

## MAJOR REPORTS – PART 2

### Summary

This report comments on some of the documents that were published towards the end of 2006, and accompanies the 'Major Reports' document which discussed the Stern Review, Eddington Study, etc..

This report comments on:

- Office of Fair Trading (OFT) recommendation that BAA be referred to the Competition Commission; and
- 'Predict and decide. Aviation, climate change and UK policy' (Oxford University's Environmental Change Institute (ECI), September 2006).

### Introduction

- 1 There were a number of documents published in the final months of 2006, two of which are discussed in this report which supplements the SASIG item 'Major Reports'.
- 2 The Executive Summaries from both the OFT and ECI documents are produced in Annexes to this report.

### OFT Referral of BAA to the Competition Commission

- 3 The Office of Fair Trading (OFT) initiated a consultation process in December 2006 in respect of their report on UK airports. Comments have to be submitted by 8 February 2007. The executive summary is at Annex A (page 5). The full report is available at: <http://tinyurl.com/yfgrgp>.
- 4 The OFT is suggesting that the Competition Commission should undertake a market investigation into the supply of airport services by BAA. It is also suggesting that the Government should publish criteria about the de-designation of airports, transfer decisions on designation to the CAA, and for the CAA to advise the DfT whether or not to de-designate Manchester airport.
- 5 The OFT is concerned that the current regulatory framework gives BAA an incentive to make investments and to justify charges to airlines without necessarily expanding capacity. Creating competition between airports would create better incentives to ensure that expansion takes place in a timely, cost-effective manner focused clearly on the needs of airlines and on the travelling public. It could deliver lower prices and higher quality service. The OFT received criticisms from the major airlines in relation to BAA's current investment plans.
- 6 There were no criticisms about Manchester airport where the OFT feel that competition from other airports is driving down prices faster than the regulatory requirements.
- 7 ***SASIG comment:** It is a strange anomaly that Heathrow, Gatwick, Stansted and Manchester airports are designated for the purpose of financial regulation. This particular study seems to be putting in process a mechanism for de-designating*

*Manchester whilst at the same time seeking an investigation on breaking up BAA's ownership in the south east and in Scotland.*

- 8 *One way in which airport operators can facilitate growth is by reducing the prices they charge to airlines and others. The purpose of designation has generally been to stop prices rising in a way which would be unfair to the airlines and travelling public. It would seem that the opposite has been happening at Manchester. It does not seem that there are any relevant comments that SASIG could make to the OFT on this issue.*
- 9 *At this stage the OFT is asking for comments on their recommendation that there should be an investigation into BAA's monopoly. They are of the opinion that if BAA's airports were in separate ownership they would compete more strongly against each other, provide additional facilities more quickly and possibly lower prices so as to benefit the airlines and subsequently the passengers. In other words this would fuel even faster passenger growth.*
- 10 *The OFT acknowledge that airport expansion and increased air traffic give rise to local and global environmental concerns but they note that it is not their role to examine the validity of those concerns although they see no conflict between tackling them and developing more competition in airport services.*
- 11 *If it is appropriate for SASIG to make representations to the OFT about their preliminary decision on BAA then there are two choices:*
  - *to object to an investigation into BAA's monopoly on the basis that anything that slows down growth is preferable to fanning the flames of expansion; or*
  - *to support the investigation on the basis that it is the Government who determines the priorities for investment by setting them out in the Aviation White Paper and that it is the Government that is best able to consider the environmental, social and economic implications, more so than the OFT, the CAA or indeed BAA itself.*
- 12 *In order for any representations to OFT to carry any weight, a very extensive justification of one of the two points above would need to be prepared and submitted. Within the timescale (early February) this may not be the best use of SASIG resources as it seems likely that SASIG will be seen as trying to slow down growth for environmental reasons.*

#### **'Predict and decide. Aviation, climate change and UK policy'**

- 13 Please see Annex B (page 7).
- 14 In November 2005, the Environmental Change Institute at the University of Oxford commissioned a review of the evidence about the significance of aviation to climate change and potential policy measures for mitigating its impacts. The final report built on an interim paper (also called 'Predict and Decide') produced in December 2005 for the Stern Review, and a subsequent consultation draft (called 'Predict and Decide II'). The report is available from the Environmental Change Institute website, and via the following link: <http://www.eci.ox.ac.uk/research/energy/predictanddecide.php>.
- 15 The report's authors stress the incompatibility of the national aviation policy with national climate change targets. They conclude that the Government need to explore a policy of managing demand for air travel. They also warn that this needs to be done before our national culture becomes more dependent on air travel. "The greatest threat to the UK's successful mitigation of climate change is contained in a growth in demand that *has not yet happened.*" (pg. 36).

- 16 The study addresses many aspects of the approach, assumptions and direction presented in the Air Transport White Paper. There are however, a number of areas omitted from the study, due either to them being considered beyond the scope of the study or not possible in the timeframe available. Of these, the omission of noise and local air pollution is a considerable drawback; once again, these difficult issues have not been brought into the core discussion.
- 17 The valuation of environmental damage is an area requiring further development. The Department for the Environment, Food and Rural Affairs has committed to updating its latest estimates of the social cost of carbon following publication of the Stern Review. This work would seek to address the uncertain but potentially major impacts that the current models do not capture. (pg. 43)
- 18 The authors consider that flying cannot be regarded as a socially inclusive activity, citing Civil Aviation Authority data which indicates that much of the recent expansion is due to people in the top three socio-economic groups flying more often (pg. 4, & Chapter 3).
- 19 The future volume of air passenger demand is discussed with the conclusion that "...if flying remains cheap, the current Department for Transport forecasts of passenger traffic in 2030 may represent a serious underestimate of future demand." (pg.36) It is reported that annual passenger growth has been 6% on average since the mid-1970s (pg. 36 & Chapter 4).
- 20 The following table shows the output from analysis of the scenarios for expansion considered in the White Paper using updated forecast data.

Figure 4.1 Different airport capacity scenarios for 2030\*

	2 Max Use of Existing Runways	7 STN + 1	1251 STN+1, LHR+1 (2020, 550/600)	1252 STN+1, LHR +1 (2016, 550-690)	1253 STN+1, LHR +1 (2020, 655/700)	13 STN+1, LGW+1 (w-5)	1551 STN+1, LHR+1 (2020), LGW(ws)	Unconstrained
Total passenger movements (millions)	431	448	466	476	478	474	484	501
Lost interchanging passengers	-35	-27	-20	-16	-15	-17	-13	
Lost terminal passengers	-35	-25	-15	-9	-7	-10	-4	
% lost passengers interchanging	50%	52%	56%	64%	68%	61%	75%	

Source: Data received from DfT, 2006, based on an updated version of Annex B6 from DfT (2003c).

\* Table headings refer to different scenarios considered in the Aviation White Paper. 1251 is the favoured scenario, as defined in section 3.7.

- 21 These figures serve to illustrate just one of the areas in which the authors have challenged the content of the White Paper. The reference to 'lost passengers' derives from the premise in the White Paper that if further capacity is not provided, the result will be the 'loss' of passengers.
- 22 The data above indicates that in all of the scenarios at least 50% of passengers are simply using the airports to interchange – transfer from one arriving flight to another departing flight to continue their journey. This category of passenger is considered to

be of least value to the UK, the 'loss' of who may actually be of benefit in terms of releasing capacity for more 'valuable' passengers.

- 23 On the issue of air-rail substitution, the report cites a 2004 Stockholm Environment Institute (SEI) study which states that this "...will not happen by chance and requires a clear steer from Government policy." (pg. 51) A sample of studies which have been undertaken by a wide range of practitioners over the last six years are listed; the general consensus is that a well loaded, modern train contributes considerably less to climate change than its aviation equivalent.
- 24 The unusual situation that exists in the UK, whereby a fifth of international passengers arrive or depart at UK airports (see the White Paper supporting document 'Key facts: Aviation in the UK', 2003) indicates why the UK can be expected to take the lead in tackling aviation's contribution to climate change.
- 25 The report clearly sets out that the rate of aviation growth increase needs to be addressed and brought into line with other Government commitments. "...emissions from aviation...will quadruple during a period in which overall UK emissions are aiming to reduce by 60%." (pg. 14)
- 26 *SASIG comment: This report provides useful discussion of many of the issues still outstanding from the White Paper. The authors have sought to make this study easily comparable with the content of the White Paper to facilitate assessment of national policy.*
- 27 *The coverage of research carried out since 2003 is valuable for updating the accuracy of facts and figures used in such discussions. For instance, the work carried out for Defra by the Centre for Air Transport and the Environment at Manchester Metropolitan University that looked at detailed air fleet characteristics to examine the impacts of different aviation growth scenarios. (pg. 14)*
- 28 *If SASIG were to respond to this study in any form this could be on the basis of the following comments:*
- *The work by the Environmental Change Institute is to be welcomed as a useful addition to the current national aviation debate.*
  - *Some of the report's conclusions are very much in alignment with SASIG's current position, particularly the need for an informed debate about future choices, considering aviation in its national context.*
  - *The omission of noise and local air pollution from the study is a disappointment, and is certainly a vital area for further research in the style of the 'Predict and decide' study, i.e. using the latest studies to assess national policy in these areas.*
- 29 *It is proposed that the Environmental Change Institute and other relevant academic institutions be provided with copies of the SASIG report 'The 2003 Aviation White Paper. Did the Government get it right?'*

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**OFT Referral of BAA to the Competition Commission (OFT882)****1 EXECUTIVE SUMMARY**

1.1 The OFT is proposing to refer the supply of airport services by BAA within the UK to the Competition Commission (CC) for a market investigation. This paper sets out our reasons and gives interested parties the opportunity to make representations. (Under section 169 of the Enterprise Act 2002, when the OFT is proposing to make a decision on a reference to the CC it must first consult, so far as practicable, any person on whose interests the reference is likely to have a substantial impact.)

1.2 We are also making recommendations to Government under section 7 of the Enterprise Act in relation to airports in the North of England. We recommend:

- Government publish criteria for de-designation of airports
- CAA advises the DfT whether to de-designate Manchester airport before the statutory price control reference to the CC is due, and
- Government consider transferring decisions on designation to the CAA.

1.3 Aviation is vital to the UK economy. UK airports had an annual turnover of £2.8 billion in 2005. (Keynote, Airports, 2006) More significantly aviation carries large volumes of traded goods, is vital in linking business with the wider world and underpins the UK tourism and travel industries.

1.4 One company, BAA, owns airports through which over 60 per cent of UK air passengers travelled in 2005. (CAA Airport Statistics)

1.5 In publishing 'The Future of Air Transport' in 2003 (Department for Transport, The Future of Air Transport, 16 December 2003) the UK Government laid out a framework for a major expansion in airport capacity over the next 30 years to meet a forecast doubling of passenger demand. It is therefore timely to ask the question whether a structure of ownership of airports that limits the potential for competition in key parts of the UK is the best way to serve the interests of air travellers.

1.6 The OFT believes that BAA's high regional market shares in the South East of England and Lowland Scotland, the system of economic regulation of airports, and capacity constraints combine to prevent, restrict or distort competition. This view is based on our analysis of the market but is also consistent with strong expressions of concern received from interested parties (especially airlines).

1.7 In Lowland Scotland, BAA's ownership of Edinburgh and Glasgow airports limits competition between these two airports. There are high barriers to entry and these airports are not subject to detailed price regulation. There is one independent competitor in this region, Prestwick airport, which seems to have had some positive effect on Glasgow airport. We believe there is room for competition to provide further benefits to air travellers. We consider that joint ownership of Glasgow and Edinburgh airports restricts, prevents or distorts competition.

1.8 In the South East of England, BAA's ownership of Heathrow, Gatwick and Stansted limits competition between airports to promote the delivery of extra capacity in a timely and cost effective manner. The overwhelming bulk of the planned expansion of capacity set out in the 'Future of Air Transport' would take place at BAA owned airports. BAA has made it clear that it will only deliver this capacity, subject to planning permission and continued Government support, if it is allowed an appropriate settlement at its price regulated airports (Heathrow,

Gatwick and Stansted). We received a wide range of critical representations from airlines in relation to BAA's current investment plans in the South East of England.

1.9 None of the major airlines operating out of BAA airports in the South East of England expressed confidence in BAA's current investment plans for the South East of England.

1.10 In contrast we did not receive airline complaints relating to investment at Manchester airport which appears to be subject to greater competition from separately owned airports. This competition appears to be driving down prices faster than regulatory requirements.

1.11 We also have concerns about the impact of the current regulatory framework. In particular, BAA has an incentive to make investments justifying higher charges to airlines, without necessarily expanding capacity ('gold plating').

1.12 Competition between airports would create better incentives to ensure that expansion takes place in a timely, cost effective manner focused clearly on the needs of airlines and therefore ultimately the traveling public. It could also deliver lower prices and a higher quality of service.

1.13 In the short term, we consider that the lack of competition between BAA's airports in both the South East of England and Lowland Scotland leads to higher charges than would be the case if these airports were owned by separate firms. These raise costs to air travellers, with consequential effects on business and tourism.

1.14 Heathrow and Gatwick have performed poorly in international surveys of the quality of service at airports. Weak competition could be a contributory factor. During the same period Manchester airport won IATA awards for the quality of its service.

1.15 Some airlines have referred to BAA's management of the airport security crisis in August of this year as a symptom of 'poor management' caused by a lack of competition. However, given the unpredictability and complexity of this crisis, we do not have clear evidence of a causal link and have not reached a view on the extent to which this criticism is relevant to our study. Consequently our conclusions do not rest on BAA's response to this issue.

1.16 Finally, airport expansion and increased air traffic, give rise to both local and global environmental concerns. It is not the OFT's statutory role to examine the validity of those concerns nor to develop policies to deal with possible adverse environmental effects arising from increased air travel. We see no inherent conflict between tackling environmental problems and developing more competition in airport services.

1.17 We consider that there is a reasonable prospect that appropriate remedies would be available if the CC were to find an adverse effect on competition. These may take the form of requiring BAA to divest some of its airports, or recommendations regarding the regulatory system, or both.

1.18 Given the concerns raised, we are consulting on whether a market investigation by the Competition Commission (CC) is the most appropriate way of examining and resolving the above issues. The consultation runs until **8 February 2007**.

## **‘Predict and decide. Aviation, climate change and UK policy’**

### **Executive Summary**

The UK Government is committed to a 60% reduction in carbon dioxide emissions from UK activities between 1990 and 2050. Many climate scientists now believe that even tougher targets are needed, but in all cases swift action is required to reduce climate impacts. Yet the UK’s Aviation White Paper sets a policy framework that supports a major expansion in aviation activity, which would enable air passenger movements to increase from about 200 million in 2003 to about 470 million in 2030.

This report assesses the implications of aviation growth in the UK, while recognising that there would be some positive benefits. Available evidence about the scale, nature and impacts of the projected rise in air travel is used to weigh up the arguments for and against restraining aviation, particularly passenger air travel.

In the light of this evidence and the UK’s environmental goals, the report concludes that the Government will need to explore a policy of managing demand for air travel. This is likely to include:

- A change in strategic policy to give a presumption against the expansion of UK airport capacity;
- A fiscal package to make flying less attractively priced;
- A communication strategy that builds on existing public support for addressing aviation’s environmental impacts and ensures that the contribution of flying to climate change is understood and recognised.

### **Why is demand for air travel a challenge?**

In just ten years, between 1990 and 2000, carbon dioxide emissions from UK aviation have doubled. During the same period, the combined emissions of carbon dioxide from all other UK activities fell by around 9%. A review of various forecasts of UK air travel growth indicates that aviation emissions are set to more than double again between 2000 and 2030 and could increase to between 4 and 10 times their 1990 level by 2050.

Aviation is excluded from international inventories of greenhouse gases for the Kyoto Protocol. If it is assumed that the impacts will be included in the UK’s aspirations to stabilise climate change, several factors have to be considered:

- First, aviation’s potential impact is even bigger than the forecasts of carbon dioxide emissions suggest. Quantifying the effect of the other emissions is scientifically problematic and not undertaken in this report. Hence, the figures quoted for the climate change impact of aviation are conservative and only refer to the minimum contribution.
- Second, the UK generates more flights than any other European country: a fifth of all international air passengers worldwide are on flights that arrive or leave from UK airports. Hence, aviation makes a proportionally greater contribution to climate change for the UK than for most other countries.
- Third, even at the lower end of the forecast range, carbon dioxide emissions from aviation are set to reach 17 million tonnes of carbon (MtC) by 2050. The higher end of the range is 44 MtC. Meanwhile, the UK is attempting to limit the carbon emissions of all its activities to 65 MtC by this date. This means that, in order to offset aviation’s emissions, all other sectors of the UK economy would need to reduce their emissions by 71%–87% instead of the currently planned 60% from 1990 levels. There is no sign that this can or will happen: the existing 60% target is already extremely challenging.

- Fourth, these growth forecasts already allow for improvements that may be achieved through changes in air traffic management, other operational procedures and technological development. If these do not occur, emissions could be even higher.

The implication is that the UK will be unable to meet its targets for reducing climate change impacts without action to curb the demand for air travel. It is a political decision as to whether the aim should be to restrict the anticipated growth in aviation emissions, stabilise them at current levels or reduce them in absolute terms.

### **Who flies?**

Passenger traffic at UK airports has grown at an average annual rate of about 6% since the mid-1970s, with an increase of 12.5 million new passenger movements in the last year. Much of the recent expansion in flying has occurred because better off people are flying more often. There is little evidence that those on low incomes are flying more; flying cannot be regarded as a socially inclusive activity.

UK residents make 67% of all trips affecting UK airports. The greatest growth has been in international leisure flights – there are now five overseas holiday flights to every business flight made overseas by a UK resident. Between 1994 and 2004, 70% of the additional international trips that occurred were UK residents going abroad for leisure. The largest category of future trips from UK airports is likely to be more of the same - UK residents travelling abroad for leisure purposes.

The UK is increasingly developing an air dependent culture. If action to tackle flying is postponed, we will enter an era in which frequent flying is increasingly the norm for better-off households, with lifestyles adapted to this expectation, including far greater ownership of second homes abroad, and more geographically-distant networks of friends and family.

### **Aviation's contribution to UK tourism and the economy**

The case for supporting the predicted growth in flying has been made partly on economic grounds. Aviation does bring economic benefits (such as employment) which would be impacted if the future growth in aviation were curbed. However, this would be offset by public revenue from a more appropriate fiscal package for aviation and the potential effect of higher air fares on the growing tourism deficit. The balance between the costs and benefits needs to be carefully assessed.

The Government recognises there is a £17 billion tourism deficit resulting from UK residents spending more money abroad than overseas visitors bring in: for every £1 an overseas visitor spends in the UK, a UK resident spends £2.32 abroad. In 2003, spending by domestic tourists accounted for four-fifths of the UK's £74 billion tourism earnings. New analysis for this report shows that in the six months after the 2001 terrorist attacks, people's reluctance to fly meant that the money lost from overseas tourism was outweighed by an increase in domestic spending by UK residents. Together, this evidence indicates:

- The majority of spending at UK tourist destinations is not reliant on international aviation, since it is actually coming from UK residents;
- If air travel becomes less desirable, there could be a significant increase in expenditure in the UK by UK residents, to the benefit of the wider economy.

### **What does the public think?**

Public opinion surveys dating from 2002-6 suggest that support for making flying more expensive on environmental grounds has grown over time. The most recent public opinion survey, conducted by Ipsos MORI, found that:



- Support for a policy to constrain the growth in air travel outweighed opposition, with less than 22% of respondents opposed to such a policy;
- There was majority support (about 60%) for airlines to pay higher taxes to reflect environmental damage, even if this meant higher air fares.

The main effect of increasing air prices would be to avert new growth in demand for journeys that has not yet taken place. The UK has the opportunity to choose a more sustainable trajectory, in which we do not continue to build our society around increasingly high levels of flying or encourage an expanding 'air culture'. This path could offer significant benefits in terms of public revenue and the regeneration of UK domestic tourism and, most importantly, in setting a credible course towards fulfilling the UK's commitments on climate change.

### **How could the demand for air travel be restrained quickly?**

Air Passenger Duty (APD) is a duty levied by the Government on passenger trips from UK airports. Raising the level of APD is the most obvious measure for affecting demand quickly, because:

- UK fares for both leisure and business flights have fallen dramatically in real terms over the last 15 years. Estimates suggest that at least 40% of the recent growth in air travel has been generated by fare reductions. Raising APD would help to counter that trend;
- The Government's preferred solution - to include aviation in the EU Emissions Trading Scheme – is likely to take a number of years to achieve and its impacts will depend on the detailed design of the scheme;
- Increases in fuel prices, as a result of market volatility, cannot be expected to have a consistent, long term effect on fares;
- Raising APD is legally straightforward and does not require international agreement, unlike other measures such as aviation fuel taxation.

Another policy that deserves serious consideration is the addition of VAT to domestic air tickets. The Government could also pursue other options, including encouraging the EU to abolish duty free on extra-EU flights and gaining international agreement to implement an aviation fuel tax or a charge on enroute emissions from flights.

Making flying more expensive, by introducing new taxes or charges, offers one of the quickest ways to address the demand for air travel. New charges are likely to be socially progressive since the profile of aviation use means that they are primarily likely to deter richer members of society from flying more. An appropriate fiscal package for flying would also raise significant public revenue, which could be spent on more socially inclusive opportunities or reducing other taxes. One estimate suggests that aviation's tax advantages amount to £9 billion p.a. of lost revenue for the UK Treasury.

For the longer term, more radical solutions such as personal carbon allowances could be appropriate.