Testing the Regulatory Model: The Expansion of Stansted Airport

DAVID STARKIE

Abstract

This paper examines the application of price-cap regulation to the UK airport industry, with particular reference to the expansion of London-Stansted. This expansion is relevant to the debate concerning investment incentives inherent in the RPI–X approach and whether the UK style of regulation encourages the ‘sweating of assets’ at the expense of new investment. Stansted’s expansion also suggests a willingness of the authorities to accept the leveraging of market power in pursuit of perceived public-interest goals; it provides an insight into the behaviour of economic agents when capital market disciplines are mute; and it illustrates some unintended consequences that can follow from market intervention.

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I. INTRODUCTION

The decision in the December 2003 White Paper, The Future of Air Transport, to support the expansion of London-Stansted airport was controversial, as was a similar expansion decision made in 1985. Much of the controversy has focused on planning and environmental issues, but both these decisions have had major implications for the economic regulation of airports; in this context, expansion of Stansted tested, and continues to test, the regulatory model. In particular, its expansion is relevant to the debate concerning investment incentives inherent in the RPI–X approach to economic regulation and whether the UK style of setting maximum prices (price caps) encourages the ‘sweating of assets’ at the expense
of new investment. Stansted’s expansion also has a wider significance: it suggests a willingness of the government and the competition authorities to accept the leveraging of market power in pursuit of perceived public-interest goals; it provides an insight into the behaviour of economic agents when capital market disciplines are mute; and it illustrates some unintended consequences that can follow from market intervention.

The structure of the paper is as follows. First, it outlines the policies for the restructuring, partial privatisation and economic regulation of the airport industry set out in the 1985 White Paper on airports policy (Section II). The White Paper was accompanied by proposals for a substantial expansion of Stansted, and parliamentary undertakings were given regarding its financing; these are outlined. At the time, some commentators expressed doubts that the project on the scale proposed was financially viable, a view borne out subsequently by the airport’s financial performance (Section III). The resulting pricing policies led to a formal complaint of market distortion; the regulator’s decision is reviewed (Section IV). An important feature of economic regulation applied to the London airports was that the allowable rate of return was based on their combined assets. In practice, this led to the leveraging of Heathrow’s market power in order to compensate for Stansted’s poor return (Section V). The motives and the regulatory risks that BAA, the airports company, faces are then considered (Section VI), prior to noting that its risk profile has changed significantly as a result of the regulator’s 2003 decision to base the price caps on the asset base of each airport (Section VII). This decision preceded publication of the 2003 White Paper, which announced the government’s decision to support the development of a second runway at Stansted (Section VIII). BAA argues that this latter project is not financially viable on a stand-alone basis in the time frame envisaged by the government, but is justified by public-interest issues; these are subject to detailed consideration (Section IX). The penultimate section considers the investment incentives in price-cap regulation in the light of the Stansted proposals (Section X). The paper concludes by reflecting on the positions adopted by various stakeholders and by suggesting that a formal price cap for Stansted might no longer be appropriate.

II. THE 1985 WHITE PAPER ON AIRPORTS POLICY

The current structure and ownership of the UK airport industry reflect in large measure the policies set out in the 1985 White Paper on airports policy (Secretary of State for Transport, 1985), precursor to the 1986 Airports Act. The White Paper set out the government’s views on the structure, ownership and regulation of UK airports in general and the future development of London’s airports in particular. It stated that airport policy should be directed to making ‘the best use of existing facilities and providing new capacity only when this is economically justified’ (paragraph 3.1) and that ‘it also continues to be the
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government’s policy that air transport facilities should not in general be subsidised by the tax payer or the rate payer. Airports … should normally operate as commercial undertakings’ (paragraph 3.2). In the event and as we shall see, this commercial objective later proved difficult to reconcile with the government’s concurrent decision that substantial, additional capacity in the south-east was to be met by the development of Stansted. First, however, I will set out the background to the White Paper and some of the policy details contained in it or in the ensuing legislation. Specifically, I consider the structure and ownership of airports with particular reference to the privatisation of the British Airports Authority; the framework of economic regulation established under the 1986 Airports Act; and the proposals to expand Stansted airport on a large scale. All three matters are interrelated in the ensuing argument.

1. Structure and Ownership of UK Airports

At the time of the White Paper, nearly all large airports were in the public sector and were owned either by the British Airports Authority or by various local governments. The Authority owned seven airports, four in Scotland and three — Heathrow, Gatwick and Stansted — in the London region; the only significant airport in the south-east it did not own was Luton. As a consequence, it dominated the national air transport market, accounting for 80 per cent of international passengers handled at all UK airports. The largest local authority airport was Manchester, with 6.0 million passengers per annum and a 10 per cent market share. Of the London airports, Heathrow was pre-eminent, with over 30 million annual passengers and a focus on premium long-haul international traffic. Gatwick, the UK’s second-busiest airport, with nearly 15 million annual passengers, focused on charter and short-haul traffic (both the more price-elastic parts of the market), whilst Luton (1.6 million annual passengers) and little-used Stansted (0.5 million annual passengers) were dominated by charter carriers.1

The 1985 White Paper announced the government’s intention that as many as possible of Britain’s airports should become private sector companies. The British Airports Authority was to be privatised, with each of its seven airports organised as a separate company under a single holding company. It was not proposed to enforce the sale of local authority airports to the private sector, but all major airports were to be set up as airport companies to improve financial disciplines and to facilitate the transfer of ownership. The British Airports

1Since the mid-1980s, Heathrow, Gatwick and Stansted’s combined share of the national market has declined a little but the three airports still retain over 90 per cent of traffic in London and the south-east. At Luton and Stansted, low-cost carriers have replaced much of the charter traffic and, for reasons set out below, Stansted has grown much more rapidly than Luton. Manchester still retains a market share of about 10 per cent. Passengers using low-cost carriers are particularly price sensitive.
Authority was subsequently privatised (by flotation of shares) in 1987 and thus became BAA plc.\textsuperscript{2}

One controversial aspect of these proposals was the intention to privatise as a single group all seven airports then controlled by the British Airports Authority. This had been strongly argued for by the incumbent management, and at that time it was the practice to privatise the state utility industries without restructuring; BT and British Gas had already been privatised in this way. Not until later in the 1980s was greater emphasis placed during privatisation on facilitating competition by distinguishing the core natural monopoly elements of a utility enterprise and setting up the rest as separate potentially competing companies. Nevertheless, arguments for dividing the British Airports Authority were advanced by a number of parties at the time of the White Paper, particularly by the local authority airports led by Manchester. The government did not dismiss out of hand such possibilities but it concluded that competition between the airports was possible but limited, especially where Heathrow was concerned. On the other hand, dividing the ownership of the Authority’s airports would, it was thought, have undermined an important plank of airports policy — namely, the Traffic Distribution Rules (TDRs).

The TDRs were a policy for intervening in the market, first introduced at Heathrow in 1977 when it was considered that problems caused by a shortfall of capacity at an existing airport could be tackled by directing traffic to another nearby airport. It was envisaged that further intervention would become necessary and that having an integrated airport system under common ownership would both facilitate the administration of such a policy and minimise its commercial impact on any individual airport. Privatising the Authority’s London airports as a group was consistent with this policy. In the event, in the early 1990s, the government decided to set aside the most important TDRs, thus removing the original \textit{raison d’être} for having Heathrow, Gatwick and Stansted in integrated ownership.

2. Economic Regulation

The presumption at the time of the 1986 Airports Act was that major airports, like other public utilities, had significant market power and therefore should be subject to economic regulation. Although the Act brought all airports with an annual turnover exceeding £1.0 million within the scope of economic regulation, more stringent regulation was reserved for those ‘designated’ by the Secretary of State under S.40 of the Airports Act. The airports designated following the 1986 Airports Act were Manchester, Heathrow, Gatwick and Stansted.

\textsuperscript{2}The current ownership picture of UK airports is complex. In addition to BAA, some previous local authority airports, including Luton, are now wholly within the private sector whilst others have introduced private capital. There are two airports that were previously in the private sector but have now been taken over by the local-authority-controlled Manchester Airport Group.
The regulatory process applied to these airports after they were designated mirrored that applied to the already privatised BT and British Gas, although there were some differences — notably, the important role given to the general competition body in advising the industry-specific regulator, the Civil Aviation Authority (CAA). The focus was on the so-called RPI–X approach to constraining the growth in prices: the increase in average charges is limited to the growth in the retail price index (RPI) minus a factor, X. The latter is set to allow for a rate of return consistent with the cost of capital. The return is calculated taking into account forecasts of: air traffic; total revenues (including substantial revenues from commercial activities such as airport retailing, known as the single till approach); net operating expenditure after taking into account feasible improvements in efficiency; depreciation of existing capital assets; and the proposed capital expenditure programme of the company. The last two components are the constituents of the regulatory asset base (RAB). It is intended that the company should earn an appropriate return on its RAB, so much time and effort are spent calculating the firm-specific cost of capital (using the Capital Asset Pricing Model). Subject to accurate forecasts in the round and to an accurate assessment of the cost of capital, the company is guaranteed a satisfactory return on its asset base, and this in turn is reflected, through X, in the prices it can charge.

Account is also taken of whether the projected cash flow is sufficient to sustain the investment programme and whether certain financial criteria, important to the credit rating of the company, are likely to be met. These factors are considered in a forward-looking manner and particular emphasis is placed on a forthcoming period, which is usually five years. Every five years, the process is repeated and X is reset. The approach is considered to provide the regulated company with incentives to seek out operating efficiencies because further gains not anticipated when setting X can be retained to enhance earnings per share. Because of this incentive mechanism, the RPI–X model has been considered by many to be superior to rate-base or rate-of-return regulation. Rate-of-return regulation ties the allowed profits of the firm to its use of capital. This provides the firm with an incentive to substitute capital for labour and, with uncertainty present, could also lead to gold-plated investment and, in addition to the excessive capacity accompanying overcapitalisation, to excessive service quality (Averch and Johnson, 1962). But RPI–X has also been criticised. Because it is said to focus on short-term efficiencies, the approach is argued to encourage ‘asset sweating’ and to give inadequate incentives to invest. Other critics have pointed out that, particularly with the need to reset X periodically, the RPI–X approach (with its emphasis on cost of capital and the RAB) has converged in practice to rate-of-return regulation (Stern, 2003). This has led to the description of the UK approach as rate-of-return regulation with a regulatory lag (Armstrong, Cowan and Vickers, 1994, p. 172; Giulietti and Waddams Price,
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forthcoming). It is an issue that I will return to after examining the behaviour of BAA in relation to Stansted.

3. The Expansion of Stansted

On the same day that the White Paper was published in June 1985, the government issued its decision letters following long public inquiries into proposals for the development of Stansted and Heathrow airports. The letters on the planning applications approved that for Stansted (with conditions) but turned down that for Heathrow. Stansted was a former wartime bomber base that had been incorporated into the British Airports Authority when the nationalised company was formed in 1966. The expansion project was strongly supported by the Authority’s management, led by Sir Norman Payne (whose personal aim at Stansted was to create the ‘best airport in the world’).

The intention to expand Stansted on a substantial scale and to privatise it within the same company as Heathrow and Gatwick led the local authority airports, of which nearby Luton was one, to express concern that this would lead to its cross-subsidisation to their disadvantage. Much of the ensuing debate in Parliament focused on this issue. Nicholas Ridley, the then Secretary of State for Transport, tried to allay these fears on a number of occasions during the debate on the White Paper (Hansard, 5 June 1985):

I can confirm that there will be no subsidy to Stansted. The only investment will be of commercially raised money paying commercial rates of interest. That will cause landing charges to rise at Stansted to levels commensurate with other airports (column 315);

I confirm that Stansted has benefited financially from the profits of other BAA airports. This should not be the case in future under our proposals (column 317);

I have tried through the subsidy assurance … to make this development happen only if it is necessary and economic (column 321);

As for cross subsidy and fair competition, putting each airport into a separate public limited company means that any transfer of funds will be transparent. As I said, we shall make sure that the transfer of funds takes place only at commercial rates of interest. That in its self will cut out cross subsidy (column 325);

I have given every assurance this afternoon that there will be no opportunity for a cross subsidy to Stansted to the detriment of other competing airports. Market forces will prevail

3Sibley (2000) also points out that rate-of-return regulation, as now applied, typically allows the firm to keep economic profits earned between rate reviews, and therefore it is suggested that there is probably little to choose between the two regulatory models. For a good review of the earlier literature on rate-of-return regulation, see Train (1991).
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to the extent that it will be for the proprietors of airports, whether Stansted, Manchester or any other to decide whether investments are made at commercial rates of interest (column 329).

The government’s intention, therefore, was that Stansted should be financed directly by the capital markets or indirectly by inter-company loans made at commercial rates of interest. The development was also to reflect market forces and to be viable. As we shall see, the expansion of Stansted did lead to cross-subsidies that were to the detriment of other competing airports, it has not proven to be a viable expansion by normal commercial standards and average charges have still to rise to levels commensurate with those of other airports.

III. FINANCIAL FORECASTS AND PERFORMANCE

1. Financial Forecasts

At the time of the Commons debate, research at the Institute for Fiscal Studies (IFS) was examining in detail the commercial case for the proposed expansion of Stansted. In the 1985 White Paper, the government had stated that it would expect BAA to show that the investment would earn an acceptable rate of return. The researchers were sceptical that this would be the case (Hill, Starkie and Thompson, 1985; Starkie and Thompson, 1985, 1986a and 1986b).

The proposal was to construct initially a terminal capable of handling up to 8 million passengers per annum, together with the associated infrastructure (aircraft aprons, taxiways and access roads) necessary to support this volume of traffic. The new terminal was planned to have about four times the capacity of the then underutilised terminal; the latter was to be replaced, giving a net addition in the first phase of 6 million passengers per annum. At the time, this was broadly equivalent to the number of passengers using Manchester, the country’s third-largest airport.

The analysis took the traffic forecasts set out in the 1985 White Paper together with the cost estimates that had been presented to Parliament. Assumptions were made concerning the precise phasing of construction expenditures, the running costs of the proposed terminal (these were based on the figures for Gatwick), the expected economic life of the investment and, importantly, the net income to be expected from the new facilities (this too was based on Gatwick figures).

The conclusion of the research was that net present revenues would fall well short of the net present cost of the investment. For the investment to break even, net income per passenger would have had to increase in real terms by almost 20 per cent, at which level it would be well above the comparable Gatwick figure. The bottom line was that the scale of the proposed investment was considered to
be suspect and not driven by market forces, a view supported by Stansted’s subsequent financial performance.

2. Financial Performance

At the time of the mid-1980s debate on airports policy, Stansted was making a large loss, before capital charges, equivalent to 40 per cent of turnover. It had recorded a loss on operating account for the previous 14 years. Not since 1970–71 had it made an operating surplus, and this was at a time when it had less traffic than in 1984–85.

There were a number of probable reasons for this poor performance. First, Stansted’s terminal capacity was at the time well in excess of that required for its traffic. The 1985 White Paper showed that it had more spare terminal capacity than any other UK airport bar one (Liverpool) so that capital charges and operational overheads were disproportionately high. Second, there were indications that the pre-privatised British Airports Authority was providing an excessive level of service in relation to traffic levels. For example, the airport was open 24 hours in spite of a trivial amount of night-time traffic. Third, revenue yields per passenger were also comparatively low and had been declining over the longer term.

By 1990–91, shortly before completion of the major expansion in terminal facilities, annual passenger traffic had grown to 1.1 million, a little more than half the notional capacity of the old terminal, and the operating loss by now exceeded 100 per cent of turnover. Four years later, in 1994–95, Stansted’s financial performance had improved (see appendix 5.9 of Monopolies and Mergers Commission (1996)) but the loss was still considerable, at approximately one-third of turnover. Not until 1997–98 (see appendix 4.7 of Monopolies and Mergers Commission (1996)) did Stansted make an operating profit, at which point it had been making losses consistently for over a quarter of a century.

Operating profits continued to increase, slowly, into the twenty-first century, but it was evident from the Competition Commission’s 2002 review of BAA’s London airport companies that the airport still lacked market power; it was estimated that Stansted’s revenue per passenger from airport charges was £2.99 net of adjustments (compared with an estimated £4.08 at Gatwick). Overall, the airport continued to earn a return below its cost of capital and it was expected to continue to do so until 2008, when it was assumed by the Commission that Stansted’s net yield would increase gradually towards Gatwick’s projected yield (Competition Commission, 2002, paragraph 2.310). But, even if this assumption proved accurate, the equivalence of the investment return and the cost of capital would come almost 20 years after large-scale expansion of Stansted commenced.

Thus, Stansted’s financial performance has been consistently poor over several decades and the airport still makes a return less than its cost of capital. In
normal commercial circumstances, one might have expected closure of the facility or restructuring as a smaller but financially sustainable operation. Why BAA has been willing for Stansted to sustain such losses over such a period of time is a subject to which I will return. But first it is worth noting one adverse consequence of Stansted’s poor financial performance.

IV. DISTORTION OF COMPETITION

BAA’s three London airports were kept together at privatisation purportedly to avoid the adverse consequences for any one airport of a change in the TDRs. This policy stance overlooked the position of Luton, sandwiched between Stansted and Heathrow. Another argument advanced — that the opportunities for competition between airports were limited — was an equally anomalous view (Starkie, 1994). It sat rather awkwardly with S.41(3)(c) of the 1986 Airports Act. This section gives the CAA, as the regulator, the power to impose conditions when it is judged that an airport operator has fixed charges that are insufficient to cover the cost of a service or facility and those charges materially harm the business of another airport operator. But for pricing at one airport to be harmful to another airport, there has to be a prospect for serious competition, a notion that the White Paper rejected when it argued against the breaking-up of BAA.

In June 1993, Luton airport complained to the CAA that Stansted was in fact pursuing a course of conduct as described in S.41(3)(c). In essence, the complaint was that Stansted was levying charges that were too low and that these low charges were materially harming Luton because they had led to the transfer of traffic from Luton to Stansted. The specific example was given of the transfer of Ryanair services.

In response, the airport company accepted that it was not making a return on capital employed or even a profit on book cost, but argued that to be expected to do so in the early days of a major development would be unreasonable. As Stansted’s revenues exceeded those costs that would be avoided by closing the airport down, BAA maintained that there could be no finding of unreasonable or anti-competitive behaviour. Closing the airport or putting it on a care-and-maintenance basis would be most unlikely to outweigh the loss of revenue. Stansted was not subsidised, BAA argued, but borrowed from the Group on fully commercial terms.

The CAA formally responded to the complaint (Civil Aviation Authority, 1993). It accepted as ‘strictly true’ BAA’s denial that it subsidised Stansted but, given the state of Stansted’s balance sheet, it was thought ‘improbable’ that the borrowings could have been obtained except from fellow members of the Group (paragraph 49). It also said that it would be inconsistent with the CAA’s earlier decision to treat BAA’s three London airports as a system if it did not ‘allow at least a measure of cross-subsidy’ (paragraph 43). It nevertheless conceded that the scale and timing of the expansion of Stansted had been premature, and it was
the excess capacity that was at the root of the problem. In the circumstances, the CAA accepted that Stansted had little choice but to engage in heavy promotion on a scale that might not otherwise have been prudent or justifiable. Closing the airport or placing it on a care-and-maintenance basis would have done considerable damage to the airport’s future prospects. The CAA did recognise that Stansted’s net charges (i.e. after discounts) to airlines clearly failed the sufficiency test and it accepted Luton’s contention that Stansted’s pricing policy was causing it material harm. In these circumstances, the CAA found that the S.41(3)(c) tests were met.

However, the CAA pointed out that the Statute provides for a remedy only if the CAA thinks fit. This appeared to be the crucial point. The CAA was unable to come up with a realistic remedy, given that closure or contraction was not considered feasible. The best that could be achieved in the circumstances was to follow a policy of loss minimisation. It added:

Luton has been materially harmed but that harm stems from the Government’s decision in 1985 that the next significant tranche of airport capacity to serve the South East should be at Stansted … For the Authority to find that the policies Stansted has pursued … should be inhibited or reversed because of their effect on Luton would be tantamount to saying that the decision to develop Stansted was wrong. (paragraph 61)

The CAA went on to conclude that no remedy was appropriate.

The CAA obviously had to make a very difficult decision. Faced with circumstances where infrastructure costs were sunk and operating costs were low, it probably made the correct economic decision overall, but in reaching the conclusion that no remedy was appropriate, it is open to criticism that it took too much on trust from BAA. For example, the CAA did not appear to consider whether closure of some facilities on a temporary basis might have been worthwhile. The CAA could also be criticised for failing to challenge BAA as to whether contracts with each individual airline were priced at least to recover marginal costs. The economic literature suggests that in the circumstances where an incumbent’s average price level is regulated, as is the case here, the incumbent has an incentive to price-discriminate and to price below marginal cost (Armstrong and Vickers, 1993). There are strong indications that this is what was happening at Stansted.4

V. HOW DOES BAA BALANCE THE BOOKS?

Until the latter half of the 1990s, Stansted had been returning operating losses for about 25 years. Why, therefore, did BAA, a major public limited company,

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4In 1996, three years after the CAA’s decision, net revenues from traffic charges at Stansted did not cover the direct or volume-related costs of providing for Ryanair, whose move from Luton had instigated the original complaint (Monopolies and Mergers Commission, 1996).
persevere with the ambitious investment plans inherited from the British Airports Authority? Furthermore, with Stansted still not expected to produce annual returns equivalent to its cost of capital until 2008, why has BAA not taken drastic steps to curb losses at the Stansted subsidiary? Part of the answer to these questions is to be found in the willingness of the government to designate Stansted and thus bring it within the scope of S.40 of the 1986 Airports Act, and part of the answer is to be found in the way that the industry regulator, the CAA, has applied economic regulation.

Designation of Stansted was, on the face of it, a peculiar decision. To suggest that, at the time of designation in 1987, Stansted had significant market power was patently absurd. Even in 1996, after a significant growth of traffic, the Monopolies and Mergers Commission was to note that ‘As regards STAL [Stansted], the CAA suggested to us that there seemed to be little monopolistic power and very little reason to apply a maximum to charges which would be likely to be binding in the immediate future’ (Monopolies and Mergers Commission, 1996). But, given Stansted’s weak market position (its relative inaccessibility and concentration on price-elastic market segments), it was important for BAA that it was designated if the major plans for expansion were to go ahead without detriment to shareholder interests; the government obliged.

Designation was not by itself, however, a sufficient condition for securing shareholder interests; it was also necessary to link the Stansted expansion with the pricing power of Heathrow; the latter is considerable because of high levels of demand for access from international scheduled carriers relative to the runway and terminal capacity available (expansion of which is subject to severe planning and environmental constraints). The link between Stansted and Heathrow was achieved by a particular treatment of BAA’s assets in the regulatory process, which was to calculate the allowable rate of return on the combined assets of Heathrow, Gatwick and Stansted — what is referred to as a system-wide RAB. Consequently, where any one airport is unable to earn its cost of capital, prices are adjusted elsewhere in the system so that the system as a whole earns its cost of capital (see Competition Commission (2002, paragraph 10.36)).

Thus, the airport system approach to the RAB ensures that the financial deficits of Stansted are recouped through higher charges at Heathrow. BAA is prevented by the regulatory price cap from charging market-clearing prices at Heathrow and capturing the scarcity rents associated with its capacity constraints, but, in effect, it has been permitted to set prices that sufficiently leverage its market power to ensure that, across its three London airports when taken together, the books are balanced. As a consequence, there has been no financial penalty from excessive expansion of Stansted; the combination of an allowable return reflecting the cost of capital, a system RAB and considerable market power in at least part of the system leads to a satisfactory outcome for BAA.
Finally on this issue, it should be noted that the taxpayer has also lost out as a consequence of Stansted’s overexpansion and generally poor financial performance. Stansted has been able to sell its tax losses to other Group companies (albeit at the appropriate rate so that there has been no subsidy hidden as part of the transaction). But the other Group companies have been able to offset these losses against their profits, thus reducing, overall, the Group’s tax liabilities. This practice of trading tax losses within a group of companies is a legitimate practice, but, because of the losses caused by overexpansion at Stansted, general tax revenues are less than they would otherwise have been. It is also possible that the sale of these tax losses constitutes the icing on the BAA cake; it is not clear that adjustments were made for this tax benefit when setting the regulatory price caps (which is done on an after-tax basis).

VI. MOTIVATION AND RISK

There is now an extensive economic literature on the principal–agent problem — for example, the problem that owners of enterprise capital have in ensuring that managers pursue objectives in their interests. The private sector attempts to resolve the problem by giving management financial incentives that are compatible with shareholder interests. In addition, discipline also comes from the threat that underperforming companies are liable to be taken over, putting management jobs at risk.

Arguably, this latter discipline is weaker the greater the capitalisation of the company. Consequently, privatising the former British Airports Authority as a whole would, in normal circumstances, have reduced the threat of a subsequent takeover. But in this particular case, a restriction was written into BAA’s Articles of Association at the time of privatisation, limiting any single shareholder to 15 per cent of the equity. As a result of a recent ruling in the European Court concerning the free movement of capital, the restriction is to be removed, subject to a successful resolution, at the 2004 AGM, but thus far, because of it, it has been impossible to subject BAA to a hostile bid. Possibly reflecting these circumstances, it has been the major UK airlines in particular that have lobbied for the government to intervene to break up BAA. The system RAB approach does, however, make this a more difficult proposition, which is likely to be an added reason why the approach has found favour with BAA.

Given these circumstances, has BAA’s behaviour with respect to Stansted been consistent with maximising shareholder value? There are indications that BAA’s management has been pursuing a policy of maximising market share by building excess capacity and then pricing in the Stansted market at (or, at peak

\[Vickers \text{ and Yarrow (1988) provide a good review of the general problem.}\]
times, below) short-run marginal costs and recouping total costs, including the investment costs, from other airports where demand is less elastic. Nevertheless, in the peculiar circumstances that Stansted has found itself in, it is possible that maximising market share through investing in excess capacity has not been inconsistent with maximising shareholder value. Incorporation of Stansted in a system-wide RAB and the fact that BAA is allowed its cost of capital across the three airports combined mean, in effect, that any financial downside from pursuing a market-share strategy has been compensated for by increased charges and the extraction of rents at Heathrow.

It is, however, a strategy not without risks attached, depending, as it has done, on regulatory acceptance of a system approach. Absent the system approach, the lack of a satisfactory return on Stansted’s capital would have forced operating efficiencies, pricing adjustments and a probable write-off of capital. Consequently, the regulatory review leading to the fixing of the price cap for BAA’s London airports for the period 2003–08 is of particular significance.

VII. THE 2003 PRICE-CAP DECISION

In its review of the 2003–08 price cap (Civil Aviation Authority, 2002a), the CAA indicated at an early stage that it proposed to set aside the system approach and consider each London airport separately. It considered the case for stand-alone price caps to be very strong for two reasons. First, the demand and capacity conditions were different at each airport, with each airport largely serving separate markets. It therefore considered that a focus on airport-specific caps allowed for a better tailoring of incentives to the needs of each individual airport. Second, it also considered that the use of an airport’s own asset base to fix its price cap diminished the ability of the airport operator to subsidise ‘premature or gold-plated investment’.

The Competition Commission in its October 2002 recommendations to the CAA suggested that the system RAB approach should continue. It did not accept that because airlines are not prepared to switch airports, investment at Stansted does not reduce excess demand at Heathrow. Under a separate airport approach, if Stansted were unable to price up to a cap that reflected its own cost of capital, the return of the three airports as a whole would fall short of BAA’s cost of capital.

There are now well-defined peak periods at Stansted during the course of the day. Peak demand normally drives the investment case and therefore peak pricing is a way of testing whether and when additional capacity is justified.

It also quoted BAA as saying that airlines mainly operated from Stansted because they were unable to operate from Heathrow (paragraph 2.45). It is difficult to conceive of the low-cost airlines that dominate Stansted moving to Heathrow if room were made available; the characteristics of Heathrow make it unsuitable for the low-cost carrier business model with the emphasis of the latter on fast turnrounds.
This would be inconsistent with the previous basis of regulation and would put at risk BAA’s ability to finance its investment (paragraph 2.51). The Competition Commission also said that it saw no evidence of undue investment at Stansted and no evidence that investment was predictably excessive nor, therefore, that a system RAB was driving such an outcome (paragraph 2.54). The Commission also shared the concern of the Department for Transport that a stand-alone approach could inhibit the financing of additional runways at Stansted, the ‘need’ for which may rise because of constraints on runway developments elsewhere (paragraph 2.56).

The CAA in its November 2002 Proposals for Consultations rejected this view and restated its intention to adopt a regulatory approach for the future based on the stand-alone regulation of each airport. This proposal was supported during the consultation phase by a number of airlines, particularly those operating from Heathrow. Airlines operating from Stansted took an opposing view. BAA, as might have been expected, argued strongly against the proposal, suggesting that the change of policy was premature in pre-empting the government’s forthcoming White Paper; the Department for Transport made the same point.

In its Decision in February 2003, the CAA confirmed its position that regulation was to be based on a stand-alone approach with the price cap for each airport set in accordance with its own RAB. This decision did not affect the price caps during the period 2003–08 because these were fixed taking into account the expected return on capital over the forthcoming decade and it was anticipated that Stansted would, finally, produce an adequate return over this time horizon. Nevertheless, the CAA left the door open for a return to the status quo ante, but confirmed its earlier proposal that it would expect ‘compelling evidence to demonstrate that users in aggregate were genuinely better off as a result’ and, no doubt with the Luton case in mind, ‘that the impact of [a system-wide RAB] was not unduly distortionary or discriminatory as regards other airports in the southeast’ (paragraph 3.24).

From BAA’s point of view, this change of policy on the part of the regulator is of critical importance. It means that, at least for the time being, BAA cannot rely on securing a return on further investment at Stansted by being allowed to leverage its Heathrow market power. And in the event that the CAA can be persuaded to adopt a system approach in the future, the current decision will have increased perceptions of the regulatory risks involved.

Elsewhere in its report, the Commission anticipated that Stansted would be meeting its cost of capital by the end of the current quinquennium.

This comment should be set alongside those in paragraph 1.14, which suggests that the Commission was reluctant to get to grips with BAA’s capital expenditure programme. Its consultants were also critical of some of BAA’s procurement processes (see paragraphs 9.66–9.75).
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VIII. THE 2003 WHITE PAPER

The purpose of the White Paper, *The Future of Air Transport*, published in December 2003, was to set out the strategic framework for the development of airport capacity in the UK over a period of 30 years.10 Within this framework, airport owners were expected to bring forward proposals to be considered through the planning system in the normal way. The government saw its role as primarily one of enabler and regulator, given that the major airports are, in the main, operated within the private sector.

Publication of the White Paper was preceded by an extensive consultation process, the release of a number of technical papers by the Department for Transport, including regional studies of site options for airport expansion, and the subsequent release of the responses to the consultation. The BAA submission (BAA, 2003) reviewed the various site options and was of the view that ‘one additional runway at Stansted would be financially viable, subject to the scale of the additional costs not calculated [in the preliminary studies], although the charges needed to remunerate the investment would need to be shared across users of the London system as a whole’ (paragraph 7.51).

BAA’s analysis had suggested that charges needed to remunerate the investment would have to increase above the 2003–04 level (for Stansted) in real terms by around 35 per cent if approached on a system basis and by around 120 per cent on a stand-alone basis. To more than double real charges was not considered feasible. Thus, an additional runway at Stansted was not viewed as commercially viable without cross-subsidy from other London airports (or, alternatively, without direct subsidy). BAA went on to argue in favour of cross-subsidy through the system approach invoking what might be thought of as public-interest arguments in doing so. It suggested that maintaining the system approach would continue to be justified on the grounds that all users would benefit from the provision of additional capacity in the South East, irrespective of its location as a result of the reduced congestion, enhanced airline competition and lower air fares. There would be wider public interest benefits to developing airport infrastructure in a way that underpinned the economic health of London, the South East and the UK as a whole.

As for the White Paper itself, and notwithstanding BAA’s conservative response on the commercial viability of further investment at Stansted during the consultation phase, its major pronouncement was that ‘the Government now supports the development of a second runway at Stansted as the first new runway to be built in the South East’ (paragraph 11.40). It went on to add that

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10In contrast to its 1985 predecessor White Paper, it did not contain any legislative proposals.
The Government will not promote or pay for the development of Stansted. New airport capacity should be paid for by airport users. We look to the airport operator to take it forward in a way that is responsive to users, and to provide necessary funding. It is a responsibility of the regulator, the CAA, amongst its statutory duties, to encourage timely investment. The Government expects … Regulator and airport operator, to secure an appropriate framework to bring the development to fruition. It expects this process to be guided by the decisions in this White Paper, as well as by the regulator’s duties towards users of airports, towards the operation of airports, and towards investment in new facilities at airports.

One could interpret this statement with its emphasis on the regulator’s statutory duties as an indication that the government sees the system approach as the appropriate means for funding the further expansion of Stansted. The reference to statutory duty is a reference to Section 39 of the 1986 Airports Act that *inter alia* requires the regulator ‘to encourage investment in new facilities at airports in time to satisfy anticipated demands by users of such airports’. But it does beg the question of what is timely in these circumstances and whether promoting an investment that is not financially sound would breach the Statute, bearing in mind that another clause in Section 39 places a duty on the regulator ‘to promote efficient, economic and profitable operations of such airports’. If the government were to favour the former clause, then it would also appear to contradict its own appraisal framework set out in the consultation, which stated that commercial viability was ‘a hurdle that must be passed’ by developments on new or existing airport sites (Department of the Environment, Transport and the Regions, 2000, paragraph 13.1).

The response of BAA to the White Paper was to announce that it would press ahead with the expansion of Stansted, that the process of seeking planning permission had begun and, interestingly, that it hoped to reduce significantly its earlier estimated costs of expansion (these estimates had formed the basis for the calculated increase in the level of charges required to remunerate the investment)\(^\text{11}\). BAA warned, however, that by adopting a stand-alone approach to financing the expansion, there was considerable risk that timely provision would be prejudiced and that this might make government subsidy necessary, adding that ‘without financial support from Government, the airport operator would have to wait until demand, and hence airlines’ willingness to pay, for new capacity had risen to a level that would justify investment in the new runway. Such a delay in providing new capacity would not be in the interests of airlines, their passengers or the wider economy’ (*Business Weekly*, 28 November 2003). Yet again, BAA was suggesting that there were public-interest arguments

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\(^{11}\)This might suggest that removing the system RAB has already led to a more careful examination of investment proposals. It is worth noting that the cost of a terminal expansion opened at Stansted in 2002 was, on a square-metre basis, about double the estimates used by the Department for Transport’s consultants in the airport options study leading up to the 2003 White Paper.
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justifying either leveraging its market power at Heathrow (to cover the projected financial shortfall of an early expansion at Stansted) or the payment of a direct subsidy. In its response to the consultation, it had advanced two such arguments for an early addition to Stansted’s capacity: reduced congestion elsewhere in the system and enhanced airline competition leading to lower airfares. It is to these two arguments that I now turn.

IX. PUBLIC-INTEREST ARGUMENTS

1. Relief of Congestion Elsewhere in the Airport System

The first public-interest argument put forward by BAA to justify financial (cross-)subsidy of Stansted is that it would reduce charges at Stansted (albeit, in the case of cross-subsidy, at the expense of higher charges at Heathrow/Gatwick); this attracts traffic to Stansted that would otherwise use busier airports, and thus congestion costs are reduced at the latter. This positive externality is to be allowed for over and above any financial margin. Before examining the essence of the argument further, a few comments on the size and nature of airport congestion are called for.

First, it is usual to declare a capacity for the runway(s) at an airport, defined as the permitted maximum number of aircraft movements in a specified time period; this in turn constrains the scheduling of services. The declared capacity for runways might also reflect constraints elsewhere in the airport system, so that permitted runway use is used to balance the airport system as a whole. Defining capacity also involves specifying service quality. For example, the degree of average delay at Heathrow agreed as acceptable is 10 minutes. These administrative rules reduce the amount of congestion in the system and therefore reduce the potential benefits of reduced congestion if flights switch between airports. Second, recent contributions to the theory of airport congestion have argued that the traditional approach overestimates the marginal costs involved (Brueckner, 2002; Mayer and Sinai, 2002). It does not take into account the fact that a particular flight might very well impose delay on other flights operated by the same airline and that the delay costs that an airline imposes upon itself are, in effect, internalised. Third, the economically efficient response to congestion is to adjust prices where the congestion occurs. Although use of the price system in the airport context is constrained by international treaties and obligations, there is a surcharge for the use of runways at Heathrow and Gatwick during busy times together with a reasonably well-functioning secondary market in slots. These measures also help to reduce the scale of the congestion externality as well as assisting with the efficient allocation of existing capacity.

Putting to one side these considerations (all of which suggest that the congestion problem at crowded airports with dominant users is perhaps not of great consequence), the nub of the BAA argument, although one that is implicit,
is that the reduction in the congestion externality as a result of flights switching to Stansted will exceed the ‘deadweight’ loss as a result of the use of resources priced at less than their (marginal) value in alternative uses. The argument hinges therefore upon the extent to which airlines using Heathrow and Gatwick will be attracted to Stansted by reduced charges. The smaller is the degree of switching of flights from one airport to another relative to the overall increase in the demand for flights at the airport where the price is reduced (i.e. the smaller is the cross-price elasticity relative to the direct price elasticity), the less likely it is that the reduced congestion externality will exceed the deadweight loss.

In the case of Stansted, the indications are that the elasticity conditions necessary to secure a net welfare gain are most unlikely to occur. In spite of considerable and long-standing excess demand for the use of Heathrow at current levels of charge and in spite of low charges at Stansted, Heathrow operators have shown no inclination to transfer to Stansted. But, because of pent-up demand at Heathrow (with airlines seeking many more slots than are available), to make an appreciable difference to congestion at Heathrow, switching would have to be considerable. Switching between Gatwick and Stansted is more likely, given the current structure of the market, but currently congestion at Gatwick is not especially severe. On the other hand, the direct price elasticity for air travel from Stansted on low-cost carriers is thought to be high. Consequently, it seems most unlikely that subsidising charges at Stansted in order to relieve congestion at Heathrow or Gatwick will result in a net gain in welfare.

2. Increasing Competition in Air Services

BAA’s second public-interest argument starts from the premiss (which again is implicit) that in order for there to be a welfare gain, airlines do not have to respond to pricing differentials by transferring flights between airports. Instead, the generous provision of capacity at Stansted together with low charges encourages competitive entry into the market for air services and thus lowers airfares at other airports. Although the subsidy that is necessary to secure this outcome results in some loss of welfare (the resource costs of expanding Stansted exceed the net benefit to Stansted passengers), passengers at congested airports where competitive entry is not possible also gain from the lower airfares at Stansted: economy fares on short-haul routes out of Heathrow, for example, will be reduced by the increased (subsidised) competition from Stansted. This gain is assumed to offset the uneconomic use of resources at Stansted, resulting in a net gain overall.

This argument perhaps has greater merit but it also retains some significant weaknesses. Although the price mechanism is not used at busy airports to clear the market for the use of runways and terminals by airlines, prices are still used to ration passenger numbers to available seat capacity. This is done by the
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airlines using yield management techniques: the balance of seats between different classes and the price of those seats are continually monitored and adjusted as the number of seat bookings on a particular flight increases towards the maximum number of seats available. The result is that both the seat load factor and the average price of the ticket (the yield) increase with demand, and where demand is high the airline is able to secure a margin on sales in excess of, and perhaps well in excess of, operating costs. This excess is a scarcity rent.

The CAA has argued that airlines operating out of Heathrow in particular gain a significant scarcity rent. During the recent review of the airport price caps, it undertook research that showed that revenues from flights to a number of destinations from Heathrow greatly exceeded those from similar flights from Gatwick. It estimated, for example, that a BA short-haul flight operating out of Gatwick would show an additional profit of £2 million per year at Heathrow. This difference, referred to as the Heathrow premium, does not take account of the higher operating costs experienced at Heathrow (Bishop and Thompson, 1992); therefore the net premium is likely to be less but probably remains substantial.

In relation to the proposition that (cross-)subsidising flights out of Stansted has the beneficial effect of reducing fares at congested airports such as Heathrow, the scarcity rent or fares premium is of significance. In so far as fares at Heathrow are reduced by competition from Stansted (and at the moment there are relatively few common destinations served from both Heathrow and Stansted), the likely effect will be to reduce the fares premium at Heathrow and thus the scarcity rents. However, and importantly, this is not an efficiency gain but a rent transfer; the scarcity rent will, in effect, have been transferred from Heathrow airlines (a reduction in producer surplus) to Heathrow passengers (an increase in consumer surplus): a situation that will continue so long as demand at Heathrow exceeds capacity.

This is not to argue that there could not be some efficiency gain as a result of subsidised fares at Stansted. Even in a more crowded future at Heathrow, there will be times, particularly in the winter season, when demand is less, so that there is the potential for selling more capacity; the ensuing increase in output would represent a welfare gain. But it is doubtful that this gain would be large enough to offset the net loss at Stansted (where the resource cost of the additional, subsidised output will exceed its value to Stansted passengers).

British Airways (BA), on the other hand, argues strongly that a fares premium at Heathrow, where it holds about 40 per cent of the slots, does not exist; it points out that if such a premium did exist, it would be reflected in excess profits and return on capital, which BA does not experience. If there were no scarcity rent at Heathrow, this would strengthen the argument that subsidy at Stansted could beneficially impact on fares at Heathrow (but output would still need to increase). However, it is difficult to accept, in the light of the CAA evidence and more particularly in view of BA’s willingness to pay other airlines operating at
Heathrow considerable sums for an exchange of their slots, that there is no Heathrow premium.\(^{12}\)

A fares premium at Heathrow and the absence of excess profits for BA can be reconciled, however, by the fact that BA has an extensive network of routes, not only at Heathrow but also out of Gatwick and other regional centres such as Birmingham, Manchester and Glasgow. On the fringes of these networks, BA probably faces strong competition; some services will be marginal and others might well operate at a short-term loss, albeit with the prospect of more profitable operations in the future. Other routes might be marginal even if competition is absent because of low levels of demand. It is possible, therefore, that BA uses rents from Heathrow to sustain a larger network and a greater service frequency (particularly to feed traffic to long-haul services) than it would otherwise do in the absence of those rents. Consequently, if competition from subsidised routes at Stansted cut into the Heathrow fares premium, BA’s more marginal services, particularly those out of regional airports, could be at risk. Other airlines might respond to cuts by BA by increasing their services at these airports, but the extent to which they are able to do so will depend upon their having a much lower cost base than BA in comparable circumstances (to compensate, in their case, for the absence of a Heathrow premium). A response from other airlines is also less likely if BA responds to pressure on fare premiums at Heathrow by cutting frequencies rather than routes. Similar arguments are likely to apply to BMI, the airline with the second-largest slot portfolio at Heathrow. Therefore, the likely extent and the direction of change in both prices and output across all the relevant networks are not at all clear.

In addition, account also needs to be taken of the likelihood that further Stansted subsidy would again lead to a serious distortion of competition between airports. It was accepted by the CAA that Luton Airport was materially harmed by the last major expansion at Stansted, and other airports in the Midlands and East Anglia were probably affected too (although to a lesser degree than Luton). At the time of Luton’s complaint, it was argued that there was no suitable remedy available; the excessive capacity at Stansted had already been ‘sunk’ and therefore low prices were inevitable if available capacity was to be used efficiently. This argument does not apply in the current precommitment context. Moreover, although there might in the past have been benefits from bringing forward airline competition at some cost to competing airports by expanding Stansted prematurely, it is difficult to justify further premature investment on the same basis now that low-cost airline competition is in place.

12Press reports in October 2003 suggested that BA had finalised the acquisition of two pairs of slots for which it paid £12 million.
X. PRICE-CAP REGULATION AND INVESTMENT INCENTIVES

The Stansted expansion project clearly raises a number of issues regarding both the structure of the airports industry and particularly the regulatory framework that is applied to it. The UK approach to economic regulation operates by restraining average prices (in the airports case, average revenues) in a way that provides the regulated firm with incentives for efficiency because subsequent savings in expenditure, exceeding those anticipated at the time that the regulated price (revenue yield) is set, enhance company profitability. But, as I noted earlier, some of the recent literature has argued that this approach fails to give adequate incentives to invest because of problems of regulatory commitment, the longevity of sunk investment and the *ex-post* opportunism that this can give rise to, and the general focus of the approach on short-term efficiencies. On the other hand, others (for example, Littlechild (2003)) have noted that pressures on regulators have led, in practice, to a steady convergence of the RPI–X approach with rate-of-return regulation, the latter generally regarded as encouraging overcapitalisation and excess capacity.

BAA’s approach at Stansted appears to support the view that an RPI–X approach does not inhibit the regulated firm from investing in capacity. The company’s apparent willingness, verging on zeal, to expand capacity at Stansted in advance of a level of demand that would justify the investment indicates a strong disposition to overcapitalise (as a firm subject to traditional rate-of-return regulation would do). Similar indications arise from BAA’s reluctance, in spite of peakiness in the use of infrastructure, to use time-of-day pricing to test the strength of demand. But it is a predisposition that the RPI–X approach appears to do little to restrain. Because the regulator is setting a price, usually every five years, with reference to an allowable return on assets, the regulated firm with market power has an incentive to expand its asset base provided that the regulator allows for this in the prices it can charge.

The regulator can, of course, try to press down on such tendencies by scrutinising the proposed capital expenditure programme when resetting X. The regulator of the water utilities, for example, does this, but it has not been the practice in the airports industry. Generally speaking, the capital expenditure programme put forward by BAA has been accepted without detailed examination. During the recent periodic review, for example, the Competition Commission commented that ‘we have not adjusted BAA’s forecast for capital expenditure: even if there is scope for lower costs on some projects, there is in our view likely to be a demand for any cost savings to be spent on additional projects’ (Competition Commission, 2002, paragraph 1.14). The CAA has also been reluctant to challenge details of the capital expenditure programme, believing that this would result in too intrusive regulation (see, for example, Civil Aviation Authority (2002a, paragraph 3.27)). Instead, it has sought to encourage the airport companies and the airlines to engage in a process of
consultation and mutual agreement on an appropriate programme of works; but the airlines have viewed the process as one that is less than satisfactory (see, for example, Competition Commission (2002, paragraph 9.84)).

The consequence of this regulatory approach is that it has provided an opportunity for airport companies to exercise their market power indirectly through higher-than-necessary levels of investment in capacity and in costly gold-plated investment. In the specific case of Stansted, this process has been taken a step further: BAA has been allowed to leverage market power at Heathrow in order to finance an expanded asset base in the distinctly different Stansted market so as to provide services in the latter at (short-run) marginal cost. This has been at the expense of competing airports, particularly Luton, which might suggest that BAA’s enthusiasm for expanding Stansted was really motivated by a desire to pre-empt capacity increases by competitors, a case of an entry deterrence strategy on the part of BAA. The position taken by the government in the most recent White Paper appears to confirm that such a strategy is still working.

In the general debate on the (de)merits of the RPI–X approach, and especially the claims that it leads to underinvestment, the issue of an entry deterrence strategy on incentives to invest appears to have been neglected. But if the Stansted case is not exceptional, it suggests that the regulatory approach to sanction investment aimed at capturing market share can be a potent instrument for the dominant firm to use.

XI. CONCLUSIONS

The expansion of Stansted in the late 1980s and early 1990s (at least on such a large scale) was most likely a mistake and one that might well have been foreseen. The project emerged from a planning process; it was not market driven. It has since been partially rescued by the low-cost airline revolution (which, arguably, it helped to facilitate). Stansted dumped excess capacity onto the market cheaply (reflecting short-run marginal costs after capital had been sunk) and the low-cost airlines responded, but it will be nearly 20 years later that Stansted’s annual return covers its cost of capital (now anticipated for about 2008). During the intervening period, BAA has been allowed by its regulator (encouraged by the Competition Commission) to leverage its market power at

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13Nor is it the practice to consult Heathrow airlines on the investment programme at Stansted (or vice versa).
14In the 2003 White Paper, the government declined to support Luton’s proposal for a second runway largely because its analysis indicated relatively limited traffic growth so that, given existing capacity, a second runway was ‘unlikely to come to fruition for many years’. Perhaps this is not a surprising conclusion, given both the government’s predisposition to expand Stansted and BAA’s pricing policy at Stansted. Nevertheless, it might be questioned whether this is an even-handed approach on the part of the government and whether the decision should not be left to market forces (subject, of course, to the usual local planning scrutiny).
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Heathrow in order to produce a satisfactory return overall, thus compensating it for Stansted’s poor financial performance following its earlier overexpansion.

There are signs that history might soon repeat itself. The government has decided that it will now support the development of a second runway at Stansted as the first major new development in the south-east. It has also stated that it will not promote or pay for this development in spite of analysis having strongly indicated that such an expansion in the time frame envisaged would not be commercially viable on a stand-alone basis. BAA argues, therefore, that it should be allowed to continue to leverage its market power elsewhere so that it can cross-subsidise further expansion at Stansted. This confronts the new policy stance of the regulator adopted as part of the 2003 price-cap decision that, in future, investment in each airport is to be judged, for the purposes of determining the price caps, on a stand-alone basis. The regulator did, however, leave the door ajar for reintroducing a system-wide RAB, indicating that it was prepared to revert to the status quo ante if compelling evidence was forthcoming demonstrating net user benefits and no undue distortion of the aviation market.

I have therefore examined two public-interest arguments put forward by BAA as grounds for market intervention. Both of these focus on potential user benefits not incorporated in Stansted’s revenue stream. I find the first argument, concerning the relief of congestion at airports other than Heathrow, generally weak and probably unsustainable. The second argument, that cross-subsidising Stansted might benefit air passengers more generally because of the additional airline competition engendered, is a line of argument that might have had credibility in the past but not now that the low-cost airlines are well established. It also has other significant weaknesses. The chief effect at Heathrow is likely to be the transfer of scarcity rent from airlines to consumers without any noticeable impact on output: the effects would be largely distributional in nature rather than representing an improvement in economic efficiency. But, in so far as output is affected, the efficiency consequences could be negative instead of positive, with a negative impact occurring if network airlines operating out of Heathrow cut back on marginal services (both at the London airports and at regional airports), the fixed costs of which are currently sustained by profitable operations at Heathrow. In addition, there is likely to be further serious distortion of competition between airports, particularly between Luton and Stansted, the former having suffered ‘material harm’ from Stansted’s previous overexpansion.

Reflecting upon the recent White Paper and its proposals for a further major expansion of Stansted (with an expectation of completion around 2011–12), it is difficult to appreciate the position taken by some of the stakeholders. First, it is not at all clear why BAA’s management should want to continue to cross-subsidise investment at Stansted from its other airports. In the past, management has been able to pursue such an approach (and gain market share as part of an entry deterrence strategy) without prejudice to shareholder interests because of the regulator’s endorsement of the system RAB approach. It is less evident that
shareholders will be well served in the future by the public-interest arguments that the BAA management has adopted, even if the regulator can be persuaded to accede once again to a single RAB for all three London airports. This is because of increased regulatory risk: the regulator is not able to precommit to future policy, and compelling evidence that might lead to the re-adoption of a system approach might also turn out to be less than compelling at a later date. Whether the BAA management will maintain its current stance once existing protections from the full disciplines of the capital market have been removed remains to be seen.

It is also difficult to appreciate why the government should want to encourage an approach based on cross-subsidy, given the emphasis that is now placed on environmental considerations. The effect of the system RAB approach and the expansion of Stansted at a rate faster than that dictated by the market has been to encourage its use by marginal aviation activity. It is odd, therefore, that the White Paper should set out the government’s environmental concerns and its determination to pursue economic instruments for mitigating environmental impacts, whilst at the same time appearing to encourage at Stansted marginal aviation activity that fails to meet infrastructure costs directly attributable to it.

Finally, it is to be noted that, in the past, the combined RAB approach to the setting of regulated prices at BAA’s London airports has inhibited opportunities for reducing the scope of regulation. Stansted has never had any real market power so its price cap has not been binding. But, in order to facilitate its accelerated development ahead of market forces, it has had to be ‘designated’ and thus subject to the rigours of a regulatory regime. Now that the regulator has set aside the combined RAB, this provides an opportunity to reduce the regulatory burden by de-designating Stansted and allowing greater scope for competitive forces to shape its future.

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