

Civil Aviation Authority Response to the Department for Transport on its Consultation on the Protection of Regional Air Services to London

INTRODUCTION

1. The consultation seeks views on the criteria that the Government should use to trigger consideration of whether and how to protect existing regional air services to London. It follows the announcement in the December 2003 Future of Air Transport White Paper that the Government would consider imposing Public Service Obligations (PSOs) in certain limited circumstances to guarantee a minimum level of air services on existing routes from UK regional airports to London. This would potentially allow landing and take-off slots at congested London airports to be ring-fenced for those services. Before imposing a PSO the Government would further evaluate the merits of the case against the requirements of European law.

2. The CAA broadly welcomes the Government's consultation paper, and recognises that there may be instances where PSOs are a necessary and useful tool for protecting air services to regional points. However, the CAA believes that any proposals need to be seen in the context of what the market has delivered already, and the impact the imposition of PSOs would have on market development. This points to a need to ensure that PSOs are tightly controlled and sparingly used.

3. This paper first sets out some market context, goes on to discuss the CAA's general views, and then offers more detailed comments on the points raised by the consultation paper.

CONTEXT

Growth of regional air services in the UK

4. Regional services have developed considerably over recent years. There has been a marked increase in short-haul scheduled flights from regional UK airports as a result of the liberalisation of the market, and in particular the emergence and development of low-cost carriers. The evidence would seem to point to some long-term changes in the nature of the market, with a growing role for regional airports, an increased density of services and greater variety of available destinations, so tending to reduce the percentage of regionally-originating traffic relying on connections via London.

5. For example, in 1990 there were 15 international destinations with frequent¹ services from Manchester; by 2002 the total had risen to 41 with the new destinations including capital cities such as Stockholm, Madrid, Rome and Vienna. European networks of varying coverage are also developing at other regional airports in the UK where previously there were only one or two international services. Regional airports' share of the international market increased from 17% in 1973 to 32% in 2003. Many regional airports, even those with no link to London, also have services to an alternative hub such as Amsterdam, with competitive connecting times to many destinations, thus reducing (though not eliminating) the importance of Heathrow, and London generally, as a connecting point.

¹ Defined as more than 500 flights a year, the equivalent of a daily service each weekday.

6. That said, connections to London from regional points remain important. Over the period 1990 to 2003, the number of domestic destinations served from Heathrow has more than halved and the overall frequency has declined by a third (Table 1). However, there is now a much wider spread of services around the other London airports where frequencies have increased by about 250% over the period. The number of regional destinations with a London service has remained the same. Five destinations lost direct services to London between 1990 and 2003 (Birmingham, East Midlands, Humberside and Exeter, and Liverpool which was reinstated in 2004). Five destinations gained a direct service during the same period (Blackpool, Cardiff, Dundee, Londonderry and Prestwick). Overall, the number of flights between regional airports and London airports increased by 38% between 1990 and 2003.

Table 1

	<i>UK Destinations Served</i>		<i>Round Trips per day</i>	
	<i>1990</i>	<i>2003</i>	<i>1990</i>	<i>2003</i>
Heathrow	18	8	118	79
Gatwick	11	13	36	62
Stansted	3	10	3	36
Luton	2	6	3	20
London City	0	7	0	23
<i>Points served from London</i>	<i>20</i>	<i>20</i>	<i>160</i>	<i>221</i>
<i>Points served from London (excluding Heathrow)</i>	<i>12</i>	<i>18</i>	<i>42</i>	<i>141</i>

Notes:

Includes Isle of Man and Channel Islands routes.

A destination is assumed to be "served" from a London airport only if there are more than 500 non-stop round trips during the year, i.e. the equivalent of a daily weekday round trip service. The number of destinations served in a given year is therefore an average figure and not necessarily representative of a given point in time. Similarly the number of round trips per day is an average across the year so is again not necessarily typical of a specific day.

Belfast City and Belfast International are counted as separate destinations in the table as are Prestwick and Glasgow.

The route from Heathrow to Belfast International fell below the threshold in 2003. In 2004 bmi started two new services at Heathrow, one to Aberdeen and one to Inverness thus increasing the number of domestic destinations served at Heathrow to nine.

Source: CAA Airport Statistics

7. Recent events show a relatively favourable picture for regional services. Since January 2003, seven new services to London have been introduced from UK regions, with another announced for November 2004 (Table 2). Two of these routes are to Heathrow. In the same period a further two routes have been introduced but then suspended, while only two existing routes have been suspended.

Table 2*New routes since January 2003*

		<i>began</i>	<i>weekday frequency</i>	<i>notes</i>
easyJet	Gatwick–Belfast International	Feb 03	3 x A319	
easyJet	Gatwick–Inverness	Feb 03	1 x A319	
Air Wales	London City–Cardiff(–Swansea)	Apr 03	2 x ATR42	1
Ryanair	Stansted–Blackpool	May 03	2 x 737	
BA CitiExpress	London City–Glasgow	May 03	4 x RJ100	2
BA CitiExpress	London City–Edinburgh	Oct 03	3 x RJ100	
VLM	London City–Liverpool	Feb 04	5 x Fokker 50	
bmi british midland	Heathrow–Aberdeen	Mar 04	5 x A319/320	
bmi british midland	Heathrow–Inverness	Mar 04	1 x A319	
bmi regional	London City–Leeds/Bradford	Nov 04	4 x ATR42	3

Routes suspended since January 2003

		<i>ended</i>	<i>weekday frequency</i>	<i>notes</i>
bmi british midland	Heathrow–Belfast International	Mar 03	3 x Fokker 100	4
BA CitiExpress	Gatwick–Leeds/Bradford	Mar 03	3 x Jetstream 41	
BA CitiExpress	London City–Glasgow	Oct 03	4 x RJ100	
Air Wales	London City–Cardiff(–Swansea)	Oct 04	2 x ATR42	1

Notes:

The table excludes Channel Islands & Isle of Man routes and the Plymouth/Newquay–Gatwick service transferred from British Airways CitiExpress to Air Southwest in October 2003.

1 Swansea only served via Cardiff, four days per week only. Route due to be suspended October 2004.

2 Route suspended October 2003.

3 Services begin 1 November 2004.

4 bmi continues to operate Heathrow-Belfast City.

Source: CAA airport statistics, OAG Flight Guide

Market-based solutions

8. Given the success of liberalisation in boosting services from regional airports it is also worth considering whether market-based solutions might provide possibilities for regions to secure access to congested London airports. For example, change to the European slot regulations might in future provide a clear legal basis for the trading of slots at congested airports. This could allow regional bodies to acquire a small slot holding through trading, without the need for the Government to introduce measures such as PSOs and ring-fencing of slots. A secondary trading market in slots may also allow airlines with a major presence in the UK market to expand their slot holdings, thus relieving the pressure to transfer slots used for regional services to more profitable international routes.

9. The restrictions enshrined in bilateral air services agreements can also form a barrier to foreign airlines seeking to operate new services from regional airports on a “fifth-freedom” basis. Loosening these restrictions could boost long-haul services from regional airports, although the impacts on the airline industry and consumers would need to be fully considered.

GENERAL COMMENTS

Maintaining the integrity of the single European aviation market

10. The benefits conferred by the liberalisation of aviation in Europe, both generally and in the regions, suggest that the interests of users will be best served if airlines are free to operate air services in competition with one another according to their commercial judgement, subject only to the application of normal competition policy². Similarly, users will tend to benefit most through airports being run on commercial lines, with their owners seeking to maximise the efficiency of their operations.

11. A key pillar of the EU's "third package" was the European market access regulation 2408/92³, allowing EU airlines to fly any route within the EU. Article 4 of this regulation allows a Member State to disapply this freedom where it imposes a PSO, subject to certain conditions. The intention of Article 4, in the CAA's view, was to allow for the protection of and/or support for very thin, essential, "lifeline" routes that cannot otherwise sustain a commercial air service. This is acknowledged on page 2 of the consultation paper.

12. The CAA accepts that there may be wider economic and social benefits from air services that cannot be captured by the operator of the air service driven solely by the profit motive. If these benefits are significant, then it may be reasonable for local or national government to seek to support the service. PSOs are one tool available to public bodies to support such air services. However, their use will risk distortion to the normal workings of the airline market. **The CAA view, therefore, is that PSOs should be used sparingly and in tightly defined circumstances to mitigate negative impacts.** PSOs should be restricted to ensuring the retention of essential services and be regularly reviewed.

13. The CAA welcomes the statement on page 3 of the consultation paper that the withdrawal of a service to one London airport will not be enough to trigger consideration of a PSO as long as there is an adequate overall service provided to other London airports. This will help to limit the potential negative impacts of a proliferation of PSO routes on the most economically efficient usage of slots at very constrained airports such as Heathrow.

14. The CAA notes that some characteristics of PSOs can have downside effects and hidden costs. These are explained further below.

Slot ring-fencing

15. Regulation 95/93 states that a Member State may reserve certain slots at a fully co-ordinated airport when a PSO has been imposed on scheduled services on a domestic route from that airport.

16. By preventing scarce slots at congested airports from being put to alternative uses, such ring-fencing could impose a high and hidden cost on the airline industry and on the economy generally. The potential scale of the problem is perhaps illustrated by the number of possible candidates for PSOs. There are nearly 50 airports in the UK outside the South East but the limit of Heathrow's capacity – the peak hour departure

² CAA Statement of Policies on Route and Air Transport Licensing, 23 December 2003, see http://www.caa.co.uk/docs/589/Statement_of_Policies_Dec_2003.pdf

³ Council Regulation (EEC) 2408/92 of 23 July 1992 on access for Community air carriers to intra-Community air routes.

capacity in the morning – is only 42 flights. The excess of demand for slots over supply at Heathrow has increased the value of slots. Although the value of slots will obviously vary by time of day, the slots needed to support peak morning and peak evening round trips would be towards the more valuable end of the range. So, the recent exchange of a pair of slots at a reported cost of £10m gives an insight into the hidden cost of ring-fencing. **Before any decision on ring-fencing is taken, therefore, there should be complete transparency about the full costs involved (including the value foregone from possible alternative uses of the slots).**

Subsidies

17. Page 6 of the Partial Regulatory Impact Assessment states that “unlike the PSOs currently imposed on routes within Scotland, we do not envisage that there will be need for subsidy on these regional routes to London”. **In view of the competition implications of subsidy (see below), we welcome the Government’s statement that it does not envisage subsidy on these routes.** However, if a subsidy is paid to an airline to provide a PSO service, the CAA believes that there would be advantage in its being funded by those who perceive the benefits from it. This is most likely to mean a local or regional body, rather than other users or the general taxpayer. This should avoid PSOs being seen as “free goods” which regional bodies may be tempted to bid for even where the economic benefits are small relative to their cost. If the cost is borne by those who stand to benefit, there is a much greater likelihood of decisions on the level of subsidy taking proper account of the likely benefits of the service. **We therefore also support the principle set out in the consultation paper that local bodies should pay any PSO subsidy.**

Competition Issues

18. The imposition of a PSO is likely to create a barrier to entry where access to the route is limited to one carrier only for a set period of time. Preventing other airlines from competing on a route risks stunting innovation and the development of more efficient services, new products and lower fares, resulting in higher fares or an inferior product than otherwise. It could reduce cost pressure on the airline operating the PSO service and so generate requirement for subsidy.

19. These issues bear on the process whereby any exclusive right to serve a route under a PSO is granted. The initial grant of that right should be non-discriminatory and transparent, with all EU airlines given the opportunity to bid as set out in Regulation 2408/92. And, while it may be necessary to grant monopoly protection for a period to persuade an airline to commit the necessary resources to serve a PSO route, **the contract should be sufficiently flexible to ensure that the market remains contestable. Restrictions on entry should be kept to the minimum necessary, so that an alternative carrier can in due course bid to run the service better or for a reduced or zero subsidy.** The CAA would propose that PSOs be retendered periodically, to maintain contestability and cost pressure on the incumbent. The period should be kept short and the tender process framed so as to encourage bidding and innovative solutions. It should not be forgotten that the airline to which any protection or subsidy is awarded will be enjoying a significant concession from the liberalised market created by the third package and from state aid rules.

Risk of proliferation and gaming

20. The CAA believes that use of PSOs should be a last resort. **The CAA therefore welcomes the Government’s statement in the consultation paper that if**

a given route met the criteria for a PSO, discussed below, that would merely be a trigger for considering whether a PSO should be imposed, rather than the PSO being an automatic consequence. It will be important to consider carefully in each case whether intervention is necessary or desirable, in order to avoid a proliferation of PSOs and consequent re-regulation and distortion of competition in the market for UK domestic air services. The CAA would like to see a consistent approach across Europe (ideally with decisions taken against consistent and clear standards) resulting in a tightly constrained use of PSOs. Otherwise, as may already be the case in certain parts of Europe, PSOs will be overused, at best deterring non-subsidised operators and at worst foreclosing the market altogether, with an obvious detrimental effect on competition and consumers.

21. The CAA is also concerned about the potential for airlines to “game” the system. At its simplest this might take the form of an operator of a profitable route threatening to downgrade the service in order to solicit a PSO and so obtain protection from competition and, potentially, a subsidy. A more complex game would be for airline A to withdraw from a competitive domestic route in order to solicit the imposition of slot ring-fencing through a PSO on airline B, thus leaving airline B more constrained in its use of slots on other routes. It will be difficult to design a scheme that prevents gaming of this sort, which again points to minimising the risk by limiting the numbers of PSOs.

Review of the third package

22. The European Commission has recently consulted on possible revisions to the third package that created the single aviation market, including the criteria for the imposition of PSOs under Regulation 2408/92. The Commission has sought views on whether, for example, these should be simplified. While the CAA understands the Government’s wish to fulfil White Paper commitments, it will be important to ensure that the timing of any decisions takes due account of any relevant changes to European law.

RESPONSES TO SPECIFIC QUESTIONS IN THE CONSULTATION PAPER

1 (a) Interpretation of “Peripheral region”

23. The consultation paper suggests that a “peripheral region” be defined with reference to the length of journey time to central London. The CAA is not convinced that this is a sensible definition. It would be more appropriate to interpret the word geographically, where “peripheral” means “at the periphery or boundary”, i.e. pertaining to an outlying region.

24. A journey time of more than three hours from London by public transport, which the consultation paper suggests should define a peripheral region, could include a major population centre in the middle of the country. This is demonstrated by Annex B of the paper, which implies that every airport in the UK with a service to London except Cardiff, Liverpool and Manchester would be a “peripheral region”, which seems an odd outcome. The consultation paper justifies the three-hour threshold with the comment that for longer journeys air is the mode of choice. That may be, but it does not amount to a convincing description of “peripheral”. The statement is backed up with the example of Scotland–London, but this is hardly an appropriate justification when Annex

B clearly shows Scotland–London routes to have a minimum journey time by public transport of between 4½ and 8¾ hours, not 3 hours.

25. These definitions are expressed in the context of regional air services to London. However, the PSO mechanism in Regulation 2408/92 potentially applies to all UK (and indeed EU) routes. Any definition adopted as a result of this consultation will therefore read across to PSO applications made in respect of services to/from any UK airport, and would, somewhat perversely, make London a peripheral region if viewed from, for example, Leeds.

26. We would therefore urge the Department to adopt a more precise meaning of “peripheral”. The interpretation suggested so far risks widening the ambit of PSOs unnecessarily.

1 (b) Development Region

27. The CAA would prefer the second option set out in the consultation paper, which would allow a service to qualify as being to a development region if the main urban centre that it serves is in receipt of Objective 1 or Objective 2 funding. This would seem clearer and simpler than a definition based on catchment areas.

1 (c) Thin Route

28. Although Regulation 2408/92 already uses 30,000 passengers per annum as a suitable thin-route threshold (see Articles 4.2 and 6.1), the consultation document suggests that the thin-route threshold should be set at 50,000 passengers for the purposes of Article 4.1(a). This figure is based on a 50-seater regional aircraft operating two return services every day of the week, with an average load factor of 65%. If it is deemed that this type of service represents a sensible way of defining a “thin route”, then the CAA would argue that, as the Saturday and Sunday services are likely to be operated at a lower frequency, then some downward adjustment should be made to the passenger numbers.

29. It would seem (based on CAA statistics) that a load factor of 55% would be more representative for a route of the type envisaged and that the weekend services might more likely be operated once daily. These adjustments would reduce the threshold from the 50,000 suggested to around 30–35,000 passengers.

30. **The CAA would therefore suggest a thin-route threshold of 30,000 passengers**, which would be both reasonable and more consistent with Regulation 2408/92.

2. Adequate Provision of Services

31. According to Article 4.1(a) of the Regulation, the “adequacy” of a scheduled service concerns fixed standards of continuity, regularity, capacity and pricing. **The CAA view is that it would be difficult to set any definitions for these that could be applied uniformly to all potential routes. We suggest that adequacy has to be looked at case by case against the evidence submitted by the parties concerned.**

2 (a) Minimum frequency

32. The consultation paper proposes that “there should be a minimum frequency of two return flights each day” if a PSO is imposed. The CAA doubts the value of setting

a minimum frequency; again we would prefer a case-by-case approach. There can be no general presumption that a given frequency is inadequate, since this will depend on the nature of the route. Where a route predominantly caters for point-to-point leisure passengers, a once-daily service may meet the requirements of the market and would not necessarily be inadequate. If the Government believes it absolutely essential to define “adequate” in terms of a blanket minimum frequency across all city-pairs, then it should be no greater than two return flights each day, operating year round, and to/from any London airport. The Partial Regulatory Impact Assessment (page 6) states that setting the minimum any higher would increase the likelihood that subsidy may be required.

2 (b) Should the minimum level of service vary with route density?

33. The consultation paper says that the Government recognises that a minimum two a day service may not be considered “adequate” (in the context of Article 4.1) on certain routes and invites comments on whether a minimum level of service should vary with passenger numbers on the route.

34. The suggestion that decisions on PSOs may need to reflect “the current market size of a route” would potentially catch dense routes where, in the CAA’s view, PSOs have no role – because, for example, a significant reduction in service by one carrier may lead, through the working of the market, to replacement of that capacity by another carrier, albeit potentially serving a different London airport. **The CAA is not therefore attracted to the suggestion that minimum service levels should vary depending on the existing passenger numbers on a particular route, or that a PSO should be considered where capacity falls below a certain percentage of that available on a particular route in a specified season.**

2 (c) Should there be a trigger mechanism, based on changes in seat capacity?

35. There is no evidence that an inflexible linkage between seat capacity and PSOs is justified. It is better to assess a PSO on a case-by-case basis and the “adequacy” of the service against route circumstances. If the criteria for considering a PSO can be controlled by a carrier’s own behaviour (or by “gaming” behaviour by its rivals) such as by announcing a capacity reduction, then this could give carriers an incentive to “play the system”, as the consultation paper notes. **The CAA, therefore, does not believe that consideration of PSOs should be triggered automatically by changes in seat capacity.**

Early warning systems

36. As the Partial Regulatory Impact Assessment (page 7) notes, there are risks associated with imposing an inappropriate trigger mechanism or minimum threshold. The proposed “early warning” notification process for airlines would seem to impose a burden on both the industry and the Department for Transport. The CAA questions the assessment of “no significant additional cost” in the Partial Regulatory Impact Assessment. If one airline is contemplating a reduction in capacity, it could not judge the effect on the city-pair as a whole, because it would have no knowledge of other airlines’ intentions. Under the system proposed, every airline operating the 40-plus regional routes to London would therefore have to notify every reduction in capacity four months ahead, no matter how small the change. Perhaps a better system would be one where the early warning requirement only extended to “sole providers” on a city-pair.

3. Proving the Economic Case

37. The consultation paper refers to “the responsibility of local bodies to demonstrate the importance of a service to the economic development of the region concerned, in accordance with Regulation 2408/92”. The word “importance” here is actually incorrect, and potentially misleading. Regulation 2408/92 clearly states that the service must be **vital** (that is, essential, not just important) to the economic development of the region. Whatever scheme is put in place in the UK must be fully consistent with EU law, to avoid the risk of legal challenge as well as the economic disadvantages set out in this note. The economic case for a PSO should therefore include convincing evidence to demonstrate that all alternative options for supplying the service have been exhausted.

Civil Aviation Authority
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