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**A Question of Governance,
Organisation and Ownership**

Response by
THE ADAM SMITH INSTITUTE

to the July 2000
Civil Aviation Authority Consultation Paper
Issues for Airport Reviews

Introduction

The Adam Smith Institute was founded in 1977 as a non-profit and independent economic policy think tank. The focus of the Institute is the promotion and achievement of enhanced economic efficiency through a greater reliance on market mechanisms.

Over the last two decades, the Adam Smith Institute has been the world's foremost authority on the practicalities of market-based economic development, including privatisation, regulatory reform and public-service restructuring. The Institute played a leading-edge role in the development of UK policy on these issues from the early 1980s, and now advises governments all over the world on continuing economic reforms.

Many of the Institute's proposals, at one time iconoclastic, are today commonplace around the globe. They include:

- competing and privately run utilities;
- shifting government services away from direct public-sector provision towards contracting out;
- economic regulation that promotes rather than supplants competition;
- giving consumers greater rights in the supply of government services.

The Institute has invited David Stanley to prepare this response to the CAA Consultation Paper *Issues for Airport Reviews*.. Mr Stanley is an airport professional who has successfully completed 130 airport commissions in 26 countries over the last twelve years. Full details can be accessed at: www.stanleyassociates.co.uk

The background

Interlocking issues. It is important that any response to the Consultation Paper is made with a full understanding of the current context of aviation policy. In parallel with the consultation on *Issues for Airport Reviews*, a number of major issues are under active debate. These issues include:

- The need to increase airport capacity particularly in the South East.
- The privatisation of the National Air Traffic Control System.
- The golden share in BAA held by the government and European concerns about this.
- The reshaping of the global airline system in which BA is playing a major role.
- The current negotiations on the North Atlantic routes and their implications with respect to access to our major airport.
- The increasing concerns regarding environmental issues, balanced against the value of aviation for the economic prospects of the UK.

Naturally, the CAA must act within its current brief in formulating the Consultation Paper but any outcome to the consultation must recognise:

- The role of competition in minimising the need for regulation.
- The changes in the airline industry (since airlines are the airports' customers).
- The balancing of the concerns of local communities (particularly on the environment) the national economic interest, and the requirement of airport shareholders.

It is our belief that competition within the airports industry is insufficient, resulting in its over-regulation. While the Consultation Paper concerns the regulation of the main London airports and Manchester, many other airports are also subject to regulation [See Appendix 1 below].

Regulation breeds irrationality. The top-down, highly-regulated structure within which airports operate has caused decision-making to be slower and less rational than it might have been in a market-led system.

The tortuous debates on airport capacity in the South East provide a good example of this irrationality in policymaking:

- In the early 1960s the deregulation of charter services led to rapid expansion of the UK holiday industry and accelerated growth in the regional airports as services started to relate more closely to demand.
- In the 1970s, the advent of the 747 saved London Heathrow from premature runway congestion. But this was recognised as being only temporary, and a most detailed public inquiry looked at all conceivable options for what was then seen as the home of the UK's major airport.
- The proposed solution was the nearest greenfield site to Luton Airport, at Cublington. However, environmental concerns blocked that scheme, while cost considerations thwarted the more environmentally friendly proposal to develop Maplin Sands.
- In the early 1980s, the less-ambitious (but still fiercely resisted) proposal to develop Stansted led to a classic compromise whereby Manchester was allowed to develop and growth at Stansted was capped. For a short time, Manchester became the world's fastest-growing (and most expensive) airport.

The irrationality of this whole process was clear even at the time. It was followed by the privatisation of the London airports area system and the corporatisation of UK airports in line with the Airports Act 1986, and the effective birth of today's regulation.

The objectives of privatisation were to free the airport system from the constraints of public expenditure and allow the dynamic aviation industry to expand in line with demand in a market-led fashion.

Lack of dynamism. In normal circumstances, in any fast-growing industry we would expect providers themselves to make market-driven decisions about capacity and the location of services, on the basis of customer needs and the business case for the different options.

And yet, once again, the government has now had to undertake its own study of what it sees as the needs of the market, and to make its own top-down decisions about how airport providers should respond. Presumably it will favour additional capacity being proposed at locations of its own choosing, rather than those demanded by airlines and their passengers.

The clear lack of initiative by the airports industry in terms of anticipating and meeting the developing opportunities, coupled with the debates on regulation, implies one of two things:

- That the privatisation of the airport system under the 1986 Act has in fact failed, and that the only way to develop an airport system is through a centrally controlled government-funded body; or
- That the current ownership of airports does not provide sufficient incentives or financial resource for them to bring forward dynamic development proposals that respond to perceived market needs.

We would quickly dismiss the argument for a return to central control and state ownership, which has so clearly failed before.

Rather, we believe that the ownership of airports, particularly in the South-East of England (as designated by the BAA Privatisation Act of 1987), fails to provide incentives to the company to satisfy its market.

Furthermore, because of its domination of the industry, BAA is not allowing other potential investors to make the necessary investments to provide competition to the existing system.

We believe that radical changes are needed. And there is an opportunity for the current regulator to promote a change of ownership structure of the airports by negotiating the appropriate regulatory systems when the present systems end in 2002.

The framework

We believe that regulation should focus only where it is essential, and that changes in today's regulatory structure are necessary to achieve this.

The Civil Aviation Authority should remain as the agency monitoring and controlling the safety aspects of the aviation industry in the UK. In addition it should be seeking by example to raise the safety awareness throughout the world.

However, it does not appear to us that the economic regulation of the airport industry co-exists comfortably alongside this safety remit.

At the time of the privatisation of BAA and the Airports Act of 1986, the Civil Aviation Authority was seen as the natural home for the new role of economic regulator: and the political mindset was not to set up new public bodies if it could be avoided.

However, regulatory structures have to change as the business of the regulated enterprises change. In the utilities sector, for example, we now have a single regulator for electricity and gas, because competition has led to big changes in the provider market including the integration of gas and electricity companies into multi-utilities.

In airports, similarly, we have seen the large-scale development of airport retailing and other revenue streams, which it is not clear should be subject to the same regulation as, say, access to slots. We need a regulator who can focus more clearly on these issues and resolve them — an economic role which is quite dissociated from the role of safety regulation.

Likewise, there may even be a potential role for a new transport regulator covering all modes of transport. While the differences between air and rail sectors (for example) may be large, they are less than those between safety and economic regulation, and we need regulators who can concentrate with precision on each of those different functions.

An economic-only regulator could bring greater focus to the issue of how to minimise the burden of economic regulation by maximising the spread of competition — confining regulation to the irreducible monopoly nodes and letting competition do the rest. That in turn would allow the scale and powers of the regulatory bodies to be minimised.

Conclusions

The airport industry is in a state of constant change. It is still subject to far too much random interference and control. Indeed, it has become deeply dependent on government decisions and initiatives — even though the government's top-down decision-making system is ill-equipped to resolve the environmental and other issues in airport development.

To bring in the benefits of increased competition, reduce interference, and focus regulation where it is strictly necessary, we propose:

- That issues of safety and economic regulation are separated and supervised by different regulatory bodies.
- That the relationship between competition and regulation be recognised.
- That a policy to maximise competition and to focus and minimise regulation should be a stated aim of this exercise.
- That the effects of the current ownership of airports should be taken into account, with regulation being used if necessary as a tool to increase competition.
- That government and the airports industry address the environmental issues on a rational basis, exploring market-based alternatives to today's top-down planning and control structures.

Over the next few months the Adam Smith Institute will comment in detail on all aspects of the current debate. It will seek to show how, by reviewing the current situation and setting it in a competitive system, the major problems besetting the airport industry may be addressed.

Appendix A

Airports Subject to Economic Regulation at 1 February 2000

Aberdeen	Heathrow
Belfast City	Highlands and Islands*
Belfast International	Humberside
Biggin Hill	Leeds Bradford
Birmingham	Liverpool
Blackpool	London City
Bournemouth	Luton
Bristol	Manchester
Cambridge	Manston
Cardiff	Newcastle
Coventry	Norwich
East Midlands	Plymouth
Edinburgh	Prestwick
Exeter	Southampton
Fairoaks	Southend
Filton	Stansted
Gatwick	Sywell
Glasgow	Teesside
Gloucestershire	

*Highlands and Islands Airports are:
Barra, Benbecula, Campbelltown, Inverness, Islay,
Kirkwall, Stornoway, Sumburgh, Tiree and Wick