

## NPS Consultation Response: **Thematic Paper**

# Domestic connectivity

May 2017

### Key Points:

- The NPS cites increased domestic connectivity as a benefit of expansion but offers no commitment to this. This is because, legally, both Government and airport have very little ability to determine routes, which is fundamentally a matter for airlines.
- In the absence of any realistic prospect of intervention by Government or airport in the determination of routes, the market will prevail. In this case, the Airports Commission forecast that, with a third runway, Heathrow would offer just four domestic routes, half of the eight offered today.

## 1. Context

- 1.1 There are eight domestic routes currently operating from Heathrow Airport<sup>1</sup> down from eighteen routes in 1990.
- 1.2 Over the years, the number of domestic routes from Heathrow has decreased because the airport operates at around 98% capacity<sup>2</sup>. At this high level of capacity utilisation, slots are scarce, particularly at peak times. As such, there is an opportunity cost for each slot, as airlines weigh up the relative profitability of each route. In February 2016, a pair of slots at Heathrow changed hands for \$75m (around £55m). A domestic flight will struggle to show itself to be more profitable than an established longhaul route. As Heathrow has become increasingly capacity constrained, many domestic flights have inevitably been squeezed out.
- 1.3 This is an issue of concern for many parts of the UK who see their access to Heathrow as being of economic importance, both for the access to London but also the onward global connections that a major London airport can offer.

## 2. Claims for more domestic routes

- 2.1 The NPS echoes the Airports Commission (AC) and Heathrow Airport Limited (HAL)

<sup>1</sup> Heathrow Website <http://www.heathrow.com/plan-and-book-your-trip/destinations-and-airlines>

<sup>2</sup> NATS Website <http://nats.aero/blog/2014/05/managing-capacity-heathrow/>

in claiming that a third runway will boost domestic connectivity and cites this as an important benefit. The NPS highlights the opportunity to secure new domestic routes<sup>3</sup> and Heathrow's aspiration for six new domestic routes<sup>4</sup> is repeated.

- 2.2 However, it is telling that despite such claims, some of which featured prominently in the consultation material, the NPS offers no commitment to such an improvement in connectivity, nor any clarity on how it might be achieved.
- 2.3 This is because legally, both Government and airport, are heavily restricted in their ability to influence which routes are flown. This was something that was acknowledged by the AC<sup>5</sup>.
- 2.4 Indeed, this week, IAG, owner of British Airways wrote to the Government<sup>6</sup> to remind it that "It's not in Heathrow's gift to increase domestic flying from the airport. Airlines, not airports, decide where to fly based on routes' profitability."

### **3. Slot allocation rules**

- 3.1 The rules governing slots and routes are substantial and are designed to prevent unfair competition and distortions of the market.
- 3.2 As the AC set out, the Slot Regulation stipulates that "once a slot is allocated at a co-ordinated airport its use thereafter is governed by the Regulation, which generally permits the slot holder to transfer its use from one route or type of service to another. There is no exemption from this rule."<sup>7</sup>
- 3.3 HAL, as the operator can vary the aeronautical fees charged, but can only do so in line with the costs of providing the service. While the costs involved in servicing a domestic flight are lower – without the need for passport control or customs – the difference in charges will be dwarfed by the relative profitability of the route.
- 3.4 HAL has proposed a route development fund – and similar mechanisms can be implemented by Government bodies. However, these are restricted in use and, notably, time limited. When the funding ends, there would be nothing stopping the airline operating the route to switch the slots to a more profitable international route.
- 3.5 The main legal tool open to Government is the use of Public Service Obligation (PSO) contracts. These can be used to ensure flights to peripheral or development regions. However, there are several restrictions governing the use of PSOs.
- 3.6 PSOs are determined based on the economic need at the time; it would be illegal for

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<sup>3</sup> Draft National Policy Statement, 3.29

<sup>4</sup> NPS Foreword (destinations indicated are Belfast International, Durham Tees Valley, Humberside, Liverpool, Newquay and Prestwick)

<sup>5</sup> Airports Commission: Final Report, July 2015 – 15.12, page 314

<sup>6</sup> Daily Telegraph, 22 May 2017, British Airways anger at Heathrow's bid for more domestic flights

<sup>7</sup> Airports Commission: Final Report, July 2015 – 15.12, page 314

Government to make a future commitment to guarantee a PSO on a certain route. PSOs cannot be implemented when the regional airport in question is already served by another London airport. Nor is it clear whether a PSO can specify a particular London airport – given that PSOs are designed to connect cities, rather than individual airports.

- 3.7 As such, the legal options available to Government and airport to influence the destinations that airlines serve from an expanded Heathrow would be extremely limited.
- 3.8 The above restrictions are primarily codified in EU law. Some have perceived an opportunity arising from the planned exit of the United Kingdom from the EU, if the relevant EU rules were not enacted into UK law. However, any potential gain from suspending such competition rules applicable to aviation would have to be weighed against the likelihood of the UK being excluded from the single European aviation market, which could have far-reaching consequences for UK connectivity. As such, the Government would be right to assume that the restrictions on slot allocation will continue to apply.

#### **4. Domestic routes: likely scenario**

- 4.1 In the absence of any realistic prospect of intervention by Government or airport in the determination of routes, market forces will determine the use of new slots that become available following expansion of Heathrow.
- 4.2 Analysis by the AC found that, even with a third runway, the number of domestic routes offered by Heathrow would fall to just four<sup>8</sup> (without expansion, it predicted three routes).
- 4.3 This should come as no surprise. The AC found that an expanded Heathrow would be operating at 80-90% capacity by 2030, shortly after the opening of a third runway<sup>9</sup>. At this level of capacity utilisation, slot availability would already be constrained, particularly at peak times, and airlines would make the same trade-offs as they maximised the profitability of their slots.
- 4.4 The suggestion in the NPS that domestic connectivity would improve as a result of Heathrow expansion is therefore wholly misplaced. Those around the UK pinning their hopes on a third runway to give them direct flights to Heathrow will find themselves sorely disappointed.

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<sup>8</sup> Airports Commission: Final Report, July 2015 – 3.29, page 77

<sup>9</sup> Draft National Policy Statement, Appraisal of Sustainability, Appendix B, Table 9, page 22