



SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

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Prime Minister

NBRM

19 November 1985

ECONOMIC REGULATION OF AIRPORTS

I was grateful for a copy of Nicholas Ridley's minute to you of 4 November. I am grateful for the further thought that he has given to these issues and am reassured by the advice he has received from his merchant bankers about the proposed arrangements for dealing with the overlap of jurisdictions of the CAA and DGFT.

I am now therefore content with what is proposed.

I am copying this to Nicholas, to other members of the E(A) and to Sir Robert Armstrong.

A.Y.

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10 DOWNING STREET

From the Private Secretary

18 November 1985

ECONOMIC REGULATION OF AIRPORTS

The Prime Minister has noted the institutional arrangements for the economic regulation of airports set out in your Secretary of State's minute of 4 November.

5/9
The Prime Minister has also noted the obligations indicated in the shorthand "reasonable profits". These will make it difficult for the BAA to break out of the mould of a safe but unexciting utility. The Prime Minister has asked whether, with the novel creation of privatised international airports, "reasonable profits" has to be interpreted in the narrow context of a public sector utility. Would it be possible to leave greater scope for the BAA to become more enterprising and profitable without at the same time opening up opportunities for monopolistic behaviour?

I am copying this letter to Private Secretaries to members of E(A) and to Michael Stark.

(DAVID NORGROVE)

Richard Allan, Esq.,
Department of Transport.

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Prime Minister 1

Agree to write as proposed? (There is no need to

batter you with an extremely tedious
correspondence.)

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PRIME MINISTER

8 November 1985

DLW

11/11

ECONOMIC REGULATION OF AIRPORTS

Yes - in accordance with your own comments
Wesford
Affairs

Following consultations, principally with the Treasury and the DTI, Nicholas Ridley is seeking endorsement for the arrangements covering the economic regulation of airports after privatisation, notably of the British Airports Authority (BAA). This bears on the forthcoming Airports Bill.

Satisfactory, well-tried regulatory arrangements already exist for airport safety, security and protection of the environment. This leaves the regulatory régime covering the economic aspects of airports, ie air traffic charges, the allocation of limited airport capacity to competing airlines and the provision, usually by franchise, of passenger services such as duty free and retail shopping, catering, and car parking.

At first sight, such regulation divides neatly into the air traffic side of airports where the CAA has the requisite experience and expertise, and the passenger handling side of airports which is more natural territory for the ^{Director General of Fair Trading} DGFT and general competition law. The snag is the Government's international obligations. These dictate the principle of non-discrimination against foreign airlines wanting access to UK international airports; and the obligation to ensure that income from commercial activities is taken into account in setting traffic charges, and that the traffic charges are

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- 2 -

cost-related and allow only "reasonable profits". This means that in any event, the CAA needs to exercise judgement on the commercial relationships between an airport and third parties across the range of normal airport activities.

Essentially, two concerns have surfaced during recent interdepartmental consultations; firstly, that confusion over the dual roles of the CAA and the DGFT will create muddling ambiguities and cast a shadow of uncertainty over the BAA prospectus; secondly, that the CAA will be placed in the role of overall profit regulator for privatised airports, and, moreover, a regulator required to limit such profitability to a "reasonable" level.

The arrangements resulting from the recent consultations should satisfactorily allay the first of these concerns. The CAA will be the prime regulator of all core airport activities. The continuous and detailed regulation of air traffic charges will be avoided. In practice, maximum air traffic charges at a given airport will be set for 5-year intervals, and during each such period will be adjusted by a formula akin to RPI-X. Before the quinquennial resetting of traffic charges, the MMC would undertake a comprehensive review of the airport company's affairs, including its cost structure and efficiency, and would advise the CAA on its findings.

The principle of "reasonable profit", as framed in our international obligations, is both difficult and important.

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It is bound to have a significant bearing on the attractiveness of BAA plc to investors - and hence on the Government's proceeds. At least the 5-year review mechanism for air traffic charges will avoid continuous detailed regulation of airport profits, and will still leave some incentive for privatised airports to be enterprising and strive for cost savings. Nonetheless, with all but BAA's peripheral operations (eg hotels, conference centres, hypermarkets) broadly limited to "reasonable profits", it will be difficult for BAA to break out of the mould of a safe but unexciting utility.

We would recommend that you should:

I would say "note": this is not really something for you to bother with.

- Note*
- [Endorse] Nicholas Ridley's proposed institutional arrangements for the economic regulation of airports. (Treasury and DTI will agree.)

- At the same time, urge him to explore the scope for enhancing the "reasonable profits" aspect of the BAA prospectus. Given the novel creation of privatised international airports, is it possible to fulfil the spirit of our international obligations whilst retaining a strong profit motive for enterprise and efficiency? Must "reasonable profits" be interpreted in the narrow context of a public sector utility? (Treasury will readily agree.)

And without monopolistic behaviour.

JW
JOHN WYBREW