

Some of the Main Points of the OFT Report

Chapter 4 OVERVIEW

Apart from Channel Tunnel and ferries, no realistic alternative to air travel exists. Competition between airlines has intensified following liberalisation of the European aviation market in the 1990s.

The aviation industry is subject to significant regulation. Competition between airports needs to be considered in the context of existing regulations.

BAA owns airports through which over 60% of all UK passenger trips occurred in 2005.

The Department for Transport forecast 350 to 460 million passengers will use UK airports by 2020.

The growth in airline passengers is expected to be split between Full Service airlines (such as British Airways) +5% Low Cost Carriers (e.g Ryanair) +305% and Charter airlines -8%

The key issue is to ensure appropriate investment in additional airport capacity to underpin a competitive aviation industry in the future

In recognition of the market power of a privatised BAA, its London airports are designated to be subject to controls on the prices that can be charges. A key issue in this process is the need to ensure future investment in appropriate infrastructure to meet anticipated demand from airlines.

The powers of the CAA are more limited than other independent economic regulators and, for airports, CAA has no concurrent powers to enforce competition law but it does have a power to impose condition on regulated that are found to be pursuing courses of conduct that are broadly anti-competitive. If the airport operator opposes the conditions, the CAA cannot implement them but can refer them to the Competition Commission for consideration.

Air Service Agreements which govern flights beyond the European Union with other countries dictate the degree of access to each other's airspace and can impede competition in air services to certain destinations from the UK. The most important of these Agreements to the UK is that with the USA, the most significant long haul destination.

Some aspects of international aviation are regulated by the International Civil Aviation Organisation (ICAO) which embeds the principle of non-discrimination on grounds of nationality of carrier in charging for services.

OFT considered the extent to which airlines and air passengers view different airports as substitutes for one another. The airports rely on revenues from charges to airlines, from services delivered directly to passengers and from activities such as car parking. **It examples Heathrow Airport where approximately 45% of revenues are derived from these services; 18% of total revenue is derived from retail concessions and 5% from car parking.**

The report points out that airlines rarely swith their entire service from one airport to another but a substantial majority of UK traffic is accounted for by airlines present at several airports. **At Heathrow the two largest airline users are British Airways and BMI (British Midland) both of which operate from a number of other airports.**

Factors which affect airline demand for an airport are listed and one of the most significant affecting choice for **Heathrow is the restrictions imposed on the opportunities for foreign airlines to access the airport due to the limitations imposed by Air Service Agreements as well as the shortfall in the airport's capacity to handle more flights and the runway slot allocation system.**

Table 5.2 Areas of Origin and Demand for Heathrow Passengers in 2005

South East and East Anglia	55%
Scotland	0%
North West England	0%
Yorks & Humberside	1%
Others	9%
Interlining	35%

Of those interlining, there are of course, passengers from the UK regions using the air links to Heathrow, in particular those from Scotland and from NW England .

Given the joint ownership of the largest airports within the South East by BAA, the extent to which they compete cannot be based on the current behaviour of airports and airlines such as pricing decisions by the airports and switching of bases by airlines.

London City Airport was given approval in 1998 for 73,000 Air Transport Movements annually which severely limits the scope for City Airport to develop as a major competitor to Heathrow. (Note; This comment ignores the physical limitations of the airport site which has only one runway without the opportunity for another, the short length of the runway and associated steep approach paths which must be followed and the lack of space for large scale terminal and stand extension).

Table 5.3 Shares of SE and East Anglia region passengers by airport 2005

Heathrow (BAA)	42%
Gatwick (BAA)	27%
Stansted (BAA)	19%
Luton	8%
London City	2%

Figures do not round due to Heathrow attracting passengers from outside the South East

Department for Transport analysed the areas of origin of passengers and concluded that all the BAA airports drew most of their customers from districts in which passengers have at least one of the alternative airports available to them, not necessarily the nearest.

In considering the overlap in the destinations served from the major London airports in 2005:

- **Heathrow ran daily flights to 180 destinations, Gatwick to 210. Of these, 86 destinations were served from both airports**
- **Of these 180 destinations served daily by Heathrow over 40 were also served daily from Stansted**
- **Stansted and Gatwick had flights to around 80 common destinations on a daily basis**

From the passenger perspective, OFT concludes that there is substantial choice already available for specific destinations.

Considering factors influencing passenger choice of an airport, the report points out long haul passengers may be willing to travel longer distances (in some cases flying to the “starting” airport) while business passenger prefer to use their closest airport.

OFT concludes that the relevant geographical market is South East England and East Anglia as BAA airports account for 80% of all air passenger trips across the geographical market and that there is significant overlap between BAA airports in the South East in the Origin and Destination of airport users. **This is said to indicate that there is clear potential for competition between these airports for airline business, at least in the longer term.**

BAA said that Heathrow was not attractive to low cost carriers as it could not accommodate quick turnround times and that Stansted was less attractive to long haul carriers with their high volume of interlining traffic. ***Note that the contention about Stansted is borne out by experience of failed attempts by long haul carriers.***

Airline submissions pointed out that the combined effects of Air Service Agreements, airline alliances and code sharing **inhibited moves from Heathrow. Some stated that Amsterdam, Paris and Frankfurt were already principal competitors for Heathrow.**

The OFT conclusions on the South East market deal with geographic markets, competition etc. but ignore the reality of whether there is any more room at each of the airports as they are and, with the present expectations of more capacity and quality of infrastructure, are their conclusions realistic?

CHAPTER 6 BAA AIRPORTS IN THE SOUTH EAST

Interlinked feature of the market for the supply of service in the South East which OFT suspects prevent, restrict or distort competition are:

- joint ownership of Heathrow, Gatwick and Stansted by BAA
- the existence of development restrictions and capacity constraints
- the regulatory regime applied to BAA's airports

Planning agreements at Gatwick would preclude the construction of any further runway to increase capacity until after 2019

CAPACITY CONSTRAINTS

The report acknowledges that all South East airports are operating at capacity at peak times of the day and at Heathrow, for most times of the day. In these circumstances, there is little incentive to attract business from other airports. Furthermore, if airlines were to leave Heathrow or Gatwick, there is little doubt that other airlines would be quick to fill any capacity freed up.

BAA cannot directly allocate capacity as this is done by an separate company, ACL Ltd, and applications for runway slots at Heathrow are significantly higher than the available capacity. BAA pointed to two significant capacity constraints – operation of runways in segregated mode and the planning condition limiting movements to 480,000 annually.

OFT concluded that development restrictions and capacity constraints are a feature of the market that restricts, prevents or distorts competition.

EFFECT OF REGULATION ON INVESTMENT INCENTIVES

OFT questions the view that any investment funding should be generated by higher charges to current users before the investment takes place. Investment projects are usually selected on their ability to generate new revenues, not in view of the scope to raise current prices to fund them.

ASSET BASE

Airline views are quoted including concern about the high cost of the Heathrow East Terminal project which might even reduce capacity. **There was also a concern that BAA had an incentive to invest in retail space rather than aeronautical facilities and that too much retail activity tended to delay passengers getting to the boarding gate, to the detriment of airlines.**

BAA said that the status of Heathrow East depends on a satisfactory price control resulting from the current CAA price review.

JOINT OWNERSHIP

OFT believes that in Chapter 5 - The Market in Which UK Airports Operate which has already been summarised - it has made a case to show the large extent to which the BAA London airports could compete to serve the same airlines and passenger. ***This creates sense of unreality in the mind of the reader bearing in mind the aversion of airlines to having to set up any more high cost base and handling facilities than necessary and the lessons already apparent from the British Airways experience of doing this at Gatwick.***

BROAD CONCERNS ON INVESTMENT AT AIRPORTS IN THE SOUTH EAST

Claims made by airlines about BAA investment policies are quoted. One claimed that whilst the severest capacity constraints occur at Heathrow, BAA had given greater priority and resources to developing Stansted Airport. Another said that BAA had an incentive to delay Heathrow investment while upgrading Stansted as this would reduce the investment risk at Stansted.

Another concern that was raised by airlines using Heathrow was that if BAA made a loss making investment at Stansted, it might seek to recoup its losses through higher charges at Heathrow and Gatwick. They were concerned that the CAA might change its current policy which militates against cross subsidy of one airport by another.

IMPLEMENTATION.

One airline said that delays were costly to airlines and to passengers but not to BAA. **It said that BAA postponed investment until the airport was operating to capacity, This made it more costly to expand (for example, because work could only be carried out at night). It claimed that 30% of capital expenditure at Heathrow was wasted because contractors were operating in a constrained environment, when work could have been performed at a much earlier stage.**

BAA INFLUENCE ON AIRPORT STRATEGY

Some airlines have expressed the view that BAA has more knowledge and expertise than other interested parties, in providing the information DfT needs to formulate transport policy including the White Paper itself. They have argued for example, that the environmental constraints on building a third runway at Heathrow may have been overstated in the White

Paper and could be overcome. Their concern is that on commercial grounds, and to meet the demands of air travellers, expansion of capacity at Heathrow should take precedence over expansion at Stansted.

CONCLUSION ON FEATURES AFFECTING COMPETITION IN THE SOUTH EAST OF ENGLAND
Taking into account its analysis and in particular the overlap in airport catchment areas, OFT believes it has reasonable grounds to suspect that the joint ownership of Heathrow Gatwick and Stansted airports prevents, restricts or distorts competition in the South East of England. **It suspects that development restrictions and capacity constraints, the regulatory regime and joint ownership of Heathrow, Gatwick and Stansted airports, acting alone and in combination, are features of this market that prevent, restrict or distort competition, in particular by distorting investment incentives. This is to the detriment of airlines and ultimately of air passengers.**

AERONAUTICAL CHARGES AND PRICES AT AIRPORTS

IATA drew attention to disparities between prices and costs in the airline industry and those of UK airports. It said that average airline non-fuel costs had been reduced by 14% since 2001 whilst labour productivity had improved by 34%. In contrast, there had been an 11.7% increase in Heathrow charges in 2005-2006 and an 8.7% increase in 2006-2007.

SERVICE QUALITY

This is an important question for the HACC and a major concern for the Passenger Services Sub-Committee. CAA introduced a scheme of standards and rebates to be paid to airlines when some specified elements of quality fell short of defined standards. CAA believes that this has resulted in a greater focus by airport management on service quality and general improvement in the specific areas covered by the scheme at Heathrow. However, some airlines expressed dissatisfaction with service citing problems with heating/cooling problems, travelators out of service, insufficient seating, roof leaks, poor segregations systems and inadequate security staff levels.

The penalties for breaches of service level agreements were felt to provide an insufficient incentive to BAA to ensure reliability.

Benchmarking the level of customer satisfaction at BAA airports against other international airports is provided by surveys conducted by the Airports Council International (ACI – the trade association for airports).

In the first quarter of 2006, on the measure of overall satisfaction among travellers, at the fifty eight airports surveyed, Stansted was ranked 43rd, Gatwick 44th and Heathrow was 56th. On this measure, it appears to OFT that BAA airports, especially Heathrow, have performed relatively poorly in respect of service quality.

SECURITY ARRANGEMENTS

OFT received submissions from airlines concerning the effects of the security alert of August 10 2006 complaining of insufficient manning of security gates at London airports and the time taken to increase staffing levels as a result. On its own initiative, BAA provided its assessment of those events and the reasons behind the increased delays those events caused. It exemplified instances where airlines had heightened operational difficulties it faced, for example, through allowing passengers to arrive at central security with excessive hand luggage and inappropriate items.

