

## **CONSULTATION ON THE STATUS OF STANSTED AIRPORT RESPONSE BY DAVID STARKIE:**

On 14 March 2007 the Economic Regulation Group of the CAA issued an open letter requesting evidence and advice on the issue of the (de)designation of Manchester and Stansted Airports. The responses to this request were published by the CAA on its website on 8 May. There were 7 responses, 6 from airlines or their trade associations. The easyJet response was principally concerned with Stansted and was the only one with this focus. Because of the importance of the airlines' views on the (de)designation issue, my approach to the Department's Consultation is to concentrate on their concerns, as expressed in their responses to the CAA's open letter. This is my response to the Department's Consultation on Stansted. It focuses upon the concerns of easyJet. As recorded in my oral evidence to the House of Commons Transport Committee (*The Work of the Civil Aviation Authority 13<sup>th</sup> Report, Session 2005-6*) I am in favour of Stansted being de-designated.

**“easyJet believes that airports can have market power [and] that given the opportunity airports will take advantage of their market power.”**

The first part of this statement is largely self-evident: all point-of-service activities set in a spatial (geographical) market potentially have some degree of market power as a result of the costs of overcoming geographical separation between customer and point-of-service. Thus, the local convenience store has some market power given that for those customers located close to it, it is more convenient to use than other retail outlets. However, the store's ability to exercise this market power is limited to by its ability to price discriminate between customers faced with different degrees of (in) convenience. This important feature, the (in)ability to segment and thereby align the sub-market in relation to market power, is an important issue in relation to airports (see below).

The second part of the statement is a belief for which no evidence is provided. Whilst it might be considered reasonable to expect airports to take advantage of their market power, there are in fact reasons why airports might choose not to fully exploit even substantial market power but to attenuate aeronautical charges below the profit-maximising level. Because airports normally gain much of their revenues from retailing and other passenger related activities (associated with which are rents reflecting a superior location), the airport has an interest in increasing passenger volumes. This provides an incentive for airports to attenuate the aeronautical charges below the level a profit-maximising airport would charge if in the business of only providing runways and terminals *per se*. This argument is set out in more detail in Starkie 2000<sup>1</sup>, and was endorsed by the Australian Productivity Commission in their 2002 Report recommending the removal of formal price-caps from Australian airports.

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<sup>1</sup> 'A New Deal for Airports?' In Robinson, C. (Ed.) *Regulating Utilities: New Issues, New Solutions*, Edward Elgar, Cheltenham.

**“...overlapping markets for passenger travel mean that aggregate assessments of an airport’s demand/supply position are unlikely to be an accurate picture of what is really going on, and that an airport’s market is not clear cut.”**

The thrust of easyJet’s objections to the CAA’s analysis of travel demand and airport selection in a geographical market is to emphasise the complexity of the market, the fact that there is a multitude of sub-markets and that the CAA’s analysis is inadequate in this context. I do not agree. The easyJet argument, whilst correct in pointing out the many dimensions of the air passenger market, ignores a fundamental point: the airport (in contrast to the airline) is very limited in its ability to discriminate between the varied passenger demands, either via a passenger service charge or via charges made to airlines. The airport cannot, for example, price discriminate between a (potential) passenger living close to the airport and a passenger living some distance away, perhaps in easy reach of an alternative airport. Similarly, the airport is limited in its ability to set different charges for flights to unique destinations such as the example given by easyJet of Olbia. This inability, or at best limited ability, to price discriminate in a way that can distinguish the sub-markets, has important implications. Essentially, it means that prices set by an airport are influenced in large measure by the fringe of competition, by demand at the margin, by passengers that have an effective choice of airport and by those airlines that are more willing to shift (some) activity to other airports. These other airports need not be alternative airports in the same geographical market; an airline operating at Stansted is interested in its operating margin not in the London and South East market *per se*. Thus, the competitive threat to Stansted comes also from the potential shift of airline capacity (in whole or in part) to airports in other UK regions or to another EU member State. In this context, the availability of stands and slots, etc. at Luton, Gatwick, etc. is not the deciding factor in determining the response of a Stansted-based airline to an increase in charges. This inability for airports (unlike the airlines) to effectively price-discriminate is reflected in the relatively low margins achieved by unregulated UK airports; generally these margins are significantly below the average achieved in the service sector of the economy<sup>2</sup>. In contrast, the margin achieved by the largest airline based at Stansted, Ryanair, compares well with service sector returns<sup>3</sup>.

**easyJet analyses whether Stansted is full and secondly whether, if it is, it can raise prices. It concludes in the affirmative on both counts and that Stansted has market power.**

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<sup>2</sup> This observation is based on my analysis of 2005-6 financial data (specifically operating profit as a percentage of fixed assets) for unregulated UK airports with an annual turnover of £5m and over, to be published in David Starkie, *Aviation Markets: Studies in Competition and Regulatory Reform*, Ashgate/IEA, March 2008. The average net return of service sector companies exceeded 20 per cent in 2006.

<sup>3</sup> The margin referred to is that achieved across Ryanair’s network as a whole, albeit Stansted is the largest operating base in the network.

easyJet does not pose the reasonable question: if ‘Stansted is full’ would it not be sensible to raise prices to reflect the capacity constraints and thereby to ensure that the limited capacity goes to those who can use it most efficiently. In the everyday commercial world, generally not subject to economic regulation, where variations in demand are regular and systematic, where it is relatively inexpensive to adjust prices and where pricing information can be conveyed easily to the customer, it is a common practice to react to high levels of demand (relative to capacity) by raising prices. Examples include hotel pricing, the pricing of tickets for sporting and leisure events and, probably the best example of all, ticket prices charged by the airline industry. If a flight is nearly full, the airline raises its ticket prices using sophisticated yield management techniques to balance demand and supply. When there are only a few seats remaining on a particular flight, by analogy with the easyJet argument, it is possible to argue that the airline has a degree of market power which it exercises by increasing the price of a ticket. And, when demand on a route increases steadily over time, but the airline is unable to increase capacity because of slot restrictions or because of shortages of suitable aircraft, the average revenue yield on the route will increase. But these are hardly events that would justify introducing an elaborate procedure for regulating the prices that airlines charge.

To investigate whether a firm has market power and whether it is abusing this position, we have to consider not only evidence on pricing behaviour but, in particular, whether the firm is seeking to deliberately restrict output; whether it is withholding capacity from the market or, when faced with steadily rising demand, whether it tries to increase the volume of capacity it is able to bring to the market. easyJet offers no evidence that the Stansted management is deliberately withholding airport capacity from the market. On the contrary, Stansted’s management are actively seeking to expand the capacity of the airport and these plans are currently opposed by easyJet (which, according to press reports, also opposes proposals to increase capacity at Luton, regarded by easyJet as Stansted’s main alternative). In short, easyJet confuses the difference between scarcity rents and monopoly rents.

**“Over the last two years prices at Stansted have effectively doubled...This increase has brought prices up to the price-cap set by the CAA. ...easyJet believes that BAA’s ability to price at the cap at Stansted ...warrants further investigation...”**

easyJet does not make clear whether the prices it is referring to are those listed in the published tariff, as opposed to prices reflected in long-term contracts struck between the airlines and the airport. Because contract terms are usually confidential, it seems reasonable to suppose that the easyJet comments refer either to the published tariff, which is only of partial relevance, or to easyJet’s contract prices, from which it would be inappropriate to generalise. Long-term pricing contracts between airlines and airports are increasingly common and have been written for Stansted. These contracts can cover a very long period (the easyJet contract with Luton Airport is for 20 years<sup>4</sup>) and compared with the standard tariff they have the effect of sharing the risks (charges are usually

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<sup>4</sup>The latest agreement was reached after the Government declined easyJet’s 2000 application for Luton to be Designated under Section 40 of the 1986 Airports Act.

crystalized in a per passenger charge only) and usually produce a revenue yield to the airport heavily discounted in comparison with the standard tariffs. In return, the airline will often give the airport a revenue guarantee but itself benefits from a stable pricing regime.

Unfortunately, the easyJet response is largely silent on the contract approach to airport charges and its relevance to the Stansted market power issue. I understand that some new contracts have recently been negotiated at Stansted. Their terms might have had the effect, as easyJet points out, of simply 'righting' Stansted prices. It is apparent from the low average revenue yield at Stansted Airport that the earlier contracts were struck on terms very favourable to the airlines and at levels that, overall, did not adequately remunerate past capital investments. If, as easyJet suggest, the Airport is now able to price at the permitted cap, circumstances might have changed but to charge at the cap does not lead to an excessive return on capital. Moreover, the recent decision by Ryanair to mothball part of its Stansted fleet over the quieter winter 2007/8 season might suggest that charges consistent with a reasonable return on capital are already at a level which brings forth a significant negative response from airport users.