



www.stopstanstedexpansion.com
info@stopstanstedexpansion.com

PO Box 311
Takeley
Bishops Stortford
Herts CM22 6PY
Tel: 01279 870558
Fax: 01279 870786

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Eric Weinstein Esq
Department for Transport
Zone 1/28
Great Minster House
76 Marsham Street
London SW1P 4DR

Dear Mr Weinstein

Consultation on proposed criteria for designation and de-designation of airports

Stop Stansted Expansion ("SSE") welcomes the opportunity to comment on this extremely important consultation.

There are potentially very substantial financial benefits to the Exchequer if the de-designation of UK airports is properly handled. We estimate that these may be of the order of £9 to £12bn. However these potential financial benefits – despite their magnitude – are neither recognised nor addressed in your consultation document which is why we are copying our response to your Secretary of State and the Chancellor as well as our local Members of Parliament, namely the Rt Hon Sir Alan Haselhurst MP, Mark Prisk MP, Brooks Newmark MP and Oliver Heald MP.

We will deal with the potential very substantial financial benefits to the taxpayer under a separate heading towards the end of this letter but first we deal with the more detailed issues raised in your consultation, as follows:

1. We strongly support the principle of airport de-designation but the proposals set down in your consultation appear to have been hastily assembled and to have been assembled for the wrong reasons. This consultation has been triggered as a result of a recognition by the CAA that it is unable to reconcile its statutory duties under Section 39 of the 1986 Airports Act, in relation to the economic regulation of Stansted with the Secretary of State's policy of supporting the development of a second runway at Stansted as soon as possible. The nub of the problem is that it is not possible for the airport operator to fund a second runway at Stansted on a commercially viable basis whilst price controls remain in place (at least in their present form). The de-designation of Stansted would remove that difficulty and enable airport charges to rise to levels beyond what could be justified by the regulator.
2. We note that the DfT's initial hope was that the difficulty with the commercial viability of a second runway at Stansted could be overcome through cross-subsidisation of the Stansted development by users of Heathrow and Gatwick. Letters to the CAA at the time of the last quinquennial review, from your colleague Michael Mann (13 December 2001) and from yourself (10 January 2003), demonstrate that the DfT has long been concerned that a second Stansted runway would not be commercially viable without cross-subsidy from Heathrow and

Gatwick users (both letters are appended). However the CAA has now made clear that its 2003 decision in favour of standalone regulation should remain the position for the next quinquennial (Q5: 2008-2013) and, in making this decision, the CAA has stated that it was mindful of the likelihood of a legal challenge that could be difficult to defend if it decided otherwise.¹

3. It is transparent that the underlying purpose of this consultation is to change the designation criteria so as to enable the de-designation of Stansted prior to the end of Q4, which has now been extended for 12 months (to 31 March 2009) for Stansted alone, to allow this to be achieved. This would release the CAA from its Section 39 duties to regulate airport charges at Stansted thereby allowing prices to rise and giving the Secretary of State's policy in relation to second runway at Stansted a better prospect of success. We view this as an attempt to circumvent the safeguards that were put in place by Parliament to prevent unfair competition and abuse of market power following the privatisation of BAA in 1987 as a single entity thereby leaving it in a dominant market position in the south east (92% of the market) through its ownership of Heathrow, Gatwick and Stansted airports.

4. It was made clear [Section 2, page 20] of the 1987 BAA privatisation prospectus² ("the Prospectus") that:

"Heathrow, Gatwick and Stansted airports have been designated by the Secretary of State for economic regulation purposes under the Act." and

"It is open to the Secretary of State to designate other BAA airports."

Section 2 of the 1987 Prospectus then went on describe the nature of economic regulation, i.e. price control, and listed the CAA's statutory duties in this respect, as defined by Section 39 of the 1986 Airports Act.

5. The designation criteria now being suggested by the Department for Transport (DfT) are so vague and discretionary that the Secretary of State would be able to select whatever evidence he considered to be appropriate to justify any particular decision.

"...we consider that any new criteria should focus on the appropriate "tests", leaving the issue of what evidence might be appropriate to be considered as part of the process of applying these tests." ³

Whilst it is true that the 1986 Act does not define the designation criteria it was clear from the outset that Stansted would be a designated airport following the privatisation of BAA. It is also worth noting that the Prospectus made no mention of the possibility of any of the designated BAA airports (listed as Heathrow, Gatwick and Stansted) being de-designated.

6. The designation of Stansted over the past 20 years has been entirely meaningless in terms of price control because Stansted has had no market power and has never been able to price up to the level permitted by the regulatory cap. However, Stansted has benefitted from designation over this time because designation has enabled it to enjoy the benefit of cross-subsidy from Heathrow and Gatwick users. Now that Stansted is finally on the verge of having significant market power as a consequence of more buoyant demand and a shortage of capacity in the south east, it would be perverse if Stansted were to be de-designated just when it is about to become a sellers market rather than a buyers market. The DfT is, in effect, proposing – or rather, paving the way for proposing – that an arrangement which has distorted the market over the past 20 years should now be reversed so as to enable market distortion to continue into the future.

¹ The evidence for this can be found in the CAA document files relating to the Q4 and Q5 reviews.

² Published by County NatWest Ltd on behalf of the Department of Transport, 8 July 1987.

³ DfT Consultation Paper, para 32.

7. The fact that Stansted is on the verge of having significant market power should not be in doubt at the DfT. In 'the Air Transport White Paper ('ATWP')⁴ much was made of the shortage of airport capacity in the south east, for example:

"Because we expect there to be an increasingly severe shortage of runway capacity at the major South East airports over the remainder of this decade, making full use of the available capacity at Stansted will be essential to avoid stifling growth."⁵

Quantification of the capacity shortage can be arrived at by examining the DfT's demand and supply analysis in the ATWP and its supporting documents such as "Passenger Forecasts: Additional Analysis", published concurrently with the ATWP, as well as in the consultation documents leading up to publication of the ATWP. In addition, the recent ATWP Progress Report⁶ confirms the DfT's view regarding the shortage of airport capacity in the south east, specifically referring to "*the congested south east*"⁷ and confirming the expectation that demand will continue to outstrip supply:

"Our new forecasts remain fully in line with what we said in 2003."⁸

"... the additional airport development supported in the White Paper would not be sufficient to support all of this unconstrained demand."⁹

8. Given the DfT's view that capacity in the south east is insufficient to meet present and future demand to 2030, the de-designation of Stansted at this time would clearly lead to higher airport charges than would be the case if Stansted was subject to price control. BAA would be able to raise prices and generate significant additional profits which, it would appear, the DfT intends would accrue directly to the airport operator. The motivation behind this is clearly to assist BAA's owners, ADI¹⁰, and its main shareholder, Ferrovial¹¹ in over-coming the difficulties of funding a second runway at Stansted. However, it is questionable whether this would be consistent with the following policy statement in the ATWP:

"The Government will not promote or pay for the development of Stansted."

9. In any market, competition depends upon there being competing providers of capacity and a degree of excess capacity such that real choices can be made. On both counts, it follows that it would be premature to de-designate Stansted at a time when (i) it remains an integral part of a London airports 'system' operated by BAA alongside Heathrow and Gatwick and (ii) the DfT considers there to be a severe capacity shortage in the south east. Expansion plans exist for Luton and Heathrow airports as well as for Stansted but these, even if implemented, will not materially add to capacity for several years. Subject to an important exception explained under 'Financial Benefits' below, de-designation should not be contemplated before the start of the next regulatory review period (2013) and then subject to there being sufficient competition in the market at that time, or expected shortly thereafter.

10. The Office of Fair Trading ('OFT') announced on 30 March 2007 that there is to be a full market investigation by the Competition Commission ('CC') into the structure of the UK airports market in the south east (and in central Scotland). This investigation will provide evidence, analysis and insights into the workings of the market which will be invaluable in informing future decisions regarding the (de)designation of airports. In addition, the CC investigation may well lead to substantial structural change in the market. Until such time as

⁴ 'The Future of Air Transport in the United Kingdom', DfT, Dec 2003 ('ATWP')

⁵ ATWP, para 11.26

⁶ DfT, Dec 2006

⁷ ATWP Progress Report, para 5.1

⁸ Ibid, para 4.10

⁹ Ibid, para 4.11

¹⁰ Airport Development and Investment Ltd

¹¹ 62% of ADI is owned by Grupo Ferrovial, S.A.; 28% by Caisse de dépôt et placement du Québec and 10% by GIC Special Investments Pte Limited (Singapore)

the CC has reported it would be premature to change the (de)designation criteria and it would be irrational and irresponsible to de-designate Stansted ahead of the CC's report.

Financial Benefits

11. As stated at the start of our response we strongly support the principle of airport de-designation. One of our main reasons for so doing is that we recognise there could be a very substantial benefit to the Exchequer, i.e. to the taxpayer. Removal of price controls at Stansted would enable the airport operator to increase airport charges and the additional revenues would drop down in full to EBITDA¹². The value of this can be estimated by looking at the EBITDA multiples paid for airport businesses in recent acquisitions which have been in the range 15x to 20x (some have been much higher)¹³ – i.e. an additional £1m of annual EBITDA would add £15m to £20m to the value of the business. The benefit of this added value should primarily accrue to the Exchequer rather than to the owner of the airport..

12. Subject to the CC report leading to the establishment of greater competition in the south east (i.e. a break-up of BAA), Gatwick and Stansted airports could be de-designated immediately thereafter. Heathrow could also be de-designated although this would need to be done on a phased basis so as to allow users time to adjust. Manchester could be de-designated now (without changing the (de)designation criteria) subject to agreement between the airport operator and the Exchequer on the price to be paid for de-designation.

13. Competition is always preferable to regulation and so the aim should be to establish the conditions for competition, to de-designate all four airports which are presently designated as soon as practicable thereafter, to dismantle the present system of economic regulation (price controls) by the CAA and thereby to enable airport charges to rise to market clearing levels. In the absence of a permanent regulator for these four airports, reliance would be placed on the general framework of UK and EU competition law to deal with any individual cases of abuse of market power or operators acting in a way which has an adverse effect on competition and/or a detrimental effect on customers resulting therefrom. This is the framework which presently applies to every other UK airport (i.e. the non-designated airports) and appears to work effectively even though almost all airports are to some extent monopolies.

14. Following de-designation airport charges at Heathrow, Gatwick and Stansted would be able to move towards market clearing levels and this would have wider benefits, as a leading City analyst argued in a May 2006 research note:

*"20 years of utility regulation have left Heathrow underpriced and undervalued in relative economic terms... Capacity can be better rationed through something closer to open-market pricing, having the effect of driving out the operators of small aircraft or uneconomic routes who are only using Heathrow because of the artificially low aeronautical charges, thereby freeing up capacity, lowering the investment requirement of BAA and reducing the planning and environmental pressure."*¹⁴

15. At privatisation in 1987, airport charges at Heathrow were £6.69 per passenger and in 2005/06 had risen only to £7.89 – an average annual increase of only 0.6%. If Heathrow charges had kept pace with inflation, they would be over £13.00 today. It is perhaps not surprising that there is such demand for further capacity at Heathrow or that Heathrow slots change hands for substantial sums of money. Airport charges are significantly lower at the BAA London airports than at comparable European airports. The 2005 TRL review of airport

¹² Earnings before interest, tax and depreciation.

¹³ Budapest (2005) x28; Bratislava (2006) x23; London City (2006) x28.

¹⁴ Dresdner Kleinwort Wasserstein Research Note, Mark McVicar, May 2006.

charges ranked Heathrow at 27 and Gatwick at 44 in a worldwide league table of charges at 50 major airports¹⁵. Stansted did not even make it into the top 50.

16. As an illustration of the potential financial benefit of de-designation, let us assume this takes place in 2012/13 (as the midpoint in a phased programme) and leads to an uplift in airport charges per passenger of £5. By 2012/13, the total number of passengers forecast for the four designated airports is 186 million¹⁶. An EBITDA multiple of 15x to 20x produces a value added figure in the range of £14.0bn to £18.6bn¹⁷. This would need to be shared with the airport owner in order to incentivise the owner to pay the price of de-designation. For the purposes of this illustration, it is estimated that the net benefit to the Exchequer would be of the order of £9bn to £12bn, allowing for some phasing. The airport owner would include the cost of de-designation on his balance sheet and amortise over a period of time. Thus, any examination by the OFT or CC into whether the airport owner was making excess profits would have regard to this expense.

17. In addition to the very substantial financial benefit to the Exchequer, the wider benefits described in the analyst's note above should not be underestimated. And there would be a further benefit: de-designation of Heathrow, Gatwick and Stansted would encourage greater use of regional airports and thereby reduce the present over-concentration of air travel upon airports in the south east.

18. In conclusion, we consider the present DfT consultation on the (de)designation criteria for airports to be wholly inadequate. As we have stated, we believe that it has been put together in haste and for the wrong reasons and the proposals set down in the consultation are, at best, premature. In addition, the DfT has failed to consider the potential opportunity for the Exchequer and the opportunity to phase out the economic regulatory role of the CAA while at the same time improving the efficiency of the UK airports market. Instead, the DfT has put forward proposals which would give rise to higher airport charges at Stansted, the benefit of which would accrue not to the taxpayer but to the shareholders of BAA, namely, Grupo Ferrovial SA, Caisse de Dépôt et Placement du Québec and GIC Special Investments Pte Limited (Singapore). Any hasty decision to de-designate Stansted (and Manchester) without securing the main share of the financial benefit for the taxpayer would set a precedent and undermine the ability of the Exchequer to secure a price for the future de-designation of Gatwick and Heathrow, where dedesignation has a far higher value.

20 We urge the DfT to consult with Treasury colleagues and others and give far more detailed consideration to the whole question of (de)designation and not to make a premature decision which could cost UK taxpayers dearly and would pre-empt the outcome of the current CC investigation.

Yours sincerely

Brian Ross
Economics Adviser

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¹⁵ 'Review of Airport Charges 2005', Transport Research Laboratory, Oct 2005.

¹⁶ Taken directly from the most recent forecasts published by BAA and Manchester Airport.

¹⁷ $186m \times £5 = £930m \text{ pa} \times 15 = £14.0bn, \times 20 = £18.6bn.$