



Damian Devlin | University of West London, UK

# THE MARKETISATION OF AIR TRANSPORTATION PUBLIC SERVICE OBLIGATIONS

*Exploring the conditions under which air transportation public service obligation subsidies might become a successful investment in the economic development of peripheral regions*





**A**ir transportation Public Service Obligations (PSOs) are an EU regulatory mechanism which allows governments to correct air transportation market failures by supporting services to peripheral regions. This article reports the first findings from a study that explores the conditions needed for a shift in the paradigm of PSO funding, from that of subsidising an air service to an investment in the regional development, while simultaneously creating greater demand for that service.

### Background

The importance of aviation to the UK economy has recently become a high-profile topic, not least because it is central to the argument for a third runway at Heathrow airport. In 2015, even before Brexit and the renewed vision for a global UK had emerged, the Airports Commission (2015) urged the government to confirm Heathrow's expansion quickly and demonstrate the country's commitment to remaining a well-connected and open economy. The benefits of a well-connected economy are considerable and include facilitating foreign direct investment; attracting tourists; increasing market reach, and business productivity improvements (Airports Commission, 2015). However, in order for a region within the UK to gain the benefits of air transport connectivity, it must first have access to it and access is not evenly distributed throughout the country.

The main cause of the differences in access to aviation connectivity across the country is the lack of demand on routes to peripheral regions, i.e. those regions with small populations and low levels of economic activity, which makes these so-called 'thin routes' unprofitable for commercial

airlines to operate. Prior to the creation of a single European aviation market in 1992, 'thin routes' were either subsidised directly by governments or cross-subsidised by a national airline. However, the involvement of governments in the aviation market went beyond simply supporting 'thin routes' and protectionist bilateral agreements created a fragmented market that suppressed competition, at the expense of passengers (Reynolds-Feighan, 1995). The extent to which passengers have benefited since the creation of a single European aviation market is typified by the travelling behaviours fostered by airlines such as EasyJet and Ryanair. But the new competitive environment and profit orientation of airlines left services to peripheral regions vulnerable, as airlines would no longer cross-subsidise loss-making routes. To close this gap, the EU developed public service obligations (PSOs) as a mechanism that permits governments to support 'thin routes'.

### Public service obligations

A government would consider implementing a PSO in the event of a market failure because of the positive relationship between aviation connectivity and economic development. The only circumstances in which EU regulations permit the implementation of PSOs are when a route is essential for economic or social purposes. Once a PSO is approved by the EU, governments are able to regulate competition on it or compensate an airline for losses occurred while operating it. In either case the airline is selected following a tender process and the route must adhere to strict criteria governing the eligibility and proportionality of a service, which balances the connectivity needs of the peripheral community with maintaining a competitive aviation market (European Commission, 2017).

### The challenges of peripheral regions

A key determinant of a region's prosperity is whether it has a core or a peripheral location. The core-periphery structure is a feature of modern society which is organising increasingly into core cities, where people and businesses are concentrated, within expanses of less populated or economically active rural and remote peripheral regions. By 2030 the global population living in cities is forecast to reach 60%, double what it was in 1930. Cities first located and grew, where they did, because of advantageous natural resources and topological features or the early adoption of emergent technologies, like canals or railways. However, cities have continued to grow long after the value of the original advantage had diminished.

Businesses tend to agglomerate – determined by the concentration and dispersal forces that pull and push them towards a location of greatest benefit and regulated by the cost of transportation. Businesses agglomerate because the concentration of economic activity and markets creates opportunities to increase profitability which, if these are greater than the transportation cost of accessing their markets in other locations, attracts more businesses, workers and investors (Fujita, Krugman & Venables, 1999). However, concentration also causes congestion and increases competition and these things add costs. Economic activity is dispersed when the cost of being part of an agglomeration become greater than profitability gains or transportation costs, and businesses are pushed to re-locate to less congested regions (Martin, 2008). Another form of dispersal force is when economic activity such as agrarian and mineral extracting activity or any activity requiring heavy industrial plant is immovable (Ottaviano & Puga, 1998).

Traditional sectors have, for years, provided employment in peripheral regions, but automation and globalisation have caused their demise. Governments advance policies that strengthen agglomerations because the 'spillover' of benefits into peripheral regions cause economic convergence. However, the greater the distance a region is from an agglomeration the weaker the spillover benefits are – until they become negligible. Peripheral regions then become locked into conditions determined by past circumstances and unequipped to compete in the modern economy, conferring on them a lagging region status in need of ongoing development support (Martin, 2008).

The approach traditionally taken by governments to regional development has been centrally determined and 'spatially-blind' policies that took no account of the circumstances of a particular region and entailed different approaches to equity redistribution. Recently growth-orientated 'place-based' policies have emerged which acknowledge regional differences and recognise that economic growth can be achieved locally by valorising unique local assets. The role of place-based development strategies is to assist peripheral regions identify and exploit these opportunities (Barca, 2009). The driving forces behind these strategies and through which

value from local assets will be unlocked, are entrepreneurship and attracting knowledge intensive sectors (Stephens, Partridge & Faggian, 2013). However, peripheral regions, when compared to core centres, face two challenges in delivering place-based strategies. Firstly, they lack the necessary commercial capacity and capability, and secondly, their remote locations and inferior transport connectivity makes external markets, labour pools and collaborators less accessible. Arguably, these seemingly different challenges are in fact the same issue viewed from two different perspectives, because the causality flows in both directions, which is to say, economic activity generates connectivity demand and connectivity facilitates economic activity and thus they sustain each other.

### The study of public service obligations in the UK

The economic characteristics of agglomerations and urban centres are comprehensively studied, whereas those of peripheral regions are less well understood and the conditions necessary to encourage entrepreneurship and attract knowledge sector businesses are not yet sufficiently developed. Public service obligation (PSO) studies are concerned only with supply side matters, while insufficient attention is paid to understanding the conditions necessary to increase demand for PSO services from within the regions they serve. Increased demand could create favourable conditions for competitive PSO contract tenders and introduce the possibility for a reduction in public subsidy or their imposition by regions that might otherwise view them as unaffordable. Identifying a framework of technical or policy conditions that could stimulate greater demand for PSO services could lead to a reduction in the need for public support or the eventual marketisation of the route. Such a framework could be used by policy makers and practitioners, when defining appropriate criteria for the proactive utilisation of PSOs in regional development strategies or in devising pathways that take PSOs from publicly underwritten to commercially self-sustaining routes.

Local authorities are caught in a practical and political 'tug-of-war' to maximise the level of social services they provide the community, on one side, and, on the other, to support business growth by subsidising services. Then, each region's peripherality is compounded by intra- and inter- regional overland connectivity shortcomings, caused by environmental disruptions; thin and poor-quality transport networks, or a combination of both. Moreover, the local authorities' commitment to supporting aviation connectivity, whilst not insignificant, only partially matches the total funding necessary and they remain critically reliant on central government funding. Further, transport connectivity is crucial to the success of the development strategies that regions have adopted, which are dependent on knowledge intensive sectors that are outward looking. Finally, the long-term timeframe of these development strategies is not matched by the permissible duration of a PSO or the shorter government funding commitments.







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The literature on regional development and air transportation connectivity has shown that both the decision to implement a PSO on a route and the level of demand for that route is influenced by a range of organisations, circumstances, assets and externalities – which are bound by a complicated network of relationships. The nature of which, and how they might impact on or be impacted by regional development strategies and PSOs, could also differ by region. Therefore, this study explored the perspectives of local and national governing authorities, businesses and organisations, and the perspectives of business leaders and service providers. This was in order to understand the influence that location and local conditions have on a region's ability to achieve economic growth through place-based economic strategies, and how fully the current PSO service is able to support such strategies. Doing so would help to identify any changes necessary to PSO arrangements that would positively influence the use of air transportation in overcoming location and local challenges, as well as changes necessary in attitudes towards PSOs to positively influence the marketisation of these routes. The regions studied are those areas served by Cornwall Airport Newquay, Derry City Airport, and Dundee Airport as these are the catchment areas of UK airports with a PSO service to London. In examining

stakeholder perspectives three key ideas emerge. Some of these findings are categorised as (1) passenger choice; (2) the feasibility of alternatives, and (3) low connectivity confidence.

#### **Passenger choice**

Interviewees described how the air service from London was important to businesses as a tool to dispel the misconceptions that clients hold about a business competence based on its peripherality:

*'we'll have shown them that we aren't a bunch of yokels... we'll talk about the airport all of the time to try and make them comfortable that we are not out in the sticks'*

*'we have to show them that we can get to them just as quickly when we are needed'*

However, they reported that there were few options for bringing clients into the region for business:

*'We wouldn't even suggest the train. The length of the journey just adds to the idea that we are removed from everywhere'*

A greater fear they described was that it would be an even more damaging message if the current PSO route was discontinued:

*'How could we be taken seriously? We're telling people that we're serious about business and at the same time we take it away. Nobody would take us seriously.'*



The high value that business attaches to the air service to London does not translate into their consistently using it for their own travel needs. Reasons like high fares or service levels might have been anticipated, except that there can be a high inconvenience cost to choosing the alternative mode or airport:

*'If I have to be at a meeting in London at 9am I'll get up at 3am to get the bus to [alternative airport] to catch the 6:30 flight.'*

For other participants, the decision to make a journey by rail is one of productivity:

*'On the train I can have meetings with my team or we can prepare for presentations. Other people can join us at stations along the way.'*

*'The train takes me right into the heart of London. By plane I have to drive to the airport, park, wait at the airport, get through the airport at the [arrival airport], hope there aren't problems getting into London and then get a taxi or tube to where I need to go. Then I have to do it all again going home and hope I don't miss my one flight back.'*

### The feasibility of alternatives

Local entrepreneurs in particular are willing to contend with high levels of inconvenience to gain the best value price and service, either by using an alternative mode or an airport further afield. Due to the strong attachment they had to the region, such levels of inconvenience had not

prompted them to consider relocating. However, this does have implications for business growth as it might constrain their ambitions:

*'It's exhausting. Getting up at that time of the morning really knocks it out of you and there's only so much of it I would do. Yes, yes it would limit what we can do.'*

Investors or businesses exploring new locations begin with a low tolerance of poor-quality connectivity and this can hinder the region as a choice as a business destination:

*'When we are showcasing, they won't even get to see the [region]... they have a clear idea of what they need to see and have very little time to see it. They want to fly in, see what they need and fly out again... If takes two hours out of a day just to get them up there and then they don't get to see everything they have told us to show them, it's too much of a risk.'*

*'we had wanted to base everybody there, but now it is just back office functions. Professional services, senior consultants, we have had to open a London office to base them in. Bottom line, we had planned on 300 staff there, but now it's only 80.'*

### Low connectivity confidence

Participants described the role that funding arrangements have for confidence levels in the future security of aviation connectivity. Within the business community this is simply an





impression that they had gained, without necessarily knowing why. Nonetheless it creates levels of uncertainty that range from unhelpful to inhibiting:

*'From what we read in the newspaper, you know the airport gets money from the council... but we don't even know if the airport is going to be there in a few years' time, so we can't rely on it.'*

*'The council should tell us what's happening instead of us finding out through social media. I could be employing ten staff in a year, but I need to know if it can be here or in London.'*

For those participants involved in council transportation planning this is a more immediate and serious issue:

*'Without the PSO route there wouldn't be an airport.'*

The local authorities understand the importance of air transportation connectivity to the local economy, which is why they also support the region's airport in addition to the PSO. It is this combined sum which they take into account when balancing the need to support the local economy with a responsibility to provide community services.

*'We know that it is important to the region, we know it is an investment. But what do we not spend the money on instead? The schools, emptying the bins? We already spend millions on the airport. There has to be a limit.'*

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### Conclusion

There are measures that could increase the contribution of PSOs to a region's economic development. Entrepreneurs and investors in innovative businesses and modern sectors are critical to the development strategies adopted by the regions but they require unencumbered access to international markets. If they are to start-up or locate to a peripheral region they need to be confident that market connectivity will be maintained into the future. It is unlikely they would have sufficient confidence in a region's connectivity unless the commitment to a PSO and the necessary funding was similar to the long-term timescale of the development strategies, which ultimately will generate growth in demand for the route. The criteria for defining the quality of transport connectivity options, and whether different modes or airports are actually suitable alternatives, also needs rethinking.

While businesses located in a peripheral region benefit from lower congestions costs than in a city, they also forgo the benefits of a city location. To compete as a business destination a peripheral region must ensure that the lower costs, which make it attractive, are not simply replaced by the cost and inconvenience of inadequate connectivity. Therefore, the connectivity a PSO provides needs to be the highest attainable, and not a 'least bad' option. To achieve this the justification and funding for a PSO should be determined by an assessment of a region's actual needs, i.e. those that will support regional development goals, and not by that which an arbitrary budget can afford. Likewise, PSO contract conditions that prevent aircraft being utilised for other services should be resolved so that bureaucracy does not limit connectivity.

Operational procedures and revenue management strategies should also be re-engineered to better reflect the attitudes and realities of businesses in peripheral regions. Entrepreneurs in particular are pragmatic in their thinking and view air transportation as they do other utilities. They are particularly sensitive to the cost of fares and are surprised not to receive promotional activity similar to other services. They also object to pricing strategies which, because of their pragmatic attitudes and an awareness that a lack of transport options makes them a captive market, they view as profiteering. To them a fare increase is the failure by the airline to understand and respond to their connectivity needs.

These preliminary findings are only a snapshot of the research project and they will be developed further as the study continues. They do suggest however, that entrepreneurs located in peripheral regions are less sympathetic towards some of the aviation industry's norms that 'frequent flyers' are accepting of. Possibly because they are more sensitive to the time and financial cost of business travel, they appear motivated to explore all options to find the one most acceptable on each occasion. To address the issues affecting demand, local and national government may need to reconsider their priorities when assessing a PSO route and airlines might benefit by reviewing the suitability of their commercial and operational practices in this market. In addition, there appears to be a gap between the long-term nature of the economic development strategies adopted by peripheral authorities and the limited duration of a PSO. This implies that a long-term approach is required to the regulation and funding of PSOs to align these with the needs of the economic development strategies. This would provide certainty to the prospective industries and investors essential for economic growth and from which increased demand for the PSO service will be derived.

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### About the Author

Damian Devlin is a research student at the London Geller College of Hospitality and Tourism

### Keywords

Air transportation; connectivity; peripheral regions; public service obligations; regional development