Economic Perspective 2

PRIVATISING THE BRITISH AIRPORTS AUTHORITY: COMPETITION, CAPTURE AND CONTROL

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Although apparently successful, the government's privatisation programme has faced much criticism over the manner in which it has been implemented. This criticism has centered on potential conflict between the economic and policital aims of the policy. Conflict arises because, in most cases, in order to maximise economic efficiency gains, privatisation should be combined with liberalisation. In other words, the change in ownership should be accompanied by greater competition. But if the government creates a more competitive environment for the newly-privatised concern, three problems emerge.

First, the future profits of the organisation are likely to be lower, and these will be capitalised in a lower initial share price. Therefore, the revenues raised by the programme, and the corresponding fall in the PSBR, will be reduced. Second, the speed and ease with which the privatisation programme can be carried out will depend crucially on the degree of co-operation and commitment shown by the existing senior management. The more competitive the environment the government plans to impose on these managers, the more uncertain and difficult will be their position in the future, and the less likely they will be to support the Government's plans. Third, if the policy is to be used to encourage wider share ownership, then such shares should be as attractive as possible. Shares in companies operating in very competitive markets are a risky investment for small shareholders (Sid).

The major criticism of the government has been that when faced with these trade-offs, short-run political considerations have too often dominated. Currently, legislation is passing through Parliament to enable the privatisation of the British Airports Authority (BAA). Detailed examination of this legislation provides a useful case study upon which to test such criticism. Privatisation of the BAA is of particular concern to Scotland as this organisation currently has a near-monopoly of airport provision north of the border.

Characteristics of the airports industry and the proposed legislation

At present the BAA handles about 75% of British air passenger traffic. It controls seven major airports: Gatwick, Heathrow, Stanstead, Prestwick, Aberdeen, Edinburgh and Glasgow. Other airports are either operated by local authorities or by the Civil Aviation Authority (CAA): for example, Norwich is a local authority airport, whilst Inverness is controlled by the CAA. The industry is heavily-regulated. The development of new airports is severely restricted by planning procedures. At the moment there is excess airport capacity in Scotland, and excess demand at Heathrow and Gatwick. Landing charges made by airports are controlled by the government through the CAA, and are covered by two major international agreements: the 1944 Chicago Convention, and the UK/US bilateral agreement known as Bermuda II. At present landing charges are extremely

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low, and where aiports make profits it is primarily through their duty-free sales, catering facilities and car-parking charges. Finally, the government has powers to allocate traffic between airports. For example, at the moment all direct transatlantic flights into and out of Scotland must use Prestwick.

The **Airports Policy** White Paper of 1985 outlined the government's thinking concerning the privatisation of the BAA.(1) It is envisaged that the regulations presently controlling the industry will be retained. Moreover, it is planned to privatise BAA as a single entity: a private company will be formed which will have substantial market power, particularly in Scotland and South-East England. The decision not to privatise each airport separately appears curious, particularly from a government ostensibly committed to a more competitive economy. The government has made five arguments in favour of a monopolistic market structure for the BAA. A detailed scrutiny of these arguments seems in order.

1. The impossibility of competition

The government argues that three factors determine an airline's demand for landing rights at a particular airport: price (landing charges), location, and the amount of interlining traffic, ie passengers changing planes. The government's position is that price cannot be used as a mechanism for competition between airports because landing charges form a very small proportion of total airline costs and "[o]ur international obligations prevent us from raising our charges to a level which would reflect the true value of access to the most favoured airports and thus preclude price competition".(2) The government believes that the most important determinant of an airport's market is its location, which is fixed, and that the amount of interlining traffic is governed by the size and location of the airport rather than landing charges. Accordingly, the government concludes that there is no scope for competition between airports.

Such a pessimistic assessment of the potential for competition seems uncharacteristically defeatist. As far as the scope for price competition is concerned, the international agreements which deal with landing charges are very loosley-worded. It has been argued that price competition consistent with these agreements could be achieved by setting up a market for access rights to airports at specific times (slots) and allowing resale of such rights.(3) Under such a scheme, the relative attractiveness of the various airports to the airlines would be reflected in the price of a slot. Slots at Scottish airports would presumably command a lower price than those at Heathrow, but the high price of slots at Heathrow would cause some airlines to switch their routes to Gatwick or Stanstead.

A market for slots would offer an effective mechanism for ensuring that the price differentials between airports reflected real economic factors, such as the extent to which each airport can command a local monopoly. At the moment, the price mechanism is not used to distribute the traffic between airports, and consequently those airlines enjoying the privilege of landing at Heathrow are able to earn profits far in excess of what they would otherwise be able to earn. In other words, the airlines capture the economic rent element flowing from an airport's favourable location. If airlines had to bid for slots, the BAA would receive these economic rents, which would be capitalised in the share price so that the taxpayer would benefit upon privatisation. Further, each airport has an incentive to fill any slot as long as the price paid is greater than the cost of servicing the landing. This means that the possible adverse allocative effects of each airport's local monopoly status would be minimised. A final defect of the present system is that it poses a barrier to entry to new airlines which have limited or no access to the most favoured airports.

The government asserts that airlines are very sensitive to airport location and relatively insensitive to landing charges. However, there appear to be no empirical tests of this assertion. The main problem is that landing charges and choice of airport have in the past been controlled to a greater or lesser extent by the government. No-one knows how a deregulated market would work. A reason for assuming that demand is insensitive to landing charges is that at present they make up a relatively small proportion of an airline's costs. But two important points should be made here. First, if landing charges were increased to reflect the scarcity of access to certain airports, their importance would clearly rise. Second, there are quite considerable variations in the proportion of an airline ticket's price which is composed of landing charges. In particular, on short-haul routes (eg London-Glasgow), the landing charge can account for as much as 10% of the ticket price, as against the average of 5% for all routes.(4) Therefore, short-haul traffic might be sensitive to changes in landing charges, even if landing charges remain around their present levels.

We feel that price competition between airports is possible and that after privatisation the BAA, which will then be charged with maximising profits for its shareholders, will press for a relaxation of the present pricing rules. However, even if such changes were not made, airports can compete in other ways. An airline's decision to use a particular airport will depend on passenger demand and the cost of using that airport. Passenger demand will clearly be heavily influenced by location and the extent of inter-lining traffic. However, other factors will play a part too: such as, the standard of surface transport connections, baggage handling facilities, car parking availability and restaurant and shopping provision. Additionally, airports can engage in marketing, support the mounting of new routes or flights for the airlines and provide better facilities for airlines so that turnaround times and taxi-ing costs are reduced. Such forms of non-price competition are more likely to be important where airports have overlapping catchment areas, as for example in the central belt of Scotland.

2. The undesirability of competition

In moving the second reading of the Airports' Bill, Nicholas Ridley, the then Secretary of State for Transport, argued that even if airports were able to compete on landing charges, such competition would have undesirable consequences. For example, domestic and feeder traffic would tend to be squeezed out of Heathrow in favour of the more profitable European and long-haul traffic. This could adversely affect Scottish airports, as they are heavily dependent on London routes: Scottish-London traffic accounts for 57% of the combined business of Glasgow, Edinburgh and Aberdeen airports.

Two points should be noted here. First, this argument assumes there is scope for price competition. Second, the problem identified stems not from the form in which privatisation takes place, but rather from the change in objectives which privatisation will impose. In short, a privatised BAA will be concerned with profits, not regional equity. If this is seen as undesirable, it simply strengthens any existing argument for the continued regulation of the BAA airports. The only relevance this has for the question of whether the BAA airports should be privatised as a group or individually is which form of privatisation can be regulated more effectively. This is an issue to which we return later in the paper.

3. Greater internal efficiency through economies of scale

In the White Paper, the government argued that there are economies of scale in airport management so that the joint privatisation of the BAA would have cost advantages. Particular emphasis was given to the benefits for Scottish airports from economies in centrally-provided management services such as training, financial control and senior management supervision, though neither the government nor the BAA presented empirical results to substantiate these claims. However, work carried out by the Institute for Fiscal Studies found no evidence of economies of scale within BAA over the period 1969 to 1981, a period during which BAA expanded to include Aberdeen, Glasgow and Edinburgh airports.

The economies of scale argument is unsubstantiated. However, other relationships between company size and efficiency appear to favour privatising the BAA airports individually. One of the main arguments for privatisation is that the company becomes subject to the discipline of the stock market. Briefly, an inefficient company will have a share price which fails to reflect fully the profit potential of the assets it owns. As such it will be vulnerable to takeover where the managers are likely to be replaced. In the strong version of this argument, the very threat of takeover is enough to ensure that company management remains efficient.

However, this mechanism works less than perfectly. In particular, empirical studies suggest that stock market discipline is more stringent for small firms in competitive markets than large monopolistic concerns.(5) There are a number of reasons why this might be the case. One is that the existing management have an informational advantage over prospective bidders because outsiders will have difficulty in accurately calculating the profit potential of a firm's assets. This difficulty will be greater with monopolistic firms. Where there are a large number of firms in the industry, the company's competitors can be used as comparators: in a monopolistic industry such close comparison is not available.

A final argument relevant under this heading is that the government has often attempted to use privatisation as a means of increasing workers shareholding in their own firms. The claim is that this should improve company efficiency, as individual workers will have a direct incentive to increase the company's profitability. In as far as this argument is valid, it should have greater force, the smaller the privatised concern. Moreover, the government generally is in favour of smaller companies, praising their dynamism and record of job generation in the recent past. It is therefore strange to find the government's allowing the BAA's current publicity campaign which stresses the fact that it is the world's largest airport authority.

4. Ease of regulation

Even after privatisation UK airports will be operating in a heavily-regulated environment. The government will continue, through the CAA, to pursue national avaiation policies on matters such as route licensing, control of major investments, safety and security. Moreover, major airports will have strong local monopolies, and will therefore be subject to periodic scrutiny from the Monopolies and Mergers Commission (MMC). The form privatisation takes will affect the ease and effectiveness of Government regulation of the industry. The White Paper argues: "Privatising BAA as a whole will retain maximum flexibility in the administration of Government aviation policies".

There is clearly some substance to this claim: control is likely to be simpler with fewer, rather than more, managements to deal with. However, there is a problem concerning the effectiveness of regulation under these circumstances. Again, the issue involves information. Aviation policy will be made using information on technical possibilities and costs derived primarily from a monopolised group of seven airports. Such information is likely to be inadequate or even misleading. First, the information will primarily be coming from one source which has an incentive to present that information in ways which favour the business rather than enlighten the relevant regulatory body. Second, monopolies have a weaker incentive to control costs than competitive concerns. Therefore, data on production are not likely to reveal the best practice techniques. More useful information would be obtained from the managements of seven independent airports competing for business.

Moreover, if there is only one source of information, there is a strong possibility that the regulatory body (whether the CAA or the MMC) will be "captured" by the organisation it is supposed to regulate. BAA plc will be able to claim that it speaks for the industry when it offers opinions on matters relating to airports, and its voice is likely to be heeded. BAA plc will argue for its own interests, which are likely to favour more restrictions on competition between airports and consequently be detrimental to consumers' interests. This general problem of "capture" has been recognised for some time in the US where there is considerable experience of the practical difficulties of the public regulation of private monopolies.

5. Facilitate implementation of the Scottish Airports Policy

In the **Airports Policy** White Paper, the government reaffirmed its commitment to the Scottish Lowland Airports policy. Prestwick airport, which is making a loss and which happens to be located in the constituency of George Younger, the present Minister of Defence, is to continue as Scotland's sole transatlantic airport. The situation will be reviewed in 1989, when the government hopes that Prestwick's economic performance will have improved, though this hope seems rather optimistic.(6)

If the airports were privatised individually, Prestwick would only find a buyer at a negative price. If the government were not prepared to pay overtly to dispose of Prestwick, the airport would have to remain in public ownership and competitive tenders invited for keeping it open at minimum cost, much as is being done for unprofitable bus routes. On the other hand, if the airports are privatised jointly, the losses at Prestwick (and also Stanstead) will be cross-subsidised from the profits of the other five airports.

It might be thought that under joint privatisation the losses of operating Prestwick and Stanstead will be borne by the shareholders of BAA plc. This is erroneous. These losses will be capitalised in BAA's share price at the time of flotation, and will therefore be financed ultimately by the taxpayer. In reality, the Scottish Lowland Airports policy could be pursued under either of the options for privatisation. The main difference is that joint privatisation will conceal the true cost of the political decision to retain Prestwick.

Competition, control and capture

Discussion of the problems of privatisation conventionally focuses on the conflict between the potential long-term efficiency gains from liberalisation and the short-term revenue gains from the share flotation. Detailed examination of the BAA proposals reveals that the interests of the existing management might unduly influence the form of the privatisation too.

A number of elements of the case put forward by the government lend support to the notion that it has already been captured by the industry. First, there is considerable overlap between the evidence submitted to the government by the BAA and the government's own arguments. In particular, the BAA stressed the existence of economies of scale in the management of the seven airports. In the White Paper, the government appears to accept this unsupported assertion without question. Second, in arguing against the possibility or desirability of price competition, the government is allowing the economic rent of certain airports' unique locations to remain with those airlines which have favoured access. Implicitly, air travellers are here being given precedence over the taxpayer. All appearances therefore suggest a complex chain of capture involving the airlines, the BAA and the government.

The BAA is to be privatised as a whole, giving it a virtual monopoly of airport provision in Scotland. The arguments in favour of such a structure appear to us to be very weak and fail to offset the strong economic arguments supporting competition. For Scotland to gain from privatisation, liberalisation must occur too. It is important to act soon. The MMC has never yet recommended the break-up of a monopoly that is already in existence. Morever, the capture argument suggests that the MMC would be sympathetic to the BAA's views which are strongly opposed to any break-up.(7)

References

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6. J Stevens, "Prospects for Lowland Airports and Air Services", **Fraser of Allander Institute Quarterly Economic Commentary**, August 1985.

7. See, for example, the BAA's evidence to the select Committee on Scottish Affairs: Scottish Affairs Committee, **First and Second Reports on the Impact of Privatisation on the Scottish Lowlands Airports Policy**, 1985.