making global connections:

the potential of the UK's regional airports

Edited by Paul Hackett

THE SMITH INSTITUTE

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Introduction
Paul Hackett, Director of the Smith Institute

The highly charged public debate about new runways in the South East has until recently been conducted largely through the lens of London and the arguments for and against expanding capacity at Heathrow. However, as the government's Airports Commission's latest report[1] makes clear, there are also other important strategic issues at stake, not least the role of regional airports and regional connectivity in the prosperity of all regions and nations in the UK. This collection of essays by key stakeholders and experts could not be more timely; indeed, the Smith Institute will submit this monograph of essays to the Airports Commission as evidence.

The institute is extremely thankful to all the authors who have contributed to this monograph. What is most impressive is the range of opinions, covering perspectives on all the important issues surrounding the future of the UK's regional airports. We hope that at the very least the contributions will raise awareness of the regional dimension and stimulate a debate both regionally and nationally.

Regional policy
In his chapter Michael Ward, former chief executive of the London Development Agency, places the spotlight on the topic of regional economic development and outlines the deep disparities between our regions. He points out that of the country's 39 local enterprise partnerships (LEPs), those with the lowest GVA per head are not in the Greater South East. This, he comments, presents a major challenge to any government, and he fears that a loss of regional connectivity will hardly help. While traditional industrial regions lag behind London and its hinterland, they all see improved connectivity as a key plank in their economic strategy, be it high-speed rail or air transport. Ward states that successful regions need to have international links, not only for exports and foreign direct investment but also to remain in contact with supply chains. Quoting the American economist Robert Reich, he argues that economic success will come through universities and airports.

UK regional airports
Louise Congdon, managing partner at York Aviation, and Richard Connelly, a senior consultant at the same firm, also stress the importance of regional airports to local and regional economies. While the operation of airports in themselves is important to regional economies, it is their business passengers and freight that are the main

1 Airports Commission *Utilisation of the UK's Existing Airport Capacity*, discussion paper 06 (June 2014)

drivers of economic growth. Congdon and Connelly observe that regional airports have experienced passenger growth over the last 20 years. However, while this growth has resumed after the recession, it has been concentrated in London and a few other large airports. At regional airports, meanwhile, growth has largely been predicated on outbound leisure markets rather than on business-focused connectivity. The authors then set out the different priorities for differently sized airports, from survival (and subsidy) for smaller airports to direct connectivity for larger airports. In conclusion, they suggest that the success of regional airports will be tied to whether global destinations can be reached through a hub airport.

Regulation

Dougal Ainsley and David Mundy, lawyers at Bircham Dyson Bell, recognise the economic benefits of regional airports, but point out that the state's withdrawal from aviation has largely left regional airports to the fate of the market. The government does have regulatory powers, including over slot allocations and public service obligations, both of which could help increase services to regional airports. However, unlike other European countries, the UK government has been reluctant to intervene and use such powers. Even if they did, Ainsley and Mundy are sceptical about the potential effectiveness. They argue that using stronger regulation to improve regional access to hub airports would be unlikely to change regional connectivity without extra capacity in London.

Airline view

Jim French, founder of Flybe, is equally concerned about the lack of airport capacity in London. He gives a view not only from the perspective of the UK's largest regional airline but also from someone who has had 40 years' experience in regional aviation. He laments successive governments' failure to build additional runways but also thinks the industry has failed to push the agenda. He cites the fact that Heathrow has only six UK regional destinations while in Amsterdam the figure has peaked at 20. Jim French calls for a regional connectivity strategy, greater cross-party support to ensure delivery over the long term, and slot guarantees and funding to ensure that services within the UK connect to a hub airport.

Long-term planning

Jon Riley, a partner at Pinsent Masons, highlights particular planning issues, especially those affecting smaller airports. He suggests that small changes in planning policy and law could enable regional airports to do much more to serve their economies and leisure markets. By making it easier to develop around airports, recognising the national importance of operational development for improved connectivity, and improving public transport to and from airports, not only the airports but also the competitiveness of our regions could be improved, he argues.

A new hub solution

James Brass from York Aviation explains why a new four-runway hub could provide a better level of regional connectivity than either a third runway at Heathrow or an expanded Gatwick. He mentions the impressive list of world cities in the UK, but comments on the declining level of domestic connections to London airports. He outlines why London has competitive advantages over other major European cities when it comes to connectivity and asks why Heathrow is not doing better. He argues that London's ever-growing economy demands a large, four-runway airport with sufficient capacity to maximise the number of destinations that might be served. Such an airport, he says, would include allowing airlines to develop and reconnect domestic destinations that would allow the regions full access to a reinvigorated London hub.

An investor's perspective

John Godfrey, corporate affairs director at Legal & General, notes that the banks have had to retrench following the financial crisis, which has left a void in project finance. However, institutional investors have considerable "spare" liquidity and are keen to invest in major infrastructure projects, including UK airports. The problem, he says, is that while the world is awash with funds there is still too much political uncertainty. Whatever the benefits to UK plc, he claims that investors will always remain wary while there is so much controversy and disagreement. Godfrey calls for more effort to forge a cross-party consensus and less political meddling in projects once they have been started.

Liverpool John Lennon Airport

Mark Povall from Liverpool John Lennon Airport notes that despite the impressive growth of Liverpool city region over the last 15 years it still lacks local connectivity to global markets. While the airport offers direct flights to a host of capital cities, the main one missing is London. With slots being used for more profitable long-haul routes, the lack of access to London's hub airport has significantly reduced the connectivity of Liverpool city region to international markets. He calls for greater capacity in the South East, but says that any strategy for increasing airport capacity must include ring-fenced slots for regional routes. These routes, he states, should be future-proofed so that as demand grows key times are retained to ensure regional connectivity.

Regional business users

Business users are critical to the success of regional airports. Steve Brittan, managing director of BSA Machine Tools, argues from the perspective of a business based in the

West Midlands. He points out that it would be of huge benefit and put Birmingham on the international map if its airport could cater for long-haul point-to-point services.

Stuart Patrick from the Glasgow Chamber of Commerce makes a similar point in relation to the importance of air travel to the Scottish economy. He highlights the concerns that many businesses in Glasgow have raised over the reduction of flights to London – now only nine a day, compared with 15 three years ago. Stuart also draws attention to the air passenger duty charges on domestic flights, which he says are higher in the UK than in any other EU country. He calls for a cut in the duty, which he claims would actually increase revenues to the Treasury.

For Nigel Schofield, a board member of the Cheshire & Warrington LEP, the nature of regional economies, which are less reliant on services, increases the need for physical presence and access to a wider spread of destinations. Despite demand (60 percent of businesses are located closer to non-London airports) many of these destinations, he says, are not served by regional airports. If this continues, Schofield believes, investors will look abroad to locations elsewhere in Europe.

Conclusion

The authors of this report share the Airports Commission's view that future regional airports "will play a crucial national role, especially at a time when the major London airports are operating very close to capacity". There is little disagreement over the economic significance of domestic connectivity, both to London and non-London airports. As the commission's interim report noted: "the regions benefit from both access to the capital's economy and from long-haul connectivity. London benefits from the contribution that those regional passengers make to enhance the business case for its long-haul routes."

Yet, as this report highlights, many of these airports (which grew rapidly in the 1990s) are now struggling. Air traffic and air routes between London and the UK regions are declining, and are forecast to continue to do so. As the authors explain, this is partly due to capacity-constrained London airports, a fall in demand for some domestic services during the recession, and intense competition from foreign hub airports, as well as other factors such as tighter security, regulation and better national rail services. Whatever the mix of reasons, the authors are right to focus on what the loss of regional connectivity means for the UK's future prosperity and international competitiveness. Can we afford to witness a diminution of regional connectivity at a time when regional imbalances are worsening? And if not, then what actions should government take to support the UK's regional airports?

Chapter 1

Regional airports in the UK – their history, importance and vulnerability, and the sharp decline in hub connectivity

Louise Congdon, Managing Partner at York Aviation, and Richard Connelly, Senior Consultant at York Aviation

Regional airports in the UK – their history, importance and vulnerability, and the sharp decline in hub connectivity

Regional airports fulfil both economic and social roles within their catchment areas, and there is a strong correlation between a region's GVA and the number of passengers using the local airports. GVA growth drives passenger volumes and, in turn, improved connectivity drives further GVA growth, potentially creating a virtuous circle of growth. However, not all connectivity is equal, with routes carrying more business passengers or air freight being the main drivers of wider economic growth, over and above the direct economic contribution made through the operation of the airport itself. The existence of this relationship serves to highlight the importance of connectivity to the regions. While growth in passenger volumes is the most important factor for the airport itself and the direct economic and social contribution it can make, the nature of the route network is vital to understanding the role that an airport can play in delivering wider growth into the regional economy. Connections to major global cities, such as London itself, are often vital in delivering economically valuable connectivity.

There is strong anecdotal evidence that simply having an airport can make a difference to whether investment can be attracted to an area. In particular, anecdotally at least, regional stakeholders believe that connectivity value is gained through their local airport's visibility on global distribution systems, the international flight booking systems. They believe that this allows inward investors, or those considering trading with local firms, to recognise easy flight connections to a region. Where airports don't have hub connections with network airlines, such as Liverpool John Lennon, the city can become in effect invisible to those seeking to do business.

While, ultimately, it has to be acknowledged that air accessibility is only one of a number of factors that will attract investment and business activity to an area, having no convenient air access can simply result in a region never getting on the shortlist. But the devil is in the detail as, while a broad portfolio of leisure services can be important to attracting employees to live in a region, it is connections to markets that attract businesses to an area or enable them to flourish. It is in this context that the role of regional airports needs to be considered.

Regional airports in the UK have expanded rapidly over the last 20 years. Between 1993 and 2007, the peak of regional air passenger demand, the market had grown by 156 percent, compared with the UK average (including the London airports) of 115 percent.[1]

1 Civil Aviation Authority airport statistics – terminal passengers

This growth was not evenly distributed, however, with major gains experienced at airports such as Liverpool (1,088 percent), Bournemouth (1,285 percent) and Bristol (429 percent). Others, typically the historically stronger regional airports, fared less well – for example, Manchester (71 percent), Birmingham (127 percent) and Glasgow (74 percent). To some extent this reflected the higher starting point for these airports in terms of passengers handled, but, more significantly, reflected the very rapid growth of low-fares airlines at smaller airports, particularly in the post-2002 period, albeit this came at some cost to airport profitability in some cases due to the intense competition to attract these airlines.

More recently, all airports saw a decline in traffic during the recession, but growth has resumed in the market overall since 2010. However, such growth is principally occurring at the London and the larger regional airports tied to strong city economies. It is also linked to a shift in low-fare carrier strategies towards a focus on more traditional markets and a shift in emphasis towards serving business travel needs, at least to some degree. To some extent, this is a reversion to historic patterns of growth, concentrated on the larger airports, which leaves some of the more remote regions and smaller economies vulnerable to a relative loss of connectedness, with potentially damaging economic consequences. In an increasingly globalised economy it is not enough to stand still, and relative changes in connectivity between competing regions can make a difference. In some cases, this has left airports vulnerable to closure where capital costs were incurred to facilitate expansion, and fixed costs cannot easily be shed when traffic growth reverses.

Although regional airports saw much more rapid growth than those in London over the period to 2007, they made relatively small inroads into the overall share of the UK air travel market captured by the London airports, with the regional share rising from 35 percent in 1993 to 42 percent by 2007. In the post-recessionary period, the regional share of the overall market has fallen back to 39 percent. So despite all the rapid growth experienced by individual airports, the overall pattern of UK air connectivity remains the same as in the past, which is that it is dominated by London.

To some degree, there has been a shift in the nature of air connectivity offered in the regions away from hub connections, particularly to London, towards more direct air services. This would, on the surface, appear to be a good thing. However, for all the growth in services at regional airports over the period 1993-2007, much of this has been on routes that primarily serve outbound leisure markets, even where services have been developed to a wide range of cities across Europe. Where the development has been less strong is in business-focused connectivity, either to hubs or globally. The rapid development of low-fares services has undoubtedly brought benefits to passengers through the provision of local services to meet local needs (albeit a large part of this was stimulation and discretionary travel). These, in turn, will have delivered clear social and economic benefits making the regions more attractive to live in, delivering measurable journey time savings, and acting as catalysts for inbound tourism, but they have left many regions still dependent on hub connectivity to secure connections to globally significant business markets.

In practice, since 1990 some 11 UK airports have lost air service connections to the Heathrow hub, namely Birmingham, Durham Tees Valley, East Midlands, Guernsey, Humberside, Inverness, Isle of Man, Jersey, Liverpool, Newquay and Plymouth. In some cases, such as Plymouth, the loss of the Heathrow service triggered a downward spiral for the Airport into sustained losses and even closure. The same is true of Durham Tees Valley, albeit the Airport is seeking to diversify its activity to secure long term viability. The routes to London were often the most profitable for smaller regional airports at least, as well as delivering a much of the economically valuable connectivity.

Even for those cities that have retained their direct air service connections, the frequency of those connections has fallen and there is less competition in the market on routes from Aberdeen, Belfast, Edinburgh, Glasgow, Leeds Bradford, Manchester and Newcastle. The erosion of access for the regions to the hub has resulted in poorer connectivity to London overall, despite the growth in low-fares services to the other airports and despite the growth in rail travel, particularly to cities like Leeds and Manchester. Perhaps more importantly, regional cities have seen their connectivity to destinations globally reduced as connections via Heathrow are simply less convenient, because of the longer time gaps between flights and the higher fares.

On the face of it, the UK regions appear well connected to other hubs in Europe, particularly Amsterdam, which has connections by the hub airline to 12 UK cities and to another eight by other airlines. However, the number of seats offered by full-service airlines to their hubs in Europe began to decline well ahead of the recession, as low-fares airlines took their place providing point-to-point services but reducing the convenience with which passengers could connect.[2] Over and above the dramatic reduction in services to the Heathrow hub, this constitutes a real loss in effective regional connectivity to global markets.

So, while regional airports appear to have seen improvements in international connectivity (at least prior to the recession), with the low-fares carriers launching

2 Passengers seeking to transfer from low-cost services to global links do so at their own risk of flight delays as such connections are not recognised by the airlines and separate tickets would need to be purchased.

services from the regions to hub, city and leisure-orientated destinations, these were aimed to a large extent at leisure travellers. In the case of city destinations, there is evidence that the launch of these services may have undermined the existing provision of flights by traditional full-service carriers, with each surge in capacity growth by low-fares carriers matched by reductions from incumbent carriers. To the extent that low-fares airlines launched services to hubs such as Paris and Amsterdam, this itself damaged connectivity to hubs and the availability of through tickets to global destinations, as the network airlines often reduced frequency as a consequence.

Of course, the picture is not consistent across all airports, and some have continued to develop services to destinations that are of high economic and business value. This is often underpinned by strong regional economic performance or specific drivers of demand, such as the oil and gas industry in Aberdeen. The picture is bleaker at those airports which gained rapid low-fares growth at the expense of existing services, and which during the downturn have seen a significant retrenchment of services, such as Coventry and Durham Tees Valley. These airports may be expected to continue to struggle in the near term as the competitive constraints imposed by the low-fares services from neighbouring airports make it difficult for them to attract airlines to offer new services. A number of airports have closed, including Sheffield, Plymouth and, most recently, Manston, as they have struggled to generate sufficient traffic to cover the high fixed costs of airport operation. A number of others are potentially vulnerable, and further airport closures could be significantly damaging to regional prospects.

Despite relatively minimal growth in terms of business-focused routes within Europe, there is a more positive story to be told about regional long-haul route development, albeit these developments are patchy across the UK. Manchester Airport continues have one of the strongest offers for long-haul services of any non-capital city in Europe, beaten only by the major Lufthansa hub at Munich. The breadth of services is underpinned by key long-haul hub destinations, such as in the Middle East and on the eastern seaboard of the USA. The importance of Manchester as a long-haul originating destination was highlighted when Emirates made the airport the first non-capital city destination for its Airbus A380 super-jumbo aircraft. Manchester Airport is not alone in this success, with Glasgow and Edinburgh, and to a lesser extent Birmingham, continuing to deliver strong growth in this sector of the market. However, while these developments are good for the areas around these airports, they are less helpful for those regions that have lost or seen diminution of their hub connections, and they do not add to the basket of routes available globally from the UK as the destinations served are almost all duplicates of those available from Heathrow.

So the picture that emerges is one of polarisation between winners and losers. To some extent, regional airports and their local stakeholders were seduced by the "low-fares bubble" into believing that there was an inexorable trend to growth in direct services which would ultimately deliver broader economically beneficial connectivity. While this "bubble" has not burst, the low-fares airlines are shifting their focus somewhat towards more traditional economically driven and pre-existing markets, with a growing emphasis on business travellers, and away from the practice of stimulating new markets based on ultra-low fares. For the UK, at least, this probably reflects the recognition that the market has been stimulated as far as it could be within the broader economic context and taking into account the tax burden of air passenger duty. As rapid expansion of new direct routes from smaller regional airports has become a much more distant prospect, the importance of hub connections has become greater again.

On the other hand, some of the larger regional airports, particularly Manchester and Edinburgh, are doing relatively well and, to a degree, their focus is shifting away from European hubs to those in the USA, the Middle East and the Far East. This provides improved direct connectivity to key US cities and to places like Dubai, Hong Kong and Singapore, as well as onward connectivity. Hence, it could be argued that, among the regional airports, the strong are getting stronger and the weak weaker.

So what can be done to address this? In practice, regional airports have different priorities according to their size:

- The larger regional airports are focused on improving direct long-haul connectivity, with reductions in or holidays from air passenger duty accompanied by a liberalisation of air service agreements to encourage more airlines to operate direct routes.

- The smaller regional airports are focused on survival and seeking a means to return to growth, potentially with the help of the government's recently announced Regional Air Connectivity Fund.

- The mid-sized regional airports are seeking growth across all markets but are concerned that they face an uneven playing field both in terms of potential incentives which may be offered at the smaller airports (EU state aid rules limit support to new air services to airports with less than 3 million passengers a year in the main) and in terms of the UK air passenger duty burden which makes them less able to compete with European airports to attract additional low-fares services.

However successful the regional airports are, there will remain many global points that can be reached only through a hub airport. Regional air travel markets remain too small to support services directly to the full range of potential globally important cities, and connecting via a hub will always be necessary to reach many of these. A key question therefore is whether it matters if the connection is via a UK hub or elsewhere. It is often argued that the foreign business traveller or tourist is more likely to visit a UK region if their gateway is a hub in the UK rather than Paris, Amsterdam or Frankfurt. This may or may not be true. What is true is that the strength of point-to-point demand between the UK regions and London far exceeds that equivalent demand to Paris, Amsterdam or Frankfurt or, indeed, to any other hub. Hence, other than where rail is a highly effective competitor in terms of journey time, the strength of the London market will virtually always result in a higher frequency of service to a London hub than would be possible to any other hub. As a result, the time penalty for connecting through the hub will be reduced and connections will be more efficient and economically beneficial.

Overall, this matters as what regions need is convenient access. Where markets are too small to support direct services, this has to be via a hub. Regional airports have been doing a great job in providing improved connectivity, albeit they have not really eroded the connectivity gap to London. For some airports, the priority is in extending their own global reach; for others, securing and maintain a strong hub connection is paramount. Nonetheless, connectivity to the UK's main hub will remain important for all regions given the broad global network which can be sustained by the strength of the London market – the largest city air travel market in the World - and to connect to the economic powerhouse that is London in its own right.

Chapter 2

Regional policy

Michael Ward, Research Fellow at the Smith Institute

Regional policy

In the 1930s, British governments, spurred by the collapse of traditional industries and the depression, began to invest in spatial economic policies designed to enable declining regions to rebuild their economies and grow employment. Those policies survived, in one form or another, until the coming of the 2010 Coalition. The final institutional form for regional policy was the network of nine English regional development agencies established after 1997.

From 2010, the regional development agencies were replaced by local enterprise partnerships (LEPs), intended to cover smaller geographical areas.

Figures now available from the Office for National Statistics provide a basis to compare the relative prosperity of the LEPs. Table 1 shows the LEPs with the highest output in terms of GVA per head in 2012:

Table 1: LEPs with the highest GVA per head in 2012

Local enterprise partnership	UK = 100
London	174.8
Thames Valley Berkshire	164.3
Enterprise M3	121.9
Oxfordshire	116.9
West of England	116.2
Hertfordshire	113.4
Cheshire & Warrington	113.4
Buckinghamshire Thames Valley	113.2
South East Midlands	104.9
Greater Cambridge & Greater Peterborough	101.6

Source: ONS

Only two of these areas are not in the Greater South East – Cheshire & Warrington and West of England. The area of the West of England LEP is centred on Bristol and Bath. (South East Midlands is the area around Milton Keynes.)

Table 2 gives the equivalent data for the LEPs with lowest per capita GVA:

Table 2: LEPS with the lowest GVA per head in 2012

Local enterprise partnership	UK = 100
Heart of the South West	76.6
Lancashire	76.4
The Marches	76.3
Tees Valley	75.8
North Eastern	75.5
Greater Lincolnshire	74.1
Stoke on Trent & Staffordshire	72.6
Sheffield City Region	71.1
Black Country	70.6
Cornwall & Isles of Scilly	61.2

Source: ONS

In contrast to the more prosperous areas, none of these LEPs is in the Greater South East. The pattern of relative prosperity has remained substantially unchanged over time. Table 3 looks at the performance of the LEPs that had the highest GVA per head in 2012 over the period 1997-2012.

Table 3: Performance over 1997-2012 of LEPs with highest 2012 GVA per head
(UK = 100)

Local enterprise partnership	1997	2001	2005	2010	2012
London	164.6	167.8	168.4	173.1	174.8
Thames Valley Berkshire	163.7	169.2	178.2	160.7	164.3
Enterprise M3	114.1	122.1	114.3	119.2	121.9
Oxfordshire	112.3	116.0	112.7	113.0	116.9
West of England	113.6	113.1	114.9	117.3	116.2
Hertfordshire	119.2	129.9	126.2	111.9	113.4
Cheshire & Warrington	110.0	110.3	109.7	114.4	113.4
Buckinghamshire Thames Valley	114.0	118.5	113.7	114.3	113.2
South East Midlands	109.5	106.6	106.4	106.1	104.9
Greater Cambridge & Greater Peterborough	104.3	103.7	99.7	101.4	101.6

Source: ONS

Table 4, similarly, compares the experience of the LEPs with the lowest GVA per head:

Table 4: Performance over 1997-2012 of LEPs with lowest 2012 GVA per head
UK = 100

Local enterprise partnership	1997	2001	2005	2010	2012
Heart of South West	80.3	78.8	79.9	79.3	76.6
Lancashire	82.0	78.6	78.8	76.5	76.4
The Marches	84.9	78.1	79.4	76.0	76.3
Tees Valley	78.0	72.8	78.2	78.4	75.8
North Eastern	71.4	72.3	77.6	73.9	75.5
Greater Lincolnshire	85.7	75.7	74.0	74.8	74.1
Stoke on Trent & Staffordshire	80.0	75.2	75.5	73.0	72.6
Sheffield City Region	70.5	68.5	72.6	72.8	71.1
Black Country	85.4	81.2	77.2	73.5	70.6
Cornwall & Isles of Scilly	60.8	59.7	62.9	66.0	61.2

Source: ONS

In general, therefore, the stronger LEP areas either maintained their position in relation to the rest of the country, or improved it, between 1997 and 2012. The weaker LEPs either stayed where they were, or became weaker.

These statistics present a picture of continuing uneven economic performance across England. Traditional industrial regions continue to lag behind London and the Greater South East. All see improved communications as part of their future economic strategy.

The LEPs have now produced local growth plans or development strategies, and most of these – like the RDA strategies before them – emphasise connectivity and communications as a key element in business growth. While some focus on air transport, others see connections via high-speed rail, and the projected HS2 line, as critical.

It is striking that, of the 10 strongest-performing LEP areas, all bar one are close to the London airports network. Many of these LEP areas lie in or around the M3/M4 corridors to the west and south-west of London, with strong links to the existing international hub airport at Heathrow. The only one of the 10 strongest LEP areas to lie in the North of England is Cheshire & Warrington – covering the prosperous hinterland immediately to the south of Manchester Airport.

Tees Valley LEP, in its 2011 statement of transport ambition, cites earlier work by the RDA as showing that:

... international airports are vital infrastructure that contribute to the competitiveness and prosperity of regions (both in terms of business and inward tourism).
– Tees Valley LEP *Connecting the Tees Valley: Statement of Transport Ambition* (2011)

The North East Economic Review, commissioned by the North East LEP, found:

Making, trading and exporting requires connectivity to global markets by air. Ever stronger links from Newcastle Airport to the major global air hubs are required, plus continuing direct flights to the more distant British cities. The maximum number of global destinations needs to be available from Newcastle with one change of plane.
– *North East Independent Economic Review Report* (North East LEP, April 2013)

Successful regions need to have international aviation links, not only for the import or export of goods, but also for companies to remain in contact with their international supply chains. Where elements in the production process may be outsourced to a range of countries, designers and managers need to be able to visit quickly in order to deal with problems or changes on the spot.

These links take two forms: direct services for UK regional airports, as referred to by the North East LEP; and services via London. A progress report following the 2003 aviation white paper stressed the first of these:

Encouraging people to fly on direct services from their local airport, rather than making a long journey to a hub airport, not only reduces emissions but can also reduce travel time for business and leisure users....

Regional airports now serve a wide range of international destinations. Newcastle Airport, for example, served 113 international destinations in 2005, and Manchester Airport served 239 international destinations. The Government issued policy guidelines in October 2005 to encourage international airlines to fly direct to, and through, UK regional airports.
– Department for Transport *The Future of Air Transport Progress Report* (December 2006)

Direct international services from UK regional airports have continued to expand. The Airports Commission in its interim report showed that, between 2003 and 2013, the number of passenger seats from non-London airports to destinations outside Europe more than doubled. A major factor in this growth was the emergence of new airlines based in the Gulf states:

Emirates now serves Birmingham, Glasgow, Manchester and Newcastle, as well as Heathrow and Gatwick. Both Etihad and Qatar offer services from Manchester and Heathrow. The substantial onward route networks available from these airlines' hubs, particularly to South Asian and Far Eastern destinations, have opened up many new opportunities for long-haul travel from Manchester and other regional airports.
– Airports Commission *Interim Report* (2013)

The growth of these new providers has also enabled more air passengers from UK regions to connect with other international services outside the UK – both at Amsterdam's Schiphol airport and increasingly at Dubai.

Services via London have been the traditional means for air passengers from the English regions to link to international services. Both the 2003 and 2013 white papers on aviation refer to this:

Good links to London airports are important to regional economies.
– Department for Transport *The Future of Air Transport* (December 2003)

A number of respondents to the consultation – particularly from Scotland, Northern Ireland and some English regions – stressed strongly that continued connectivity to London airports is essential to their regional economies and to national cohesion.
– Department for Transport *Aviation Policy Framework*, Cm 8584 (March 2013)

But while direct services from regional airports to international destinations have been expanding, services to the London airports have declined. The interim report of the Airports Commission documents the decrease.

In 1990, 19 other UK airports had at least weekly flights from Heathrow. By 2012 the figure was eight. The Airports Commission estimates that, unless capacity is expanded, by 2040 as few as four domestic destinations could have direct flights from Heathrow. As long as Heathrow remains the major airport for international services, replacing Heathrow flights with connections to other airports in London and the South East would not help international business travellers. And in fact such flights have declined:

In the last six years a number of services to non-London airports other than Heathrow have been discontinued: Gatwick has lost or reduced services to Manchester (and Flybe's 2014 withdrawal from Gatwick may further diminish its domestic routes); Stansted has lost or reduced services to Belfast City, Blackpool, Guernsey, Liverpool, Manchester, Newcastle, Newquay and Prestwick; London City has lost services to Belfast City, Liverpool and Manchester; and Luton has lost or reduced services to Aberdeen and Inverness.

– Airports Commission *Utilisation of the UK's Existing Airport Capacity*, discussion paper 06 (June 2014)

The Tees Valley LEP describes what has happened in the case of the Durham Tees Valley Airport:

Durham Tees Valley Airport (DVTA) has, in common with other regional airports, seen a decline in passenger numbers. Retention and modest growth of existing markets in the future is vitally important for the Tees Valley. DVTA had a throughput of 288,296 passengers in 2009 representing a significant decline from 2008.

– Tees Valley LEP *Connecting the Tees Valley: Statement of Transport Ambition* (2011)

One reason for the decline in domestic air traffic in the UK is clearly the recession. The number of passengers flying overall, as well as the number of passengers taking domestic flights, fell in the recent recession. But whereas total passenger numbers revived in the period 2010-12, domestic UK traffic recovered much more slowly. Indeed, the Airports Commission in its June 2014 discussion paper, *Utilisation of the UK's Existing Airport Capacity*, points out that:

... economic recovery has not been spread equally across the country. The recession impacted London and the South East less forcefully than other areas of the country, and a flat lining in demand for domestic travel between 2010 and 2013 may be an indication of the slower rate of recovery in regional economies.

– Airports Commission *Utilisation of the UK's Existing Airport Capacity*, discussion paper 6 (June 2014)

The management of Heathrow argue that limited capacity at that airport is a major reason for the decline in domestic air services. But the Airports Commission's own analysis suggests that some of this could be overcome if airlines were prepared to use larger planes for their domestic routes.

And the terms of the competition between domestic air services and other modes –

mainly intercity rail – have changed. New security arrangements for airline check-in make the overall duration of a journey by air longer. And improved rail services have made the train more attractive again.

The picture, therefore, is not altogether clear. Some international passengers who in the past would have flown to London from a regional UK airport to connect with a long-haul flight can now fly directly from their regional airport to their ultimate destination. Some now fly to an alternative hub, in continental Europe, the Gulf or elsewhere. But the number and frequency of domestic routes has fallen, and it seems likely that capacity constraints form part of the explanation.

The economic performance of Britain's traditional industrial regions continues to lag behind that of the more prosperous London and Greater South East. If businesses in the declining regions are to maximise their effectiveness in global markets, they need access to air transport. The ease with which they can connect with international flights via the London network of airports has itself declined. Capacity constraints in the South East are not the only reason for this, but they are significant.

The economy is changing. International investment is no longer about luring huge manufacturing plants to greenfield sites; it is about knowledge, research, development, and the exchange of ideas. The American economist Robert Reich has argued that the key ingredients for success in the economy of the future are universities and airports, or as he puts it: "brains and quick access to the rest of the world".[1]

1 Reich, RB *The Work of Nations* (1991)

Chapter 3

The regional business user

(i) Perspective from the West Midlands
Steve Brittan, Managing Director of BSA Machine Tools

(ii) Perspective from the North West
Nigel Schofield, Economist at Warrington LEP

(iii) Perspective from Scotland
Stuart Patrick, Chief Executive at Glasgow Chamber of Commerce

Perspective from the West Midlands
Steve Brittan, Managing Director of BSA Machine Tools

BSA Machine Tools Ltd is a manufacturing company based in Birmingham that produces high-quality machine tools. We are located within five miles of Birmingham Airport. We have 30 full-time employees, with a further 250 in the local supply chain, and an annual turnover of £5 million.

Some 90 percent of the business is export trade, predominantly to long-haul destinations. Our customers are located globally, in North America, South America and the emerging markets of Asia. Regular business trips are undertaken throughout the year by BSA personnel to our customers, and vice versa. Our business travel destinations are Mexico, Houston, Louisiana, China (including Beijing, Shanghai, Wuhan, Shenyang, Chengdu and Chongqing) and Pakistan.

At present, BSA uses carriers to fly from Birmingham Airport to European hubs or to Dubai to connect with long-haul flights, as this is easier than travelling to Heathrow. When BSA visits customers in Taiwan, we do fly from Heathrow via Hong Kong but this incurs the added inconvenience of travelling to and from London: fighting through traffic congestion and incurring parking expense and hotel fees.

These difficulties also affect our overseas customers visiting our plant here in Birmingham. It would be of tremendous benefit and put Birmingham on the international map if Birmingham Airport could cater for long-haul point-to-point services.

At this time 3 million business people travel to London airports from the Midlands each year to visit their customers overseas. These businesses incur cost and time penalties as a result of insufficient aviation connectivity. And the inability to travel easily to new markets is seriously damaging economic growth.

Businesses in the Birmingham Airport catchment area are exporting more goods to emerging markets in Asia and the Middle East than any other region. The Birmingham Airport runway extension, opening later this year, will put the airport in the top six with the longest runways, thus enabling longer-haul flights. Half a million businesses and 6.5 million employees are located in Birmingham Airport's catchment. This makes it the second largest business catchment in the UK. Birmingham Airport will have charter flights available this summer to Beijing (with the carrier China Southern Airlines); this is an example of the connectivity that regional business requires.

Business currently benefits from the connectivity of the West Coast Main Line rail link/ Birmingham International train station, plus the close proximity of the M42 and M6, conveniently located adjacent to Birmingham Airport.

The airport's close proximity to the HS2 interchange station means it would benefit substantially from the HS2 connectivity packages and transport improvements that have been proposed by Birmingham City Council and Centro, thus expanding its catchment even further.

As new markets emerge worldwide, regional business must be able to reach these destinations within the shortest timeline and with minimum hassle. Improving regional travel connectivity is vital to regional business growth and to enable regional business to compete in emerging world markets.

(ii) Perspective from the North West

Nigel Schofield, Board Member of Cheshire & Warrington LEP

The two key factors that drive regional business travellers' decisions are cost and the total travelling time for a journey. For most business travel, this applies not only to the decisions on how to travel, but also to those on whether to travel at all.

Most regional business travel relates to manufacturing, engineering, technology, and related businesses. This tends to increase the need for a physical presence with the overseas customer, and naturally means a wider spread of destinations than for London-based travellers. However, the destinations served direct from the regional airports are currently far fewer than from London airports, despite their being better located to serve 60 percent of British business.

There is an inevitability about this, as regional business travel is more economy minded than travel from the South East, which reduces route profitability for airlines. London airports also gain the benefit of much greater transfer traffic.

Consequently, London airports have concentrated on high frequency of flights to key international destinations, while business travellers from outside the London area have either lost their air service connections to London or chosen alternative hub connections overseas to reach their destinations.

This absence of direct connections from the regions damages the UK economy in total and the regions in particular. The extreme example is in foreign direct investment into the UK.

The decision criteria that drive business traveller decisions for exporters (principally cost and time) also drive major business investment decisions, as direct air connections from the overseas head office to the location of new investments is a crucial factor in the selection process.

While London needs direct services to keep pace with the demands of business, so do the regions, as the decisions about the location of business activity are increasingly made with a very tight control on costs.

This does not relate merely to air travel but also to the cost of facilities, recruitment, local transportation and so forth, so in the absence of good direct connectivity to the UK regions, overseas investors are naturally inclined to look at lower-cost locations across Europe rather than to the UK regions or London.

Viewed in this context, the UK's connectivity with international markets is best judged not purely on connections to London, but on those to all regions in the UK compared with their global competitors.

So the regional business traveller needs direct access by air to a good, efficient hub in the London area which serves as an international service provider to as many destinations as possible, where national demand can be sensibly concentrated into one viable service. However, businesses in the regions would prefer new direct flights from a convenient airport to destinations that are only currently served from London, rather than additional rotations out of London.

While construction work takes place on a true hub for the UK, the spare capacity and frustrated demand that exists in the regions can be addressed by support for new services from regional airports, both to assist existing UK business and to encourage more FDI into the regions.

(iii) Perspective from Scotland
Stuart Patrick, Chief Executive at Glasgow Chamber of Commerce

Scotland is located on the periphery of Europe, so travelling by air is not a luxury but an essential element of business and family life.

Glasgow city region is Scotland's biggest city and the fourth largest in the UK. Glasgow is home to the largest number of businesses (28,515), supports the most jobs (561,000), makes the highest economic contribution (£24.9 billion) and has greatest amount of export activity (25 percent of all Scottish exports) in Scotland.

Engineering, whisky and life science companies export to a hugely diverse range of overseas markets. We send pumps, compressors and temporary power generators to every country where oil, gas or minerals are extracted. Single malt whiskies and seafood of every description reach all around the world.

Glasgow Airport is our primary gateway to the world. It sustains more than 7,300 jobs and contributes almost £200 million to the national economy – more than any other airport in Scotland.

To maintain our current competitiveness, it is therefore critical that we continue to build direct point-to-point services from Glasgow to the rest of the world. But our population can never be big enough to support direct flights to the more unusual destinations we need to reach, so we also have to grow – or at the very least protect – access to major hub airports. Heathrow, as the UK's hub airport, today offers the greatest number of onward connections and frequency of feeder services. The interaction between Glasgow and London in financial and business services, creative industries and public administration keeps the demand high for frequent links with Heathrow. But capacity constraints now mean increased competition for slots, and we all know that domestic access has been in decline.

In March 2011 British airline BMI decided to withdraw its service between Glasgow and London Heathrow, leaving Glasgow Airport with nine flights per day compared with the 15 that were in place prior to BMI's withdrawal.

In a survey of leading Scottish businesses carried out by the Scottish Council for Development & Industry in 2011, respondents were asked about the importance of access to Heathrow. Some 67 percent of respondents stated that the loss of BMI's Glasgow-to-Heathrow service had a large degree or some degree of impact on their business.

Furthermore, 65 percent said their business would suffer a high to severe impact if there was a further reduction in or discontinuation of services to Heathrow.

Regrowing the frequency of our contacts with our primary hub airport is therefore one of the most important policy issues that Glasgow Chamber of Commerce pursues. The contentious debate about runway capacity and the length of time to resolve it is hugely frustrating and genuinely damaging to business opportunity.

But there are related issues we have to tackle. The business community is also concerned that air passenger duty adds costs to our exporting businesses and dissuades airlines from flying to and from Scotland.

Successive governments have increased APD, so that passengers now pay up to £188 on long-haul flights. A typical family of four will pay an average of almost £120 this year in APD.

The UK has the highest rate of APD of any major European country. Our European neighbours are far more competitive, with many governments (Ireland, Denmark, France) reducing or abolishing APD in order to support their indigenous airlines.

In February 2013 PwC published major new research which found that significantly reducing or abolishing APD would result in a significant increase in the UK's gross domestic product and lead to the creation of tens of thousands of new jobs.

It also found that reducing or abolishing APD would actually increase the revenues to the Treasury from other taxes so much that it would pay for itself.

More locally, good surface access is also critical to the future growth of any airport, and this is particularly true of Glasgow. Funding for a proposed direct train link from the city centre to the airport was pulled by the Scottish government in 2009, and so other options are being considered, including a tram-train link. We remain highly vocal in support of that investment.

Chapter 4

Liverpool John Lennon Airport and the need for a London hub feeder service

Mark Povall, Director of Air Service Development at Liverpool John Lennon Airport

Liverpool John Lennon Airport and the need for a London hub feeder service

Liverpool John Lennon is a regional airport with a current annual throughput of more than 4.2 million passengers and scheduled flights to over 50 destinations. It is located seven miles to the south of Liverpool city centre, serving the needs of the Liverpool city region and beyond.

Over £130 million has been invested at the airport in recent years, helping to grow passenger numbers almost tenfold, from around 450,000 in the mid 1990s to present levels. This on-going investment in airport facilities to provide an efficient operation and high levels of customer service has helped firmly establish the airport as a gateway not only for Merseyside but for the North West as a whole.

The airport is also now one of Merseyside's major employers, attracting inward investment and bringing significant tourism benefits, helping to boost the region's economy. Purely through its operations, the airport is a significant driver of prosperity in the Liverpool city region, currently supporting around £109 million a year in GVA and around 2,650 full-time-equivalent jobs in the area.

The Liverpool city region is one of England's fastest-growing regional economies, with a population of 1.5 million people driving a £20 billion economy. Latest data published by the Office for National Statistics on economic output for each local enterprise partnership (LEP) area shows an annual growth rate of 4.2 percent between 1997 and 2012, ranking the city region ninth among the 39 LEP areas and making it the only Northern LEP area in the top 10.

Key business drivers in the economy are advanced manufacturing, life sciences, financial and professional services, maritime and logistics, the visitor economy and, more recently, renewables. Together these have created thousands of new jobs.

However, while the airport and the local economy have seen huge improvements in recent years, the city region still lacks local connectivity to global markets. Business and leisure passengers have the opportunity to choose to fly direct from Liverpool John Lennon Airport to a host of European capital cities, but the most-needed destination missing is London. While an air link to the capital would serve a market looking for quick access by air to the capital, it is the opportunity to serve a major hub airport that is of greater significance because of the worldwide connectivity it brings.

Liverpool John Lennon Airport last had true connectivity to a major London hub airport in the early 1990s. In March 1992, British Midland Airways ceased its regular flights to London Heathrow, choosing to use its Heathrow slots for more profitable routes to Europe instead. As a consequence, the Liverpool city region has lacked a hub feed service to London for over 20 years now, and while a short-lived link to Amsterdam was available more recently, worldwide connections via London are currently lacking and remain high on the airport's wish list.

Capacity constraints in the South East have meant that the opportunity for regional airports such as Liverpool to re-establish regular flights to a London hub airport has simply not existed for some time. However, the renaissance of the city region has meant that the demand for improved global connectivity is greater now than at any point in the past 20 years.

Demand for a link to a hub airport is self-evident from analysis of the latest CAA passenger survey data, which shows that over 950,000 passengers from Liverpool John Lennon Airport's core catchment area took a connecting flight from other UK airports. Over 690,000 travelled from Manchester Airport to a hub, while over 250,000 travelled to one of the London airports for onward travel.

This data also shows the attraction of a hub feeder service for both the business and the leisure markets. Over 280,000 of these passengers travelled on business, while 30 percent of the total demand comes from foreign nationals visiting the Liverpool area. Currently the traffic mix is fragmented, with passengers travelling via a number of gateways including London, Paris, Amsterdam, Frankfurt and the Middle East in order to access long-haul connections.

With a global perspective and exceptional economic strengths, Liverpool is recognised as one of the UK's leading business destinations. The city region is strongly connected to global markets and is home to a host of leading international businesses including Jaguar Land Rover, Unilever, the Peel Group, Novartis, Prinovis, NSG Pilkington, Stobart Group, Santander and Maersk.

At the same time, large-scale projects such as Liverpool SuperPort, the Mersey Gateway, Sci-Tech Daresbury, Liverpool Waters and Wirral Waters will all bring multibillion-pound investment to the region in the coming years.

The region's visitor economy has seen huge improvements too. Visitors to the Liverpool city region spend £3.4 billion a year, which supports 46,000 jobs in the local economy.

In 2012 Liverpool was the fifth most popular destination in the UK for international visitors, with 550,000 staying visits, and the visitor economy asset base has improved beyond recognition in recent years with regeneration projects such as Liverpool ONE, Arena & Convention Centre Liverpool, Liverpool Cruise Terminal, and the Museum of Liverpool.

Yet, with so many developments and improvements to showcase and more demand for international business and leisure travel, the lack of global connectivity remains and hinders the region's greater potential for success in an internationally competitive market.

Having recognised the need for regional access, it is also important that any strategy to increase hub capacity in the South East to benefit regional airports across the UK includes the ring-fencing of slots for regional routes to ensure that any expansion of capacity is not simply consumed by carriers wanting to operate more direct long-haul flights serving the South East. It should also be future-proofed, so that as traffic and demand grow, important slots at key times are retained for regional connectivity, despite growing pressure to facilitate potentially more lucrative direct routes serving the South East.

Chapter 5

The airline view

Jim French, Founder of FlyBe

The airline view

Having been employed for almost 40 years in regional aviation, I have seen many changes in our industry:

- **Aircraft technology** has greatly reduced the environmental impact of each flight and reduced the cost per seat mile flown (supersonic commercial air travel having come and gone).

- **Computer-driven** transformation in the marketing and selling of an airline seat has given the consumer the power to make a purchase.

- **Deregulation** has enabled increased competition across the industry, with very different business models being offered – the launch of the low-cost airlines being the most dramatic in the last 20 years.

- **Terrorism** using aviation as its highest-profile target has required security checks that have brought significant complexity, disruption and costs to an industry which has otherwise made great strides to reduce all these.

There has been massive overall growth in air travel from and to the UK and also within the UK (Heathrow excepted), with substantial airport expansion at every major UK airport from Aberdeen to Southampton. Apart from some development grants in outlying regions, almost all this investment has been borne by the private sector.

British aviation has been a success, with great forward vision and entrepreneurial spirit being demonstrated time and time again.

However, one topic that has been on the agenda throughout is yet to be addressed: *how to solve the dilemma of Heathrow capacity and additional runway capacity in the South East*.

As a country and an industry, we have failed to address and resolve this key strategic issue and, as a consequence, other European countries now lead the way in intercontinental travel through the development of hub airports, which have been allowed to grow in terms of terminal and runway capacity. It is now these countries that are best placed to meet the demand and growth potential from the emerging nations around the world, whereas our indecision has handicapped our future economic prosperity.

We have allowed only one new runway to be built since the 1950s – Manchester's second runway. (Yes, we have also converted a former dockland into an airport, London City Airport). During this time, Amsterdam has expanded to five runways while Paris, Frankfurt and Madrid all now have four.

I do not just blame the successive governments, which have used aviation as a political football rather than consider airport development as a key strategic cornerstone to building world trade.

I also blame the industry, for completely failing to push aside individual interests and bring together our considerable commercial mass in order to speak with one voice to persuade the various governments, civil servants, regulators, the media and the public over the last 50 years of the importance of building sufficient runway and terminal capacity in the South East to ensure we remain at the forefront of intercontinental travel and trade.

As an industry, this has possibly been our greatest failing.

The opportunity for regional airports

However, this lack of strategic vision to address the capacity issue in the South East has been used by regional airports and regional airlines as an opportunity for growth – to find alternative solutions to ensure intercontinental connectivity with the world by launching "Heathrow bypass routes" to continental and now, Middle East and US hubs.

Amsterdam Airport and KLM were the first to recognise this opportunity. They partnered with Air Anglia and then Air UK to develop a comprehensive feeder system from virtually every airport in the UK to Amsterdam Airport. They even launched a marketing campaign, which mocked the British dithering by naming and marketing Amsterdam Airport in the UK regions as "London's Third Airport".

They also saw the potential of retail trade within their airport before anyone else and pioneered the duty-free shop for the international traveller. And in particular, for the international connecting traveller using Amsterdam – it became almost an excuse to justify using Amsterdam to connect as opposed to Heathrow! Passengers climbed off the Air UK aircraft clutching their bright yellow duty-free bags from Amsterdam Airport, thereby publicising the fact that there is an alternative to Heathrow.

The number of UK regional airports serving Heathrow has fallen from 26 to six, and yet the number serving Amsterdam has peaked at over 20 during the same period.

And this traffic has grown from half a million passengers a year from the UK regions to Amsterdam in the early 1980s to now over 4.5 million passengers – a ninefold increase. Meanwhile, domestic passengers from the UK regions to Heathrow have grown in number from 4.5 million to 4.9 million – a mere 10 percent increase in 30 years.

What did Amsterdam offer that Heathrow did not?
Quite simply, Holland does not have the population to support an intercontinental airline such as KLM nor a major point-to-point intercontinental airport like Schiphol. The Dutch government backed a strategic plan to turn Schiphol into an intercontinental hub, thereby enabling KLM to develop its global network.

They realised as a nation that the only way for them to develop the broadest range of international destinations was by adding every potential passenger to their system of spokes. If every spoke carried just one passenger for each destination beyond Amsterdam, then the economics of serving that destination were completely transformed, enabling Schiphol to develop a network much greater than the Dutch market could support.

They recognised that there must be sufficient runway capacity to enable the hub and spoke system to work. It was essential that planes could arrive at the airport from many destinations within a time block, let their passengers disembark, and within an hour or so depart again, carrying passengers from across the globe to their required destinations.

They accepted that their runways would operate at near 100 percent capacity only during the waves of connecting flights arriving and departing. Their average use would only be around 70 percent of the potential capacity. But they realised that unless they could enable the peaks to grow, then the hub would be compromised. Furthermore, additional runway capacity would also act a relief valve in the event of disruption.

They also designed a terminal that was a single interlinking building where passengers could transfer without having to leave the building to catch a bus or a train to another terminal.

What did other airlines and hub airports do?
Air France followed with its own hub feed system for Paris Charles de Gaulle Airport and built four runways. It developed a feeder network to the UK regions. Lufthansa did the same with Frankfurt. Then came Continental Airlines, which built a range of direct services to New York from around the UK regions as spokes into its New York hub, feeding the USA from the UK regions.

Most spectacular has been the development of Dubai and the feeder service by Emirates Airlines through its hub in Dubai, transferring passengers across the globe. Nearly 2 million passengers a year now fly to Dubai from Manchester, Glasgow, Newcastle and Birmingham. We now also have Finnair pushing traffic destined for Asia and the Far East.

These millions of passenger numbers have been lost to the UK hub at Heathrow: a missed opportunity to further strengthen and develop our own hub.

What did Britain do during the same period?

Runway capacity
We lacked a clear and cohesive strategic vision for airport capacity policies in the South East. We failed to build additional runways and instead we increased runway utilisation to over 99 percent, thereby totally compromising a true hub and spoke system. Heathrow has become a "compromised" hub, where interlining is facilitated through a convergence of schedules as opposed to an optimised multi-wave hub connectivity schedule, and consequently the airport has missed its true potential.

London is a world-class centre for trade, but because of the lack of a clear and cohesive strategy its airport system is third-class.

Heathrow has fallen behind its European competitors in offering the broadest range of destinations to the emerging nations. In the 1990s Heathrow offered more destinations than any other single European airport. It has now slipped to fourth. Frankfurt offers more than 250 destinations, Heathrow around 180. Of serious concern is the rate at which the UK is falling behind our competitors in developing direct services to the new emerging markets around the globe.

Terminal capacity
We took 25 years to approve and build a fifth terminal building at Heathrow. Thankfully, because BAA has been split to form competing airports around London, there is now a real incentive to develop terminal standards and capacity at each of the airports. Terminal 5 is world-class and Terminal 2 will be too.

One can only imagine what might have developed had the monopoly been broken in 1965 when BAA was created, or in 1986 when it was privatised. There is a lesson to be learned here: if governments and regulators are not prepared to make strategic decisions, then they should step aside and let the market do it for them.

No regional connectivity strategy

In the mid 1980s, we deregulated the industry following on from the USA, as have most other European countries. In the USA and other European countries, however, it was recognised that in a deregulated environment there was a risk that the commercial focus would gravitate towards the dense volume routes and that secondary routes could be in danger of being withdrawn. Consequently they introduced regional connectivity strategies (with financial support as necessary) that protected regional services into the main airports.

The UK did not introduce a regional connectivity strategy, nor did it offer financial aid to ensure the viability of such services. Furthermore, we allowed airlines to trade in slots, thereby creating a very valuable asset that could be sold off to the highest bidder, or sacrificing UK regional destinations at the expense of new destinations.

As a consequence, air services from the UK regions to Heathrow have been reduced from 26 cities to six, while airports such as Amsterdam and Paris have twice that number and more. This lack of any regional connectivity strategy has not only handicapped the potential of Heathrow as a hub but has also had a significant negative impact of those regional communities. This lack of connectivity resulted in the point-to-point traffic not having services to London and consequently these communities suffered considerably in terms of economic investment and growth.

Virtually every other European country recognises that regional communities depend upon day-return access to the capital city. Any lack of connectivity with a region is a serious deterrent to investment. It is key to economic prosperity and for international trade to develop. Consequently, most still operate a comprehensive regional aid support programme.

It is interesting to note that not only has central government failed in this area but also the regional development agencies responsible for developing investment were very reluctant to support air travel.

For 50 years, billions of pounds of public money have been poured into building factories big and small across the regions – in the assumption that was all that was required. Yet we have spent virtually nothing on ensuring access to those regions. Customers, sales teams and products would find their own way there, it was assumed. And yet it is these elements of business that are the lifeblood and the food source for these factories. The physical buildings are merely the skeleton.

And we wonder why we have around the country graveyards of desolate factories, which operated for only a few years if not mere months.

Airline economics

So what happened to the airlines during this period? In the mid 1980s there were 14 airlines offering domestic services in the UK. Today there are seven, with two others being dedicated to Channel Island services. The feeder airlines were taken over by KLM in the case of Air UK (Amsterdam Airport) and BA in the case of BMI (Heathrow).

Heathrow is dominated by BA, with Virgin breaking into the three to four trunk markets in order to protect its feed traffic. (I would like to see five years of service before I classify that as a stable market.)

Air France, KLM and Lufthansa operate their own wholly owned subsidiaries on the majority of their routes. Commercial relations exist with one or two others.

The simple and somewhat harsh economic reality is that history has proved hub feed routes are extremely difficult to operate on a sound economic basis – especially now that low-cost airlines have burst the yield bubble.

Feeder routes carried point-to-point and interline traffic.

Before the low-cost era, point-to-point fares were relatively high. The interline yields on the feed sector were relatively low, as prorate calculations shared the revenues between the feed airline and the long-haul carrier. And the long-haul carrier demanded the lion's share. There were formulae and agreements that were designed to protect both parties, but experience has demonstrated time and time again that the feeder carriers were left with too little.

And when the low-cost carriers came along and burst the bubble of high fares on the point-to-point markets (even from and to neighbouring airports) the feed carriers had to respond by dropping their point-to-point yields. The routes then became uneconomic and were withdrawn.

The hub airlines moved fast to protect their feed traffic and bought out these airlines or operated the routes themselves with their subsidiaries. They too responded to the low-cost threat by introducing lower-cost products and lower fares, and as a consequence the independent feeder airlines were squeezed out of the market. And that is why you now see very few independent feeder airlines serving any of the major hubs across Europe.

And without a regional connectivity strategy, the big airlines have no need or desire to operate to regional airports where the markets are small, so these regional economies suffer.

Taxation – air passenger duty

The UK is leading the way once again with the most punitive and expensive aviation tax applied to all departure passengers. And since it is a departure tax, domestic passengers are hit on both their outward and return flights, with £26 tax on a return domestic journey. International business-class passengers pay as much as £388 tax on a long-haul journey.

The Dutch government has scrapped this tax. So a passenger now buys a one-way ticket to Amsterdam and buys the next flights as independent schedules, thereby saving on punitive taxation. There are inconveniences resulting from not interlining, but significant savings for the regular long-haul passenger.

Heathrow loses out again.

What is required?

If the UK is minded to build more runway capacity in the South East, then the priority should be to develop the hub system.

Irrespective of whatever decision is made (as long as the decision grants additional runway capacity), any such additional runway capacity should be considered as a national strategic asset. As a national asset, ideally it should be delivered on an all-party basis in order to avoid political games in the future – but that is probably asking for the impossible.

As a precondition to any approvals given, it should be required from the outset that there will be a regional connectivity strategy introduced which will:

- guarantee access for three services daily to each of the UK regional airports no longer served by Heathrow;
- ensure that the slots for these services remain the property of the state and not the airlines, or alternatively that no trade be allowed with these slots; and
- provide for regional funding to subsidise these services, just as they are subsidised across Europe.

Such policies will ensure that:

- Britain is able to develop alongside it European partners and compete for international trade across the globe;
- the regions of the UK are given their best opportunity to attract long-term inward investment, thereby assisting in the rebalancing of the UK economy which appears to be on everyone's political agenda;
- the funds are in place to enable regional connections to be economically viable for the small regional airlines.

Chapter 6

Is regulation the answer?

Dougal Ainsley and David Mundy of Bircham Dyson Bell

Is regulation the answer?

This chapter considers whether regulation could provide a means to improve air links from the UK regions to London, thereby unlocking the potential of the UK's underused regional airports.

A brief history of aviation regulation

From its early days until relatively recently, a high degree of state control was a defining characteristic of the global aviation industry. National authorities often set limits on fares. As states have exclusive sovereignty over their airspace, governments had to negotiate international traffic rights. Airlines, whether publicly or privately owned, were restricted to operating routes selected by government bodies.

The picture today is different, in some parts of the world at least. The US liberalised the aviation sector in the 1970s, followed by the UK in the 1980s. In addition, the EU has been introducing measures to liberalise the internal aviation market since the 1990s. Many nationally owned airlines have been privatised, new providers have entered the market and new business models have been established. Within the EU and where countries have agreed "open skies" arrangements, intergovernmental negotiations on individual routes are no longer necessary – airlines are now free to select routes and set fares depending on perceived market demand, negotiating their operating conditions with airports as they need to. In the UK in particular, the reform has also included the privatisation of airport infrastructure. In summary the state's role in these open market systems has been reduced from one of overall controller to that of regulator.

This regulation, unsurprisingly, is still extensive. Safety is a major objective, and economic regulation has been introduced to ensure fairness for the various market participants, consumers in particular. As air transport is clearly of strategic importance to a nation, it might be expected that robust regulation would also exist to enable states to ensure that socially and economically desirable services are provided, even if these are not profitable, or not profitable enough to be provided by the market without government intervention. This might be expected, but it is the case?

Capacity constraints

The first obstacle to providing services from regional airports to London airports in general, and Heathrow in particular, is lack of capacity at the London airports. All five of London's principal airports – Heathrow, Gatwick, Stansted, Luton and London City – are "co-ordinated airports" (i.e. demand for their capacity outstrips supply for at least a portion of their operating time such that available capacity has to be allocated to airlines through an independent co-ordinator). Only one other airport in the UK is co-ordinated (Manchester).

Clearly it is more difficult to run services to a congested airport, and this lack of capacity is undoubtedly part of the reason for the decline in regional services to congested London airports. Furthermore, commercial pressures would tend to exacerbate this trend as both airports and airlines stand to benefit more from large, long-haul services with higher passenger numbers. Does regulation offer any means by which this capacity crunch can be made to bear any less heavily on regional services?

The use of capacity at congested airports is dealt with by way of slot allocation. A slot is the right to schedule a landing or departure at a congested airport during a specific time period, including the right to access the airport terminal for passengers and crew. Within the EU, slot allocation is governed by a European legal instrument, which in the UK is supplemented by implementing regulations, the Airport Slot Allocation Regulations. Under this system, an airline that holds a slot in one season has first claim on that slot in the same season the next year (so-called grandfather rights). Airlines must use their slots for at least 80 percent of the time for which they are held, otherwise the slot goes into a pool for reallocation (the "use it or lose it" rule). If new capacity is created at an airport, the resulting slots also go into this pool. Slots are allocated from the pool by an independent co-ordinator, which must allocate 50 percent of them to "new entrants" as defined in the regulations (broadly speaking these are airlines with no or only limited presence at the airport in question).

These rules are principally concerned with ensuring that the allocation of slots at congested airports is based on neutral and transparent rules that do not discriminate on the basis of nationality between EU member state airlines; they are not primarily a mechanism for enabling member states to ensure airports make capacity available for regional services. The regulation does, however, acknowledge that there can be a need, under limited circumstances, to make special provision for the maintenance of adequate domestic air services to regions of a member state. Furthermore one of the definitions of a new entrant is an airline that requests slots for a service to/from a regional airport where no other airline operates such a service.

While this latter provision in theory supports the allocation of slots to services for regional airports, in reality opportunities for its application are likely to be infrequent. At all congested airports slots are clearly at a premium and closely guarded by incumbents. Airlines have been reported to operate ghost services to avoid the "use it or lose it" rule, and are able (in the UK) to sell slots they no longer need to a different airline. The creation of new slots through the addition of new airport capacity, whether by lifting planning restrictions, changing operating systems or the provision of new infrastructure, is a relatively infrequent occurrence (the provision of new runway infrastructure being particularly rare). As such these provisions are only likely to have a substantial positive effect on regional connectivity in the event of a substantial increase in capacity at a congested airport.

A related impediment is that the impetus has to come from airlines to request such slots, but regional services may be less attractive to airlines. Encouraging airlines to serve regional routes, which are often unprofitable or less profitable, is the focus of a different regulatory regime.

Supporting regional services

Commercial airlines naturally want to operate profitable, sustainable routes for which there is high passenger demand. Governments (including the EU), on the other hand, might want routes to be served for reasons of economic and social policy; routes for which there may be lower demand from fewer passengers but which the government nonetheless sees as important for reasons of social cohesion. They might, for example, wish to ensure that airlines run services from the regions to London to ensure people living in those regions have adequate transport facilities, and to support the economy of the regions. Access to Heathrow, used as a hub by airlines and alliances, is often considered particularly valuable as it provides access not just to London, but also to connecting flights to a large number of destinations around the world. While some regional airports offer services to continental hubs such as Amsterdam Schiphol, it could be argued that these are less viable as there is not as much demand from passengers travelling to the destination to supplement the passengers on transfer flights.

Airlines are understandably reluctant to serve unprofitable routes, or even routes that are profitable but not as profitable as others that they could focus their efforts on instead. Due to the costs and difficulties in obtaining access to London's congested airports, it is likely that many more UK region-to-London routes fall into these categories than would be the case if there was not such an acute capacity problem.

In the absence of outright state control to design, manage and fund the route network, regulation is an alternative means by which commercial carriers can be coaxed into operating un- or less profitable but socially desirable routes. As with slot allocation, the most obvious regulatory tools – public service obligations (PSOs) – are of EU origin. Member states can impose PSOs on routes between airports (usually both in the same member state), one of which serves a "peripheral or development region", or any "thin" route (one for which there is low passenger demand) that is considered vital for the economic and social development of the region served by the airport.

The PSO allows the authority that imposes it to ensure an airline delivers a minimum level of service for a certain period, at set frequencies and set prices, even if an airline would not, for commercial reasons, normally offer such a service. Provisions in the slot allocation regulations (discussed above) allow the government to reserve slots at co-ordinated airports that are necessary for the delivery of the PSO-backed service. If, once the PSO has been imposed, no airline offers the specified service, the operation of the route is put out to tender, the terms of which can include subsidy. These rules are in effect a branch of the wider EU rules on state aid – air transport is a service of general economic interest that can, where justified, receive subsidy notwithstanding the general prohibition on the selective transfer of state resources to businesses.

While the rules are set out in EU regulations, the administration of PSOs is left to national governments. As a result there is disparity in the use of PSOs between member states. Use of PSOs in the UK has not been extensive. Direct comparisons are problematic given the difference between countries in factors that would influence a decision on whether to impose a PSO, such as geography and population distribution, but it does appear that PSOs are used less in the UK than they are in, say, France, where a policy of linking the regions to Paris for economic reasons explains the significant number of PSOs supporting such routes. In the UK, in contrast, there are no PSOs on routes between the regions and London at the time of writing. PSOs are used to support routes between Scottish island airports, and between the mainland and those islands, but even here the level of subsidy appears to be lower than for equivalent routes in, say, Ireland, such that even the subsidised fares are viewed as expensive.[1] There is at least an arguable case that many other routes in the UK, including from various regions to London, would meet the EU criteria and so could legally be protected by a PSO.

The apparently lower level of PSO use in the UK compared with other countries is perhaps unsurprising given the policy context. Successive UK governments and the Civil Aviation Authority (CAA) have been committed to creating an aviation sector that functions on market principles as far as possible, with minimal levels of government intervention. For example, the CAA recommends an improved secondary slot trading mechanism as the most efficient way to allocate resources at congested airports, suggesting that regional authorities that valued the access sufficiently could simply

1 Williams, G and Pagliari, R "A Comparative Analysis of the Application and Use of Public Service Obligations in Air Transport within the EU" in *Transport Policy* vol 11, no 1 (January 2004), pp55-66 (https://dspace.lib.cranfield.ac.uk/bitstream/1826/930/4/public_service_obligations_in_air_transport-2004.pdf)

pay market price for the necessary slots.[2] Guidance from the Department for Transport articulates the arguably restrictive UK application of the PSO regime – the central UK government will not initiate PSOs but rather leaves it to regional bodies to make the case; PSOs are unlikely to be appropriate for new routes; PSOs will not be considered on routes that have received start-up funding; PSOs will not be considered if there is a service from the regional centre to another of the six London airports.[3] While the Department for Transport may have a case in asserting that this approach is required by the EU rules, the evidence suggests other member states take a more robust and inventive view.

The way forward?

In short, regulation is not the answer – at least not unless there is a change in UK policy such that there is a greater willingness to interfere in the market in the interests of improving regional connectivity, perhaps accompanied by a more concerted effort to rebalance the UK economy by improving the fortunes of the regions. The onus currently is firmly on regional bodies to drive the introduction of such services by making the case to a reluctant central government, and those bodies are not always well placed to do so.

It can be argued that even an activist government would be restricted in what it could achieve with these regulatory tools – the EU rules are built on free-market principles and as such there are genuine limits on intervention in the regulatory regimes as they stand now (whether or not they are as restrictive as UK policy would suggest). For example, PSOs can't be used simply to improve connectivity for its own sake, the route has to be "vital for the economic and social development of the region". As such the potential of these regulations to improve regional access to London, particularly to its most congested, most desirable airports, is limited at best. It is hard to see that large-scale change could be achieved otherwise than by the provision of new capacity in London.

2 For example, see: Civil Aviation Authority *Reforming Airport Slot Allocation in Europe: Making the Most of a Valuable Resource*, CAA briefing (April 2006) (https://www.caa.co.uk/docs/589/ERG_slots_doc.pdf)
3 Department for Transport *Guidance on the Protection of Regional Air Access to London* (December 2005) (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/266383/pso-policy-guidance.pdf)

Chapter 7

Long-term planning for regional airports – rectifying recent blips

Jon Riley, Partner at Pinsent Masons

Long-term planning for regional airports – rectifying recent blips

Not so very long ago, the wealth of our regional cities was vastly increased by international trade. The Industrial Revolution saw huge growth at ports in Bristol, Hull, Newcastle and Liverpool. Men dug canals through Northern valleys to connect the Pennine mills to Liverpool's docks and the world beyond, creating lock systems that conjured the appearance of pushing water uphill. London built canals too, but was blessed with the Thames and the English Channel, its very own gateway to trade on the continent and beyond.

Today, international trade remains of critical importance to the nation's economy. At the same time, it is accepted that there is a need to rebalance the economy between London and the rest of the UK. Generally it is accepted that improving infrastructure and connectivity is essential to achieving that goal, although there are competing views about the best way to achieve that, the debate around HS2 being just one example.

International trade still needs international connectivity. London has major airports at Heathrow, Gatwick, Stansted, Luton and City – today's Cinque Ports. Our regions have a vibrant mix of airports providing much-needed connectivity abroad, and within the UK.

Regional airports drive regional economies. They allow overseas trade, in the form of exports and business travel. They facilitate imports, and bring tourists to spend money. To increase their contribution to their host regions, airports need to grow responsibly. Expressed simply, growth means increasing passenger numbers and freight volumes. It does not always mean more runways.

Yet the planning system weighs against regional airports. This paper explores the reasons for that case, the case for change, and how our regional airports have begun – like the canal builders – to push water uphill.

The place of regional airports

Today's regional airports have a rich history, growing from private aero clubs or redundant military facilities, usually with a phase of ownership by local government. The public-sector stake in our regional airports is still substantial.

The role of regional airports has been transformed in recent years by the emergence of low-cost airlines and Gulf carriers. Air passengers from the UK regions still depend heavily on Heathrow as a primary hub, but both the continent and the Gulf offer other options.

The vital economic contribution of regional airports is well recognised by successive governments, from Labour's 2003 air transport white paper *The Future of Air Transport* to the Coalition's 2013 *Aviation Policy Framework*. However, a number of fundamental policy and legislative shifts have made it harder for regional airports to grow to serve their host communities.

Keeping regional airports in their place?

Planning decisions affecting regional airports are normally made by the local planning authority, in accordance with the planning policies prevailing at the relevant time. What those planning policies say about airports is therefore fundamental to an airport's investment decision to pursue a planning application for growth, and ultimately its chances of getting planning permission in its hands at the end of the process.

Planning policy is now driven by the National Planning Policy Framework's promotion of sustainable development, leading to an increased and welcome focus on the balance between prosperity, people and place. The NPPF informs how local councils write their own planning policies. The NPPF acknowledges infrastructure growth as a pillar of sustainable development and recognises the role of airports in serving business, but in the author's view did not go far enough in recognising what regional airports contribute to their local economies.

The Coalition government's *Aviation Policy Framework* followed the blueprint of the NPPF in terms of the balance it properly strikes between the three strands of sustainable development. Again, it explicitly recognises the economic benefits of regional airports. However, it was a long time coming, which led to uncertainty and made planning harder for those airports in the interim. Equally, the APF moved away from supporting specific development at named locations, unlike its predecessor, the 2003 white paper. There are mixed views on whether or not that is a good thing. Some welcome flexibility, but others will feel that they have taken a backward step and make the case for growth all over again at a local level, without the protection of policy at a national level. Finally, the decision to create the Airports Commission to examine the question of one or more new South East runways means that the APF is not a comprehensive national policy statement.

There has also been a hiatus in regional planning while the Coalition abolished the regional development agencies (RDAs) and regional spatial strategies (RSSs). Regional policy tended to support airport growth, in turn guiding the preparation of local authority planning policy to do the same. RDAs tended to see the economic benefits of "their" airports and support growth. Local enterprise partnerships (LEPs) and combined authorities are starting to fill the strategic gap, but some airports were – and still are – casualties of a policy void within their own regions.

Most airports have impacts – positive and negative – on more than one local authority area. In the absence of RSSs, those local authorities are now under a duty to co-operate when it comes to preparing their own planning policies, but planning inspectors examining local planning policy have repeatedly identified failures to achieve that goal. The lack of top-down regional planning policy has allowed cracks to open up between neighbouring authorities on a number of planning issues.

The current policy suite also neglects market demand for development around airports, to serve passengers and freight, and the desire of international businesses to locate their offices as close to an airport as possible. Supporting more development in proximity to airports also has the potential to unlock development value to pay for surface access improvements. There is no doubting the sensitivity of this in political terms, especially as many airports are in or near the green belt. There needs to be a pragmatic policy steer from government to drive a proportionate amount of additional development around regional airports, not just to increase capture of the catalytic economic effect of air travel but also to boost funds to improve public transport options.

Without sufficiently supportive policy, both consistently across a set of host local authorities and at a national level, the process of obtaining planning permission at and around regional airports remains a lottery for some, while costly and lengthy for all.

The insignificance of regions?

The Planning Act 2008 has been heralded as a step change in how we deliver nationally significant infrastructure in England and Wales. It established a fast-track planning system for those infrastructure projects designated as "nationally significant infrastructure projects" (NSIPs).

Six years on, the system is generally perceived as working well. Crucially, it guarantees a six-month examination period – putting an end to the mammoth planning inquiries seen for Stansted's second runway and Heathrow's Terminal 5.

The 2008 act also places decision making with the secretary of state, following a recommendation from a Planning Inspectorate panel, rather than with the local authority. The local planning committee does not get to decide whether or not to grant planning permission. For airport development, which is often controversial and highly politicised locally, that is potentially an attractive feature. Councils are not excluded from the process, and contribute vitally during the pre-application and examination phases. Their most visible role is compiling a local impact report to give their informed view of the impacts – positive and negative – of the proposed development. However, that is generally the tip of the iceberg: local authorities set to host NSIPs play a substantial role in responding to a promoter's pre-application consultation.

However, for an airport project to be an NSIP and benefit from the fast-track lane, the bar is set high. The construction or improvement of an airport cannot be an NSIP unless it will deliver 10 million passengers per annum or at least 10,000 air transport movements of cargo aircraft. And it has to be in England or in English waters.

At the risk of stating the obvious, 10 million is a lot of passengers. Only a project delivering a new runway in the South East is likely to hit that threshold. Birmingham would need to double in size to qualify. Manchester would probably need to build another runway. Cardiff, Leeds Bradford, Newcastle and Newquay are not of a size that would target that scale of growth. Yet they are undoubtedly – individually and taken together – nationally significant for connecting Wales, Cornwall, Yorkshire and the North East.

Each of those airports, and numerous others, are vital to the economic well-being of their host communities. Keeping them not just viable but vibrant requires letting them improve and grow responsibly, through a planning system which places proper weight on their collective contribution as nationally significant infrastructure. Scotland is not within the remit of the 2008 act, but connectivity with the rest of the UK and the wider world is an issue of vital importance in the context of Scottish independence. This paper acknowledges the invaluable role of Scottish airports, but does not consider their position further.

For a railway to be an NSIP, it need only be two kilometres long. What then is the right threshold for allowing an airport project to qualify as an NSIP under the 2008 act? One option would be to set the threshold to catch certain designated airports seeking to expand by more than a specified percentage of their average annual passenger numbers for the past five years. There is power in the act for the secretary of state to bring such a change into effect without primary legislation. There is also scope for the secretary of state to designate individual projects as NSIPs, but while welcome that adds uncertainty for airports and their investors, and delay to the planning process.

There is a further, fundamental problem. Even if the bar in the 2008 act could be lowered to allow more regional airports to rely on the faster planning process, there is no national policy statement on airports to guide the secretary of state's decision whether or not to grant development consent. Any national policy statement that emerges from government following the recommendations of the Airports Commission in 2015 is likely to address only the question of runway capacity in the South Rast. The Aviation Policy Framework is broadly supportive of regional airports, but it does not back specific levels of growth at identified locations, as the 2003 aviation white paper did, or as the national policy statement for nuclear new-build does.

The government should, however, be given credit for the steps it has already taken to fine-tune the 2008 act. For example, one legislative change means that landside commercial development over a certain size at a regional airport could be considered as an NSIP and therefore rely on the 2008 act planning route. The rationale for that change was based on the recognition that some commercial schemes have a positive economic effect of such scale that it is nationally significant. The same logic should be applied to regional airports themselves.

Rebalancing transport spending

One of the biggest constraints on growth at regional airports is surface access. For airports to grow responsibly, they need to be able to persuade more of their passengers to travel at least some of the journey to the airport by public transport. Rail or other fixed links are preferable because they offer greater certainty of travel time over bus journeys, but buses will always have a valuable role to play. Equally, car journeys to airports will never be eradicated.

Government spending per head on public transport in the regions is dwarfed by what is spent on London. Even on the government's own figures, twice as much is spent on London. That is a historic trend across numerous governments, but one effect is that many of our regional airports remain poorly served by public transport. That puts their host regions at an instant economic disadvantage to competitor regions across Europe and potentially further afield.

The position is improving. The latest National Infrastructure Plan reinforced government assistance for projects at Manchester and Birmingham. However, the overriding impression left by the Aviation Policy Framework is that Whitehall expects airports and the private sector to take the lead in funding surface access improvements. After decades of inequality and under-investment in transport infrastructure outside London, that is hard to swallow for many.

Finding ways to push water uphill

Regional airports were early adopters when the new normal of regional governance emerged, playing a key role in reshaping regional strategy and governance, uniting business and the public sector. They were quick to submit or support bids for the early rounds of the Regional Growth Fund and secured places on the majority of LEP boards. The LEPs in turn understood the benefits of having a strong local airport and generally offered support to the sector, typically for improved surface access or symbiotic business parks. The Finningley and Rossington Regeneration Route Scheme, linking junction 3 of the M18 to Robin Hood Doncaster Airport, is a prime example of a scheme brought forward with LEP backing.

A number of airports submitted bids to become enterprise zones with simplified planning regimes. Manchester's Airport City is perhaps the best known, but Newquay's Aerohub was also successful. The new local development orders which should make micro-planning within the enterprise zone easier are still young and untested, but is being watched closely across the sector as an attractive concept which stands to enhance the existing permitted development rights that airports enjoy beyond their existing operational confines to a wider commercial application.

Conclusions

We have resourceful regions, with a history of innovation and independent spirit. Around the UK are communities ready to grow their tourist industries and to trade with other regions overseas. Regional airports do their utmost to serve those needs, as well as the thriving leisure market, but so much more is achievable with only modest changes to our planning law and policy.

Furthermore, those changes need not radically change the balance between people, places and prosperity. Making it easier to develop proportionately around airports, and recognising operational development for improved connectivity as nationally significant, coupled with a re-prioritisation of transport funding from central government, would dramatically improve the profile and competitiveness of our regions.

Chapter 8

An investor's perspective on UK regional airports

John Godfrey, Corporate Affairs Director at Legal & General

An investor's perspective on UK regional airports

Two basic premises serve as the starting point for any discussion of infrastructure investment:

- the availability of funding; and
- the capacity of the investment to reward risk appropriately.

This is as true of airports as of any other asset.

At present, there is plenty of liquidity in the market – the world is awash with money – but there is a relatively high level of political and policy uncertainty, which can mean an investor ends up being exposed to unrewarded, and hence undesirable, risk.

This article aims to unpick these two issues in the context of UK regional airports, and offers some suggestions.

Funding is available
Since the credit crisis we have seen sustained ultra-low interest rates and the creation in the UK of £375 billion of new money via quantitative easing. The apocryphal visitor from Mars might expect that this would result in record investment in the broader economy. But it has not been so: investment as a share of GDP is below levels seen back in 1955 – a long-term secular decline, with only recently some signs of pick-up.

What has happened is that the creation of new, narrow money has been more or less offset by the destruction of "broad" money (the old sterling M4). New money has chased yield via financial assets – witness the rise in bond and equity markets roughly in parallel with quantitative easing. In contrast, despite low interest rates, traditional capital expenditure has been restricted in both the public and private sectors, due to constrained public spending and a lack of business confidence.

The issue has, moreover, been compounded by the pressure on banks to retrench and strengthen balance sheets, which restricts this traditional source of project finance. So we need to turn to non-bank financial institutions such as insurers, pension funds and sovereign wealth funds.

Historically, opportunities for UK institutions to invest in long-dated UK assets with suitable credit ratings have been limited. The sterling capital markets for corporate credits are simply insufficiently deep, so institutions have been forced to invest overseas, typically in US corporate bonds – with associated foreign exchange costs. In the domestic project finance market (including PFI), banks have crowded out the long-term institutions, and the institutions have therefore not invested in skills and teams capable of structuring big infrastructure investments.

With banks now retrenching, however, opportunities are being created for long-term institutions. Insurance companies and pension funds have long-term liabilities (the need to pay out on pensions or annuities, the need to invest policy-holder funds and to generate returns on shareholder capital), and these liabilities need to be matched by long-term assets. Unlike banks, insurers and pension funds do not do "maturity transformation". It is best, where possible, to match not just the maturity of the liabilities and assets, but also the currency, so as to avoid the frictional costs of forex hedging, swaps, derivatives and so forth.

For a UK insurance company with a long-dated portfolio of UK, sterling-denominated liabilities (for example, an annuity, book which can go out to 40 years or more), investing in UK infrastructure therefore makes a great deal of sense. It has the additional advantage of potentially good "recoverability" if things go wrong: there is a concrete (literally) asset which is identifiable and may be easier to get hold of than may be the case in a convoluted recovery and pay-out process on a defaulted foreign bond.

Regulation is key

The economics of infrastructure investment make sense for insurers and pension funds, but the way regulators treat the capital of financial institutions is equally important. The prudential capital regime (that is, how much capital is needed to back these investments) needs to be stringent enough to protect policy-holders, but not so over-cautious that it prohibits investment in anything other than government bonds. This is what the UK government recognised when, in the autumn of 2013, it secured an outcome to the EU's Solvency II negotiations on insurance capital that made infrastructure investment feasible.

The direct result of this was the agreement between HM Treasury and six leading industry participants that they would invest a collective £25 billion in UK infrastructure over the next five years. From Legal & General's perspective, this was if anything a low number. Our annuity book stands at £38 billion, out of a UK total of over £150 billion, and repatriating say £10 billion from just our investments in the US would be perfectly feasible.

Pension funds face the same economic issues, and the relevant regulation in their case is the IORPS Directive. They have complex governance, but the National Association of Pension Funds is making progress on an infrastructure fund, and a series of interesting examples from overseas (notably Canada) can help point the way.

Unrewarded (?) political risk

If the economics make sense, and the regulation is pointing in the right direction, then the next issue is the investments themselves.

Here we run into the matter of political risk. Infrastructure in a democracy is notoriously a political issue. If we look across categories of infrastructure (very broadly defined), we can see how difficult this can make investing for the long term.

- Housing (and associated development), which is arguably the simplest and most obvious form of infrastructure investment, is subject to a complicated, time-consuming and unpredictable planning regime.

- Energy investment is fraught with uncertainty about pricing regimes and preferred sources: an institution would need to think very hard about investing in, say, offshore wind or nuclear when it is entirely dependent on a subsidy regime that could be changed so as to render the assets in effect worthless.

- Transport is similarly political: for example, our London airports issue has been serially unresolved since the 1970s; we still await a decision on road pricing; and HS2 remains contentious and political to the extent that many serious investors will think twice before committing resources to even thinking about it.

The issue of political risk (including regulatory risks) can be approached in three ways.

First, the political process can try to mitigate it, either through achieving a higher degree of cross-party consensus on big projects (remembering that long-term investments last across the lifetime of several parliaments), or by establishing structures for delivery of projects that operate at some distance from the day-to-day political hurly-burly. In this respect, Sir John Armitt's proposals have much to commend them.

The second way is to price in the political risk, in the knowledge that rational capital seeks a reward for uncertainty. This of course can be unattractive for government, but can be a price worth paying at a time of fiscal constraint. Notably, government guarantees (as opposed to actual funding) do not appear on the national balance sheet, an accounting quirk that governments are increasingly happy to utilise.

The third way is in effect to split the risk, with government providing guarantees for the early stages of projects and retreating later, once the project is established, making way for private capital and moving its own capital on to the next initiative.

In practice, these approaches can be employed in combination: but the main point is that government must try to reduce political risk, and resist the temptation to meddle once a project is up and running. Otherwise the effect will be to drive institutional capital back towards pure private-sector investments, which stand or fall on their economic merits alone rather than depending on taxpayer subsidy and therefore on aspects of public policy.

We, for example, have found it relatively straightforward to invest in large distribution centres (such as for Tesco and Next) serving the needs of an increasingly online generation of shoppers – a trend presumably wholly immune to political intervention. It would be enormously encouraging if regional airports could fall into the same category.

Airports

For investors, this places a heavy onus on the fundamental economic case for airports, whether primary (like Heathrow), secondary (Gatwick, Stansted, Luton, Glasgow or Manchester) or more straightforwardly regional (Bristol, Bournemouth, Leeds-Bradford and so on). The fundamental economics clearly demonstrate room for growth – as discussed elsewhere in this publication. This confidence in the future is shared by the airport operators themselves: the last five years have seen 21 applications for expansion.

Britain's secondary and regional airports clearly have more available capacity, unlike Heathrow which is operating at full stretch. Moreover, a thriving regional airport can itself be a catalyst for further growth. At Legal & General we have a strong view that effective business hubs with sector specialities can drive regional economies: media in Manchester, car manufacture in the West Midlands and the North East, biotech in East Anglia and so on. Each of these is likely to be enhanced by good air links.

Different airports, of course, have different business profiles: the East Midlands is building a formidable freight presence, while Manchester is well used for business travel as well as by holiday traffic. Despite some impacts to user numbers and revenues from the recession, short-haul and leisure are hugely important markets: convenient flights to Tenerife, Alicante and Palma remain the bread-and-butter business for many regional airports. The CAA has modelled 95 million passenger journeys from regional airports and the trend is upwards as, for example, airports such as Liverpool John Lennon expand the range of destinations, and the broader impacts of returning economic growth are felt.

While economic modelling can support a good business case for investing in a leisure-centric regional airport, assessing business use is trickier. Recent data suggests a complex picture – it is virtually impossible to review this without also taking into account the relative strengths of hubs including Heathrow, but also competitors such as Schiphol and Charles de Gaulle. For example, data suggests that for business users outside London and the South East, only Manchester seriously competes with Heathrow. Lack of long-haul capacity from many regional airports is an issue: survey data suggests that many use the regional airport to make a short flight to a hub – with Amsterdam and Paris disproportionately winning business from Heathrow as the hub of choice.

The issue is therefore not just about the standalone economic merits of regional airports, but also how they fit in the broader scheme of things: can the UK provide an environment where the non-London traveller can benefit from the airport's proximity to home, and can they get to their destination either directly or, if a change at a hub is required, by doing so within the UK?

The London solution is therefore not something that can be ignored in the debate about regional aviation – indeed, it needs to be an input to the Davies Commission's thinking about the need for new runway capacity in the South East.

This brings us back, almost full circle, to the twin issues of long-term investment and political or regulatory risk.

The market delivered a good real-life illustration around the turn of the year as Spanish owner Ferrovial pondered the adjustment of its portfolio via the sale of its 25 percent interest in Heathrow and the acquisition of three regional airports (Aberdeen, Glasgow and Southampton) for a reported consideration of £950 million, or 12.3 and 10.7 times earnings for the Scottish and Hampshire airports, respectively.

The rationale for the switch was reported as being that CAA pricing policy made it difficult to achieve economic returns from an equity investment in Heathrow, whereas a more generous pricing policy existed for the regional airports. This is of course a logic that applies for equity holdings, and for holders whose outlook is not long-term in the same way as the UK institutions like Legal & General.

By contrast, those matching assets to liabilities over very long periods can invest in bonds (though equity is not out of the question, depending on the source of the investment) and are less hungry for short-term yield than for predictable long-term returns: we already have some fixed-income investments in airports. Bond investments could even be index-linked, if that matched the CAA's pricing regime.

By way of comparison, our £1.25 billion of investments in student accommodation permit the universities to charge very predictable rents, while the shortest tenure is 26 years and the longest 50 years, and similar economics apply to several hundred million-pound investments in social housing.

The investment case
Drawing these strands together, the investment case could be summarised as follows:

- There is a clear macroeconomic case for regional airport investment, especially as growth returns and capacity is utilised.

- Each investment would need to be considered on its merits, depending on whether the airport is business-, leisure- or freight-focused, and in what combination.

- The location and capacity of hubs in the UK and overseas is an important part of the equation: any London solution under consideration by Davies needs to gel with the regional airport infrastructure.

- The regulatory regime for airports (as for any other infrastructure investment) needs to be clear and predictable. Investment in new capacity must, so far as possible, be insulated from short-term political factors that cause uncertainty.

Most importantly, investment in regional airports can help spur broader growth in the regions – something the UK needs if a balanced and sustainable recovery is to be achieved. Long-term institutions have considerable "spare" liquidity and need long-term investment opportunities rather than investing into financial asset bubbles – clearly, we want those investments to make a positive difference to the broader economy, and provided we are not expected to take unrewarded political risk, will choose this sort of investment.

Chapter 9

The new hub solution – how a four-runway hub airport delivers the regional connectivity that the whole of the UK needs

James Brass, Principal Consultant at York Aviation

The new hub solution - how a four-runway hub airport delivers the regional connectivity that the whole of the UK needs

The UK is and has been for a long time a trading nation. London is an important part of this, but it is far from being the whole story. There are important world cities all across the UK. The Globalisation and World Cities Network identified Manchester, Birmingham, Edinburgh, Bristol, Glasgow, Leeds, Belfast, Southampton, Newcastle, Liverpool, Cardiff, Aberdeen, Sheffield and Nottingham as having world city status in its 2012 analysis.[1] This dispersal of the UK's international economy drives a need for regional international connectivity to enable growth and on-going evolution and development. It is against this backdrop that we need to considered the future role of the London airports, the global hub airport at Heathrow and a potential new four-runway hub to the east of London in relation to the UK nations and regions.

Heathrow is the world's busiest international airport now. It provides valuable connectivity to the world's business and trading centres. However, increasingly the nations and regions of the UK are becoming isolated from this powerful source of global connectivity. Fewer and fewer UK cities have an air service connection to the hub at Heathrow and, where these connections remain, frequency is often falling, making it harder to use the hub efficiently. Furthermore, it is not just UK domestic destinations that are being lost. Heathrow's route network is being eroded more generally, particularly short-haul destinations, and there is also a belief that the airport is not developing routes to emerging markets as quickly as perhaps it should. Ultimately this means that Heathrow's strength as a global connector for the UK regions is itself declining.

This paper considers the future for a London-based hub as a provider of connectivity for the UK nations and regions. Specifically it considers why a four-runway hub can change the current dynamic and why, ultimately, either a third runway at Heathrow or a second runway at Gatwick – or even potentially both – are suboptimal solutions in the long term. It considers the two main interlinked aspects of potential development that are important to long-run regional connectivity:

- the ability of the hub to deliver the best possible route network; and
- the ability to deliver stable, long-term access for UK domestic routes.

The key to understanding the potential importance of a four-runway hub to UK regional connectivity is to understand how we have reached the present situation: how

1 Derudder, B and Taylor, P *The World According to GAWC* (2013)

the UK has ended up with what is currently the best-connected hub airport in Europe in terms of economically important destinations but with increasingly few domestic connections to that hub. This requires consideration of the economics of hub airports and of the way that capacity constraints impact on the incentives facing airlines.

The hub and spoke models operated by network airlines, such as those that are the dominant forces at Europe's main hub airports, rely to a significant extent on network breadth. Serving a wide range of destinations enables these airlines to consolidate demand from a wide range of geographic markets on a single point, thereby enabling them to supplement demand from the local area immediately around the hub with demand from elsewhere on any given service. This makes it possible to serve routes that would not be viable (or at least not viable at the level of frequency offered) based purely on local demand. In other words, hub airports are able to offer a range of destinations in excess of what might be justified purely on the size and strength of their local catchment.

In relation to the question we are seeking to answer here, the point to note from this is that hub and spoke models are used to supplement local demand to build a broader route network. The underlying strength of an airport's local catchment area remains fundamental to its ability to develop a route network.

London remains an important city economy and a leading financial centre. The financial services industry is one of the largest generators of high-value business air travel, which is a core driver of profitability for airlines. It is one of the world's most visited cities for business and leisure tourism, which helps to provide a balanced inbound/outbound demand profile that is highly prized by airlines. It is the only city in the UK with the demand profile able to host the UK's hub airport.

The question then becomes: given the advantages that London offers, why is Heathrow not doing better? Why are the other European hubs offering a significantly greater range of destinations than Heathrow? The answer is, of course, the well-documented capacity constraints that face the airport. It is also the existence or otherwise of these constraints in the future that will determine the extent to which a London hub airport, whether at Heathrow or elsewhere, can develop the best possible route network and the extent to which it will be able to act as a hub airport for the UK nations and regions.

Capacity constraints at airports change the way that airlines behave by changing the incentives they face. Capacity constraints introduce distortions into the functioning of the market that ultimately impact on airline decisions about what to supply and when. This dynamic is highly complex, but some of the key prevailing forces are described below.

For those airlines based at Heathrow and which have hub operations there, decisions about new routes or route rationalisations become increasingly either/or in their nature in the face of constraint. If a new route is to be launched, or if a service is doing well and capacity/frequency needs to be increased, this must be at the expense of something else. The result is a drive towards revenue intensity (maximising the amount of revenue that can be earned per slot) because airlines cannot serve everything that is viable, and a retreat to the certainty of tried and tested markets where returns are relatively guaranteed. In other words, decisions become not about the standalone viability or network contribution of an individual route but whether that route is a better or worse option than others the airline is operating at Heathrow.

It is also results in the phenomenon of slot sitting, whereby airlines operate filler routes or frequencies while waiting for other potentially more profitable opportunities to mature or become operable to ensure that the highly valuable slot is not lost for future use. This removes liquidity from the slot market, driving up prices and making new entry from others even more difficult.

For those who serve their own hubs from Heathrow, such as Lufthansa, KLM or Emirates, growing capacity becomes harder. Slots are very expensive, so introducing new frequencies requires significant investment. Therefore, the choice is often to increase aircraft size to maximise the number of passengers that can be carried and drive up the level of revenue per slot. This contributes to rising slot values and a dynamic whereby it becomes uneconomic to operate small aircraft on relatively low-volume routes at Heathrow. It ultimately becomes more profitable for the operators of these aircraft to sell the slots to an airline that wishes to operate a larger aircraft on a higher-volume route.

For those that do not currently serve Heathrow but would like to do so, the availability and price of slots is a significant barrier to entry into the market. If the market to be served is felt to be strong enough (or in some cases where access to Heathrow is felt to be sufficiently strategically or politically important) then slots could be purchased, but the returns required to make such an investment viable would almost certainly mean that entry would be biased towards routes that can support or require larger aircraft.

In some ways it is in fact easier to describe the end result of this dynamic in terms of what has happened at Heathrow:

- The number of destinations served has fallen as airlines have focused on growing capacity on tried and tested markets with limited risk. This loss of network breadth is also slowly eroding Heathrow's ability to function as a hub airport. As destinations are lost it becomes harder for airlines to consolidate demand on Heathrow and they become more focused on the local London market, which, although exceptionally strong, cannot support the same range of destinations.

- The balance between short-haul and long-haul routes has shifted towards long-haul. These routes tend to be more profitable and support the economics of larger aircraft. They therefore tend to be more revenue-intensive for the airline and result in a more profitable use of a slot than a short-haul route. The decline in UK domestic connectivity represents a strong example of this particular change.

- Average aircraft size at Heathrow has grown and, particularly for short-haul routes, is substantially higher than at the other European hubs. This works against airlines seeking to serve relatively low-volume, short-haul markets, such as some of the smaller domestic points in the UK.

- There is a perception that the airport is failing to develop connections to long-haul emerging markets. This reflects the general risk aversion created within airlines based at Heathrow and the difficulty that overseas airlines have in entering the market to serve Heathrow given the lack of slots.

In other words the lack of capacity at Heathrow can be seen as the primary cause of the current situation we have described: a situation in which the UK has a very well-connected, but perhaps underperforming hub airport, which is increasingly isolated from many of the UK nations and regions. It also points towards the potential importance of a new four-runway hub airport. Without additional capacity at a London hub, the situation will further deteriorate. With additional capacity it should improve. However, it should be recognised that markets will continue to grow and the existing situation will simply recur in future if sufficient headroom is not created.

A third runway at Heathrow will add capacity and create headroom in the short to medium term. However, the work undertaken by the Airports Commission demonstrates that relief would be relatively temporary. By 2030, a three-runway Heathrow would be operating at 90 percent utilisation of capacity (compared to 99 percent now) and the problems that can be seen now would simply start to re-emerge. Even at 90% utilisation it is more than likely that no slots will be available at peak times of day and these slots are essential to the operation of a viable domestic or short haul service given the requirements of business users. By 2050, it would once again be completely full and there seems little reason to suspect the outcome will be different from what it is now. The result would be an underdeveloped route network at the hub and very little chance that the UK nations and regions would be able to get new connections or maintain frequency on existing routes.

A second runway at Gatwick would clearly provide additional capacity, but it is highly questionable whether this would result in a better outcome. Ultimately, airline hubs rely on concentrating demand on a single point. Splitting operations across two airports would undermine the effectiveness of any hub operation. Some have argued that Gatwick could become home to a second alliance, competing with oneWorld at Heathrow, but it is difficult to see who would operate such a hub. The other alliances have their existing European hubs and there is no UK native member of sufficient scale around which to base such an operation. Furthermore, in a world where there is a tendency towards consolidation in the airline market, it is also hard to envisage a circumstance where a new entrant would establish such an operation. It is more likely that additional capacity at Gatwick would instead be taken up by traffic of a similar nature to its existing base, with a heavy focus on UK outbound passengers and point-to-point markets. Overall, therefore, it seems unlikely that a second runway at Gatwick would be the best option in terms of overall route network development for the UK or that it would be able to act as a truly effective global hub for the UK nations and regions. It should also not be forgotten that Gatwick is itself increasingly constrained and that even with a second runway it would in the longer term still be so. It seems reasonable to suggest therefore that it too would suffer from many of the issues observed at Heathrow.

A combination of the two would again provide relief and would be an improvement on the current situation, but ultimately would not provide a long-term solution that would enable the air transport market to operate without constraints at a single location. Hence, it would be unlikely to deliver the best possible route network or to ensure accessibility for the UK nations and regions in the long term.

A new four-runway hub would, however, be different. It would have sufficient capacity into the long term so that airlines could make route development decisions based on route fundamentals rather than the distorted incentives caused by constraint. Its single location would mean that a hub could operate effectively, enabling the exceptionally strong local London demand to be combined efficiently with transfer demand as per the true hub and spoke model, thereby maximising the number of destinations that might be served and, given the strength of the London market, potentially create a hub airport with a route network substantially broader than its competitors. This would include allowing airlines to develop and reconnect domestic destinations that would allow the UK nations and regions full access to a reinvigorated London hub.

York Aviation's recent publication, *Making Connections: Improving the UK's Domestic Aviation Connectivity with a New Four Runway Hub Airport*,[2] examined the potential impact of a four runway hub on regional connectivity and demonstrated the benefits it could bring. It identified that a new four runway hub could provide enhanced connectivity to seven cities / regions with existing connections to Heathrow and could enable a further eight UK cities / regions to develop connections by 2050, resulting in economic benefits of around £2.2 billion in Gross Value Added and 18,000 jobs. This compares to the development of a third runway at Heathrow, which would result in no additional domestic services by 2050 and the loss of the existing Leeds Bradford connection.

2 York Aviation *Making Connections: Improving the UK's Domestic Aviation Connectivity with a New Four Runway Hub Airport* (2014)

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If you would like to know more about the Smith Institute please write to:

The Smith Institute
Somerset House
South Wing
Strand
London
WC2R 1LA

Telephone +44 (0)20 7845 5845
Email info@smith-institute.org.uk
Website www.smith-institute.org.uk

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