THE BRITISH AIRPORT AUTHORITY MONOPOLY IN LONDON AIRPORTS:
COMMON OWNERSHIP AND COMPETITION

Holly Bott

Senior Sophister

While discussions on transport competition often revolve around airlines themselves, in this essay Holly Bott explores competition between airports. She specifically examines the inefficiencies of the three main London airports – who until recently were owned and operated by the same company – and makes a compelling case that ensuring competition between airports is just as important as airlines.

Introduction

The British Airport Authority (BAA), the airport operator owned by Ferrovial, a Spanish construction group, has been the subject of scrutiny by the Office of Fair Trading (OFT) and the Competition Commission (CC) since early 2007. Before the sale of Gatwick in October 2009, BAA owned 7 airports in England and Scotland, including, 'the big three' in the London area, being Heathrow, Gatwick and Stansted. These airports alone accounted for more than 90% of air passenger travel in and around London, with all the BAA airports accounting for over 60% of total air passengers in the UK. With 'evidence of poor quality and high charges' (Fingleton, 2006 cited in The Independent, 2006), the 2006 OFT recommendation of a market inquiry into the BAA-owned airports was undertaken by the CC in 2007. The outcome of the detailed inquiry was the required divestment of Gatwick, Stansted and one of either Glasgow or Aberdeen airports by BAA in that order. This paper focuses solely on the London airports, since, arguably, this is where BAA wields its greatest monopoly power, and will explore the adverse effects on competition of the common ownership of the three major London airports. By way of comparison, the performance of Gatwick Airport, due to the recent transfer of ownership, is evaluated to highlight the more positive effects of increased competition between airports and a reduction in monopoly power.

Competition vs. Monopoly

Baumol's (1982) theory of contestable markets hinges on the presence of competition; markets rely on potential entrants, and more specifically on the knowledge that these potential entrants *may* enter the market, to ensure that prices tend towards long run marginal costs and move the market back towards perfect competition. The knowledge that new entrants are possible incentivises incumbents to be more efficient; banning these potential entrants only serves to make the market less contestable, encouraging laziness, complacency and inefficiency on the part of the incumbents. Protecting poor performers and restricting the exit of 'dying' firms further compounds this problem of moral hazard. How then does this relate to airports?

The Competition Commission (2009) report concluded what many have known for a long time; BAA have held a substantial monopoly over air passenger travel in the London area since the privatisation of the original, state-owned BAA in 1987. Smith (1776) notes that 'the monopolists, by keeping the market constantly understocked, by never fully supplying the effectual demand, sell their commodities much above the natural price, and raise their emoluments, whether they consist in wages or profit, greatly above their natural rate'. The common ownership of the 'big three' in London serves to effectively block out any potential entrants from the market and allows BAA to keep capacity low while charging continuously higher prices to airlines. A recommendation by the Competition Commission that the regulator of the airport industry, the Civil Aviation Authority (CAA) place an 'upper threshold on the airport charges at London Heathrow and Gatwick' (Fiddian, 2007) went largely ignored by the regulator, who allowed BAA to significantly increase its landing fees at the London airports. For example, for the period 2008-2009, the CC suggested a £10.96 cap on the charge for each passenger on board to land at Heathrow, and a £5.48 cap per passenger for Gatwick. In its 2007 proposal, the CAA allowed the charges imposed on airlines using these airports to increase to £11.97 and £6.07 respectively. The reasoning for these higher charges – increased investment for improved capacity and security at these airports – are yet to be seen in reality, with the delay of the additional planned runway at Stansted, now planned for 2019.

The Regulatory Problem

The regulator, then, can be the 'builder' of barriers, rather than the 'remover' that it should be. The common ownership of the three major airports in the London area allowed BAA to charge high prices across the board, with no significant increase in capacity or customer facilities, since it faces little competition from Luton and London City airports. The regulator, in hiking up the charges, only furthered the market from a competitive position and served, principally, the interests of the BAA monopolist. The virtues of contestability and competition are much extoled; why, then, does the regulator adopt barriers and restrict competition?

When a regulator is seen to primarily serve the interests of the incumbent(s) that it is designed to regulate, it is termed as 'regulatory capture'. Instead of allowing new entrants to enter the market and enabling competition to flourish, regulators who are 'captured' by incumbent firms, such as BAA, protect the existing firms in the market from external competition. The 2008-2009 landing fee increase is only one example where the CAA has 'caved in to intense pressure from BAA' (Peston, 2008). Incumbent firms, protecting their own interests, will often attempt regulatory capture, but are rarely open about this strategy; BAA 'expressed disappointment' with elements of the CAA price-setting proposal, but are 'largely trying to spare the blushes of the regulator' (Peston, 2008).

BAA: Common Ownership and Competition

A principal objective in privatizing BAA in 1987 was to provide adequate airport capacity and to support airline competition. But with the current inadequate capacity and the widespread criticism of BAA's management of several of its airports, the Competition Commission, prompted by a reference under the Enterprise Act 2002 by the Office of Fair Trading, was required to carry out a market inquiry. The Competition Commission found, unequivocally, that 'BAA's common ownership of airports in South-East England…gives rise to adverse effects on competition in connection with the supply of airport services by BAA' (Competition Commission, 2009). The scope for competition in this market was determined by 'evidence on competition between airports and the circumstances in which it occurs' and 'evidence on demand substitutability between BAA airports' (Competition Commission, 2009). The report confirmed a significant degree of competition between some non-BAA airports in the UK, for example between Birmingham International Airport and East Midlands Airport; this allowed competition for new routes and on services, such as the provision of facilities for the quick turnaround times required by the low-cost carriers. Crucially, the conclusion that BAA's London airports (Heathrow, Gatwick and Stansted) faced very little competition from non-BAA airports, but that there was significant overlaps in catchment areas and substitutability of demand between the BAA London airports, prompted the suggestion that 'in the absence of common ownership, there would be competition between them' (Competition Commission, 2009).

The continuing BAA monopoly in this market had distinct but related adverse effects; airlines faced higher charges, restricting some potential entrants (mainly in the form of low-cost airlines) and, in turn, passed these increases on to the air passenger. Low-cost airlines, such as Ryanair, are the least able to pass on these increases to their customers, since they risk damaging their main source of competitiveness – their price advantage. No wonder, then, that Michael O'Leary, CEO of Ryanair, has been vocal in his calls for the break-up of the BAA monopoly. Mr O'Leary stated that 'Ryanair has fought long and hard for the break-up of the high cost, inefficient BAA airport monopoly. Over the past 3 years, traffic at Stansted Airport has declined from a high of 24m passengers to just 18m passengers in 2010. This was entirely due to the BAA's high and rising prices and the hopelessly ineffective regulatory regime run by the clueless CAA which was long ago captured by the BAA monopoly' (Dickenson, 2010). O'Leary captures the essence of the problem; both airlines and air passengers, who face the real burden of these monopoly-induced high prices, are the clear losers from such a market situation. BAA, having captured the regulator, are clear winners. Barrett (2000), notes that, pre-deregulation of the airlines, ‘the ease with which cost increases could be passed on to non-competing airlines made life easier for airport managers’; these costs have been significantly reduced by the deregulation of the airline industry and the increased competition within the sector, but, arguably, these costs remain higher than necessary in the presence of a captured regulator stifling competition within the airport market.

Disdain for the regulatory system is not limited to Ryanair alone. BAA’s capture of its regulator, the CAA, did not go unnoticed by the Competition Commission; the report concludes that the ‘system of economic regulation of airports is a feature which distorts competition between airlines by adversely affecting the level, specification and timing of investment and the appropriate level and quality of service to passengers and airlines’ (Competition Commission, 2009). Specifically, it was BAA’s common ownership of the three London airports and its effective monopoly in the market that ‘exacerbates the inadequacies of the regulatory system, reducing the benefits of regulation and therefore further distorting competition between airlines’ (Competition Commission, 2009). BAA may breathe a sigh of relief in this respect; their poor quality of service and high prices are, arguably, not the only factors contributing to adverse effects on competition within the market. But the point remains, whether it is due to the regulatory system or the monopolist, airlines (in the form of higher costs) and air passengers (in the form of higher air fares and poor quality of airport services) are the most impacted by a lack of competition.

Opposition to Competition

We would not expect the monopolist, BAA, to accept arguments for increased competition, even given the mounting ‘evidence of poor quality and high charges’ (Fingleton, 2006 cited in The Independent, 2006). BAA’s CEO, Colin Matthews, warned, in an attempt to counter the move towards a more competitive market, that flight prices were likely to rise if competition authorities forced them to relinquish their monopoly control in London airports: ‘clearly a smaller company would have a smaller balance sheet and that would make investment more expensive. It would, theoretically, lead to higher prices rather than lower prices’ (Bowers, 2006). The case against competition between airports is not a new phenomenon; in 1976 the UK Department of Trade (1976) proposed that common ownership of airports by BAA would have significant advantages, many of which are now arguably out-dated, since the deregulation of the airline industry has demonstrated the benefits of increased competition. The claim, for example, that competition would result in the concentration of activity at a small number of airports fails to recognise or allow for the popularity afforded to small, low-cost airports. Customers have flocked to small airports, achieving substantial reductions in costs and shocking incumbents who felt they could relax in a non-competitive environment. Other contentions proposed that BAA’s common ownership of airports would ensure no ‘wasteful competition’ and would allow for a common charging and investment policy. However, by their very nature monopolies are wasteful, since there is little need for efficiency, and a 'common charging policy' merely equates to price fixing.

Foster (1984) and Boyfield (1984) made successful arguments against competition, resulting in the non-competitive and unitary privatisation of BAA airports in 1987. Boyfield's claim is that planning controls and long lead-in times are obstacles to competition within the market, effectively precluding new entrants. Again this is proven out-dated by the evidence: 'the traditional view that airport investment is inevitably large, requires long-run planning and must be part of an overall strategy contrasts with the experience of London City airport in the 1980s. The cost of the project was £7 million and the construction time was forty weeks' (Barrett, 2000). Similarly, Foster's (1984) assertion that, due to economies of scale, only a few airports can be profitable is dispelled by the out-performance of Cheltenham & Gloucester airport (one of the most profitable airports in the UK despite its small volume) and, comparatively, the dismal under-performance and loss made by Stansted (which supposedly benefits from economies of scale as a result of its size). With respect to under-investment, there is no viable economic reason why a market would under-invest; monopolies, in contrast, consistently restrict output, evident in the Competition Commission's report on the inadequate capacity at the three BAA London airports. In the same vein as Boyfield's (1984) initial claim, BAA proposed that planning restrictions and capacity constraints were factors adversely affecting competition in the market and that 'a lack of spare capacity would prevent competition between the BAA London airports, irrespective of ownership' (Competition Commission, 2009). The Competition Commission ultimately concluded, however, that 'BAA, as a result of its common ownership of the three BAA London airports, has itself contributed to the current shortage of capacity' (Competition Commission, 2009). Crucially, the report found that, even in the context of current capacity constraints, 'the airports can rival each other in improving service quality and compete to retain more valuable users.' (Competition Commission, 2009). Arguments that hinge on factors such as under-investment by markets and economies of scale distract from the real benefits – improved quality of service, for example – gained from increased competition.

It is clear that BAA 'failed dismally to meet passengers' needs and that a lack of competition between Heathrow, Gatwick and Stansted had consequences for the levels, quality, scope, location and timing of investment, and levels and quality of service' (Prynn, 2008). As a result of the 'damning report' (Prynn, 2008), the Competition Commission required that BAA divest Gatwick, Stansted and one of either Edinburgh or Glasgow airports, in order to address the adverse effects of its monopoly power on competition and on BAA's customers (both airlines and passengers). The Commission believes that the main benefits from the sale will result from the 'dynamic aspects of competition, improving the way in which the London airports deliver capacity in terms of timeliness, design and cost effectiveness as well as allocation to its users' (Competition Commission, 2009). It allows that current capacity shortages and price control regulations may hinder large benefits in terms of pricing, but that increased competition would deliver ‘quality and modest pricing benefits’ (Competition Commission, 2009).

Increased Competition: Success of the BAA Divestment

The success of the remedies and the arguments for increased competition depend somewhat on the performance of divested airports, which serve as a contrast to the performance of those still under monopolistic control. Non-BAA owned airports also function as comparisons between competitive and non-competitive levels of quality, pricing and service. To date, Gatwick is the only BAA airport to have been sold. The airport has seen a year-on-year growth in total terminal passenger numbers of 2.7% between November 2009 and November 2010 (post-divestment), and, although somewhat speculative, ‘would have been in the region of 3.7% had it not been for the severe weather disruption’ (McCallum, 2010). In contrast, negative growth of -2.4% is shown for the previous year (McCallum, 2010). The strong growth was driven by ‘additional capacity, with an increase of 2.2% in average load factors’. Market comparison highlights the impressive growth, with Gatwick’s positive air passenger growth far above the total UK market’s negative growth of -3.3%, and, similarly, Ireland’s -2.8% (McCallum, 2010).

Recognition by airlines of the increased competitiveness of Gatwick airport since divestment by BAA has been noticeable; from February 2011, ‘airberlin’ will operate from Gatwick, a switch from its current base at Stansted, and the airport will be the only London airport to offer direct flights to Nuremburg. The growth of services and routes from ‘Easyjet’, ‘British Airways’ and ‘Ryanair’, as well as the relocation of ‘airberlin’ from Stansted is proof that ‘competition is working and Gatwick is playing to win’ (McCallum, 2010). Increased competitiveness at Gatwick airport allows airlines to compete further with each other on new routes and the services offered. The improved competitive environment necessitates more efficiency and a better level and quality of service; airlines benefit from the lower costs they face from the airport, and customers, in turn, benefit in the form of lower fares.

Global Infrastructure Partners (GIP), the company who purchased Gatwick airport, has spoken publicly about transforming passenger experience at the airport, with upgrades and modernisation at the heart of the transformation. Plans to ‘work closely with the airlines to improve performance’ have certainly been proven successful at GIP-owned London City airport, which is a ‘comparatively pleasant experience for most passengers’ (CAPA, 2009). The view that divestment raises the prospect of rival airport owners increasing the level and quality of service offered, or investing in better terminals to win passengers, appears to be proven in the plans for Gatwick to become a ‘customer driven airport’ (CAPA, 2009).

However, the timescale of such improvements and the move towards a more customer-centric approach ‘in the first instance, looks to be about two to five years’ (CAPA, 2009). The benefits of increased competition within the market may not be realized instantly, giving scope for those opposing competition within the market to argue that competition has had little, and less than the desired, effect. The BAA monopoly is slowly being broken up, with Gatwick only the first of its three required divestments, but concerns, such as from Easyjet's CEO, that a 'large monopoly has been replaced by a smaller one' (CAPA, 2009), indicate that proper regulation of Gatwick, and later Stansted, will be needed to protect airline passengers from the new owners exploiting their market power. Many airlines remain cautious of the 'ineffective regulatory system for airports' (CAPA, 2009); BAA managed to create a monopoly and ensure the regulator served its own interests for twenty years, so the incentive for GIP to do the same, if such behaviour is allowed, is high.

Conclusion

BAA were found to have neglected and shown a lack of responsiveness to the interests of its customers, both airlines and air passengers. The common ownership of the 'big three' London airports, Heathrow, Gatwick and Stansted created adverse effects on competition within the market, with a failure of the regulatory system to effectively carry out its duties compounding the problem. As required by the Competition Commission, Gatwick was sold to Global Infrastructure Partners, owners of London City airport, in 2009. The growth in passenger numbers since the sale of Gatwick by BAA suggests that increased competition within the market has allowed for better management and quality of services offered at the airports, increased competition in new routes and services offered by airlines at lower cost, and, thus, clear benefits for airlines and passengers. This is the theory. It must, however, be noted that divestment of Gatwick is still very recent and that the timescale for improvements and transformation of the airport looks to be from two to five years. Any improvements on competition and, thus, on benefits to airlines and passengers may suffer from a time lag before fully being realized. The regulatory system failed airlines and passengers in many respects; proper regulation must be in place to ensure that the new owners of Gatwick do not become 'another BAA' by exploiting their market power at the expense of its customers.

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