

Memorandum

# Response to RBB

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17 December 2013

## 1. Introduction

In October we wrote a paper<sup>1</sup> that commented on a report by SLG Economics Limited (“SLG”) (“the SLG report”)<sup>2</sup> about the distribution of rents between airports, airlines, passengers and cargo users at Heathrow and Gatwick. Our paper raised concerns over some of the claims in the SLG report, which put in doubt the CAA’s belief that lower airport charges will be passed on to customers. British Airways (“BA”) has commissioned RBB Economics to write a paper that responds to ours (“the RBB paper”).<sup>3</sup> The RBB paper describes our analysis as “fundamentally incorrect, contradicting as it does standard economics and the reality of the airline industry” (p.1).

The purpose of this paper is to clarify our views in the light of the arguments made in the RBB paper. We first set out some general comments on the RBB paper. Second, we address some of the specific points that RBB makes. In summary, the economic points that the RBB paper makes actually do not differ much from our views and do little to rebut our main arguments. In particular, the RBB paper does not demonstrate that an increase in airport charges from current levels would be detrimental to the interests of passengers. As such the conclusions from our previous paper endure.

## 2. General comments

As a preliminary point, it is important to note that the paper that RBB responded to was a specific response to the SLG report. It was focused on a narrow set of points raised in the

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<sup>1</sup> Compass Lexecon (2013) *Comments on the SLG report on the distribution of rents*. (“CL response to SLG”)

<sup>2</sup> SLG Economics Ltd (2013) *Q6 review of the distribution of economic rent between airport, airlines and passengers and cargo users at Heathrow and Gatwick: A Report for the CAA by SLG Economics Ltd*.

<sup>3</sup> RBB (2013) *Why increases in airport charges adversely affect airline passengers: a response to Compass Lexecon*. All pages references within the main text of this paper refer to the RBB paper.

SLG report. We have produced other papers which analyse competition between airports and the competitive constraints on Gatwick in more detail. For example we have produced papers that show how a rise in airport charges above the competitive level would lead to airlines switching (“the market definition report”) <sup>4</sup> and how capacity constraints affect the distribution of rents between airports and airlines<sup>5</sup> (“the rents paper”). The CAA has not published all of these papers and we assume RBB has not seen them. Therefore when RBB suggests that our claims are “unsubstantiated” (p.2) or that we “only address the short run” (p.3), it is not in possession of all the evidence we have presented to the CAA.

Second, the RBB paper tends to analyse issues based on the experience and position of BA. One can observe this in the way much of the evidence RBB presents is in respect of BA. For example: the ability to switch to different-sized planes (which applies more to BA than, say, easyJet and Ryanair) (p.3); the level of variable costs relative to BA’s fares (p.5); and the inability of BA to switch to Heathrow (p. 7). When analysing the competitive constraints on Gatwick what matters is how customers as a whole will react to an increase in airport charges above the competitive level – or more specifically, whether a sufficient number of airlines will switch a sufficient volume of business to make such a price increase unprofitable. It is not necessary for all airlines to react in the same way, and even if BA, for example, were not able to switch away from Gatwick the ability of other airlines to do so could be sufficient to constrain Gatwick’s market power.<sup>6</sup> RBB’s approach therefore raises the question: how representative is BA of Gatwick’s customer base? We would suggest that easyJet, which accounts for around 40 per cent of passengers at Gatwick, is more representative.

Third, an important part of the CAA’s market power analysis, the SLG paper and subsequently our response, is premised on the argument that capacity is constrained. RBB argues that capacity can be increased by: altering the size of the aircraft operated; adjusting schedules; altering which routes are flown and/or changing the timing of the introduction of new aircraft (p.3). If this were true, then neither Heathrow nor Gatwick would be capacity constrained and arguably there would be no need for a CAA investigation into Gatwick’s market power. The CAA believes that there are capacity constraints. Our point is that if the CAA is correct and capacity constraints exist at Heathrow and Gatwick, then the airlines will have no incentive to lower fares if airport charges were to fall. Fares will only change if

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<sup>4</sup> Compass Lexecon (2013) *The CAA Report’s market definition*.

<sup>5</sup> Compass Lexecon (2012) *A model of airport competition*.

<sup>6</sup> An airline would not need to move all of its capacity from Gatwick in order to constrain Gatwick’s market power. For example, the CAA has calculated that the movement of only 4% of Gatwick’s current passenger volume, or 4-5 aircraft based at Gatwick, in response to a 5% price increase in Gatwick’s airport charges would be sufficient to constraint Gatwick’s market power (CAA, *Consultation on Gatwick market power assessment: CAP 1052*, May 2013, Figure 8.25).

airport charges rise above the market clearing level.<sup>7</sup> We are not at that point yet. As the CAA states:<sup>8</sup>

...airlines tend to price to the market (i.e. the strength of passenger demand) rather than to reflect their cost base. This means that an increase in airport charges may not be passed through to passengers in the short-run, if at all.”

### 3. Specific comments

#### Impact of a reduction in charges

RBB argues that over the longer-run airlines could alter capacity by: changing the size of the aircraft being operated; adjusting schedules; altering which routes are flown and/or changing the timing of the introduction of new aircraft (p.3).

First, we note that if this were true then the same could be said about Heathrow, in which case there would no need for the CAA to impose price controls at either Gatwick or Heathrow. The available spare capacity at each airport would constrain market power at the other. However, the CAA has made clear in its various market power consultations that it does not believe that such spare capacity exists and has said these airports are capacity constrained.<sup>9</sup>

Second, RBB appears to accept that there is at least a binding constraint on the number of available slots at Gatwick at peak periods. If slots are in scarce supply we would expect airlines to utilise these valuable assets fully, and that they would continue to do so following an increase in airport charges for as long as airport charges are below the market clearing level. We agree that if airport charges increased *above the market clearing level*, we would expect airlines to reduce demand, either in the ways that RBB describes or by simply vacating their slots. This reaction by airlines would in turn constrain Gatwick’s market power. However, that situation is not relevant to the issue addressed in the SLG Report, which is whether an increase in airport charges above *current* levels would be passed on to passengers.

Third, regarding the option of changing the size of the aircraft, this is a complex commercial decision. As we understand it, RBB is arguing that if airport charges increased, reducing the profitability of an existing service, an airline might react by reducing the size of aircraft it uses

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<sup>7</sup> It has been argued elsewhere that Gatwick’s charges are below the competitive level. See for example Gatwick (2013) *CAA’s Gatwick Market Power Assessment: Response from Gatwick Airport Limited*, para. 3.6 – 3.20.

<sup>8</sup> CAA (2013) *Consultation on Gatwick market power assessment: CAP 1052*, para. 8.28.

<sup>9</sup> We note that Gatwick has made submissions to the CAA, similar to those provided by RBB, that capacity constraints are not as binding as argued by the CAA and, at the margin, there is a substantial degree of flexibility in passenger and airline choice in how they respond to changes in charges. Our papers have been prepared on the basis that the CAA’s view of capacity constraints is correct.

on that route. However, we also understand that smaller aircraft involve higher variable costs per passenger so it is not clear that switching to smaller aircraft would necessarily reduce costs and be a rational response to an increase in airport charges.<sup>10</sup>

### **Pass-through of airport charges**

RBB argues that variable costs are more likely to be passed through than fixed costs (p.4). We made the same point in our paper (on page 3) so it is not clear to us that there is any disagreement between us on this issue. RBB goes on to show that variable costs account for a large proportion of total airport charges. RBB then appears to make the implicit assumption that if an airport increased its charges it would increase both its fixed and variable charges, and the increase in variable charges would then flow through to fares. However, it is not clear to us why an airport would wish to do that. If raising the variable component would flow through to higher fares, leading to passengers switching away, it would be more rational for the airport to instead raise charges only on the fixed component.

### **Airline switching following an increase in charges**

RBB argued that how airport charges affect airlines profitability will depend on the extent to which they are passed on to passengers (p.6). We agree. However, RBB then claims that there is an inconsistency in our paper where we suggest there is both “an ease of airport switching and ... that airport charges are fully passed onto passengers” (p.6). We did make the first claim in this sentence but not the second. Our argument is (and always has been) that we would not expect any change in airport charges from current levels to be passed on passengers, due to capacity constraints.

RBB argues that what is important is not whether “some” airlines can switch, it is whether a “sufficient proportion” of airlines can switch to prevent market power (p.6). We agree. RBB claims we have not provided evidence about airline switching. As noted earlier, our market definition paper discussed the extent to which airlines would switch in response to a price increase from the competitive level. We assume that RBB has not seen that paper.

RBB then argues that a “monopolist airport operator will price to a level up to the point where airlines will eventually start switching away...but that does not, and cannot, imply the absence of any competitive concerns”. We agree. But neither Gatwick, nor any other UK airport, is currently pricing at monopoly levels. The purpose of the CAA’s price controls is to prevent that happening: the CAA regulates prices to prevent them rising to monopoly levels. Even though prices are regulated, the evidence shows that airlines are willing to move aircraft in response to increases in charges. Nor do we think that Gatwick would act as a monopolist if it were given freedom to set its own prices. Indeed Gatwick has put in place a set of voluntary Commitments, which include limits on any price increases for a period of seven years, to address any such concerns. As explained

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<sup>10</sup> For example Wei and Hansen (2003) show that for a given journey length the operating costs per available seat mile falls with the size of aircraft and then later rises. Other studies that the paper cites show that costs tend to fall with aircraft size. See W. Wei & Hansen, M. (2003) “Cost economics of aircraft size” *Journal of Transport Economics and Policy*, Vol 37(2): 279-296.

in our market definition paper, Gatwick faces competition from at least all other airports in London and most likely also from airports across Europe.

### **The scope for airlines to switch routes**

RBB claims that we have confused the case of switching an aircraft between routes at the same airport and switching an aircraft to another airport (p.7). RBB argues that the former is possible at low cost (but does not constrain the airport's pricing behaviour) but the latter involves more significant costs. We agree that these two responses have different effects but we have not confused the two. The point we made in our paper was that to the extent sunk costs are present (which the SLG paper did not substantiate) they clearly do not prevent airlines freely moving aircraft between airports. This is evident in the easyJet quote that we included in our paper which clearly describes moving aircraft "around our network to ensure we are generating the best possible return".<sup>11</sup> But that is not the only evidence. In our market definition paper we provided (literally) pages of examples of airlines that had moved aircraft over the past few years between airports, sometimes in response to changes in charges and sometimes not.<sup>12</sup> The CAA consultation report also contains pages of examples.<sup>13</sup> The important point is that in order to constrain Gatwick's airport charges airlines do not need to move their entire operations to another airport. A decision to switch a few individual aircraft to a different base could be sufficient.<sup>14</sup>

RBB claims that it would be hard for BA to transfer aircraft between Gatwick and Heathrow due to capacity constraints and the need to reconfigure aircraft (p.7). First, even if this was true, (as noted earlier) BA is just one airline that operates at Gatwick. Other operators do not face the same issues. EasyJet for instance has many bases throughout Europe and has similar configurations on its aircraft. Even within London it has a base at Stansted, where spare capacity exists. Second, even BA has choices it previously did not have now it is part of the International Airlines Group which has operations at Madrid. Madrid has spare capacity so it is not clear why BA could not switch marginal aircraft there if it wished.

Lastly, RBB only considers the actions of airlines (such as BA) with a base at Gatwick. Gatwick is also used by airlines based overseas. These airlines could easily switch from using Gatwick to using a different London airport, or could instead use their aircraft to serve an entirely different European destination.

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<sup>11</sup> CL response to SLG, p.7.

<sup>12</sup> To constrain airport pricing it does not require that airlines make "wholesale" switches of operations (as RBB suggests, p.7), it need only be enough switching at the margin to make it unprofitable for the airport to increase charges.

<sup>13</sup> See for example CAA (2013) *Consultation on Gatwick market power assessment: CAP 1052*, paras. 2.43, 5.101, 5.119, 5.144, 6.105, 6.159, 6.160, 6.107, 6.109 and 7.24.

<sup>14</sup> According to the CAA, moving 4-5 aircraft from Gatwick could be sufficient, *op cit* footnote 6 above.

### **Freedom of airport pricing**

RBB claims that allowing airports to set charges would lead to an increase in charges (p.8). RBB then argues that an increase in charges is unlikely to lead to new airports being built in the short-run so there would be no constraint on such increases in charges. We agree that an increase in charges (if it occurred) is not likely to lead to a new airport being built in the short run. But we did not make that argument and that is not our point. Our argument is that prices are currently being set well below the market-clearing level. If airports were given freedom to set prices, they would set charges at a level that reflects demand for their services. We then argue that if Gatwick's charges were to rise above competitive levels, airlines would respond by switching to other airports where they could achieve a better profit margin. Gatwick faces competition from airports both within London and throughout Europe that possess spare capacity. Our argument does not therefore require new airports to be built.

### **Efficiency of slot trading**

RBB claims that slot trading has been found to result in a number of efficiencies (p.8). We agree. As we stated in our report, slot trading has undoubtedly led to an improvement in the allocation of slots.<sup>15</sup> Our point is that one cannot assume that this trading will always lead to an optimally efficient allocation. For example, the existing mechanism for the allocation of capacity at congested airports is recognised as not being fully efficient.<sup>16</sup> In addition, airlines may act strategically (for example to avoid selling slots to a close competitor). As RBB notes "Once a slot is sold, it is sold" (p.8). It is precisely for this reason that airlines will act strategically when deciding whether to sell slots: once they sell the slot, they can no longer control what happens to it.

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<sup>15</sup> CL response to SLG, p.7.

<sup>16</sup> See SDG (2011) *Impact assessment of revisions to Regulation 95/93*, Steer Davies Gleave, March 2011.