

Agenda

Advancing economics in business

The future of airport regulation: Heathrow's perspective

Colin Matthews, CEO of BAA Ltd, explains what challenges airport regulators and governments face in tackling the new demands of a rapidly changing industry. Given the need for proportionate economic regulation and prioritising the customer experience, what are the prospects for converting UK government proposals for change into an effective regulatory framework?

UK aviation has changed radically in recent years. Open Skies between the EU and the USA, the transition of airlines such as easyJet and Ryanair from start-ups to established heavyweights, drastic changes in airport security, a growing realisation of the importance of carbon emissions, and recession have all transformed the industry and continue to do so. Given the speed of change, it is understandable that government policy and sector regulation have not kept pace.

Regarding the overarching policy environment, in my opinion, government needs to be clear-thinking and decisive. It will stretch the democratic process of the UK to bring the social, environmental and economic considerations of flying into one balanced and clear plan of action. Runway capacity will not, however, be built outside of government policy, and the suggestion that competitive market forces could transform the delivery of capacity appears to have been countered by the recent statement from Gatwick's new owners that they do not intend to develop a second runway. A new government, elected in May this year, may well want to revisit existing policy, and the sooner the outcome is clear the better.

Regarding regulation, after some 25 years of being relatively unchanged, it is time for an update. The government's recent 'Review of Economic Regulation' was welcomed by players across the industry. If enacted, it will result in some sensible changes that will update and refocus the regime: the Civil Aviation Authority (CAA) will have a primary duty to passengers; price controls will be set without an automatic reference to the Competition Commission; and a licensing regime will be introduced for the larger airports.

The aspect of regulation that strikes me as being most odd is that Heathrow Airport has been regulated in the same way as other airports, even though the business characteristics are so dissimilar. Heathrow competes with European hubs such as Amsterdam, Paris and Frankfurt for network carriers and network traffic. Heathrow's business requires the efficient handling of over 20m passengers per year, driving different systems and higher costs than are required by point-to-point airports. With different competitors, different airline customers and different costs, regulation should surely reflect different business models rather than take a one-size-fits-all approach.

The good news on this front is that the government's review has proposed much more flexibility for the CAA to adopt suitable measures at different airports through the new licensing regime. Equally encouraging, the CAA has been considering how to assess differences in market power between airports so as to be able to adapt regulation accordingly. Much remains to be done by the regulator, however, to turn these encouraging signs into an effective new framework in time for the next regulatory cycle. To my mind, the key topics fall into three broad categories:

- improving passenger experience;
- the social and economic value to the UK of a hub airport;
- the delivery of new capacity.

Improving passenger experience

Regulation should seek to mimic competitive outcomes. It is imposed as a counterbalance to

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the potentially negative effects of market power, and aims to keep the market on track when it might otherwise not deliver typical market outcomes. An important example of this would be delivery of a good passenger experience. Regulation should reward good performance and deter poor performance in the same way that the market will reward good and bad service. To do that we need to have a clear idea of what good looks like from a passenger perspective and design a balanced scorecard of measures that deliver that vision. At Heathrow we are endeavouring to focus on the end-to-end passenger experience as opposed to single processes, and while we still have a way to go to deliver the many improvements passengers want and deserve, we are putting all our effort into making every journey better. We must of course recognise that improvements come with associated costs, and that is why scoping the end-product is key to ensuring that we understand the cost-benefit dynamic very clearly. I think the regulatory framework could do more to reward good performance. We also need to look at how the regulatory framework can be used to encourage other parties operating at Heathrow to deliver a consistent service so that passengers get a good end-to-end experience. Too often, strenuous efforts to improve the overall passenger experience have been undermined by the lack of effective integration between the various parties. Sometimes the pursuit of individual accountability discourages the collaboration which so obviously benefits passengers.

The social and economic value of the hub

Around 200m passengers transferred over a European or Middle Eastern hub in 2008—competition in this market is fierce and growing. Heathrow, with 180 destinations, has now fallen behind Frankfurt (280), Paris (240) and Amsterdam (237). At the same time our service standards have improved—on the Airport Service Quality measure we are now close to Amsterdam as the best-rated of the major European hubs.

If the premise is right—that regulation must endeavour to mimic competition—it follows that regulation should encourage Heathrow to be competitive with other European hubs. That means that regulation should of course drive us to be efficient and, importantly, should support investment in new facilities to enable the airport to offer a level of service that will make Heathrow 'Europe's hub of choice'. It should also help foster the delivery of service requirements that drive hub competition, and support pricing and capacity utilisation regimes that underpin network airline operations.

Basing the new framework around passengers' interests should trigger real changes in the way airports

are regulated, particularly in the way the framework provides support for the development of Heathrow as the UK's hub airport. You only need to look at the difference between ticket prices for direct flights and flights that require passengers to change planes to see how much passengers value direct connections. Ironically, these direct connections, particularly to long-haul destinations, can be sustained only if airlines can attract enough transfer passengers to make services profitable. So for Heathrow to provide the direct services that UK passengers want, it must win the head-to-head competition with Paris, Amsterdam and Frankfurt for transfer traffic.

Looking beyond the domestic market, air travel has undoubtedly done more than any other 20th-century invention to knit together our social and economic fabric. More often than not, however, the aviation sector is taken for granted by policy-makers. And yet it makes a major contribution to the UK's economic development: London wouldn't be a destination of choice for business without Heathrow and the airlines that fly there from around the world. The value of aviation is, however, far more than economics—it plays a vital role in connecting multicultural UK to a globalised world—you wouldn't want to video conference into your daughter's wedding in Australia.

Delivery of new capacity

I have already referred to the inherent challenges governments face in balancing the social, environmental and economic considerations of flying. This is never more stark than in the debate about future runway capacity requirements. There is still more to be done to make current capacity at Heathrow work better (although slot allocation rules arguably hamper this today), and there may well be ways that regulation can help with that by promoting optimal use of the scarce capacity. Operating at 99% capacity is never going to deliver a consistently positive passenger experience. Current government policy recognises that we can't simply sweat the investment that was first made in the 1950s. As an economy we need to keep pace with economic centres with their own competitive hub airports if we are to retain our position as a destination of choice for international business. Similarly, policy-makers must understand that the reference point is no longer geographic markets within the UK. As technology continues to improve, the distance that planes can fly and their fuel efficiency means that airlines have far more choice about how they design their networks. I would also argue that of all the things we could be spending our precious carbon emissions on, air travel is one of the few uses that is not substitutable—not that that doesn't carry with it a great burden of responsibility.

A key step in managing the tension will be for the CAA to establish a clear view of passengers' interests at

each airport, against the backdrop of the overall policy outcomes that policy-makers are seeking. This will enable the CAA to identify where changes can best be made to the regulatory framework to meet passengers' interests.

The optimal balance of investment, capacity and planning and environmental issues is likely to require us to tackle both more efficient use of existing capacity and bringing forward new capacity to address tomorrow's needs.

Conclusion

For more than two decades the regulatory burden on airports has been increasing. We have certainly strayed a long way from the path that government set down at the time of BAA's privatisation. Back then, the government did not consider that 'detailed and continuous regulation of traffic charges is either necessary or appropriate for airports in the private sector'.¹ I think we would be hard-pushed to describe the current regime as anything but 'detailed and continuous'.

Every five years the CAA and Competition Commission agonise over the detail of the price cap model that will balance the need for investment with a reasonable rate of return for shareholders. This requires a level of micro-intervention that I'm sure drives everyone involved to distraction. My concern is that in wrestling each and every point of detail, not only do the parties

involved lose the ability to work out whether the increasingly complex regulatory framework will deliver its original objectives, but there is also a strong risk that they lose sight of the overall objectives altogether.

Given that, and the experiences of the other regulated sectors, wouldn't it make sense, before grinding through the detail, to first establish what we are trying to achieve? What level of service quality should we be targeting? Do we need to drive capital investment to address capacity constraints? Should Heathrow be competing with other hubs to maintain a vital economic driver for the UK?

Any and all of these would be worthy aims, and they may not all be achievable. Yet one thing is clear. You can't be a leading European hub if you don't incentivise investment or ensure the flexibility to offer great passenger experience every time.

So in these changing times it is important for us all to focus on working through the detailed implications of the new regulatory framework to ensure that it does work in the interests of passengers—my feeling is that both regulators and airports have at times lost sight of the passengers' interests we are there to serve. The new regulatory framework must deliver effective and proportionate economic regulation where it is needed, and ensure that it promotes the outcomes for passengers that would be expected in a competitive, well-functioning market. After all, that is what regulation is supposed to do, isn't it?

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If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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¹ The Airports Act 1985, p. 48, para 10.10, Cmnd 9542.