

# **Competition Commission: BAA London Airports Inquiry**

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The Competition Commission has issued a statement on its initial thinking on the single/dual till issue, and invited further views and representations on this and other issues related to its review of the three BAA London airports. I am responding to this for two reasons.

1. First, on the basis of my experience regulating the British electricity industry for nearly ten years, it seems to me that there is more to be said for the dual till approach than the Commission allows. It is likely to be more conducive than the single till to more effective regulation and more effective management.
2. Second, on the basis of my economics training and experience over some forty years, it seems to me that there is an over-riding issue that should impact on almost all aspects of London airport regulation. This is the problem of under-pricing at the two main London airports, which artificially increases the demand for use of these airports and distorts the related investment decisions. This issue is not mentioned or recognised by the Commission in its statement, yet it impacts particularly on the single versus dual till decision, as well as upon several other issues mentioned by the Commission. It is a further argument in favour of the dual till.
3. I am presently Honorary Professor at the University of Birmingham Business School, Principal Research Fellow at the Judge Institute for Management at the University of Cambridge, and an international consultant on privatisation, competition and regulation. I was formerly Director General of Electricity Supply from 1989 to 1998, Professor of Commerce at the University of Birmingham from 1975 to 1989, and a member of the MMC from 1983 to 1989.
4. I am not acting on behalf of any of the parties involved in this issue. Apart from my experience of electricity regulation, in the UK and overseas, my interest and such knowledge as I have of airport issues derives from research on airport landing charges in the mid-1970s, particularly at Birmingham airport; advice to the Secretary of State on the initial price control for BAA at the time of its privatisation; and membership of the MMC panel on the first reference of Manchester airport at about the same time. I am presently testifying in an overseas court case involving an overseas airport regulatory body. I have become interested in this issue as a result of seeing the recent submission to the Commission by David Starkie, the response by the CAA to the Commission's statement, and various recent press reports.
5. I am copying this submission to the panel on Manchester Airport Inquiry, since it seems to have adopted the same preliminary statement on the dual till issue. I assume that Manchester Airport is not under-priced to the extent of Heathrow and Gatwick; hence those particular arguments may not be so applicable to Manchester. However, other arguments in this submission – for example about the impact of the single till on management and regulation - undoubtedly are relevant, though I have not attempted to identify them in detail.

## **The overriding issue: under-pricing**

6. The overriding issue that I refer to is that the main London airport charges are seriously under-priced at present – certainly at Heathrow and also, though to a lesser extent, at Gatwick. This causes or exacerbates numerous problems, and is likely to lead to inefficient investment on a major scale. The urgent need is to increase, and not reduce, these charges. The challenge is to devise a way of doing this that does not compromise BAA's incentives to efficiency, and is acceptable to passengers.
7. In saying that airport charges at Heathrow and Gatwick are under-priced at present, I mean primarily that the charges for take-off and landing are below the prices that would equate the supply and demand for these services. At present levels of charges, there is an excess demand in relation to the capacity available. The level of charges that would just “clear the market” is much higher than the present level of charges.
8. The market clearing level of charges is not the only relevant benchmark. Another very relevant benchmark, potentially an even more important one, is what it would cost to expand airport capacity - that is, to provide more of these aeronautical services. I understand that the present level of charges is significantly below this level too. By this second criterion, too, London airport charges (at least at Heathrow and Gatwick) are seriously under-priced.
9. Heathrow and Gatwick also seem to be under-priced by international standards. A recent Australian review of airport charging shows them both in the bottom half of the charges at 40 major international airports<sup>1</sup>. Charges at both are less than half the level of charge reported for two New York airports (JFK and Newark). Different accounting practices, different circumstances and different commercial pressures (or lack of them) will of course lead to variations in airport costs and charges. Nevertheless, it is striking that charges at the two London airports are so low relative to so many other airports.

## **Problems of under-pricing**

10. This under-pricing leads to the sorts of problems that are well known in other markets when price controls are imposed to keep prices below the competitive market level.
11. First and foremost, demand is artificially stimulated. Airlines and therefore passengers are, at the margin, induced to fly to and from Heathrow and Gatwick instead of to and from other airports. Passengers are also induced to fly rather than use other means of transport – and, indeed, to travel rather than spend their time and money on other things.

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<sup>1</sup> *Price Regulation of Airport Services: Inquiry Report*, Report No. 19, Productivity Commission, 23 January 2002, Figure 2.8 page 33.

12. At the same time, there is less incentive on the airport and airlines to increase the supply of capacity – for example, by providing for planes with larger passenger capacity.
13. There are also distorting effects on other airports that could potentially attract some of this traffic. Because of the under-pricing at Heathrow and Gatwick, such other airports find it more difficult to compete.
14. There are likely to be distortions within the present use of capacity. There is excess demand for access to Heathrow, but present charges do not allocate the scarce capacity to those passengers and flights and airlines that attach the greatest value to this capacity. There must be numerous passengers, flights and airlines that are there simply because they always have been there in the past. Other passengers, flights and airlines would value the scarce capacity more highly, but are unable to get access to it.
15. In other markets subject to price controls, there is usually some adverse effect on quality. At the artificially reduced price it is not worth providing better quality. I am unable to say whether this is the case at these two airports, but I would be surprised if there were not some symptoms of that.
16. Similarly, in price-controlled markets generally, other non-price methods of allocating scarce capacity necessarily arise, which may have undesirable aspects. There is greater likelihood of political avenues being used, not to mention corruption. Again I am unable to comment on the present situation in this respect.
17. Perhaps the most important issue for the future is whether and when and how airport capacity should be expanded at Heathrow. Is expansion there the most economic way to proceed? Or would it be more sensible to expand capacity at other airports, or indeed to build new ones? Do passengers in fact value the ability to fly to and from Heathrow as much as it would seem at present, and would prefer to pay the costs of expansion there? Or is the demand at Heathrow as high as it is because it is artificially stimulated? Would passengers rather shift to other airports or other means of travel or other forms of discretionary expenditure, rather than pay the actual costs of expanding Heathrow?
18. An important disadvantage of the present artificially low prices is that they provide less valuable information about customers' preferences regarding these future investment decisions. Evidently passengers are willing to pay as much as they are presently paying in order to have greater capacity at Heathrow. However, the present charges do not show whether passengers would be willing to pay as much as it would cost actually to provide greater capacity there.

### **Advantages of increased airport charges**

19. The advantages of increasing airport charges to reflect the cost of providing more airport capacity would be the converse of the above problems of under-pricing. There would be greater incentives on airlines to schedule flights to and from other airports. Passengers would have

- correspondingly greater ability to consider flying from other airports. To the extent that increased airport charges were reflected in higher fares, passengers would have greater incentive to use other airports, to use other means of transport, and to spend more of their incomes on other activities and less on flying.
20. Airlines would have greater incentive to explore and implement ways of moving more passengers per aircraft movement. Other airports would have greater opportunity to provide alternatives and to invest in expansion. There would be fewer political pressures associated with access to Heathrow.
  21. Importantly, better information would be available about customers' preferences. The extent to which the demand for airport services responded to charges more closely related to the cost of expanding such services would be a valuable indication of how future investment policy ought to proceed. It would indicate whether increased investment ought to go ahead at Heathrow and in the southeast generally, or whether there is a stronger case for reducing or deferring some of that expenditure, and for meeting passengers' requirements in other ways.

### **What is the appropriate basis for setting airport charges?**

22. As is well known, economists are rather divided as to the appropriate basis for setting the prices of public utilities. Some argue for short run marginal cost, others for long run marginal cost. Yet other factors may also be relevant. There is no unambiguously right answer. Each method has advantages and disadvantages. It is necessary to assess which method is preferable on balance in the circumstances of each particular case.
23. One policy would be to set airport charges that would just equate the supply and demand for airport capacity at each airport. These would be "market-clearing prices" that would reflect opportunity costs. The main advantage of this "short-run" approach is that it would tend to allocate presently available capacity to the highest valued uses. It would make best use of whatever capacity is available at any time. It would ration demand when capacity was tight, and encourage additional usage when spare capacity was available.
24. Against these advantages there are certain disadvantages with this approach. First, the level of a market-clearing charge would give an indication of what value passengers would place on a small increment of capacity. But it might not be a valid indication of the value they would place on a realistically large increment of capacity, such as a new terminal would provide.
25. Second, a policy based on market-clearing charges might provide an incentive on the airport artificially to restrict the amount of capacity available in order to increase the level of its charges.

26. Third, the implied level of charges would fluctuate over time, as capacity increasingly became scarce, and then was relieved.
27. Fourth, the extent of the initial increase in charges implied by such a policy might not be acceptable to passengers and to politicians, particularly if it were thought that the proceeds would go to the airport shareholders.
28. An alternative policy would be to relate airport charges to the likely costs of expanding capacity. This would be a longer run concept of cost. Such charges might not be sufficiently high to “clear the market” in the immediate future. But they would be higher than present charges, hence would have many of the advantages indicated above. They would provide better utilisation of existing capacity, better incentives to passengers and airlines, and better information to inform future investment policies. This is not to rule out market-clearing prices, but rather to indicate that substantial benefits can be obtained by even a modest move in that direction, without some of the disadvantages of going all the way.
29. The above arguments are aimed at Heathrow especially, and also Gatwick. Whether the same solution is appropriate for Stansted I cannot say on the basis of my present knowledge. It may be that there is no excess demand at Stansted at present – indeed there might be excess capacity there at present. In that case there would be a stronger case for basing prices on short-run considerations, so as not to divert traffic away from Stansted unnecessarily. The costs of increasing capacity at Stansted may not be relevant in the near future (although further out there are proposals for an additional runway).
30. At the same time, consideration needs to be given to competing airports such as Luton, which do not have the ability to cross-subsidise from one airport to another, and which need to cover all their costs. There is therefore a case for requiring Stansted to cover its existing costs on a stand-alone basis, even if it is not yet required to look ahead to the potentially higher costs of expanding its capacity.
31. Whether it is even necessary to have a price control at Stansted, provided that this airport is not cross-subsidised by the other BAA airports, is a question that the Commission is no doubt considering, but that is beyond the scope of the present note. The focus here is on getting the charges and charging arrangement right at Heathrow and Gatwick.

### **Potential problems of higher airport charges**

32. As I understand it, present airport charges at Heathrow especially and also at Gatwick are very significantly below market clearing prices and also significantly below the costs of expansion there. The implication of the argument above is that there would be advantage if airport charges there were increased in real terms rather than held constant, let alone reduced. If the conventional price control mechanism is used, this implies RPI+X rather than RPI-X. It also suggests that consideration should be given to an initial increase in charges. This would be a Po increase rather

- than what is usually known as a Po reduction. Even with such an initial increase, there would still have to be a subsequent RPI+X to ensure that charges did not reduce in real terms.
33. Increases rather than decreases in charges have certainly been implemented before, as part of a regulatory price control. For example the initial price controls on water and electricity distribution companies provided for RPI+X rather than RPI-X, for essentially the same reason as here. Higher charges were considered necessary in order to cover the considerably higher investments in capacity that were expected to be necessary in future.
  34. Nevertheless, higher charges are likely to be resisted by at least two sets of parties: the airlines and the passengers (and no doubt some politicians). There is also a third possible objection: that increased airport charges will reduce the incentives to internal efficiency at the airport. I now take these three concerns in turn.

#### **(a) Airline concerns**

35. I understand that the airlines generally argue that they could not absorb any or all of the increase in airport charges so would have to increase fares to customers.
36. For the reason I have given, this would not necessarily be undesirable. It would have certain advantages. Passengers may not welcome it initially, but over time it would help to secure a more efficient use of resources that would lead to lower costs, lower charges and higher incomes in real terms. I deal with this aspect shortly.
37. It is possible that higher airport charges would to some extent be absorbed by airlines. This could be the case where airlines are able to secure a level of fares in excess of airline costs plus airport charges. I understand that fares are often set at about the market clearing level for each flight at each airport, with differing margins or rents obtained by the airlines depending on the flight, time and location.
38. If this were the case, then increasing charges would mean that the airlines rather than the passengers would absorb the increases in charges.
39. As indicated earlier, there would be substantial advantages in increasing airport charges so as to induce the airlines to take into account the costs of expanding airport capacity at these airports. This would encourage them to look for alternative routings and for more efficient airline movements. It seems perverse artificially to encourage airlines to use Heathrow when the costs of expanding there are so high, when other airports have spare capacity, or could expand at lower cost.
40. While one might have regard to the transitional effect on the airlines presently using Heathrow, there seems no persuasive case for protecting the airlines from paying the prospective costs of expansion, or for enabling them to continue to enjoy any existing rents. Even if it were considered desirable to protect British interests at the expense of other countries'

interests, this would not be persuasive here, since as David Starkie has shown in his recent note (para 5 footnote 1), even the apparently British airlines are about half foreign-owned.

41. There may, however, be a case for ensuring that BAA does not appear to gain to an unacceptable extent from a change in policy, at the expense of passengers and airlines. I turn to this shortly.

#### **(b) Passenger concerns**

42. The argument for protecting customers against price increases is a straightforward one. They should not have to pay more than the economic cost of providing the goods and services they wish to purchase. Arguments of economic efficiency and equity come together here, and are generally applied in other regulated network utilities.
43. The difference between airports and other regulated networks is not one of principle, but rather derives from the distorted existing level of airport charges. These charges are at present below cost rather than above or equal to cost. They do not reflect the costs of expanding capacity in the way that charges for other regulated network utilities broadly do. Nor, as noted, do they reflect opportunity costs by equating the supply and demand for airport services. The economic argument is unambiguously in favour of an increase in airport charges.
44. Of course, passengers may not find this attractive, particularly if they expect that this will simply result in a transfer of income from their own pockets to airport shareholders. If a lower level of airport charges could adequately remunerate past investment and finance future investment, they will ask why passengers should pay more.
45. Part of the answer to this question is that present airport charges alone do not suffice to remunerate airport shareholders and finance future investment in this way. Aeronautical costs are partly met by commercial revenues. I come to this shortly in discussing the single versus dual till issue. The other part of the answer to the question asked by passengers is to accept that any change in policy should indeed ensure that there is no unacceptable transfer of income from passengers and airlines to the airport.

#### **(c) Efficiency concerns**

46. A third concern is that the incentive properties of the RPI-X mechanism may be compromised if airport charges are increased. This mechanism typically works by a combination of carrots and sticks. A regulated company keeps any reduction in cost during the price control period, but at the end of the period the control is reset at a lower level to reflect achieved and prospective cost reductions. This provides a tougher target for the next period, but there is still the incentive to beat it by reducing costs even further.



47. If, instead, the control allowed charges to increase from one period to the next, when costs were not expected to increase, where would be the regulated company's incentive for increased efficiency?
48. This may not be a serious concern for BAA, insofar as the projected capital cost increases for BAA in future may offset projected operating cost reductions. This would particularly be the case if the anticipated costs of airport expansion were properly built into the control in an early and prudent way.
49. Also, there is there is still an incentive for a regulated company to increase its efficiency even if its price control is relaxed, because its shareholders still get the benefits of any cost reductions.
50. Nevertheless, there might be a difficulty if the control is not sufficiently challenging. Cost reductions might appear to others as excessive profits, and hence attract political attention. Or, alternatively, there might be a lesser incentive to increase efficiency if the threat of takeover is non-existent – as, unfortunately, is the case with BAA as a result of the 15 per cent limit on individual shareholdings.
51. These considerations suggest that there would be advantage in ensuring that there would still be, and be seen to be, an adequate challenge to BAA to increase its efficiency, even if – perhaps especially if - the price control provided for a substantial increase in airport charges.

### **A potential solution to the concerns**

52. To summarise so far, there seems to be a significant advantage in increasing airport charges to cover the cost of expanding capacity at Heathrow and Gatwick. However, there are likely to be understandable objections from passengers and airlines if they think this is simply going to put more money in the pockets of the airport shareholders for no good reason. I understand that the MMC in 1997 referred to “the large windfall profits which removal of the single till would mean for the airport companies at the expense of the airlines”. This might also reduce the incentives for the airport to increase its efficiency.
53. The solution seems to require that the desirable increase in charges to airlines and passengers should not translate directly into an undesirable increase in revenues to the airport. How can this be done?
54. Economists sometimes suggest taxes at this point. However, taxes would have the disadvantage of bringing government into the act, possibly frustrating or delaying the achievement of the desired objectives, even if taxes could be levied for such a purpose. Taxes would also lie outside the Commission's own remit, whereas the Commission needs to find a feasible solution now.
55. This suggests the possibility of setting airport charges as the sum of two components. The first component would be set on the basis of a “conventional” incentive-based price control, which might involve an RPI-X or RPI+X formula. The values of X and  $P_0$  would determine allowed

- charges that would reflect what was necessary to reward airport investors and to share with customers the achieved and prospective improvements in operating efficiency, to remunerate the previous investment in the airport, and to finance immediately planned investment at an appropriate cost of capital, and so on.
56. The second component is what might be called a “capacity expansion charge”. This would be set equal to the difference between the first component of the airport charge as just discussed, and the higher level of charge that would be desirable to remedy the present and prospective under-pricing at Heathrow and Gatwick.
  57. Whether the total charge should reflect more accurately the short-term congestion at Heathrow and Gatwick, to ration existing capacity more effectively, or whether it should reflect more accurately the longer term costs of expanding airport capacity there, is for consideration in the context of each airport. Setting this second component of the charge requires judgements about efficiency and equity. Considerations of short and long run average and incremental costs will no doubt be involved, as well distributional issues as between airport, airlines, and passengers. However, these are largely different judgements from those required in setting the first component of the charge, and it seems helpful to be able to separate them.
  58. Airlines would pay the total charge, while the airport would receive the proceeds of the “conventional” charge. Whether or how far passengers would pay the higher charge would depend on whether or how far the increased charges would be passed through to passengers. This might well differ by airport and route.
  59. The proceeds of the capacity expansion charge would be paid into a fund that would not belong to the airport. It would earn interest in the short-term, and be used in due course to meet part of the costs of airport expansion. For example, it might be used to pay part of the costs of acquiring land, or of converting it to airport use, or to remunerate local residents for the inconvenience or disruption involved. This would presumably reduce the necessary level of airport charges in the longer term.
  60. In this way passengers and airlines could be assured that the higher charges were being used for their own benefit, and not simply going into what might be perceived as the undeserving pockets of the airport shareholders.
  61. Further consideration would need to be given to the precise legal basis of such a capacity expansion charge, to ensure that it was within the Commission’s power to recommend it and the CAA’s (and BAA’s) power to implement it.
  62. For the avoidance of doubt, it should be made clear that the level of the capacity expansion charge would be calculated separately at Heathrow and Gatwick (and, if relevant, at Stansted). Each charge would reflect the relevant airport costs and needs for expansion. Consideration would need

to be given to any potential constraints on the spending of this fund – whether, for example, the proceeds of the charge at one airport could or should be used to fund expansion at another airport or at an entirely new site.

63. It is for consideration whether any part of the commercial revenues of BAA should be paid into the fund established by the airport expansion charge. On the one hand, a shift to a dual till would presumably leave with the airport shareholders that portion of the commercial profit that would otherwise have gone to reduce airport charges. Airlines, passengers and others might query the appropriateness of this. On the other hand, there are dangers in trying to expropriate too much commercial profit. It seems difficult to rule out in principle some contribution from commercial activities. In practice this issue might need to be resolved in the light of other issues such as the allocation of costs as between commercial and aeronautical uses, and the interdependencies between these costs and revenues.

### **Integration versus separation of management**

64. I comment shortly on the implications of all this for the single versus dual till issue, and on the various points noted by the Commission, but I should like first to make one general point based on experience of regulation in other industries.
65. Experience has gradually been accumulating about the possibilities, advantages and disadvantages, in a regulated context, of integrated business activities versus more separate business activities. This has particular relevance for the associated price controls on these activities.
66. To illustrate, at the time of privatising the England and Wales electricity industry, the national transmission grid was separated from the generating stations that had all previously constituted the Central Electricity Generating Board. Within the National Grid, system operation has increasingly been separated from transmission operation. Within the Regional Electricity Companies, local distribution has been separated from retail supply, and both have been separated from other commercial activities such as showrooms and contracting. There have been similar separations in the gas industry, as between the network monopoly now known as Transco and the competitive supply business now known as Centrica. (This was a separation facilitated by an earlier MMC judgement.)
67. In my view, these developments with respect to separation have been very desirable, for several reasons. They distinguish between quite different types of activities – typically between monopoly and competitive activities – that need different types of regulation. Some of these activities need little if any regulation, indeed they and customers are better without it. Others of these activities need a great deal of regulation. It is important to be able to tailor the type of regulation to the needs of each type of activity.

68. It is helpful to regulators, companies, investors and competitors to distinguish the two (or more) categories of business and regulation as clearly as possible. For example, separate accounts have long been accepted as necessary for purposes of appraising and allocating costs. Separate price controls are absolutely fundamental. In the absence of separate price controls, there would be unacceptable arguments about cross-subsidy, and the difficulties of setting price controls in any of these areas would be much magnified.
69. In the light of experience, it has gradually become accepted that separate accounts and price controls alone are not sufficient. In the electricity industry (not only in the UK) it is now accepted that it is necessary to have separate managements, staff and facilities. The Utilities Act went further, to require separate legal companies for the activities of distribution and supply, with separate licensing. The European Commission has recently indicated that substantial legal and management separation would be desirable as between the network monopolies and potentially competitive activities in both electricity and gas.
70. Separate licensing in turn enabled those companies that wished to do so to separate the ownership of these activities. This brings us to the advantages of clearer separation for companies as well as regulators. Companies resisted all this separation in the first instance. They said it couldn't and shouldn't be done, would be impractical or costly, and so on. Now, they accept it. They are organised to give effect to it, and they run more efficiently as a result. Indeed, many companies have gone further than the Utilities Act requires. For example, many companies have voluntarily divested one business activity in order to specialise or expand in another.
71. Companies generally find that they can manage more effectively if they require each of their main activities to operate on a self-standing (stand-alone) basis. For example, individual managers are clearer as to their responsibilities, and can be held more effectively to account for their performance. Managers (and whole businesses) can no longer argue that their performance is not important since only the performance of the company as a whole is relevant. Companies also benefit from specialisation and being able to give more attention to one activity rather than several.
72. Companies find that investors and analysts tend to agree with this. Opportunities tend to get overlooked by a management that has too many things to look at. Many businesses have told me after separation that they are now better run, better equipped, better financed and better able to explore and exploit new opportunities as a result of separation. Both successor companies of British Gas have particularly asserted this to me.
73. The full application of all this to airports in general, and to BAA in particular, would require more detailed knowledge than I have at present, and it may not be entirely within the Commission's remit on this occasion. I would not at this point urge the case for separating ownership of

commercial activities from that of aeronautical activities. Nevertheless, it seems to me that the advantages of full accounting and management separation, and of separate price controls, are relevant to at least two issues that the Commission has identified.

74. First, it strengthens the case for a dual till approach rather than a single till. The implicit blurring of responsibilities of a single till approach cannot be good either for regulation or for management. It also involves the regulator in greater judgement of commercial issues than would seem to be desirable.
75. Second, it strengthens the case for treating the three airports as separately as possible, and in particular for regulating them as quite separate stand-alone businesses. I understand that the CAA has proposed this and that the BAA has resisted. If so, the CAA is unquestionably right here. Separate controls and separate businesses for the three airports will provide better signals to users, better information to regulators (including the Commission), better challenges to management and better performance for all concerned.

### **Single till versus dual till**

76. The assessment of the single till versus dual till needs to be seen in the context of the above issue of airport charges and investment planning. I have argued that this is the over-riding issue at the two main London airports.
77. The Commission's first observation, in the first paragraph of its recent statement, is that, other things being equal, airport charges are likely to be lower with a single till than with a dual till approach. If this is true, then for the reasons given above this is a significant disadvantage of the single till. It is a correspondingly significant advantage in favour of changing to a dual till.
78. I now respond in turn to the individual points made by the Commission that presently dispose it towards retaining the single till.
79. "No evidence of aeronautical under-investment with single till or reason to expect it in future." Comment: Neither approach properly applied should lead to under-investment. It is more likely that the single till led to over-investment insofar as the under-charging artificially stimulated demand and thereby more or earlier aeronautical investment than might otherwise have been needed. Moreover, the distortions implicit in under-charging might have led to less efficient types of investment. This would not necessarily be obvious. It is easier to see and approve of what has been done than to work out what might have been done with better incentives, but in the event was either rejected or never even noticed.
80. "Not clear that dual till would lead to better aeronautical investment in future." Comment: My contention is that a dual till would indeed have this effect, because it would force airport management to look more closely at its airport investment policy and its operations in that area. It could not

- assume that any aeronautical problems could be overcome by a little more effort or investment on the commercial side. The airport's customers, especially airlines but also passengers, could be expected to look more critically at the airport's investment plans, and this critical appraisal should have a positive effect on the design and implementation of investment. The dual till would enable the airport's allowed cost of capital to relate to its aeronautical activities rather than be a mixture of aeronautical and commercial, and this should make for more accurate assessments.
81. "Dual till could benefit commercial activities at expense of aeronautical, and latter might not get funds or attention". Comment: A disadvantage of the single till is that no one knows or much cares how present attention and funds are determined. Dual till would require due attention to both. There is no basis for suggesting that a properly set dual till control would allow insufficient funds. The dual till would put greater pressure on the aeronautical management to make sure it delivers good performance.
82. "Fares might be higher with dual till, and in longer term problematic transfer of income to airports." Comment: I agree that fares might be higher, but that would be an advantage at Heathrow and Gatwick, for the reasons discussed. I agree that without other provisions the transfer of income to the airport could be problematic, hence my suggestion of an airport expansion charge to address this concern.
83. "No benefits from any deregulation of commercial activities." Comment: Regulation invariably introduces distortions of various kinds – for example, by reducing incentives to efficiency. It is inconceivable that some distortion has not been the case with BAA. Deregulation of commercial activities will tend to remove or reduce such distortions in those activities. A second benefit would be in terms of regulatory effectiveness. The single till presumably requires a responsible regulator to assess the potential revenues, costs and profits from commercial activities in order to decide what proportion of this should be used to offset aeronautical revenues in setting the control. That in turn presumably requires a judgement as to what revenues, costs and profits an efficient commercial activity should yield. That is not a major area of regulatory expertise (or should not be). Reducing regulatory responsibilities here could enable better regulatory focus on the aeronautical activities, hence more effective regulation. A third advantage could lie in reduced scope for the company to manipulate one activity to benefit or disadvantage the other or at the expense of the other, depending on how the company assesses the competitive and regulatory situation at any time. Such freedom, facilitated by the single till, is not conducive to efficiency or competition in either type of activity.
84. "Insofar as airport charges affect fares, high profits from commercial activities benefit passengers, and dual till might require increased regulation." Comment: I have indicated above that potential concerns about excessive profits in aeronautical activities could be addressed by means of the airport expansion charge. There might be similar concerns about excessive profits in commercial activities, especially if a dual till

- meant that such activities no longer had to contribute to airport charges. I have also indicated above that there seems to be no reason in principle why the commercial activities that benefit from the airport investments and traffic should not contribute to the airport expansion fund, provided this is done with care.
85. “No beneficial effect of dual till on efficiency in use of airport facilities.”  
Comment: I have not studied airport technology, but my experience is that a price control can generally be designed to encourage efficiency in particular areas. It would be surprising if this were not easier to do with a more focused control made possible by the dual till approach, than with the blurred responsibilities of a single till.
86. “Conceptually difficult to separate commercial and aeronautical activities.”  
Comment: Maybe, but regulators do this sort of thing all the time.
87. “Airlines should share in benefits.” Comment: Yes, but where does this lead? To protect the status quo regardless? Airlines benefit from the profits they make on the flights. They would benefit from the dual till scheme proposed here insofar as the airport expansion charge would enable additional capacity to be financed and built sooner than otherwise. It would also enable lower airport charges to be imposed in future than would otherwise be necessary.
88. “Difficult in practice to separate commercial and aeronautical investment and operating costs.” Comment: As above, regulators do it all the time. “Arbitrary judgements could harm relations between airport and its users.”  
Comment: The judgements of course need to be explained and discussed. More transparency here would probably be desirable for users as well as for regulators. Insofar as the single till may have induced a rather cosy relationship between airport and airlines, a more informed and pointed discussion about the need for and efficiency of airport investment would not be a bad thing.
89. “Introducing dual till at all three airports on grounds of regulatory consistency not compatible with treating each airport on its merits.”  
Comment: The reason for introducing dual till at all three airports is that it is the right thing to do at all three, not for “regulatory consistency”. The dual till at each airport should be in the context of a separate price control at each airport. Each component of each price control would be set to reflect the particular circumstances at each airport. The dual till would allow – indeed require – more attention to the merits of the charges at each airport. As noted, it is for consideration whether a price control is in fact needed at Stansted.
90. “Nothing to learn from foreigners, as their circumstances are different.”  
Comment: This is remarkably complacent and insular, and almost certainly wrong on the first score. The Australian Productivity Commission’s recent review of airport pricing policy in Australia and elsewhere (referenced above) is an intelligent and informed contribution to debate. In present respects it seems to be broadly in line with recent economic thinking internationally, as does the CAA’s analysis (in contrast

- to the Competition Commission's). It is not obvious why the economic and regulatory issues addressed in the Australian Productivity Commission's report are sufficiently different from those in the UK to warrant their dismissal. (Regulated companies usually employ the argument that circumstances are different when they can't think of a better argument.) It would be surprising if there were not evidence from other countries that the dual till does indeed work without all the problems hypothesised by the Commission.
91. "Dual till would not provide effective efficiency incentive to BAA via threat to revert to single till if it failed to do so." Comment: This is an inappropriate threat. Reverting to a single till would be undesirable. The dual till should be introduced with every expectation of it being permanent. Properly calibrated it will provide the necessary efficiency incentives on BAA. If BAA nonetheless performs inadequately in some respects, the solution is to take this into account in resetting the dual till controls. If appropriate further licence modifications could be considered.
  92. Para 4 of the Commission's statement notes the importance of adequate incentives to invest. This is true, though it is equally important to ensure that the proposed level of investment is fully justified. Press comment refers to an £8 billion package. Whether all this would be fully justified if airport charges were to be set at a more economic level is something that the Commission and the CAA will no doubt wish to consider.
  93. It is difficult to follow the argument in the Commission's statement that there are more appropriate means of ensuring this investment than the dual till approach. All the alternatives mentioned in the statement would seem appropriate whether there were a single till or dual till approach.

### **Professor Beesley on the single till and effective regulation**

94. The late Professor Michael Beesley, a greatly respected regulatory economist and former member of the MMC, discussed the appropriate way forward on UK airport regulation in one of the last papers that he wrote<sup>2</sup>. Although the single till was not the main focus of his suggestions, he did have some perceptive comments about it.
95. Beesley argued that in the regulation of other utilities, particularly energy, the evolution of RPI-X regulation had been towards focusing on and ring-fencing the 'core monopoly', building the regulators' capabilities for assessing future requirements for cash flows, and developing the procedures for assessing the appropriate structures of prices. He continues

"These ways of making the price control more relevant and effective ... have largely passed airports by. The chosen path of airport regulation

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<sup>2</sup> Michael Beesley, "Airport Regulation" in Beesley (ed.) *Regulating Utilities: A New Era?*, IEA Readings 49, London: Institute of Economic Affairs, 1999, pp. 81-105.



in effect ignored the problem of willing the means to the end of creating a satisfactory price control process.

...

The main technical handicap to establishing the necessary conditions for ring-fencing was the inherited 'single till' policy. This combined a highly arbitrary definition of what constituted the 'natural monopoly' activities, to be subject to price control, combined with a wholly debilitating subsidy policy.

...

The basic price regulation task, even if it had been seriously attempted, would in any case have been gravely compromised by the need to allow for the 'single till' subsidy.... The basic constraint was, of course, the international conventions governing airport charges to airlines." (pages 83-4)

96. Professor Beesley goes on to review the experience of price regulation of BAA, and concludes on the point as follows.

"So, as it has turned out, there has been no attempt, either by the CAA or the MMC, to perform all the underlying tasks of an effective RPI-X mechanism. Forward-looking flows have neither been systematically sought nor seriously analysed in any of the reviews. By contrast, in other recent utility appeals, the MMC has been assiduous in probing the underlying justifications for future cash flow elements. In the airports, the exchanges have been on the periphery of the problems concerned, more to do with the reasonable limits to be expected from the single till contribution. These criticisms are no reflection on the regulators concerned. Ring fencing is undermined by the single till.

A further consequence of these assorted handicaps has been to inhibit the use of price information to underpin judgements about price structure, within the overall allowed revenue constraints. MMC has had very little to say about this issue. It was in no position to do so with substantiated arguments." (page 87)

97. I note that David Starkie endorsed this point in his IEA lecture the next year<sup>3</sup>. I also understand that international conventions no longer mandate the single till. In my view, the weight of economic opinion would agree with Professor Beesley's judgement on this point.<sup>4</sup> This emphasises the argument in the text above, that a move from single to dual till could be

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<sup>3</sup> David Starkie, "A new deal for airports?" in Colin Robinson (ed.) *Regulating Utilities*, Cheltenham: Edward Elgar, 2001, pp. 145-63.

<sup>4</sup> I note in passing that the balance of overseas opinion may be against the single till, not only in Australia. For example, the experienced US economist and former utilities and airline regulator Professor Alfred Kahn seems to have given a view against it (as referenced in the Productivity Commission report).

expected to facilitate better regulation by the CAA and, in due course, by the Commission itself.

## **Conclusion**

98. The single till versus dual till issue has been around for a long time. To date the restraints of international conventions, and the argument that it will produce lower charges for customers, have always prevailed. The argument in this submission is that these constraints no longer apply. There are serious disadvantages with the single till approach. The costs in terms of excessive or distorted major investments in airport expansion seem potentially very high. There would therefore be advantages in increasing airport charges to reflect congestion costs or future expansion costs. The dual till approach would facilitate this. Quite independently it would bring additional benefits in terms of improved management focus and control, and improved regulation. However, it seems helpful to accompany both these changes (higher airport charges and the switch to a dual till) by an “airport expansion charge”, or similar, that would prevent an unacceptable transfer of income from passengers and airlines to the airport.