

APD Discussion Paper
Energy and Transport Tax Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ



8 September 2015

Dear Sir,

Devolution of Air Passenger Duty

I am writing on behalf to the Regional and Business Airports Group (RABA), which I chair. We are a group of 32 smaller airports from all corners of the UK, all of which handle less than 3 million passengers per year, commensurate with the definition of “regional” airports under the European Commission’s 2014 guidelines. Our members offer a combination of regional scheduled and charter air services to a range secondary cities and sub regions, which between them represent 40% of the UK population and over 60% of its land masse. They also support high value business aviation, the multi-faceted strands of the general aviation sector and the great majority of the other specialist aviation and aerospace activities which cannot be accommodated at busier passenger airports, but make such a large contribution to the UK economy, either directly or indirectly.

Air Passenger Duty is damaging to Regional Aviation and is particularly damaging to the sustainability of smaller regional airports which host low volume and highly cost sensitive services. Damaging regional aviation is therefore also to impair achievement of the Government’s Policy objectives of securing new regional economic growth and of emphasising a One Nation approach to future growth and prosperity. Enhanced connectivity is vital to improved regional economic development – and APD has the opposite effect. APD must be restructured if smaller regional airports are to be able to make their full contribution to the Government’s social and economic goals.

The relationship between airports and their local, sub-regional and regional economies as reflected not only in industry commissioned studies but the academic literature and its own research, including most recently, the extensive work undertaken by the Davies Commission. As a direct employer, facilitator of business and inbound tourism related travel, catalyst for inward investment and the centres of business clusters, thriving regional airports are very often key economic drivers within their catchment areas. Additionally smaller airports also offer life-line links to health, educational, political and other public services in remote and island communities, as well as social-economic opportunities to the communities within which they operate, often acting as a facility for the community as well as an attraction in their own right. Indeed RABA’s members are very keen to expand their role as a “community” airport, but these frequently significant but intangible benefits will only be available if the UK’s smaller airport’s remain viable. And at the moment, the current structure of the APD system is one of the major threats to their future, alongside market

distorting regulatory cost burdens and planning regulations that restrict the scope for achieving commercial sustainability and the lack of access to a national hub.

Therefore, whilst RABA recognises of the vocal concerns of some its larger regional airport colleagues about expected changes in APD within Scotland (and potentially Wales) and their potential impact on English regional airports (as illustrated by empirical evidence from the Netherlands and Ireland), this is a side issue for our member airports compared to the overall APD burden (and its differential impact) on smaller airports.

Attached at Appendix A is a summary of analysis we submitted to the Davies Commission in July 2013. That analysis and the conclusions drawn stand the test of time and are submitted here for your consideration.

In summary it makes clear our view that APD is a market distorting tax which impacts far more heavily on smaller airports than larger ones, putting them at a material disadvantage compared to their competitors. So while in these financially straitened times, the widespread industry view, RABA's included, that APD should be abandoned completely or at the very least cut across the board (to reduce associated market distortions), we are sanguine that such a measure is unlikely to be supported by government – at least in the short to medium term. Nor more pointedly is it one of the options that has been put forward for consultation.

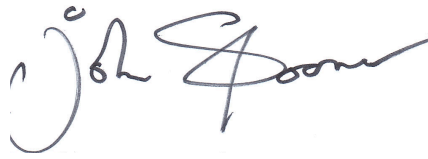
Within the limited options put forward, the RABA membership considers variable APD rates within England as the most likely to support the operations and viability of smaller regional airports. We do not, however, consider the scenario modelled by in HMRC in 2012 (paragraph 3.6) based on a 50% increase in APD at larger airport an appropriate basis for decision-making. What is needed is an approach which combines APD increases at larger or congested airports where marginal price increases would have much more inelastic impacts on demand, but reduces it as smaller airports below the EU 3mppa threshold.

Given that airports over 5mppa represented 82% of passenger traffic in 2014, and are the source of the greater proportion of long haul and higher APD rated traffic, an very modest increase of the order of 5-10% at these airports would offset APD's complete removal at all other airports, helping not only to mitigate existing market distortions but also to ensure runway capacity across the country is being used optimally. Alternatively, an approach that used modest increases in APD to capture surplus market rent at congested airports (ie those with over 85% capacity allocated), to reduce APD at smaller regional airports, could be made both fiscally neutral and generate national and regional economic surpluses. The analysis in Appendix A illustrates the former, whilst we also have access to other confidential analysis, which demonstrates the latter. This can be made available on request. What is clear is that no work has been done using DfT's suite of Airport models to look at this kind of fiscally neutral approach to the re-structuring of APD. In our view it is essential that it is and that the time to do so is now.

This, then, is the approach to APD restructuring the RABA Group advocates be examined and ultimately pursued– i.e. a marginal increase in tax at congested or larger airports and a reduction in, or elimination of, the tax at smaller airports less than 3 or 5 million mppa. Although the detailed design could be iterated, conceptually and analytically we are clear that this kind of change to the structure of the tax is capable of combining fiscal neutrality with valuable support for growth and improved commercial sustainability at small to medium sized airports and enhanced connectivity and job creating activity in the

core/secondary city and sub regional/regional economies they serve, while helping to manage demand at the most congested airport facilities in the country.

Yours faithfully

A handwritten signature in black ink, appearing to read "John Spooner". The signature is fluid and cursive, with the first name "John" written in a larger, more prominent script than the last name "Spooner".

John Spooner
Chairman – Regional and Business Airports Group

Appendix A: APD section of RABA Submission to Davies Commission - July 2013

55. The impact of APD on passenger demand is related to the percentage of the total fare it comprises and therefore the extent to which its removal [or accretion] would effect net yields (i.e. profit per seat sold). On domestic and short haul routes all evidence points to the fact that relatively modest increases in the tax quickly impact on route viability route viability in the context of average fares per sector of £75-100 for domestic and £150-£200 for international. The literature on this is extensive and we do not propose to rehearse all of its findings here. Sufficed to say, the price elasticities by band provided in IATA 2011 analysis¹, which are set out below, equally suggest substantive reductions in the tax will have a significant upside impact on demand as evidenced when equivalent taxes have been eliminated or reduced in other EU countries, most notably the Netherlands and the Republic of Ireland.

- Band A = 1.2
- Band B = 0.92
- Band C = 0.75
- Band D = 0.72
- Band B-D = 0.84

56. In 2012, HMRC published its own report into the impact of introducing price differentials, such as those that might be created by the differential application of APD, at UK airports². This report draws upon analysis completed using DfT's Aviation Model, the same model that produced DfT's 2013 aviation forecasts and which [was] used by the Commission in taking forward its work. The report argues that because the model is designed to capture the key inter-relationships between demand at different airport, it is well suited to this work. However, it also is recognizes that, as with all models, it is a simplification of reality and can never capture the full complexity of the aviation sector and that as such, although specific changes in demand for particular airports are cited within the report to illustrate the potential effects, the emphasis of the project was therefore on finding consistent patterns of results across a range of price changes within each scenario.

57. The scenarios examined included the effects of likely reductions in the rates of APD associated with devolution of the tax in Scotland, then separately in Wales, followed by various forms of increased rates of tax for Heathrow and Gatwick. What the 2012 report does not consider, is what many in the industry have been asking for some considerable time, namely either a removal of the tax completely or a combination of modest increases in the levels of tax at Heathrow and Gatwick, but combined with reductions at small and medium sized regional airports and/or other airports in the South East airport system. We can only imagine the decision to ignore these two scenarios was deliberate,

¹ IATA (2011); Economic Impact of HM Treasury Proposals on UK Air Passenger Duty

² HMRC (2012): Modelling the Effects of Price Differentials at UK Airports – HMRC Research

² HMRC (2012): Modelling the Effects of Price Differentials at UK Airports – HMRC Research Report 188

but we have considered the latter the scenario below.

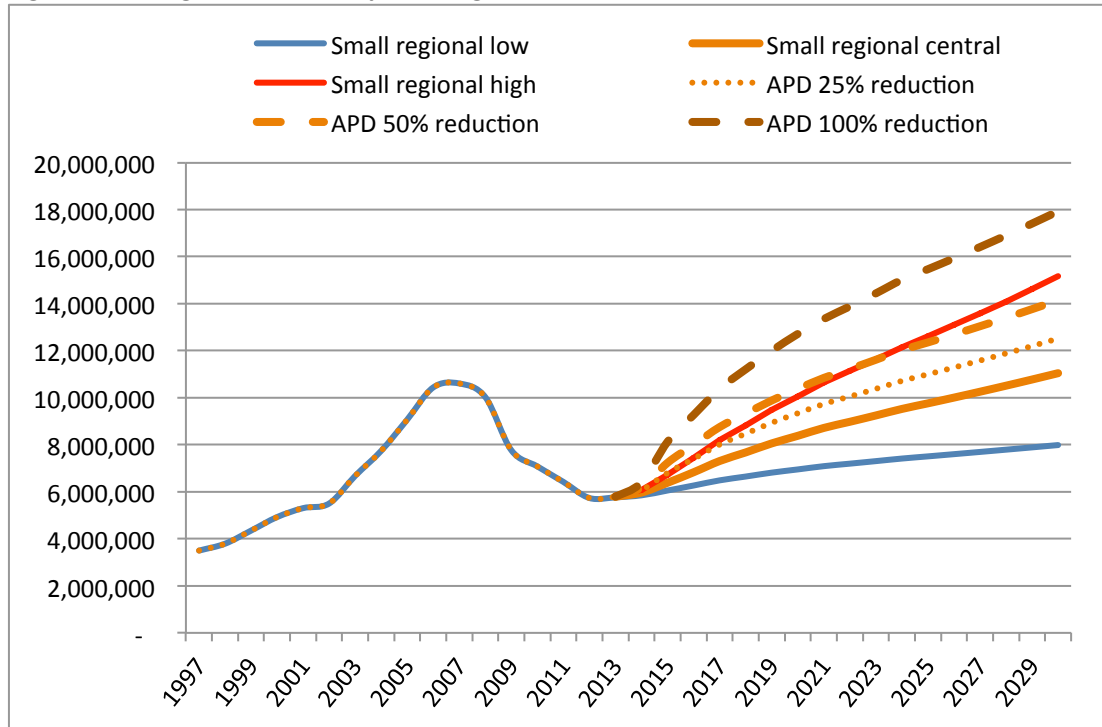
58. What the HMRC report appears to tell us is that because the size of the tax is quite small in terms of the total cost of a flight (including fare, cost of travelling to the airport etc.), even changes equivalent to doubling the tax at Heathrow and Gatwick have a relatively small impact on total demand [at those airports]. It is argued that this is because passengers would be prepared to accept higher prices to a certain extent, in order to travel from airports that offer them greater frequency and connectivity benefits. This means there is a high degree of price inelasticity at these two airports and the more modest increases in tax than those examined by HMRC would almost certainly result in there being little or no impact on passenger demand at either of them.
59. Secondly, the model predicts that price increases at Heathrow and Gatwick may only result in a shift of passengers to other airports in 'close proximity', as passengers would still prefer to travel from the same area (i.e. the South East) to minimise any additional surface travel cost. It also suggests suppliers would look to satisfy this demand by switching services to other airports nearby who are unaffected by the price increases and have the necessary spare capacity. While we think that these results are heavily influenced by assumptions associated with the 'spill function' within the DfT model, with demand being displaced as a result of 'theoretical' price premiums to the next nearest airport, there seems little doubt that if other airports within the South East, particularly those with spare capacity such as those in second tier at the outer edges of the region (e.g. Manston, Southampton, Southend) or just beyond (e.g. Norwich, Gloucestershire, Cambridge and Oxford) would benefit from the carrot and stick effect of a reduction in the level of APD. In our view, however, this would be less a function of spill traffic as assumed in the model, but of demand originating close to those airports being 'clawed back', by the resulting price differential.
60. In the case of airports that are more remote from the South East, the spill function in the model becomes increasingly diluted and uncertain, making it much less reliable as an explanatory mechanism. At these airports, we believe the generic behavioural response of a tax reduction will be to stimulate underlying demand as a result of fare reductions or airlines putting on more routes because they can capture some of the former tax pricing in higher yields. Most evidence on fare elasticities shows that thinner more marginal routes from small regional airports are more responsive to fare reductions than thicker mores established routes at larger regional airports.
61. With this in mind, and using a range of implied demand responses from reductions in APD from the HMRC report and other evidence³⁴, we have modelled the outcomes or a number of tax reduction scenarios against the central forecast we produced for the small airport sector outside the South East in our response to the demand forecasting

³ Cornwall Council (2008): Air Passenger Duty Consultation – Newquay Cornwall Airport. [This indicates a price elasticity of -1.5 for NQY, resulting in potential demand reductions of around 25-30% associated with doubling of APD, or increases of similar amounts if it were removed, but with none-core routes being more sensitive to any tax changes and therefore more likely to be subject to closure]

⁴ Consortium of Scottish Airports (2012): The impact of APD on Scottish Airports

discussion paper. The response took the form of asymmetric increases in demand relative to assumed background growth over a 5-year period, peaking at between 5-25% in the year after the tax is reduced and rapidly declining thereafter. The results are shown in Figure 4 below, in the form of comparison against our previous long run forecasts.

Figure 4: Changes to Small Airport Long Run Demand Forecasts from Reductions in APD



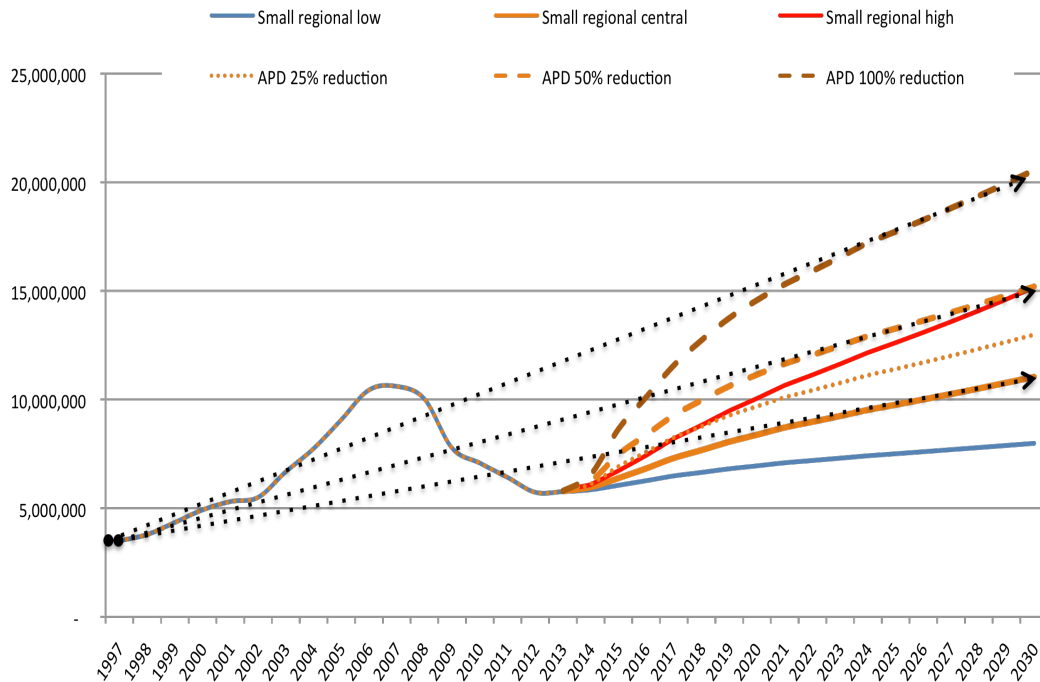
Source: Consultants Calculations

62. The results are interesting and plausible in the context of an APD charge of £13 representing 30% of Ryanair’s average short haul fare of £44 in 2012⁵. The effect of a 50% reduction in APD is to increase central case demand close to the previous high forecasts with elimination of the tax taking projected demand well beyond that to close to 18mppa by 2035, compared to 11.5mppa in the original central case.

63. If we then compare these results against the pattern of demand at the same airports since 1997, as in Figure 5, it become clear that the central case forecast with APD will result in a long run demand outturn below even the growth rates before the economic and low cost carrier boom for small airports between 2002-08; that a 50% reduction in APD would do no more than restore the long run pre2002 trend-line, while eliminating APD would produce a long term outcome equivalent to extrapolating a mid point between pre 2002 and 2002-08 growth trends

⁵ House of Commons All Party Parliamentary Aviation Group (2012): Inquiry into Aviation Policy and Air Passenger Duty

Figure 5: Comparison with Long Run Trend Projections



64. There is therefore, no doubt in our minds, that APD has had a disproportionately adverse affect on small regional airports of less than 3mppa and particularly those outside the South East. Effectively, the tax itself, and particularly the 'double whammy' impact of the tax on both legs of domestic air travel have distorted the market significantly for these airports and the catchments they serve, not only because the impact is greater on more marginally profitable services but because for many such airports domestic flying is a big part of their overall business. And this is now beginning to feed through into their commercial viability

65. While we reluctantly accept that the Treasury are unlikely to give up its APD revenue stream with the public finances as they are today, we would like to propose that it supports a re-structuring of APD so that the revenue lost by reducing the tax for airports of less than 3mppa, is replaced by small incremental rises in APD at Heathrow and Gatwick. As we have seen from the HMRC report, the latter is likely to have little or no impact on demand from these airports, but a reduction or elimination of APD for smaller regional airports certainly would ensure they can contribute far more of their potential to help address airport capacity shortages within the South East over the next 10-15 years.

66. Table 3 and 4 below, show the effect of the offsetting of tax reductions on UAG group airports plus Cardiff and Humberside, on Heathrow and Gatwick to achieve revenue neutrality for the Treasury. We believe the case for this kind of modest intervention is both compelling in terms of supporting the growth of smaller regional airports inside and outside the South East, with all the benefits that would bring, but more importantly is and unlikely to be noticed by passengers or have any material affect on demand at London's major hub airports. As an absolute minimum, given the DfT model the Commission are using in its work was used for the HMRC report, we would ask the Commission to at least ask for our revenue neutral offsetting proposal to be modelled.

Table 3: Share of APD Contributed by Smaller Regional Airports and LHR/LGW

	Pax 2012	Pax Share	APD	% APD Share
UK Regional Airports Group (Dom)	1,960,740	5%	12,744,810	5%
LHR & LGW (Dom)	5,192,654	13%	33,752,251	13%
Total UK Domestic	40,387,698	100%	262,520,037	100%
UK Regional Airports Group (Int)	3,755,039	2%	24,407,754	1%
LHR & LGW (Int)	95,591,290	52%	1,988,731,301	72%
Total UK Int	182,311,541	100%	2,767,349,581	100%
UK Regional Airports Group Total Pax	5,715,779	3%	37,152,564	1%
LHR & LGW Total Pax	100,783,944	45%	2,022,483,552	67%
Total UK Pax	222,699,239	100%	3,029,869,618	100%

Source: Consultants Calculations

Table 4: Offsetting Increments at LHR/LGW for Different forms of Differential APD Interventions

All Regional Airports with Less than 2mppa	Total Pax 2012 9,778,278	Approx APD £63,558,807	As % of Total APD 2.10%
If APD taken away from airports of less than 2mppa and added to LHR LGW it would equate to and extra fee per passenger of	£1.26		
All Regional Airports with Less than 1mppa	Total Pax 2012 6,004,625	Approx APD £39,030,063	As % of Total APD 1.29%
If APD taken away from airports of less than 1mppa and added to LHR LGW it would equate to and extra fee per passenger of	£0.77		
UK RAG Members	Total Pax 2012 4,694,239	Approx APD £30,512,554	As % of Total APD 1.01%

If APD taken away from airports from UK RAG and added to LHR LGW it would equate to and extra fee per passenger of	£0.61
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Source: Consultants Calculations