult to quantify include those that depend on the development of the aviation market or for which a wide range of scenarios can be envisaged, such as the impact of regulation upon incentives including the tendency to innovate. In some cases, these difficulties can be partially overcome by estimating ranges for costs and benefits. Another approach can be to identify those costs or benefits that can be quantified relatively robustly, and consider in what direction the other costs or benefits that cannot be robustly quantified would affect the estimates. On other occasions, when the potential costs and benefits are likely to be small and it is difficult to obtain data, it will be a proportionate use of DfT resources to acknowledge them but not spend resources trying to quantify them. Overall, it is important to recognise that costs and benefits, whether quantified or not, will all be taken into account in the final IA. We recognise that even if a cost or benefit cannot be quantified it may, nevertheless, be relevant.

In addition to encouraging interested parties to provide information, where possible, to allow potential quantification of costs and benefits, where it is not possible to quantify potential costs and benefits, we would encourage interested parties to indicate qualitatively their magnitude.

In the final IA, the DfT will make an overall judgement about the costs and benefits, taking account of quantification where that is possible. Given the potential difficulties in quantifying many of the potential costs and benefits of de-designation, the DfT would encourage interested parties who consider that quantification is possible to provide as much information as possible to inform a robust quantification of potential costs and benefits.

- **Question 4 – Do interested parties agree with the DfT’s proposed approach to considering quantitative and qualitative benefits?**

## **Costs**

We have identified a number of potential costs of de-designation. The following three potential costs are considered below:

- The risk of abuse of market power through excessive pricing.
- The risk of abuse of market power through reduced quality of service and/or investment, which can form part of a strategy of excessive pricing.
- Additional resources of the OFT, EC or affected parties to enforce competition law.

### *The risk of abuse of market power through excessive pricing*

The DfT and the Government more generally, considers that the competition law framework in the UK can be an appropriate mechanism to address excessive pricing. The CAA’s assessment of whether Manchester airport meets the second criterion indicates that competition law could be applied effectively in the airports sector. Although we go on to discuss the potential cost arising from the risk of abuse of market power through excessive pricing if an airport is de-designated, it is important to note that a key element of the competition law framework is that there should be a deterrent within the legal framework to breaching competition law in the first place. This is incorporated in a number of ways including the basis for calculating penalties for breaching competition law.

Any abuse of market power through excessive pricing would be addressed *ex post* under competition law if an airport was de-designated rather than *ex ante* through price caps for designated airports. We have not specifically considered the underlying reasons why an airport might be able to price excessively, but generally assumed that as a result of a lack of competitive pressure an airport would seek to exploit its market power. The lack of competitive pressure might also reduce the incentives for efficiency both in terms of ongoing costs and investment.

In general, any abuse of market power through excessive pricing would be addressed *ex post*, although in certain circumstances affected parties can seek injunctions in

advance of abusive conduct taking effect, potential damage to the interests of customers (airlines and passengers) may already have occurred before action is taken to address the excessive pricing, whereas with a price cap there is protection in advance for customers against pricing above the cap. The nature of any damage to airlines and passengers that could arise from anti-competitive excessive pricing is likely to manifest itself in higher prices than would otherwise occur over a non-transitory period, together with an impact on the airfares and services offered to passengers. However, these damages will be counter balanced by any relief that is obtained by the affected parties through damages. In some cases of excessive pricing, this might mean that no costs are incurred by affected parties, although in practice there may be some distortions to outcomes that are unlikely to be reversed through the awarding of such damages.

It is inherently difficult to quantify the potential cost of abuse of market power if an airport is de-designated because it depends on taking a view about whether such abuse would occur, its magnitude and how often it might occur. Manchester airport has in recent years priced below its price cap, which has been interpreted by the CAA as providing some evidence that there are constraints on the airport's ability to set excessive prices.

Prior to the final IA, the DfT would welcome the views of interested parties on whether and how this potential cost of de-designation could be quantified, including the potential sources of information, such as experience of anti-competitive behaviour in other sectors of the UK economy or airport sectors in other countries. However, these potential sources of information have substantial limitations that will affect the potential ability to develop a robust quantification of costs and benefits.

- **Question 5 – Do respondents agree with the proposed framework for assessing the potential costs of the risk of abuse of market power through excessive pricing by de-designated airports?**
- **Question 6 – Please provide any information interested parties have that would inform estimating the potential costs of the risk of abuse of market power through excessive pricing by de-designated airports.**

*The risk of abuse of market power through reduced quality of service and investment*

Many of the issues discussed above about abuse of market power through excessive pricing would also apply to abuse of market power through reduced quality of service and investment. Indeed, as noted above, reductions in investment (or other forms of artificial restrictions to capacity availability) are likely to be a necessary precondition to excessive pricing. Reductions in quality of service and investment with no compensating reduction in price can be seen as a form of abuse of market power, with reductions in service quality having a very similar impact to excessive pricing. Differences in quality or the impact of lower investment are arguably more difficult to

quantify than differences in price. Nevertheless, an important part of the evidence could be whether there is a material difference between quality standards at designated and non-designated airports, taking account of relative levels of capacity, etc. However, it is important to note that the regulation of quality of service of designated airports is relatively weak, in that the standards and financial consequences are generally developed through voluntary agreements. Further, CAA advice to us indicated that price regulation has had little impact on improving the quality of service at Manchester airport. It is also possible that de-designation will facilitate more targeted quality of service agreements between airlines and airports, and investment that better meets the needs of airlines and passengers.

- **Question 7 - Do respondents agree that differences in the quality of service and investment between designated and non-designated airports might provide useful evidence about potential abuse through this route?**
- **Question 8 - Do respondents have any relevant information to inform this assessment?**

#### *Additional OFT resources to enforce competition law*

It is arguable that as the CAA does not have concurrent powers to administer competition law in the airports sector, OFT might need to increase resources to be prepared to handle complaints if additional airports were de-designated. The OFT would also consider the need for any additional resources or diverting resources towards competition concerns in airports and away from investigations relating to potential market abuse in another sector of the economy.

We would welcome views on whether any additional, or diverted resources at the OFT would be particularly significant on an ongoing basis. The precise amount of costs would ultimately depend on the number of additional complaints received by the OFT that led to substantive investigations.

- **Question 9 - Do respondents believe that the additional or diverted resources at the OFT are likely to be substantial if Manchester airport was de-designated, and if so, why?**

## **Benefits**

The DfT has identified a number of potential benefits from de-designating an airport. The following three potential benefits are considered below:

- Avoiding the direct costs of regulation.
- Reduction in regulatory risk for de-designated airports.
- Removal of regulatory distortions.

### *Avoiding the direct costs of regulation*

When an airport is designated it will incur costs to comply with the price cap and other regulatory requirements, including participating in the periodic price control reviews carried out by the CAA. These price control reviews include a mandatory Competition Commission reference. The CAA and Competition Commission also incur costs in this process, although these are recovered from the airport concerned. CAA advice to us indicated that these costs were just under £2 million for the last price control review, which were then passed onto the airport operator at Manchester. Other stakeholders participating in the price control process, including airlines and passenger representatives, will also incur costs to understand and participate in this process, although to some degree these stakeholders can choose what level of resources to invest in the process depending on the payback they expect to receive. It is important to note that while costs relating to the price control process would be avoided under de-designation, it is unlikely that all economic regulation costs would cease. For example, the airports concerned, as now and in common with businesses in other sectors, would still need to ensure that they did not act in ways that would breach competition law.

- **Question 10 - Do respondents agree with this estimate?**
- **Question 11 - If not, how would respondents revise them and why? What costs do respondents incur to participate in price control reviews?**

### *Reduction in regulatory risk for de-designated airports*

When an airport is de-designated its prices and investment decisions will be wholly determined through commercial discussions between the airport and airlines. These discussions would not be constrained by the price cap process and the involvement of the CAA in the process. The current regulatory process can create some risk because the returns generated from investment are affected by a range of regulatory decisions, e.g. investment judged by the regulator to be inefficient could be disallowed from the Regulatory Asset Base (RAB). In addition, the price control settlements typically last for five years, whilst many capital projects are remunerated over much longer timescales. In evaluating an investment project, the airport is likely to consider the risk that there is a significantly detrimental change in the regulatory treatment of the project. Further, the price control might discourage long-term contracting between the airport and airlines, limiting the degree to which the two parties can manage the underlying market risk between them. This potential benefit of de-designation is most likely to manifest itself in lower costs associated with investment and improved management of risk by airports and airlines. This might be expected to improve the prospects for investment, delivering capacity at lower cost to consumers, and encouraging innovation and/or better quality of service because it could result in investments that better meet the needs of the airport's customers.

The role of the Competition Commission in the process for setting price caps for designated airports should act to reduce regulatory risk for designated airports, as it provides a cross-check on the approach of the CAA. Although conversely, it could be argued that it introduces greater uncertainty into the process, and adds to the overall cost and duration of the price control processes.

If, for the final IA, the DfT concludes that this potential benefit could be significant, a challenge will be to estimate its potential size in terms of the lower levels of cost of capital for the airports.

- **Question 12 - Do respondents believe that de-designating Manchester airport would have a material impact on the airport's cost of capital due to changes in the level of regulatory risk?**
- **Question 13 – What estimate would respondents make of this potential impact and how would they calculate it?**

#### *Removal of regulatory distortions*

Some of the following discussion about the impact of removing regulatory distortions may be captured by the resultant change in the cost of capital that is discussed in the section above. Nevertheless, it is worth separating out some of the components and describing their drivers, which is done below.

Where the maximum level of airport charges now and in the future are determined by a RAB based price cap imposed by the regulator, there is a risk that the airport will make investment decisions based on what it perceives the regulator will allow into the RAB rather than necessarily what the airlines require, as ultimately it is what is allowed in the RAB that is likely to be the basis on which airports can recover charges. As the CAA's encouragement of constructive engagement between designated airports and airlines shows, airlines and airports can work together to minimise the differences between their views of the required investments. However, in common with other economic regulators, due to the limited information available to it, it may be difficult for the CAA to evaluate investment plans, particularly where there is significant disagreement between airlines in their views about what is required or between airlines and the airport operator. In these circumstances, the regulator's decision might be different from that which would arise in a reasonably competitive, commercial setting. The CAA has been concerned that investment decisions at Manchester airport, particularly for the second runway, might be materially affected by the RAB based price control regime, rather than being determined by the likely demand from passengers and airlines. It is difficult to quantify this potential benefit, but it could be quite substantial if it leads to airport facilities – in terms of their size, nature and timing – better reflecting customers' needs.

It is also possible that price regulation may stifle innovative commercial behaviour. In a competitive market, businesses bear significant risks but can also be rewarded with substantial returns, which provides incentives to innovate. In contrast, price regulation allows companies to accrue a ‘reasonable’ reward based on regulatory expectations. The CAA has highlighted some innovation in UK regional airports, such as longer term contracts, no frills facilities and changing staff conditions. Some parties might argue that these new ways of effectively meeting consumer demands might have been observed at certain designated airports to a greater extent if they had not been price regulated.

- **Question 14 – Do respondents believe that de-designation of Manchester airport could remove some regulatory distortions and lead to investment decisions that better reflect customers’ needs?**
- **Question 15 – How would respondents suggest that this potential benefit be calculated?**

### **Other issues to be considered**

The Cabinet Office guidance on best practice for IAs identifies a range of factors in addition to the overall assessment of costs and benefits that should be considered. Some of these factors will be more relevant for some IAs than others.

Of these factors, it is the DfT’s initial view that a decision about whether to designate or not an airport has no direct effect on issues associated with legal aid, race equality, disability equality, gender equality and human rights. We do not propose to consider these issues further in developing the IA. The DfT will consider further the need for consideration of environmental issues and a competition assessment as part of the final IA.

The final additional factor to be considered in any IA is the impact on small firms. An initial consideration is establishing which small firms may be affected by a de-designation. The Cabinet Office defines ‘small firms’ as small enterprises and self-employed sole-traders employing less than 250 people. While the DfT has some ideas about the kind of small firms that might be affected, such as local businesses, minor airlines or even small organisations that fly for business using the airports, it would welcome stakeholder views. In the first instance, the DfT believes that this impact test sounding is best achieved through the representation of the local business community on airport consultative committees, and would actively encourage the Manchester airport committee to provide their views about any impact on small firms.

- **Question 16 - The DfT would welcome views from small businesses and the airline consultative committee at Manchester airport about the impact on small firms of whether to designate or de-designate an airport.**

- **Question 17 – Do respondents believe there is any reason why any costs or benefits arising from de-designation should fall disproportionately on small businesses?**

## **Summary**

This draft IA sets out the DfT's proposed approach to assessing the costs and benefits of potential de-designation of Manchester airport. It is likely to be difficult and disproportionate to quantify all individual incremental costs and benefits. Further, an exact aggregate estimate of net incremental benefits or costs is unlikely to be possible. However, as noted in the draft IA, an assessment of the costs and benefits of de-designation is inherent to the Secretary of State's decision criteria about the regulatory status of airports and encompasses all the relevant parameters.

In this draft IA we have sought the views of interested parties on a range of questions to inform the final IA. We would encourage all interested parties to respond to the questions set out in this draft IA and provide as much information as possible to allow the DfT to develop a final IA.