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Delivering national transport infrastructure:
public and private solutions
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Introduction

Many thanks. Great to be back at Kingston.

On the MBA programme 93 – 95 and it was genuinely transformative in my career so I feel I owe Kingston a great deal. At that time I was working in the Policy and restructuring team exploring options for and implications of rail privatisation and I went on to enjoy a really interesting and challenging career in the railways till the end of 2008 when I had a real yearning for a different sort of challenge. So for the past 4 years I have been Chief Executive of the CAA. What the CAA does: safety, airspace, economic regulation of NATS, Airports, Competition assessment, Consumer protection.

So when Graham asked me to talk on issues relating to public policy challenges it felt very much like a timely opportunity to talk about how the private sector gets involved in delivering public policy objectives given the on-going national debates about major national infrastructure project. In particular, two which are highly pertinent to the sectors I have most experience of - HS2 and airport runway capacity.

Going to start with a bit of theory about why the relationship between public and private sectors is important – and then go on to compare and contrast the experience of the HS2 and airport runway capacity debate.

Why think about the relationship between the public and private sectors – two rather obvious reasons?

Reason 1: the role and objectives of the public and private sectors are different:

- Goal of private sector to create private (economic) value for an individual organisation accountable to its owners. The goal of the public sector is to create collective public (social and economic) value and it is accountable to voters through the democratic system.
- Sometimes the objectives can be aligned: eg when private sector produces what individuals want and they are willing to pay for then one could argue that public value is being created and public policy is readily delivered through private sector.
- In many cases, effective and competitive markets can deliver economic and public value. Aviation is a good example: extensive liberalisation has enabled both industry growth and has enabled consumers to travel much more widely and cheaply.

However:

- The market alone does not always deliver the best possible outcome – especially where there are significant externalities not factored into private sector decision making. Examples include:

- Noise or CO2 pollution – where the disbenefit of the private sector is not borne by those consuming the activity
 - Consumer protection – where in practice the market is insufficient or sufficiently imperfect to ensure there is adequate protection for consumers in the private sector
 - Safety – where there is a wider public interest in ensuring other parties on the ground and in the air are safe.
- That's not to say that the private sector does not internalise these externalities to some extent:
 - Safety: it is of course essential to the business models of the private sector airlines, and there is at least a degree of alignment with the public policy objectives;
 - Consumer objectives: there are strong public policy objectives in providing suitable protection in the form of repatriating customers whose travel companies have failed, or providing appropriate compensation in the event of delay. But it's interesting to note Ryanair's recent moves to improve the realities and perceptions of service standards – perhaps an example of how the private sector internalises some of these externalities.
 - On other cases, public policy objectives such as health, education, defence or welfare would not be delivered in their entirety by the private sector wholly of its own volition: they are to a large extent public goods deemed as being required by voters but not capable of

being delivered through a simple market mechanism without some kind of Government intervention.

As we will see later, the two issues of externalities and delivery of public sector objectives are central to the intense debates around major infrastructure projects.

Reason 2: Governments have actively sought to change the boundary between public and private sectors

- Successive Governments over the last 30 years have sought to change the boundary between the public and private sectors because of the belief that the private sector will innovate more rapidly and deliver more efficiently than the public sector.
- Aligning the interests of the private sector to public sector objectives has therefore been a significant policy challenge for Governments over a 30 year period.
- There have been many theses written about the evidence to support the notion that the private sector can deliver more efficiently. Not going to talk about that in detail today. But is not simple or one size fits all solution. A cursory glance at the press every day offers case study after case study - NHS trusts, defence procurement, rail franchising, offender tagging contracts, flood insurance, energy pricing, banking crisis:
- One background issue relevant to many of these issues (especially banking, energy and aviation) is increased globalisation. A subject I remember was relatively new when I was here 20 years ago .

National governments have progressively less control over their internal affairs compared to 50 years ago as multi-national organisations (eg the EU) and global corporations have assumed progressively more influence, whether individual governments like it or not. On Tuesday night I was sat at an aviation industry dinner with the CEOs of two airports, neither of them listed but who had shareholders from 11 different countries represented on their combined boards and in between was the CEO of the UK's third largest airline, effectively part of a European conglomerate. So the era of cosy chats and backroom deals between Whitehall and Threadneedle Street, if it ever existed, is receding at best.

- All Governments therefore have an increasing challenge of using softer power to ensure that their national interests and those of their citizens are protected and advanced. Not going to dwell on this now - that's another subject in its own right - but is highly relevant context for public policy making in every country. And it is certainly an issue that CAA continually considers.

What does the theory tell us about effective public policy making?

- Before turning to our case studies, what does the theory tell us about public policy making process and the levers available to Government to align the interests of the private sector?
- In delivering public policy through the private sector it is the policy formation and policy implementation stages that are most important – Why?

With respect to policy formation, getting this process right is key – ensuring there is a proper definition of the policy problem, identifying all the relevant issues and ensuring they are taken into account properly in the decision making process. Government decisions, especially on major issues, are subject to all kinds of political and legal scrutiny, so it is imperative there is high quality evidence gathering and transparent decision making. Of course politics matter and will sometimes trump the policy goals but clarity of definition and options at least gives politicians a real chance to choose.

Different policy instruments are suitable in certain situations and environment and not in others. Each of these should be assessed on the basis of what is legal, the level of detriment or risk, the costs to all parties of implementation and the ease of implementation. But they include:

- Information provision – making relevant information available to consumers to inform their decision making and ensure the right demand signals are sent to the provider.
- Authority, mandates or rules – we use them in areas with severe risk or impact such as safety, noise limitations, airport capacity, security, airspace rules, monopoly price regulation etc. but heavy handed regulation serves no one, least of all consumers.
- Incentives / penalties / subsidies to enable or ensure the private sector acts appropriately

- System changes: transfer of authority among individual agencies to implement government policies i.e PPP arrangements
- Other tools such as hortatory policy where strong signals are used to indicate high priority policy direction may be more proportionate in other situations. A good example of this would be the way in which the Government is trying to ensure that insurance companies step up to their responsibilities following the recent flooding.

So there is a real value in carefully tailoring the solutions to the issue at hand, level of risk and the environment the policy impacts.

Moving on then to policy implementation, this stage obviously involves translating goals and objectives into an operation plan, and includes coordination of resource and people to deliver it. Considering implementations issues of course should be an integral part of the policy formation process as they are all part of assessing the risk and pros and cons of the different options.

But often, this is the most challenging aspect of public policy and more so when it requires private sector investment or involvement – this is where the initial analysis needs turning into an operational delivery plan. Inevitably, no matter how detailed the policy analysis, there will always be unexpected delivery issues and there will be stakeholders with competing interests and investment desires to negotiate.

Real World Example - HS2 vs. Airport Runway Expansion

- So two topical major infrastructure themes to explore when it comes to the differences in policy formation and policy implementation stages, in particular, are the decision to build high speed rail project HS2 and the airport runway capacity expansion in SE England. And in the second part of this talk I want to spend some time looking at both the similarities and the differences between the policy context and challenges raised by these initiatives.
- In case you are not familiar with them I will very briefly outline the state of play but would emphasise that I am not seeking to act as a promoter of or apologist for any of these schemes. HS2 is the plan to build a new railway between London and Birmingham, moving on then to Leeds and Manchester and potentially in due course to Scotland. Other than the Channel Tunnel Link it will be the UK's first high speed route at a time when countries such as France and Germany have been building such infrastructure for 40 years and in the last twenty years or so been followed by Italy, Spain and others. The operational case is essentially around the need for more capacity but if you are going to build a new line for capacity reasons, the social and economic benefits derived from high speed are regarded as highly attractive. Cost estimates vary widely, as do views on the strength of the business case. But that is not germane to this discussion today.
- In aviation terms we have only built one full length runway in this country since WW2 and none in the South of England. There have been various schemes and studies over the last 40 years but nothing

has been built. Both parties in the present coalition stated their opposition to expansion of South East airport capacity in the 2010 election manifestos, but in September 2012, following very extensive lobbying, the government established a Commission under Sir Howard Davies to make recommendations on the need for such additional capacity and if so where it should best be located. This Commission published its interim report last December which was clear on the need for additional capacity but it has been asked to report on its final recommendations after the next election. Thus far it has shortlisted three options – two at Heathrow and one at Gatwick and has committed to doing further work on the viability of an Estuary airport as promoted most prominently by the Mayor of London, Boris Johnson.

Similarities

The Drivers for both projects are similar. Debate on both projects has been extensive going back to 1980s in rail sector with other high speed rail throughout Europe and as far back as the 1960s for aviation (including the Roskilde Commission in the 1970s). There is a need to remain economically competitive with Europe and globally by providing connectivity both within the UK to enable balanced growth across the economy; and for the UK as a whole with international trading regions – many other countries round the world have and are investing heavily in infrastructure.

The UK's geographical and demographic characteristics are important for both projects – a relatively densely populated island, particularly in the South East means decisions about large national infrastructure

projects typically affect more people compared to other countries. But that island status means non-road connectivity is particularly important to support economic growth.

Both projects are major national infrastructure projects which only Government can make the ultimate decision on. This is because of their scale, the size and extent of the externalities involved (noise, CO2, demolition of homes and laying of new track) – only Government can balance the competing interests. The fact that these externalities exist – and that many different groups of citizens are affected positively and negatively in such different ways means - that any such decisions are highly political.

In both cases, the Government has a key role in setting the parameters for financing these activities. In the case of rail, investment is provided by the taxpayer and in the case of runways, the Government sets the regulatory framework under which the private sector would finance any extra capacity. Both are now in the policy formation process: HS2 is further advanced with a Bill progressing through Parliament. And I have already touched on the role of the Davies Commission.

Given these complexities, both projects are subject to long and complex decision making processes that have been subject to close public and legal scrutiny.

But other than these initial drivers, the issues affecting the public sector and private sector dimensions diverge quickly...

Significant Differences

1. Differences in the funding model: Government controls whether HS2 is built, but not new airport capacity
- **HS2** – Government can control the timescale for capacity release through the project timescale and also the amount of capacity release through the franchising arrangements:
 - In deciding how to spend the Government's (taxpayer funds) on the national railway infrastructure, Government can decide whether and how it can seek to address capacity issues.
 - HS2 – fully UK based and public sector sponsorship model gives substantial authoritative control over developers of the infrastructure and the franchise operators. This means it decides on whether, the extent to which and how the cost of this new investment is passed on to train operators and their passengers, or it is funded by taxpayers.
 - **Aviation capacity** – this is fundamentally different from HS2 because the mode, the assumption and indeed increasing European requirements all presume that airport capacity will be funded largely or entirely by the private sector – that consumers will pay. As a consequence the timescale for runway expansion completion would be determined by the market funding, ie in theory the Government could go through a painful decision making process to secure agreement to a new runway, but the airport operator or its financiers

could elect not to build it. I say in theory but we have practical experience of it. The 2003 Aviation White paper recommended the next runway in the UK to be built at Stansted but 10 years on from that decision traffic forecasts suggest that it would struggle to demonstrate a business case for at least the next 20 years.

- One of the key considerations by financiers will be how their investment is remunerated – and the extent to which prices for using airports can rise to fund this new capacity. There is no shortage of sovereign funds willing to invest providing they can be confident of a reasonable return on that investment. That return will only be delivered if passengers use the airport. Airport charges might be a relatively small part of the overall ticket price but transfer passengers in particular are highly price sensitive and a charge that mean other European hubs were more attractive as a transfer hub would fundamentally question the likely return on investment that could be achieved.
- Government could use incentives, subsidies etc. as capacity building schemes; but there will likely be a need for regulatory controls to be put in place to manage prices increases to users. This will be a key consideration for CAA over the coming months. The CAA's statutory duty is to protect consumers and not support Government decisions on investment new airport capacity. The challenge for the CAA will be to decide whether, the extent to which, and how it is appropriate to pass the costs of funding any new capacity at regulated airports on to airline users and their passengers.

2. Differences in how capacity is used: Government controls rail services through the franchising model, but has little or no control over airline services

- **HS2** – This is a government inspired, sponsored and funded scheme. Through the Department for Transport the government can determine the choice and mix of destinations, frequencies and journey times, the nature of the rolling stock provided, the seat pitch, service standards and the fares set. It does that already with the franchising process – the private sector is not free to innovate in these areas as the greater benefit is perceived to be achieved through guaranteeing minimum service levels. The use of authoritative policy tools with use of franchising to set capacity rules means the Government can be assured that a train service will be available on the new route and can largely specify the quantity.
- **Aviation capacity** – the global nature of the aviation market means Government does not control, nor indeed does it have substantial influence over, how that capacity is used by airlines. There are many examples of new airport capacity being built but not being used to their maximum because of insufficient demand:
 - Manchester airport has two runways but many fewer flights than Gatwick which has just one runway
 - Had a second runway been built at Stansted (as proposed back in the early 2000s), the post 2008 drop off in traffic means that it would now be substantially unused
 - Castellon airport was opened in Spain in 2011 to attract new passengers to the region – but has not yet had a single passenger through its terminal

- New capacity at Montreal and Tokyo are just other examples.
- Not only can government not control whether any new capacity is used, but it also cannot dictate to airlines which routes new capacity serves:
 - Especially in the liberalised Europe, nation states have forfeited the right to set traffic distribution rules
 - And even if the Government wants new capacity to be used to support access to new global markets (eg BRIC countries), if the economics dictate that the most profitable solution is even more capacity on the established NY routes, that is where the airlines will invest. Airlines behave rationally, in general at least, when utilising capacity. So at present Heathrow has 27 flights a day to New York and 80% of the UK's flights to China are to Hong Kong – because that is where business demand is strongest and the highest yields can be generated. New capacity will undoubtedly reduce the opportunity cost of introducing new destinations but it would be wrong to suggest that new capacity automatically means lots of new routes to emerging economies even if that is Government's political intention.
- The central point, therefore, for aviation capacity, is that governments can't buck the global market. For any new capacity to be economically viable, it must be built where there is global market demand and where passengers want to fly to/from. This reduces the degrees of freedom for any Government decision.

3. Redistribution of economic activity within the UK

- HS2 follows a clear government aim to redistribute economic activity and growth out of SE England and into other major regional areas. It is similar to an authoritative policy tool as government is the one deciding where the rail tracks go and therefore mandating capacity location

- Airport Capacity – as already indicated, new capacity would be delivered by the market and the market wants new capacity in the SE England. Therefore to some extent it has the opposite impact of rail where new capacity further concentrates aviation activity around London instead of redistributing it to other UK regional cities. Government has limited powers to subsidise airline routes to the most isolated areas, and can set hortatory policy to nudge markets to provide greater regional aviation access but ultimately has limited influence on delivering it. The Thames Estuary proposal might have two potential impacts on the distribution of economic activity:
 - Within the South East of England, an estuary airport might redistribute economic activity from the west to the east of London which is a stated aim of the Mayor.
 - But critics of the scheme observe that on a national basis, it would make the national aviation hub further away from many other parts of the UK and therefore entrench the south east bias within the UK economy.

4. Impact on externalities and ability to incorporate socio economic impacts

- HS2 – fully UK based and therefore the ability to fully monitor and incorporate the environmental and other socioeconomic externalities in the cost of the project. As these costs are captured then government can decide that these costs are worth incurring for the benefits. The impacts of some of those externalities, especially noise, are also distributed broadly across the route of the new railway.
- Aviation Capacity – Again aviation's status as a global industry means that many of the environmental impacts and socioeconomic costs and benefits would not be included in the costs faced by the market. Therefore not taking into account full environmental costs from CO2 without global emissions trading scheme and also not capturing potential socioeconomic development benefits gained in other countries from new routes. Government could not unilaterally impose domestic penalties for environmental costs without imposing significant competitive disadvantage to domestic operators.

And big airports of course have a very large local footprint. When they have grown incrementally over 70 years into the busiest international airport in the world as Heathrow has then the noise and air quality impact on the local community can be very significant and ultimately the constraining factor on further expansion for growth. This in many ways is the central challenge facing the Davies Commission on airport capacity. Is the impact on local residents so great that it outweighs the economic advantages of capacity expansion at this location. The means

by which the Commission will come to a view on this trade off are not yet explicit.

5. And finally Political environment

- Both HS2 and Airport Capacity were policy objectives of the last Labour government
- HS2 was adopted by coalition Government and therefore has general political consensus. HS2 is planned to run through Conservative stronghold areas, but it's unlikely that support for HS2 will lead to a major switch towards Labour as they are also broadly supportive of Hs2. And of course different impacts means that it's potentially easier to "buy off" local areas to accept infrastructure
- Airport Capacity has been much more of a political football. Areas around the principal airport locations in the SE England have a higher proportion of marginal seats and therefore the perceived chance of losing a constituency is much higher if local support for capacity expansion isn't there. Unsurprisingly then political parties and individual MPs have used the issue to try and differentiate themselves from each other. What I have noticed however is that this discussion even at a local level is often determined by some potentially false assumptions. Even many opponents of expansion tend to consider it with a more benign view if the alternative is not the status quo but closure with all the loss of economic benefits that might imply.

Finally then, what conclusions can we draw from these examples?

- External factors largely determine whether or not the Government is forced to consider capacity questions on large national infrastructure projects (eg global aviation demand for the UK, regional demand in the case of UK rail)
- Governments cannot ultimately back away from decisions about large national infrastructure projects and leave them to the private sector – too many externalities to consider. This is not a philosophical principle but an observation of practice.
- A high quality, transparent and evidence based decision making process is essential in a democratic society – but it's inevitable that such an approach slows decision-making (compared to other countries in the world with different type (ie less democratic) of Government or where the pain of externalities is felt less acutely.
- Core to these decisions is forecasts about how the private sector and individual citizens will respond to new infrastructure – will it be used sufficiently to be economically viable? This is a key judgement in the decision making process and therefore requires close consideration. In the case of rail, Government may have much more influence but in the international global aviation market, Government has little control over whether any new capacity will actually be used. A modular approach to funding this kind of project would be desirable here to reduce this risk. But in many cases, the decision is often more binary – in which case some Government support (either directly or through

regulatory policy) may be more appropriate to give some assurance around funding.

- Strong political leadership is therefore required to see decisions through. Political consensus across the main political parties is a big enabler (could the prospect of more coalition Governments help or hinder this process? Is there a possibility of increased cross-party cooperation on big decisions such as this, similar to the recent position on Scottish currency union?).
- Therefore timing of these decisions is critical (ref the electoral cycle). The Airports Commission appears to argue that starting to build any new runway before the 2020 general election is probably vital.
- Government levers on policy implementation are not perfect – but Government can create mandates for action, creates some incentives to ensure alignment of actions and use hortatory action. But at the end of the day, policy decisions and implementation are probably easier if the Government is paying the bill, whether or not they result in better value for money remains to be seen.