EXPLANATORY MEMORANDUM TO

THE ECONOMIC REGULATION OF AIRPORTS (DESIGNATION) ORDER (AMENDMENT) ORDER 2008

2008 No. 2702

1. This explanatory memorandum has been prepared by the Department for Transport and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 This Order ends the designation of Manchester Airport for the purposes of price control under Part 4 of the Airports Act 1986.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None

4. Legislative Background

4.1 Following consultation the Secretary of State for Transport decided to de-designate Manchester Airport for the purposes of price control under Part 4 of the Airports Act 1986 with effect from 1 April 2009, this being the date immediately after the expiry of the current period of price control.

4.2 This Order removes Manchester Airport from the list of airports designated by the Economic Regulation of Airports (Designation) Order 1986 made under section 40 of the Airports Act 1986.

4.3 At the same time as the consultation on the designated status of Manchester Airport, the Secretary of State for Transport also consulted on the designated status of Stansted Airport, but she subsequently decided not to de-designate this airport.

5. Territorial Extent and Application

5.1 This instrument applies to Great Britain as Part 4 of the Airports Act 1986 does not apply in Northern Ireland. The geographical situation of Manchester Airport means however that this instrument is only of practical application in England.

6. European Convention on Human Rights

6.1 As this instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

7.1 Four airports are currently designated by the Secretary of State for Transport for the purposes of price control: London Heathrow; London Gatwick; London Stansted; and Manchester

Airport. This means that the Civil Aviation Authority (CAA) sets the maximum level of per passenger charges that each of these airports can levy on the airlines who fly from them and must impose certain conditions relating to the disclosure of certain information in the accounts of the airport operator.

7.2 This instrument ends the designation of Manchester Airport, and effectively leaves it free to set its own charges in accordance with market forces but subject to competition law. This is consistent with the Government's Better Regulation agenda, which states that competition is preferred to regulation, and that where regulation is used it should be appropriate and proportionate.

7.3 In November 2006, the Transport Select Committee, in their enquiry into the work of the CAA recommended that criteria for the designation and de-designation of airports should be established. This call was echoed in December 2006 by the Office of Fair Trading in its report into the supply of air services by BAA.

7.4 On 26 February 2007, the Secretary of State for Transport responded by consulting on new criteria for the designation and de-designation of airports. On 31 May 2007, following an analysis of responses to the consultation, the Secretary of State published new designation and de-designation criteria. The CAA were also requested in accordance with section 16 of the Civil Aviation Act 1982 to provide advice on whether, when these new criteria were applied, Manchester and/or Stansted Airports should be de-designated.

7.5 On 6 July 2007, the CAA advised that both airports should be de-designated. The Secretary of State then issued two separate consultations (one on the designated status of Manchester Airport, and the other on Stansted) on 25 July 2007, using the CAA's advice as the basis for consultation. The consultation ran for 12 weeks, and was supplemented by a Stakeholder Forum and meetings between Government officials and stakeholders.

7.6 The consultation on Manchester Airport elicited 19 responses comprised of: five MPs; two MEPs; two airport operators; three local councils; three airline representative bodies; two airlines; one individual; and one freight industry body. The majority favoured de-designation. 6 respondents favoured continued designation. Following a careful review of the analysis by experts retained by the Department, it was concluded that two of these respondents had raised issues which materially questioned the advice given by the CAA that Manchester Airport should be de-designated. Consequently, the Department for Transport subsequently contacted Virgin Atlantic (VA) and the Board of Airline Representatives UK (BARUK) to clarify the issues raised in their responses, and to seek further information.

7.7 VA argued that the runway and terminal facilities provided by Manchester airport fitted its model of operations better than those offered at Liverpool and Birmingham airports. However, the Department's analysis concluded that this evidence was insufficient to conclude that overall Manchester Airport had substantial market power for long-haul activities.

7.8 BARUK highlighted the Canadian experience of deregulation, which they argued had led to higher airport charges. The DfT asked BARUK for further information on this point, but they were unable to make an explicit link between the Canadian experience and any implications for Manchester airport.

7.7 A full copy of the Secretary of State's decision[1], in which she outlined the evidence received, the analysis undertaken and the rationale for her decision was published on 15 January

[1] A full copy of this document can be found at www.dft.gov.uk/consultations/closed/consulstatusmanchester/decisionmanchesterairport.pdf

2008. The Peer Review[2] of the analysis underlying the decisions, conducted by Professor Martin Cave of the University of Warwick, was also published alongside the Secretary of State's decision document. In it, she concluded that Manchester Airport competed with other local airports such as Liverpool Airport, and that this offered real choice for passengers. Furthermore, it was noted that there is spare capacity at Manchester and competing airports now and for the foreseeable future, even allowing for expected growth in demand. Consequently, the Secretary of State concluded that de-designating Manchester will enable the airport to grow and develop without the costs of excessive regulation falling to passengers in the future.

7.8 In respect of Stansted airport, the Secretary of State concluded that unlike at Manchester, Stansted was more likely than not to acquire substantial market power, and therefore that the best interests of passengers would be served by continuing to designate Stansted Airport.

8. Impact

8.1 An Impact Assessment is attached to this memorandum.

8.2 The impact on the public sector will be to remove from the CAA its function of setting the maximum level of permitted charges at Manchester Airport.

9. Contact

David Hart at the Department for Transport (telephone number 0207 944 0083 or e-mail: david.hart@dft.gsi.gov.uk) can answer any queries regarding this instrument.

[2] A full copy of this document can be found at www.dft.gov.uk/consultations/closed/consulstatusmanchester/peerreviewanalysis.pdf

Summary: Intervention & Options

Department /Agency:	Title:	
Department for Transport (DfT)	**Impact Assessment of de-designating Manchester airport**	
Stage: Decision	**Version:** Decision	**Date: 1 October 2008**

Related Publications:
http://www.dft.gov.uk/consultations/closed/designationdedesignationairports/

Available to view or download at:

http://www.dft.gov.uk/consultations/closed/consulstatusmanchester/

Contact for enquiries: David.Hart@dft.gsi.gov.uk **Telephone:** 020 7944 0083

What is the problem under consideration? Why is government intervention necessary?

The issue under consideration is whether ex ante or ex post regulation is the most appropriate form of regulation given the market position of Manchester airport. Government intervention may be necessary through price designation under Section 40 of the Airports Act 1986 to allow ex ante regulation of the charges for Manchester airport's services to address any potential abuse of market power. The SoS has developed criteria to assist with considering the issue and evaluating whether this type of government intervention is necessary.

What are the policy objectives and the intended effects?

The policy objective is to ensure that appropriate regulation is in place to protect airport users (airlines and passengers) while ensuring that the airport can develop its operations appropriately. In the SoS's opinion, this is best achieved at Manchester airport without ex ante price regulation. De-designation will help reduce the administrative costs faced by users of Manchester airport, facilitate extra responsiveness and flexibility in the airport's activities, and may foster better investment outcomes in the future.

What policy options have been considered? Please justify any preferred option.

Consistent with the statutory framework, only one policy option was considered relative to the 'do nothing' scenario of keeping the airport price designated, which is de-designation. The lack of substantial market power at Manchester airport means that price regulation does not generate sufficient benefits to outweigh the costs. Hence, it is preferable to de-designate Manchester airport so that its charges are primarily regulated by general competition law administered by the OFT.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The re-designation of Manchester airport will be considered against the established criteria if a substantive prima facie case for designation is submitted to the DfT.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:

Jim Fitzpatrick

.....Date:10th October 2008

Summary: Analysis & Evidence

Policy Option: De-designation	Description: Manchester airport will no longer be subject to price cap regulation

COSTS

ANNUAL COSTS	
One-off (Transition) **Yrs**	Description and scale of **key monetised costs** by 'main affected groups' The key costs are better described qualitatively (or non-monetised) instead of quantitatively (or monetised). Please see below.
£	
Average Annual Cost (excluding one-off)	
£	**Total Cost** (PV) **£ N/A**

Other **key non-monetised costs** by 'main affected groups' The main potential cost of de-designating an airport is the greater risk of abuse of market power, to the extent that it is held and not effectively addressed by competition law. This cost may be incurred by airlines and/or passengers.

BENEFITS

ANNUAL BENEFITS	
One-off **Yrs**	Description and scale of **key monetised benefits** by 'main affected groups' The key monetised benefits relate to the administrative costs that will be saved by the regulatory bodies and industry not being subject to a price control review process.
£	
Average Annual Benefit (excluding one-off)	
£ 1 million	**Total Benefit** (PV) **£ 20 million**

Other **key non-monetised benefits** by 'main affected groups' While there appear to be no major regulatory distortions currently, a key benefit of removing price regulation is that it may prevent them from occuring in the future.

Key Assumptions/Sensitivities/Risks A number of the costs and benefits are difficult to estimate quantitatively because their exact magnitude is uncertain.

Price Base Year 2008	Time Period Years 30	**Net Benefit Range** (NPV) **£ 15-20 million**	**NET BENEFIT** (NPV Best estimate) **£ 20 million**

What is the geographic coverage of the policy/option?			North West England	
On what date will the policy be implemented?			April 2009	
Which organisation(s) will enforce the policy?			OFT, CAA and DfT	
What is the total annual cost of enforcement for these organisations?			£	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			No	
What is the value of the proposed offsetting measure per year?			£ N/A	
What is the value of changes in greenhouse gas emissions?			£ N/A	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £ N/A Decrease of £ N/A **Net Impact** £ N/A

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

[Use this space (with a recommended maximum of 30 pages) to set out the evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Ensure that the information is organised in such a way as to explain clearly the summary information on the preceding pages of this form.]

Scope of the impact assessment

This Impact Assessment (IA) describes how the Government evaluated the costs and benefits of de-designating Manchester airport. The economic case for the SoS deciding to de-designate Manchester airport is set out in the main body of the decision document.

Background

In deciding to de-designate Manchester airport, the Secretary of State has carefully considered the advice she has received from the Civil Aviation Authority (CAA) as well as responses from interested parties that were provided to her through the consultation process. Her decision is based on criteria that were developed, consulted on and agreed during 2007 as well as other relevant matters. The criteria take account of 1) the level of market power held by Manchester airport, 2) the potential for competition law to address market power and 3) the costs and benefits of regulation. Further information about the process, evidence received and analysis carried out is given in the main body of the decision document.

Options analysis

This section evaluates the costs and benefits of de-designating Manchester airport compared to the base case.

Base case

Our definition of the base case follows DfT WebTAG Guidance that requires all options to be assessed relative to the 'do nothing' scenario. Our base case is continuing to keep Manchester airport price designated, with the broad underlying assumption that it would be regulated using a RAB based framework. There are no additional costs and benefits associated with the base case. However, it is possible that the profile of costs and benefits for this base case may change over time, relative to the current year. In particular, there is the risk that the costs of regulation may become greater in terms of more distortions, particularly if significant additional investment was foreseen.

De-designation

We describe below the economic costs and benefits that the SoS considered to help her decide to de-designate Manchester airport

Benefits

We describe the benefits of de-designating Manchester airport below, including those that are monetarised as well as non-monetarised.

Monetarised

The key monetised benefit from de-designating Manchester airport is the administrative costs that will be saved by both the regulatory authorities and the industry.

The CAA estimates that it and the Competition Commission incurred £2 million of costs during the last price control review. Meanwhile, MAG estimates that it spent £1.3 million in regulatory expenses over the same period, of which £0.5 million seems a reasonable approximation of the incremental costs that related to the price review specifically instead of economic regulation more generally. Together, these costs sum to £0.5 million per annum. It seems likely that the airlines will have incurred a similar expense — even though they engage less with the process on an individual basis, there are many more of them. Hence, an approximate figure for the annual monetarised benefits is £1 million.

A range is generated by considering different discount rates that could be applied to this annual benefits figure. Two possible time periods over which these benefits might be recouped are 30 years or forever. The Green Book recommended discount rate for a 30-year period is 3.5 per cent, which generates a net present value figure of £20 million. The Green Book recommended discount rate for benefits that carry on indefinitely is 1 per cent. However, this discount rate seems too low given the commercial nature of MAG's operations, relative to other government activities. An alternative discount rate is a proxy for the cost of capital at Manchester airport. We have chosen 6.4 per cent, which is in between the pre-tax real WACC of 6.2 per cent for Heathrow airport and 6.5 per cent for Gatwick airport during the 2008-13 price control period. This higher discount rate generates a net present figure of £15 million.

Non-monetarised

It does not seem that RAB based regulation is creating major distortions at Manchester airport currently. One of the frequently cited problems, over investment, was not raised as an issue by the CAA or the industry. Nevertheless, de-designation might remove some of the uncertainty and distortions that the price regulation process creates for Manchester and competing airports. In particular, it might improve the flexibility and responsiveness of the airport operator. Price regulation represents quite an onerous form of regulation that changes the 'rules of the game'. For example, it requires regulatory approval of investment decisions to ensure that capital expenditure can be included in the RAB. In particular, there may be negative indirect impacts on the level of the cost of capital, price flexibility and speed of responses to events in the market. Further, it is possible that de-designation now might prevent distortions from becoming a greater factor in the future, particularly if at some point significant additional investment is foreseen at Manchester airport. Some respondents to the consultation process highlighted this possibility as Manchester airport faces increasing competition from local airports.

While the de-designation of Manchester airport does not have a specific objective of improving competition, it might have the beneficial effect of making the playing field more even amongst airports in North West England. In particular, Manchester airport might incur more similar levels of regulatory costs to those of airports surrounding it that are not subject to price designation. Further, the SoS has explicitly considered relevant competitive forces as part of her assessment of whether Manchester airport has substantial market power. Further information about the implications of competition for de-designation is provided in the competition assessment in annex 1.

Costs

We describe the costs of de-designating Manchester airport below, which are non-monetarised because of the difficulties in quantifying them.

Non-monetarised

A key potential cost is the greater risk of market abuse through excessive pricing. However, this risk does not appear material given the evidence of competitive constraints that exist, and the conclusion that Manchester airport does not have, and is not likely to acquire, substantial market power. Further information about the limited likelihood of market power abuse is provided in the main body decision document. Key considerations described there are:

- Local airports provide a meaningful substitute to Manchester airport, such as Liverpool airport;
- There is spare capacity at Manchester and competing airports now and for the foreseeable future, even allowing for expected demand growth;
- The market share of Manchester airport is declining, while the overall market for air travel is growing;
- There is high service quality at Manchester airport; and

- Airlines and the airport operator at Manchester are effectively and constructively engaged with one another to produce better outcomes at the airport.

Additional costs include the other benefits associated with price-cap regulation that would no longer materialise if Manchester airport were not price designated. They potentially include positive effects on efficiency, service quality and investment. It seems that Manchester airport does have relatively good outcomes for efficiency, service quality and investment. However, while the evidence suggests that regulation may have had a beneficial effect, it seems that competitive forces may have had a larger impact. Further information is provided in the CAA's advice to the DfT relating to criterion 3, in De-designation of Manchester and Stansted Airports for Price Control Regulation, pp.105-108.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	*Results in Evidence Base?*	*Results annexed?*
Competition Assessment	Yes	Yes
Small Firms Impact Test	No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Annexes

Annex 1: Competition assessment

This competition assessment gives an overview of the potential impact of de-designating Manchester airport upon competition. It should be noted that competitive forces were explicitly incorporated into the decision of the SoS as part of her assessment of whether Manchester airport has substantial market power. However, this annex further considers how competition might change when Manchester airport is no longer price regulated. It seems that any impact would manifest itself in terms of the ability of suppliers to compete more effectively. However, it would enhance competition by helping Manchester to compete better with airports that are local to it. At the core of this analysis is uncertainty about the effect of price regulation upon Manchester airport in the past, instead of other influences, and the likelihood of particular events in the future. Nevertheless, its conclusions appear robust.

This assessment relies upon the Competition Assessment Guidance 2007. It focuses on four key competition filter questions:

- Direct impacts on number of suppliers;
- Indirect impacts on the number of suppliers;
- Ability of suppliers to compete; and
- Incentive of suppliers to compete.

Direct impacts on number of suppliers

The de-designation of Manchester airport has no direct impact on the number or range of suppliers. It does not confer more restricted or exclusive rights of supply in terms of a procurement system, licensing system or quota.

Indirect impacts on the number of suppliers

The de-designation of Manchester airport has no indirect impact on the number of suppliers because it does not significantly raise costs. Hence, the costs of new or existing suppliers are not increased. Similarly, the ability of suppliers to enter or exit the market is unaffected.

Ability of suppliers to compete

The de-designation of Manchester airport does affect the ability of suppliers to compete through enhancing ability of Manchester airport to compete with other airports local to it. In particular, it substantially influences the price that Manchester airport can charge for its services because it gives it more freedom in the price-setting process. Instead of maximum prices being set by the regulator in consultation with the airport operator and interested parties, prices will be set through commercial negotiations between the airport operator and the airlines. This change will allow prices to be set in more streamlined and responsive fashion. In other words, the 'right' price will happen 'faster'. It may lead to innovation in the supply of production and organisational form as well as diversification in sales channels and production processes.

A further advantage to Manchester airport is that the charges for its services may be lower due to no longer having to recover the administrative costs associated with price regulation. However, this would only have a limited impact on demand because it represents a saving of £1 million for 22 passengers each year or less than 5 pence per passenger, which is a small proportion of any airfare.

Incentive of suppliers to compete.

The de-designation of Manchester airport does not reduce suppliers' incentive to compete vigorously. It has no impact on the applicability of competition law or the intellectual property and does not encourage exchange between suppliers or increase the costs of switching.