

**Peer Review of the Analysis underlying the Decisions relating to the Designation Status of Manchester and Stansted Airports, taken by the Secretary of State for Transport in January 2008.**

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I was appointed in November 2007 by the Department for Transport to conduct a peer review of the analysis conducted by the Department relating to the possible de-designation of Manchester and Stansted airports.

I am professor and director of the Centre for Management under Regulation at Warwick Business School, University of Warwick. Formerly I was professor of economics and Vice-Principal at Brunel University. I am author and editor of a number of books on regulation, including *Understand Regulation* (1999) and the *Oxford Handbook on Regulation* (forthcoming). I have written numerous articles in scholarly journals on regulatory and competition policy. I have completed three independent reviews for UK government departments and advised the governments of Australia, Canada, France and New Zealand. I have acted as adviser to the OFT, Ofcom, Ofgem, the ORR, Postcomm and the CAA (over its price reviews for 2004-9). I was a member of the Competition Commission from 1996 to 2002, and a non-executive advisory director of Ofwat from 2002-2006. I am a member of the UK Payments Council.

My terms of reference were to scrutinise the economic analysis employed by the Department for Transport in preparing its advice to the Secretary of State, and to express a view as to whether it conforms to best practice, is robust and soundly based.

The criteria the Secretary of State for Transport has adopted for consideration of designation or de-designation are as follows:

‘Designation of an airport is appropriate if, in the view of the Secretary of State:

1. the airport, either alone or together with any other airport(s) in common ownership or control, has or is likely to have substantial market power; and
2. domestic and EC competition law may not be sufficient to address the risk that, absent regulation, the airport would increase and sustain prices profitably above the competitive level or restrict output or quality below the competitive level; and
3. price regulation under Section 40 of the Airports Act 1986 would, taking account of the magnitude of the risk identified in (2) and its detrimental effects were it to materialise, deliver additional benefits (i.e. over and above competition law) which exceed the costs and potential adverse effects of price regulation (i.e. the incremental benefits are positive).

De-designation is appropriate if, in the view of the Secretary of State any of these factors would cease to apply were the airport to be de-designated.

In reaching any decision to designate or de-designate, the Secretary of State will take into account all relevant matters, including international obligations.’

My review extends only to Criteria 1 and 3, and to the economic analysis, and not the legal analysis related to those criteria. To conduct the review, I read and analysed the CAA's advice, and the responses generated by the Department's consultation document. I also had access to the record of subsequent communications between the CAA and respondents to the consultation and the Department's officials and professional advisers, and attended several meetings at which the emerging conclusions in relation to Manchester and Stansted were discussed.

### *1 Interpretation of Criteria 1 and 3*

The identification of substantial market power in competition analysis almost invariably involves consideration being given to the definition of the market, in both product and geographical dimensions. In relation to the product dimension, two related markets, at different points in the vertical production chains, are potentially relevant here. These are the market in which airlines buy airport services from airport operators and the market in which passengers buy flights from airlines. In my view it is appropriate and helpful to employ evidence from the passenger market to address the issue of market definition for airport services, since the demand for the latter is derived from demand for the former.

In relation to the geographical market definition, the Department's analysis has adopted the standard approach of examining the degree of demand and supply side substitution, and addressing attention to 'critical losses', or the scale of substitution behaviour by airlines or passengers which would make it unprofitable for an airport operator to raise its charges.

The formulation of criterion 1 refers to market power held either alone or together with any other airport(s) in common ownership or control. In the case of Stansted in particular, such airports in common ownership or control include both Gatwick and Heathrow. The market power analysis must cover the cases of both the single airport and the group.

Criterion 3, which only becomes relevant if each of criteria 1 and 2 is satisfied, requires a cost benefit analysis of regulating prices at each airport where it is relevant. The procedure for such an analysis is less developed than that for the analysis of market power; this is shown by the paucity of constructive proposals on how to implement criterion 3 from commentators in the consultation. The Department's analysis – correctly in my view – contains both a qualitative and a quantitative component. The latter requires the comparison of numerical estimates of such things as to monopoly welfare losses and the unintended consequences of regulation under different scenarios (involving different combinations of errors). These estimates are inevitably contestable, but the problem of precise estimation can be mitigated by considering ranges of values for costs and benefits, and considering to what degree the ranges overlap.

The question also arises as to the form of regulation envisaged. I understand that the CAA has indicated that it would consider alternative approaches to the current approach in next review, possibly including the 'safeguard caps'<sup>1</sup> which have been used in other sectors. I understand that the Department has received legal advice, that in the absence of any alternative being generally agreed and adopted at the date of the decision, it is reasonable to ground the estimates on the hypothesis that the existing system of price control is maintained. This is the approach which has been adopted.

Overall, I judge that the analysis has adopted the right conceptual approaches to implementing economic analysis of criteria 1 and 3.

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<sup>1</sup> Generally speaking, under a safeguard cap price limits are designed not to correspond to an estimate of efficiently incurred costs, but are set more loosely to guard against the possibility of major consumer detriment.

## 2. *The De-designation of Manchester Airport*

The Department's analysis, based on data furnished by the CAA and other respondents, led to the conclusion that Manchester Airport falls in a wider geographical market, defined alternatively as comprising airports in the North of England or the North-West of England, within which other airports exist which do not exhibit barriers to expansion.

It was argued that the same opportunities for local substitution do not exist in the cases of services provided to long haul aircraft, but also that the geographical market for such services was longer, as passengers were prepared to travel further. It might be added that price discrimination against such services is likely to be fairly transparent.

On this footing, the Department's analysis concluded that, in the case of Manchester Airport, Criterion 1 was not met. I judge that the analysis supports this conclusion. The other criteria are thus moot.

## 3. *The De-designation of Stansted Airport*

The views of the CAA and of respondents to the consultation on the de-designation of Stansted Airport are split. This reflects the fact that the analysis is a great deal less clear cut – over market definition, changes in the level of market power over the period of analysis (until at least 2014) and the costs and benefits of regulation.

I first address the question of Stansted's market power (assuming price regulation of Heathrow and Gatwick). The question hinges on geographical market definition (in particular

whether Birmingham and East Midlands airports fall in the same geographical market as the London airports, including Stansted<sup>2</sup>), and on the timing relationship between the growth of demand for airport services and the expansion of Stansted's capacity.

The systematic quantitative demand studies of passenger behaviour and preferences undertaken by the CAA and by respondents to the consultation are not capable, individually or jointly, of giving a decisive answer to the disputed question of market definition, as each of them has its own advantages and disadvantages, and differences in approach make them incommensurable.

If the CAA were right in its market definition, the absence of barriers to expansion at East Midlands airport might deprive Stansted of substantial market power over the relevant period; but if the CAA were wrong, other evidence points to a strong likelihood of substantial market power emerging. Reaching a conclusion on this requires the exercise of judgement, which the Department has sought to discharge by evaluating all the evidence relating to both airline and passenger behaviour. This has led to the conclusion that Stansted is more likely than not to acquire market power over the period. In my opinion, the evidence is quite capable of bearing this interpretation.

The conduct of the cost-benefit analysis required under criterion 3 can be illustrated in a simplified fashion as follows. Suppose the regime is subject to two errors – the 'false positive' of regulation where there is no substantial market power, and the false negative of failing to regulate where market power is substantial. The cost of the former is likely to be needless cost of regulation and numerous ways in which it can distort behaviour, slow down responses etc. The cost of the latter is likely to be higher monopoly pricing (as compared with the regulated outcome), against which must be netted out the distortions, such as

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<sup>2</sup> This is crucial because of the claimed barriers to expansion in each of the London airports.

overinvestment, attributable to regulation. The analysis would properly consider the probability of each error -a subjective judgement, but one which depends on the likelihood of market power investigated under Criterion 1 and other evidence.<sup>3</sup>

The Department's analysis has adopted this qualitative approach within a wider range of alternative outcomes, and also assigned illustrative ranges of quantitative values to some of the possible outcomes. There is inevitably a margin of error in projecting the welfare loss due to monopoly pricing and the cost of production inefficiencies associated with over or underinvestment. In my opinion, the Department's analysis and estimates are reasonable.

On this footing, I judge that the Department's analytical methods have been appropriate to the problems presented by the Stansted designation decision, and that they have been properly applied.

#### *Addendum*

A fuller analysis of the interaction of ownership, market power and regulation will emerge from the Competition Commission in 2009, which may resolve conclusively some of the issues relating to Stansted which are currently in doubt. In the circumstances, I concur with the Department's advice in relation to the designation status of both Manchester and Stansted airports.

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<sup>3</sup> In fact, because the relevant period for Stansted might well include periods of presence and absence of substantial market power, the analysis must be more complicated.