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Agenda

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Airport regulation: keeping up with an industry at full throttle?

The past year has seen major changes in the global aviation industry, with airports increasingly regarded as tradeable assets—indeed, the takeover of UK airport operator, BAA, by an international consortium has been the focus of attention for many stakeholders. Mike Toms, Oxera Director, asks whether regulation can keep pace with an industry in flux

Until relatively recently, the UK airports sector operated on the basis of a stable, informal, give-and-take partnership between government, the regulator—the Civil Aviation Authority (CAA)—and airports to deliver capacity. However, it now operates under a quite different system. The industry has to accommodate a world in which airports are tradeable assets and investment decisions are made according to strict economic criteria. This change has brought into sharp focus four core regulatory issues:

– the relationship between the government's airports policy and an independent airport regulator;
– the degree to which airports and airlines can and should negotiate key outputs, independent of the regulator or passenger interests;
– the relevance or otherwise of financing considerations to the setting of regulated airport charges;
– whether airports serving overlapping geographical markets can and should be structured to compete with each other.

Who sets airport policy?

The basis for BAA's privatisation and regulation was set out in 1985 in a White Paper that identified the CAA as the industry's regulator.[1] The subsequent Airports Act 1986 set out the CAA's duties, including an explicit duty to encourage investment in time to meet anticipated demand from users. The 1985 White Paper made it clear that regulation should respect government policy, stating that 'there must be adequate regulatory arrangements in place to ensure that the policies pursued by the management of the major airports fully support the government's aviation policies.' It also set out the government's airports policy, including the development of Stansted Airport and further development of Heathrow Airport, as the framework for regulation.

Over the following 15 years the question of ownership of policy lay dormant as there was a broad consensus in the industry about the type and pace of investment required. The issue has now returned with a vengeance, following the Air Transport White Paper in 2003, which set out developments the government wishes to see up to 2030.[2] Most notably, it stated the government's policy that the next runway for London should be developed at Stansted Airport as soon as possible, with a target date for opening of 2012.

The 2003 White Paper was the result of three years of studies of a wide range of sites, and a public consultation involving half a million submissions from individuals and organisations.

The CAA welcomed the overall thrust of the White Paper of attempting to meet demand with additional capacity provision.[3] However, it fell short of endorsing the specific policy of a second runway at Stansted Airport by 2012. The CAA's view appears to have been that the runway should only be delivered as and when it represents a sound financial investment for the airport. The fact that the soundness of the investment will depend in large part on the CAA's own decisions on the price control formula at Stansted was indicated by the CAA in 2005:

> the challenge for the CAA is to set the incentive framework to encourage BAA to implement … lumpy investments where it is economic to do so.[4]

Initially, the main difference between the CAA and the government appeared to concern the timing of construction of the runway. The regulator did not adopt the 'as soon as possible' principle because it did not accept the government's underlying rationale, and it did not adopt the government's underlying traffic forecasts. Neither did it

This article is based on a paper to be included in a forthcoming publication by the Centre for Regulated Industries (*CRI Regulatory Review 2006–7: 10th Anniversary Edition*, edited by Peter Vass, University of Bath). Mike Toms joined Oxera as a non-executive director in January 2007. He was formerly Group Director, Planning and Regulatory Affairs, BAA, and member of the BAA plc board.

find a framework in its own duties for the government's proposition that early development of Stansted would aid the UK economy generally, or benefit Heathrow and Gatwick passengers by stimulating competition between airlines.

The CAA has therefore not actively accepted in principle that, as a matter of policy, Stansted should have a second runway in the period to 2030—on the face of it, it appears to have a somewhat neutral position. This difference would be interesting, but academic, if the CAA were not in a position to effectively override government policy and determine the rate of development through its price control decisions. In this respect, the regulator has made its position on the White Paper clear, stating that it will 'take account of the white paper only as far as is compatible with [the CAA's] functions and duties'.[5]

The CAA's approach is reflected in its regulatory activity.

– In setting the 2003–08 price formulae ten months before the White Paper, the CAA announced in February 2003 that it would sanction charges for development at each airport only on the basis that it would not be remunerated from overall London system revenues.[6] The decision was taken without modelling the impact on the timing of investment in Stansted or the impact of airport capacity delivery delays on the scope for competition between airlines.

– Prior to the publication of the White Paper, BAA asked the CAA to clarify its position on the recovery of preconstruction costs for whatever runway was selected for early development. The CAA did not address this request until it had seen the White Paper. Immediately after publication of the White Paper, BAA set to work on designing the Stansted scheme and acquiring land. In September 2004 the CAA launched a consultation into whether and how such mounting costs should be recovered.[7] In January 2005 it published a decision to allow such costs into the regulatory asset base,[8] subject to onerous conditions, but then withdrew its decision and reconsulted. By March 2006 the consultation was abandoned,[9] with the issue to be decided by the Competition Commission. By the time BAA knows whether its costs will be allowed, it will have spent many millions on the scheme.

– The CAA has been careful to qualify the relevance of the White Paper. Its December 2005 policy paper states that it was:

> based on evidence then available and the government's own analysis of it using different criteria from those in the Airports Act 1986. Importantly, the white paper stopped short of mandating (or even authorising) particular developments or precluding others.

This last sentence is particularly notable in the significance it ascribes to a statement that was inserted as a legal recognition that a White Paper cannot amount to a refusal or approval of planning permission for any development.

What this discussion illustrates is a philosophical conflict between the government's wish for an orderly and planned sequence of developments to meet broad public policy objectives within environmental constraints, and the CAA's wish for economic forces to decide when and where development takes place. It also illustrates a fault line between the CAA's desire for economic forces to determine investment, and its own control of those economic forces through its price-setting duties. This leaves the airport operator in a potentially difficult position between two of its most important stakeholders.

The close of 2006 saw a development in this situation, with the CAA proposing that Stansted and Manchester Airports be dedesignated for price control and permitted to determine their own charges and investments.[10] This proposal included a statement from the CAA that it does not endorse the Stansted Generation 2 runway plan. Two weeks after this announcement, in its White Paper progress report, the government appeared to give considerable ground to the CAA by avoiding an explicit restatement of the 'Stansted runway as soon as possible' principle.[11] It admitted that the CAA's regulatory decisions could affect the timing of the project but did not exhort the CAA to use its powers to assist in early delivery.

Constructive engagement

When the CAA's new regulation team took office in 2003, it was immediately concerned about the difficulties between airports and their airline customers, concluding that this reflected a failure by both sides to communicate and engage on the issues (an alternative interpretation is that the situation reflected the airlines' shock at being confronted with a price formula of RPI + 6.5 at Heathrow to pay for Terminal 5). It also felt that the previous price review had been unsatisfactory in the degree to which the regulator was required to determine issues which might have been settled more effectively directly between the parties, notably volume forecasts, required service quality levels and capital expenditure plans.[12]

The CAA's proposed solution was to require both sides to engage constructively, and to agree the key inputs to the next price review. The threatened sanction was that failure to agree would lead to the CAA making decisions that would be unlikely to satisfy either side.

BAA supported the general thrust of these constructive engagement proposals, although it had less ambitious expectations of the outcome. Specialist process managers were appointed, databases set up online, and workstreams with deadlines agreed. Has constructive engagement worked? Yes and no.

At Heathrow and Gatwick Airports broad agreement has been reached on traffic forecasts; a shared high-level vision of the future of the airports has been created; and progress has been made towards achieving a mutually satisfactory service quality regime. At Gatwick a broad consensus has also been established on the capital programme. Significantly, at both airports there has been agreement on the levels of construction cost to be applied to capital projects. This had been unlocked by an agreement with the airports to pay the costs of airlines to appoint expert consultants.

However, significant elements of the capital programme remain unresolved at Heathrow, largely because of differences between users concerning investment priorities. Perhaps not surprisingly, users are less inclined to support investments benefiting other users than those that benefit themselves. The CAA's response has been to repeat its exhortation to the airport to obtain agreement, although with clear and rational differences between groups of airlines, it is not obvious how a consensus will be reached. Without agreement, the CAA may find itself having to make a decision on investment, although it is not clear what criteria it would employ.

At Stansted, the process appears to have been unproductive. Among other factors, media coverage of the issues has made constructive negotiation difficult. Notwithstanding this, the CAA has asked the airport to re-engage with users on an agenda defined by the airlines. History suggests that a likely result of such an engagement would be more delay to the Generation 2 scheme.

Although the process is as yet incomplete, a number of overall points are already clear.

– Constructive engagement can be helpful; however, the model is not generic and will only work if both sides choose to adopt cooperative strategies.

– The model works best where negotiation lies in the appropriate hands—ie, of line management. At the outset, BAA delegated its constructive engagement to its airport managing directors, rather than its regulation team. At Gatwick, airlines by and large deployed line operational managers. At Heathrow, airline corporate regulatory advisers were not unseen, and lawyers and the press were ghosts at the table at Stansted.

– The process needs to address the natural disparity in resources between the parties. Airports, which have all of their revenues and their capital programmes at stake, will give more attention to constructive engagement than airlines, for which airport charges may be around 5% of costs, and shorter-term issues may predominate. This puts a burden on airports to support the airlines through the issues (eg, by financing airline advisers). It also puts an onus on airlines to use their trade associations to pool their resources. One of the least satisfactory aspects of the past two years could be considered to be the failure of airline trade bodies to grasp the nettle of leadership of the issues.

– The process gives natural precedence to the views of existing customer airlines, whereas airport runways and terminals are built with economic lives of 50 years or more. Current airlines cannot be expected to speak for their successors and, indeed, they might be expected to attempt to suppress opportunities for future competition. The history of airports is littered with airports designed for airlines which folded before the facilities even opened—eg, Laker, Pan Am and TWA. Stansted Airport was designed for the likes of B Cal and Dan Air—indeed, today's two largest users of the airport did not even exist when the plans were drawn up.

– Finally, and most importantly, while the process brought airlines and airports closer, it provides no vehicle for the interests of passengers to be taken into account. Structurally constructive engagement invites airlines and airports to reach agreements that share rents, not necessarily to the benefit of consumers. The regulator should therefore have a method for developing a backstop view of whether any deal is in the best interests of the consumer.

Is financing relevant?

One of the distinguishing features of airport regulation is that the regulator does not have a duty to secure the financing of the business. Neither can it impose licence restrictions on airport financing. These issues are addressed only indirectly in the regulator's duty to set a price formula that encourages investment. The CAA's 2003 price settlement made it clear that the financing of the business was a matter for the company, not the regulator, and set a price formula based on a cost of capital which could attract new equity if necessary.[13] The decision document set the tone by stating that 'Capital structure decisions are best left to the firm'. It then developed the policy:

> The CAA approach in determining the price caps is based on actual gearing rather than notionally

> 'optimal' gearing, due to the lack of a normative model to establish the latter.

The implications of this are stated as follows:

> the CAA has therefore decided to adopt a cost of capital figure consistent with a robust view of the cost of equity … That allows for the raising of new equity as well as debt where appropriate … this should allow BAA a range of options regarding future financial policy.

The external landscape since 2003 has put this policy under pressure. BAA's purchase of Budapest Airport in 2005, using the strength of its UK airport balance sheet, caused some consternation. The emergence of highly geared private equity and infrastructure funds hungry to own utility assets has understandably also encouraged the CAA to shift its ground. The Ferrovial approach to BAA brought this into sharp focus. When Ferrovial's interest had been announced, but before a bid had been formally tabled, the CAA acted, issuing a short statement, including the following:

> The CAA will set caps on airport charges in accordance with its statutory duties and not in order to accommodate any particular financing arrangements adopted. In this context it is important that in making financing arrangements airport operators recognise the significant near and medium term investment required to upgrade airport facilities and accommodate a continuing increase in the demand for air travel in the south east of England. This is likely to require the maintenance of credit quality sufficient to ensure the cost-effective financing of future investment.[14]

This statement introduced a concept new to the CAA's policies: the need to set a credit quality standard. The practical relevance of this is understandable, although it is not clear in theory why, having set a cost of capital sufficient to attract new equity, the CAA should attempt to influence financial structures. At the time of this statement the market was awaiting a formal offer for the company. The share price had increased from £6.50 to £8.40, and observers had been expecting the bidder to rely on a highly geared financing structure. All other things being equal, one might have expected the market's response to have been to mark down the share price in anticipation of withdrawal, or a less geared lower offer. In fact, the share price was unmoved.

The bid process unfolded: Ferrovial published a mainly debt-financed offer at £8.10, and a Goldman Sachs consortium made an approach at £8.70. On May 16th, the CAA made a further statement, in conjunction with a broader policy paper, reminding the market of its concerns about financing.[15] It was explicit that the CAA would not bail out any overleveraged buyer through the price formula, and that it might take away any tax benefit from high leverage. The share price was unshaken. Both bidders found more borrowing capacity, and the group eventually changed hands at £9.50 per share.

What had happened: or rather what had not happened? Why was the CAA unsuccessful in imposing its view of gearing? There are a number of possible explanations.

– The market knew that the CAA had no legal power to prevent a highly leveraged structure. Perhaps the most significant element of the CAA's statement was the absence of any reference to any request to government to strengthen the CAA's powers. The CAA might threaten to punish high gearing through the price settlement, but making this work in practice could be challenging given the duty to encourage investment.

– The regulator had not indicated the amount of investment which it envisaged operators should plan for, although it had indicated its doubts about the urgency of delivering the Stansted scheme.

– Although the CAA stated explicitly its policy concerns, it did not express them in terms of measurable thresholds, targets or standards which had to be met. Neither BAA nor the bidders knew which balance sheet was to be tested (the individual airport, the group of airports or the owning entity), what rating was to be required, or what financial ratios were to be targeted.

The CAA expected all parties to submit their financing proposals for scrutiny, despite having no intention of pre-clearing or rejecting any of those proposals.

In the heat of a bid battle, any intervention couched in such terms was likely to be of limited impact, and this did indeed turn out to be the case.

Ownership and competition

Until May 25th 2006 there was 'only' the company's management, its investors, its creditors, its users, two potential bidders, the national media, an army of advisers and the CAA involved in the future ownership of the airports. However, the Office of Fair Trading (OFT) then joined the party, announcing that it was considering a market study into the structure of the UK airports industry. Its press notice made it absolutely clear that the potential break-up of BAA was on the list of options.[16]

There is no evidence that this intervention was part of a broader government or regulatory agenda. So far as can be determined, it was an entirely independent act. It did, however, have some immediate consequences. BAA's share price fell by 70p to below the best price on the table at that time. Had this persisted it is likely that the

OFT's intervention would have accelerated the outcome least desired by the CAA—that is, shareholder acceptance of a highly geared bid. In the event, this was postponed. BAA projected the announcement as an opportunity to reopen the consideration of improvements to the regulatory regime, and the share price recovered. Indeed, this is the most interesting structural issue raised by the OFT's interest. If it is found that London's airports could compete under separate ownership, price control would arguably need to be lifted, to allow competition to happen.

The OFT's investigation was launched under the Enterprise Act 2002. If it concludes that there is a market failure, it can either negotiate a voluntary remedy, or refer the issue to the Competition Commission. The Commission has two years to study the issue, and can ultimately direct a divestment.

BAA faces the prospect of the Commission investigating airport charges under a mandatory reference from the CAA, while the Commission is also setting out on a parallel, longer study of the airports market. The timetables suggest that the CAA will determine the price control formulae at Heathrow and Gatwick, taking account of the Commission's recommendations on prices, around one year before the Commission decides whether the airports should be broken up, possibly with recommendations that the government change the regulatory framework. The price control review for Manchester Airport—if it is still conducted—will take place one year later, concluding just before the deadline for completion of any Enterprise Act studies.

In December 2006, the CAA published its initial price proposals for 2003 to 2008, and the OFT published its draft thinking on the market, flagging real concerns about the system of price regulation.[17] In an ideal world the cart would change places with the horse, and the ownership and regulatory framework would be clarified before prices are set. However, the different statutory obligations, and multiple agencies involved, offer no certainty of such an orderly process, or of an orderly outcome. Meanwhile, airport operators are expected to push ahead, raising money and investing in the growth of the business.

It is not surprising that, in 2003, the CAA itself noted that regulated companies are not necessarily less risky than their unregulated peers!

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[3] Speech by Sir Roy McNulty, European Transport Conference, March 2004.
[4] CAA (2005), 'Airport Review: Policy Issues', December, para 16.
[5].CAA (2006), 'Airport Review: Policy Issues Update', May.
[6] CAA (2003), 'Economic Regulation of BAA London Airports: CAA Decision', February.
[7] CAA (2004), 'Regulatory Treatment of Initial Expenditure and New Runway Capacity: Initial Consultation', June.
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[10] CAA (2006), 'Airports Price Control Review: Initial Proposals for Heathrow, Gatwick and Stansted', December, para 12.
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[12] CAA (2004), 'Airport Regulation: Looking to the Future, Learning from the Past', May.
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[14] CAA (2006), 'Possible Offer for BAA plc: CAA Statement', February.
[15] CAA (2006), 'Airport Review: Policy Issues Update', May.
[16] OFT (2006), 'OFT to Look at UK Airports Market', press statement 91/06, May 25th.
[17] CAA (2006), 'Airports Price Control Review: Initial Proposals for Heathrow, Gatwick and Stansted', December; and OFT (2006), 'OFT Proposes to Refer BAA Airports to the Competition Commission', press release 175/06, December 12th.