

Q6 review of the distribution of economic rent: A response to comments from Compass Lexecon

A Report for the CAA by SLG Economics Ltd

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Q6 Review of the distribution of economic rent: A response to comments from Compass Lexecon

Introduction

In September 2013, SLG Economics Ltd undertook a review of the distribution of economic rent between airports, airlines and passenger and cargo users at Heathrow and Gatwick for the CAA¹ (the SLG Economics report¹). On 30th October, Compass Lexecon provided comments on the SLG Economics report and commented on the robustness of the arguments and conclusions² (“the Compass Lexecon report”). On 17th December Compass Lexecon provided a further paper³ (“the Compass Lexecon further comments”) responding to comments on their report by RBB Economics⁴ for British Airways (“The RBB report”). This report responds to the comments in both Compass Lexecon reports.

Whether airlines are capacity constrained

The Compass Lexecon report argues that for many flights, airlines do not have meaningful spare capacity⁵ and as a result the retail supply curve is likely to be vertical rather than upward sloping; they quote as evidence the load factors of Easyjet (which they suggest is more relevant to Gatwick) at around 90% compared to those of BA at 79.9% in 2012.

SLG Economics recognises that there may be greater opportunities to increase both capacity and load factor at Heathrow than at Gatwick, due to the higher proportion of Full Service Carriers⁶ having greater flexibility to use larger aircraft and increase the load factor on them. GAL’s consultants ICF SH&E have stated that “*Heathrow illustrates ... although the airport is effectively operating at its movement limit there is still significant scope for growth through larger aircraft and a switch from short haul to long haul markets*”⁷. There is evidence that

¹ SLG Economics Ltd Q6 review of the distribution of economic rent between airport, airlines and passengers and cargo users at Heathrow and Gatwick, <http://www.caa.co.uk/docs/78/Review%20of%20distribution%20of%20economic%20rent%20-%20final%20report.pdf>

² Comments on the SLG report on the distribution of rents, Compass Lexecon http://www.gatwickairport.com/PageFiles/689/Gatwick_response_to_CAA_final_proposals_04Nov13.pdf

³ Response to RBB, Compass Lexecon

⁴ Why increases in airport charges adversely affect passengers: a response to Compass Lexecon, RBB, <http://www.caa.co.uk/docs/78/ba%20galfinal.pdf>

⁵ Compass Lexecon report, page 2

⁶ Over 99% of passengers at Heathrow flew on FSCs, compared with 34% at Gatwick, source: CAA

⁷ The London Air Travel Market: Long Term Forecasts and Implications for Airport Capacity, ICH SH&E, http://www.gatwickairport.com/PublicationFiles/business_and_community/all_public_publications/2013

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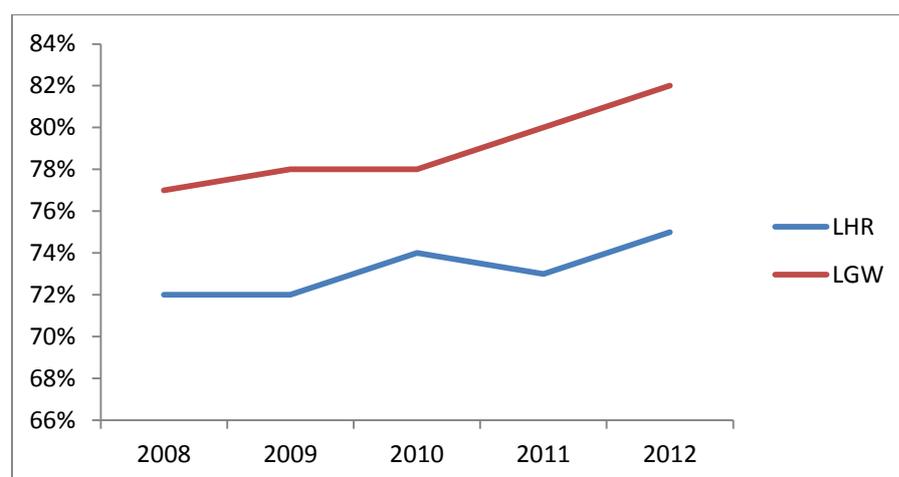
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airlines are already doing this, particularly with the introduction of the 'double decker' airbus A380 aircraft on key long-haul markets.

However there is also the possibility of growing the fleet size at Gatwick, for example the recent purchase by EasyJet of 25 take-off and landing slots at Gatwick from Flybe has led to Easyjet's Airbus 319s and 320s aircraft replacing Flybe's fleet of much smaller Bombardier and Embraer aircraft. Indeed, GAL has a stated policy of incentivising the use of larger aircraft at Gatwick, as shown in the recent Section 41 case⁸.

Compass Lexecon also suggest that small aircraft may have higher variable costs per passenger, so switching may not be a rational response to higher aircraft charges⁹. However the decision to alter an aircraft is taken at an aircraft level rather than passenger level (i.e. considering both the fixed and variable costs of the different aircraft), therefore it is the average (rather than purely variable) costs of the aircraft that are important for this decision.

Figure 1: Airport Seat Load Factors (%)



Source: CAA Airport Statistics

Gatwick saw average passenger load factors increase by a similar amount to Heathrow - from 81.2% in 2012 to 82.6% in 2013¹⁰ at Gatwick (not 90% as suggested by Compass Lexecon), implying that there is still an opportunity for further increases in load factor at

[/53022_July_Submission_Appendices_FINAL_230713_LR.pdf](#)

⁸ CAA (2013) Investigation under Section 41 of the Airports Act of the structure of charges levied by Gatwick Airport Ltd – CAA decision, APD13 <http://www.caa.co.uk/docs/5/s41gatwickflybedecision.pdf>

⁹ The Compass Lexecon further comments, page 4

¹⁰ Gatwick Airport Ltd, Investor Report, June 2013
http://www.gatwickairport.com/Documents/business_and_community/investor_relations/Gatwick%20Airport%20Limited%20Investor%20Report%2031%20March%202013.pdf

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Gatwick. Figure 1 shows the increase in seat load factors at Heathrow and Gatwick over the last 5 years showing a clear increasing trend at both airports.

To the extent that a particular airline may have load factors higher than this average (as suggested by Compass Lexecon for Easyjet), this means that load factors on other airlines are lower than the average and so they have a greater incentive to pass on airport price changes to their customers. However Easyjet did in fact manage to increase its load factors in 2013 - as reported by GAL: “*growth was achieved through incumbent airlines such as Easyjet, British Airways and Norwegian Air Shuttle growing frequencies and load factors on existing routes*”¹¹ (emphasis added). As RBB comment¹², the CAA price control is a long term 5 year review, and operational changes (altering the size of aircraft operated, adjusting schedules, altering routes flown and/or changing the timing of the introduction of new aircraft) are all possible responses within this timeframe, even if they may be less practical within a shorter timeframe. In addition, while slots may be fully used over the summer peak period, there may still be an opportunity to increase their use during the winter season and off-peak to allow further scope for growth.

The Compass Lexecon further comments suggest that the option to increase aircraft size is equivalent to the existence of spare capacity at the airport. In which case, they suggest there would be no need to impose price controls at Gatwick or Heathrow, since available spare capacity at each airport would constrain market power at the other¹³. However the ability for airlines at say Heathrow to increase aircraft size or load factor does not exercise nearly the same constraint on Gatwick’s market power as would Heathrow having spare runway capacity – since it does not allow Gatwick airlines to threaten to switch services to Heathrow in the face of an increase in airport charges at Gatwick. Therefore it is perfectly consistent for the CAA to wish to impose price controls at Heathrow or Gatwick to constrain SMP, while airlines at those airports have the opportunity to increase load factor or aircraft size (and also consistent for airlines to seek to increase aircraft size and load factor when faced with runway capacity constraints).

Therefore the arguments and evidence do support the conclusions in the SLG Economics paper.

The impact of a reduction in charges on the optimal fare

Compass Lexecon argue that even in the presence of spare airline capacity, changes in airline charges would not affect optimal fares because these are set in relation to variable rather than fixed costs, and that it is variable charges that determine the price passengers

¹¹ Ibid.

¹² The RBB report, page 3

¹³ The Compass Lexecon further comments, page 3

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face. They also argue that even an increase in per-passenger charges might not affect fares, if airlines are pricing to demand rather than costs.

As Compass Lexecon set out, airport charges are levied on a per-aircraft and per-passenger basis; as they say, one would expect per-passenger charges levied by the airport to directly affect the per-passenger marginal costs and therefore the optimal prices. At Heathrow charges for departing passengers made up 73% of the total airport charges in 2012-13 while at Gatwick they were 65%¹⁴. Therefore around three-quarters and two thirds of Heathrow's and Gatwick's airport charges respectively would be expected to feed directly into per-passenger variable costs and therefore fares¹⁵. The RBB report corroborates this, providing evidence that between 55% (in the summer) and 96% (in the winter) of Gatwick airport charges are variable on a per passenger basis¹⁶.

Compass Lexecon suggest that it would therefore be rational for the airport to raise charges only on the fixed component and that this would not affect passenger fares¹⁷. However it would be reasonable to expect the per-aircraft charges to also affect the passenger fare levels, particularly over the longer term. Airlines will want to at least cover the total costs of operating the aircraft from the revenue from passengers on that aircraft (otherwise it is not worth them operating that flight). Therefore increasing the per-aircraft airport costs will put an upward pressure on the minimum per-passenger margins in the airline yield management systems. Given that all airlines at the airport would face an increase in their costs resulting from higher airport charges, this would put an upward pressure on general market prices for airfares. It is clearly not a tenable argument that just by restructuring their charge from a per-passenger to a per-aircraft basis, airports can raise charges indefinitely with no impact on passenger fares as Compass Lexecon's line of argument suggests (it also begs the question of why such a large proportion of Gatwick's current airport charges are on a per-passenger rather than per-aircraft basis, and why they have not reduced per-passenger charges over time¹⁸).

This is also considered in the NERA report for the Competition Commission¹⁹ which states:

¹⁴ Heathrow and Gatwick Airport Charges Revenues Certificates for year ended March 2013

¹⁵ It should be noted that airports can vary charges between landing charges, passenger departing charges and aircraft parking charges, however this reflects the current mix.

¹⁶ RBB Report, page 5

¹⁷ Compass Lexecon further comments, page 4

¹⁸ Gatwick Passenger charges rose in real terms between 2005/6 and 2008/9 and have been reasonably stable between 2008/9 and 2012/13, source CAA data.

¹⁹ The effects of increases in airport charges at congested airports on airline fares: A briefing note for the CC prepared by NERA, [http://www.caa.co.uk/docs/5/ergdocs/ccreportbaa/app2\(2\).pdf](http://www.caa.co.uk/docs/5/ergdocs/ccreportbaa/app2(2).pdf)

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“BAA’s airport charges at Heathrow and Gatwick include some elements that vary directly with passengers, and others that vary with flight frequency.

- Whether increases in either passenger or frequency related charges affect airline price and output (frequency) setting behaviour depends upon whether airlines’ marginal costs increase as a result. Increases in marginal costs are less likely if the marginal cost includes a significant element of scarcity rent. However, the incidence of such scarcity rents, even at a congested airport such as Heathrow, may vary widely between airlines, and between peak demand and off-peak periods, especially in the absence of an efficient secondary market in slots.*
- If an increase in passenger related charges led to an increase in an airline’s price relevant marginal cost, this would lead directly to an increase in fares by the airline concerned, given imperfectly competitive airline markets. Such increases may be matched by competitor airlines whose price relevant marginal costs would not have been affected by the increase in airport charges. The scale of increases would depend primarily on expectations concerning competitor behaviour in response to an initial, cost-induced increase.”*

This suggests that increased airport charges that result in fare increases by some airlines then allow competitor airlines to also raise fares due to the relaxed competitive constraint on their prices. Therefore a reduction in airport charges (even per aircraft charges) would feed through (at least to some extent) into lower fares, and an increase in charges into higher fares.

The empirical evidence on airlines passing on falls in costs

The Compass Lexecon report suggests that the empirical evidence referred to in the SLG Economics paper does not suggest that costs and air fares have been falling in real terms over the last 10 years and that data for BA (which is only 15% of passenger numbers at Gatwick) does not demonstrate that airfares have fallen in real terms at Gatwick.

The data for BA used in the SLG Economics paper showed that air fares have been falling at Heathrow (where BA accounts for 45% of passenger numbers²⁰). This is summarised in Table 1 below and shows that total revenue, passenger revenue²¹ and costs have all fallen both on a per RPK (revenue passenger kilometre) and per ASK (available seat kilometre)²² basis in real terms over the 10 years between 2002 and 2012.

²⁰ Source: CAA Airport Statistics, data for 2012

²¹ Note fares and passenger revenues include ancillary services and charges such as fuel surcharge and booking fees (it excludes air passenger duty which is paid to Government).

²² Normalising revenue by the number of passenger kilometres or seat kilometres helps to adjust for the

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Table 1: Change in BA costs and revenues, 2002 to 2012 (constant 2012 prices)

	Per RPK	Per ASK
Total revenue	-22%	-11%
Passenger revenue	-19%	-8%
Cost	-25%	-15%

Source: BA annual reports <http://www.iairgroup.com/phoenix.zhtml?c=240949&p=irol-reportsannual>, CAA analysis

Similar data for Easyjet (which accounts for around 35% of passengers at Gatwick²³ and 45% of Gatwick scheduled passengers²⁴) also show a fall in total revenue, passenger revenue and costs per ASK and per RPK over the 10 years from 2002 to 2012 as shown in Table 2.

Table 2: Change in EasyJet costs and revenues, 2002 to 2012 (constant 2012 prices)

	Per RPK	Per ASK
Total revenue ²⁵	-10%	-4%
Passenger revenue	-6%	-0.1%
Operating costs	-13%	-7%

Source: Company reports, CAA analysis

However the data for Virgin (5% of passengers at Heathrow²⁶) in Table 3 shows an increase in revenues over the period, although this is still less than their increase in costs suggesting that they have not been able to capture increased economic rent from higher prices.²⁷

Table 3: Change in Virgin costs and revenues, 2002 to 2012 (constant 2012 prices)

	Per RPK	Per ASK
Total revenue ²⁸	17%	17%
Passenger revenue	10%	11%
Operating costs	21%	21%

Source: Company reports, CAA analysis

effect of the changing mix of flight distances and load factors.

²³ Ibid

²⁴ CAA Consultation on Gatwick Market Power, Figure 2.3
[http://www.caa.co.uk/docs/33/CAP%201052%20Consultation%20on%20Gatwick%20market%20power%20assessment%20\(p\).pdf](http://www.caa.co.uk/docs/33/CAP%201052%20Consultation%20on%20Gatwick%20market%20power%20assessment%20(p).pdf)

²⁵ Note: Total revenue includes non-seat revenue such as travel insurance commissions and car hire as well as revenue directly arising from passengers flying on aircraft

²⁶ Source: CAA Airport Statistics

²⁷ Consistent data for Thompson were not available due to their take-over of First Choice during this period

²⁸ Note: Total revenue includes non-seat revenue such as travel insurance commissions and car hire as well as revenue directly arising from passengers flying on aircraft

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Compass Lexecon’s second point in this section is that they were ‘surprised’ at the claim of ‘strong growth in GDP’ over this period. SLG Economics agrees the figure of 14% growth in GDP between 2002 and 2012 (this is more relevant to passenger demand growth than growth in GDP per capita, since it reflects both growth in per capita income and population growth - which also drives passenger demand). Whether 14% is characterised as ‘strong growth’ is irrelevant to the point made in the SLG Economics paper - that passenger demand has grown faster than air fares and costs and that competitive pressures have led to cost reductions being passed through to passengers as lower fares.

Compass Lexecon’s third point is that one cannot assume that growth has outpaced airport capacity and that passenger numbers have grown faster than UK GDP, suggesting that fares have fallen due to a relaxation of capacity.

Table 4 below shows the increase in the number of passengers and flights between 2002 and 2012 at Heathrow and Gatwick. It shows that the number of passengers has grown much more rapidly than the number of flights at both airports. This suggests that airport investment aimed at increasing capacity and the number of flights, has been less important than changes by airlines increasing the load factor and number of passengers per flight (discussed above). It shows that the number of flights has grown by far less than the 14% increase in GDP over the period, which does not support Compass Lexecon’s suggestion that it is airport investment and a consequent relaxation of airport capacity constraints that has driven lower fares.

Table 4: Number of flights and passengers at Heathrow and Gatwick 2002-2012

	Heathrow		Gatwick	
	Flights	Passengers	Flights	Passengers
2002	457,120	63,035,489	231,296	29,517,762
2012	469,004	69,983,139	240,439	34,218,668
% change	2.6	11.0	4.0	15.9

Source: CAA Airport Statistics

Compass Lexecon also appear to question the use of GDP as a proxy for passenger demand (although they are not explicit on this point). GAL’s response to the CAA’s initial proposals states “GDP remains the main driver of long term unconstrained demand”²⁹ and this remains the basis for the ICF SH&E traffic forecasts which inform Gatwick’s Master Plan and Business Plan. This suggests that GAL does believe that GDP is a good proxy for passenger demand.

²⁹ Economic regulation at Gatwick from April 2014: CAA’s initial proposals RESPONSE FROM GATWICK AIRPORT LTD, Appendix 12 <http://www.caa.co.uk/docs/78/GALApr13.pdf>

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The Compass Lexecon report also maintains the position of a previous Compass Lexecon paper which found that a change in airport charges will simply transfer rents between airlines and airports with no direct impact on passenger fares³⁰.

SLG Economics has reviewed the previous Compass Lexecon paper³¹ which concludes:

6.3 In absence of capacity constraints, we have shown that whatever the price set by airports, free market entry by airlines drives down airlines' profits to the competitive level. As a consequence, (i) a locational advantage does not generate a supra competitive profit for airlines and (ii) airlines realize competitive profits with and without a price-cap regulation.

6.4 In the presence of a capacity constraint, the situation is different. Such a constraint puts a limit on the intensity of competition between airlines. A direct consequence is that airlines always earn supra competitive profits in case of an effective price cap regulation, i.e., such that the airport sets its price at the maximum allowed price. This supra competitive profit always decreases and often disappears in absence of a price-cap regulation. However, it can never be the case that airlines earn a lower profit at an airport facing capacity constraint than at an airport which is not. The reason is that if this were the case, airlines would switch to the other airport.

SLG Economics believes that the empirical position of the airlines at Gatwick is between the two extreme positions of no capacity constraints and total capacity constraints modelled by Compass Lexecon. As discussed above, while there are firm capacity constraints at airports, there are still opportunities for airlines to increase their capacity by increasing load factor and using larger aircraft (the increase in passengers over the last 10 years at both Heathrow and Gatwick quoted in the Compass Lexecon report is mostly a result of airlines adopting such measures already). As a result depending on the degree of competition between airlines, some of the change in airport charges is likely to feed through to passengers – this is consistent with the conclusions of the SLG Economics report and the previous Compass Lexecon paper, but not with how it has been represented in the Compass Lexecon report.

Whether an increase in charges will lead to airlines switching airports

The Compass Lexecon report argues³² that a 10% rise in airport charges would have a serious impact on airline profits; that following a 10% airport price rise, they would expect an airline to react to the increase in its costs by switching airport; that the average

³⁰ Compass Lexecon report, page 4

³¹ A model of airport competition, A report for Gatwick Airport, September 2012

³² Compass Lexecon report, page 6

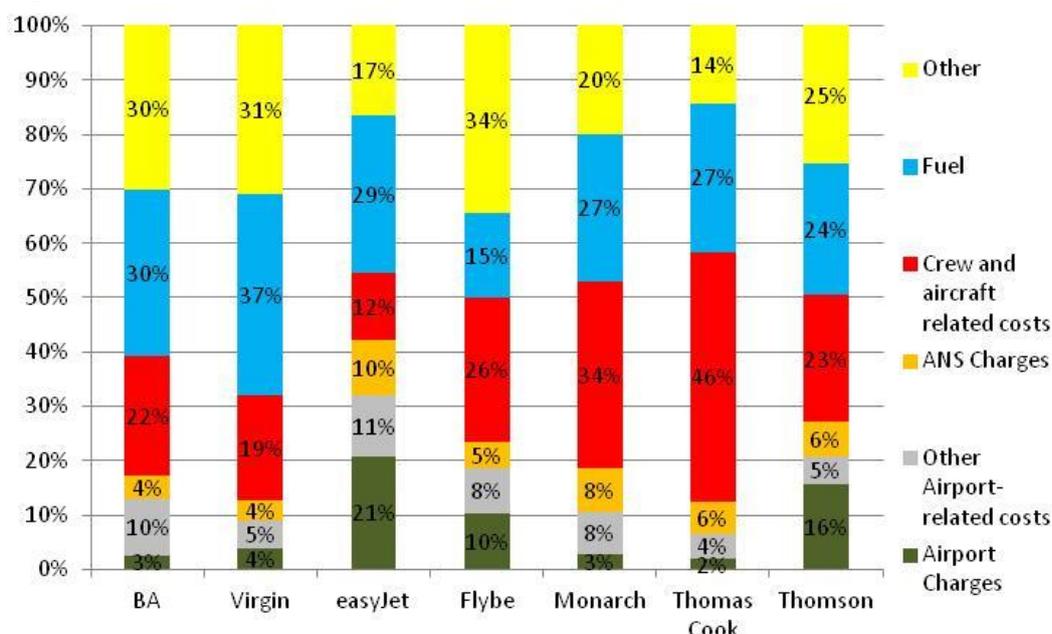
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profitability of a route is not relevant to the impact of an increase in charges; and that even if there were no marginally profitable routes, switching may occur due to an airline moving to another airport that is relatively more attractive. In their further comments, Compass Lexecon³³ raise the general comments on how representative BA is of Gatwick's customer base in terms of airlines ability to constrain market power, and suggest that easyJet is more representative.

Updated estimates of the proportion of an airline's costs that are made up by airport charges show that it is lower than suggested in the SLG Economics paper. Figure 2 shows that for LCC airlines the figure is around 20% rather than the 30% quoted, and for FSCs it is below 5%. This means that an airport charge rise of 10% would be equivalent to a less than 2% increase in costs for an LCC and less than 0.5% for an FSC. This strengthens the arguments that such a price rise would be unlikely to lead to many routes being stopped.

Figure 2: Cost breakdown for various airlines



Source: CAA, based on airline account information, latest available financial years.

The CAA has undertaken extensive research and gathered a significant evidence base over more than two years into the impact of a 5-10% price rise on airport switching, as part of their market power assessments of Heathrow and Gatwick airports³⁴. Their provisional conclusions find that switching (across all airlines) is unlikely (either on its own or in combination with other constraints on the airport) to constrain a 5-10% price increase at either Heathrow or Gatwick. This major review of the cost and likelihood of switching

³³ The Compass Lexecon further comments, page 2

³⁴ Market Power Assessments for Heathrow Airport and Gatwick Airport, <http://www.caa.co.uk/default.aspx?catid=78&pageid=12275>

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supports the statement in the SLG Economics report that: *“unless the airport price rise was very significant, it is unlikely that it would prompt the airline to switch to other airports given the sunk costs involved in their existing investments and the one-off costs involved in switching. Similarly ... it is unlikely that it would lead to many routes being stopped”*³⁵.

Whether sunk costs will stop airlines switching airports

Compass Lexecon³⁶ does not agree with the assessment in the SLG Economics report that airlines will not switch due to the *“sunk costs involved in their existing investments and the one-off costs involved in switching”* because they argue that it is unsubstantiated, not supported by evidence and that competition is for future expansion not just current routes.

While the level of sunk costs and switching costs are not set out in the SLG Economics report, they are examined in detail in the CAA’s market power assessments for Heathrow and Gatwick airports referred to above. SLG Economics accepts that sunk costs are only relevant for switching existing routes and not for future expansion. However SLG Economics believes that taken together, the evidence on switching and sunk costs set out in the market power assessments does support the view that *“unless the airport price rise was very significant, it is unlikely that it would prompt the airline to switch to other airports”*³⁷.

Whether the secondary slot trading market is efficient

The Compass Lexecon report³⁸ claims that the secondary market may not work well in practice due to the strategic considerations of airlines when selling slots, which means that prices may not necessarily reflect the opportunity cost of a slot. They also claim that setting prices at market clearing levels would provide more effective price signals and lead to a more optimal allocation of airport capacity than relying on the secondary slot market. They argue that this is consistent with the views of other regulators, in particular Ofcom in setting spectrum licence fees.

Compass Lexecon quote a report by Steer Davies Gleave³⁹ (SDG) in support of their argument that there is sub-optimal use of capacity at some airports. The SDG report which covers 15 major European airports states: *“The system of slot coordination cannot generate more airport capacity, but should be designed to ensure that limited capacity is used as effectively as possible. **At some airports, this does not occur, because of factors which***

³⁵ SLG Economics report, page 4

³⁶ Compass Lexecon report, page 7

³⁷ SLG Economics report, page 4

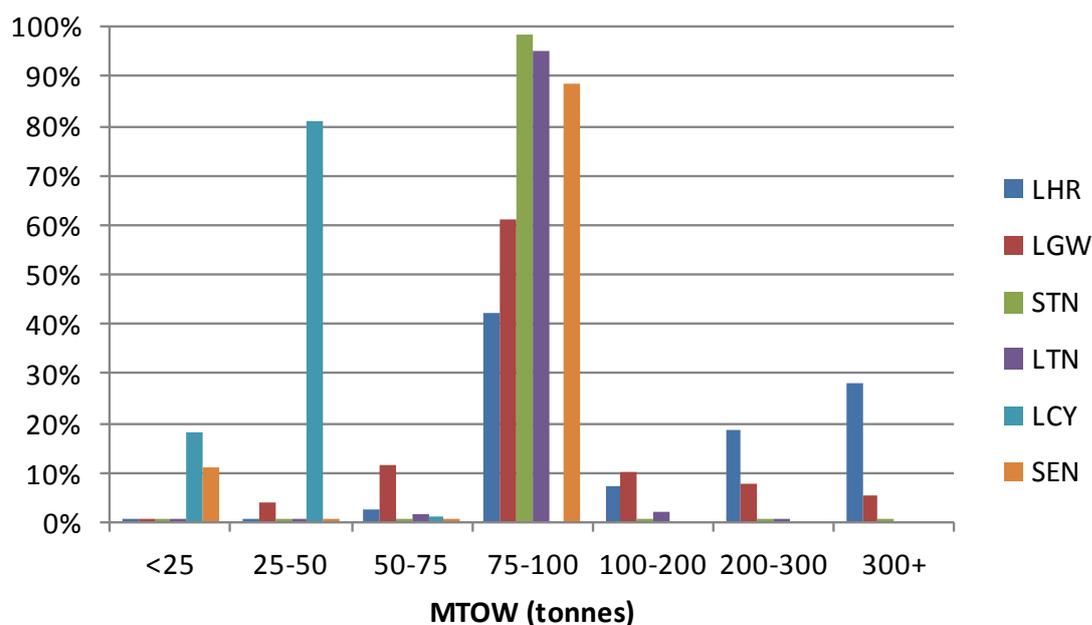
³⁸ Compass Lexecon report, pages 7 and 8

³⁹ Steer Davies Gleave (2011) European Commission: Impact assessment of revisions to Regulation 95/93, paras. 8-10. <http://ec.europa.eu/transport/modes/air/studies/doc/airports/2011-03-impact-assessment-revisions-regulation-95-93.pdf>

include a significant proportion of slots being unutilised, and use of a high proportion of small aircraft, limiting the number of passengers that can be transported within the constrained capacity” (emphasis added).

This situation of a significant proportion of slots being unutilised and the use of a high proportion of small aircraft is not reflective of the situation at Heathrow or Gatwick (although it may apply to other European airports in the SDG survey). Indeed the SDG report goes on to state “at the most congested airports such as Heathrow, utilisation is high (over 95%), and when allocating slots at Heathrow the coordinator takes into account that some slots will not be used, so this has little or no operational impact”⁴⁰ and that “of the most congested EU airports, only Gatwick airport has seen significant changes in slot holdings in the last few years, other than changes caused by the takeover of one airline by another”⁴¹.

Figure 3: Proportion of passengers by MTOW of aircraft flown in 2012



Source: CAA data

Figure 3 shows the size of aircraft flown at Gatwick and Heathrow compared to other London airports. This demonstrates that only 3% of flights at Heathrow and 17% of flights at Gatwick are small aircraft⁴² - below 75 tonnes MTOW (Maximum Take-Off Weight), while 54% of flights at Heathrow and 23% of flights at Gatwick are above 100 tonnes MTOW. This

⁴⁰ Ibid para 14

⁴¹ Ibid para 14

⁴² This is before the EasyJet purchase of Flybe slots mentioned above

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is confirmed in the SDG report which states *“use of small aircraft is rare at Heathrow and Gatwick”*.⁴³

Underutilisation of slots is also not a feature of either Heathrow or Gatwick. For example the CAA’s analysis of Gatwick daily slot allocation in 2011 reported: *“the runway is nearing capacity – utilisation rates in summer are around 80 per cent and are in winter between 70 and 80 per cent. This is on a weekly basis capturing entire days, but there are higher utilisation peaks across individual days (which can go up, in individual time frames, to near 100 per cent), for example in the 5-7am time window for departures in the summer peak week”*.⁴⁴

Therefore the basis that Compass Lexecon use for asserting that the secondary slot trading market is unlikely to work well in practice does not support their argument. Nonetheless, SLG Economics recognises that there may be imperfections in the workings of the secondary slot trading market either due to strategic behaviour by players or other factors. However the SLG Economics report does not claim that secondary trading will lead to an optimally efficient allocation (as Compass Lexecon suggest), nor that optimal efficiency is necessary for competition to have an effect; simply that *“A well-functioning market for airport slots helps to ensure that competition works effectively in the retail market ... so that the interests of airlines and passengers are well aligned”*⁴⁵.

Compass Lexecon’s second argument in this section was that setting prices at market clearing levels would provide more effective price signals that would lead to a more optimal allocation of airport capacity. The terms of reference of the SLG Economics report did not extend to comparing alternative approaches to allocating airport capacity and therefore the question of whether an alternative approach to setting airport charges such as at a market clearing level would provide a better (or optimal) allocation of airport capacity was not addressed in the SLG Economics report. What the report does suggest however, is that the significantly higher airport charges that would be likely to result from setting charges at a market clearing level would be likely to lead to higher fares paid by passengers (but would be unlikely to lead to increases in airport capacity even in the relatively long term, due to the dependency of airport investment on local and national planning restrictions).

Compass Lexecon also suggest that setting prices at market clearing levels would be consistent with the views of other regulators, in particular Ofcom’s approach to setting spectrum licence fees. Again comparability with the pricing approaches of other economic

⁴³ Steer Davies Gleave (2011), para 11.131

⁴⁴ Airport market power assessments - Annex to the CAA’s Initial Views - February 2012
<http://www.caa.co.uk/docs/5/marketpowerannex.pdf>

⁴⁵ SLG Economics report, page 7

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regulators was not part of the scope of the report. However other economic regulators set the charges for access to a fixed infrastructure network on the same basis as that applied by the CAA, for example the ORR sets track access charges for access to Network Rail's infrastructure based on a RAB building block approach similar to that used by the CAA for airports, rather than at the market clearing level⁴⁶. SLG Economics notes that the economics of spectrum allocation are very different from the economics of access to fixed transport infrastructure networks, for example different spectrum frequencies can offer the same final service, technological advances can change spectrum usage very quickly, there are a wide range of alternative applications for spectrum both at the wholesale and retail level, and technologies such as dynamic spectrum access can allow multiple users to share the same spectrum frequency. Therefore it is not at all clear that a similar pricing approach to that used for spectrum allocation would be appropriate for allocating airport capacity.

Conclusions

SLG Economics has reviewed the comments and further comments by Compass Lexecon and does not believe that they are valid criticisms of the arguments or conclusions contained within the SLG Economics report. SLG Economics therefore believes that the arguments and conclusions in its report are still valid and can be relied upon by the CAA in developing its policy proposals.

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⁴⁶ Periodic Review 2013: Final determination of Network Rail's outputs and funding for 2014-19
<http://www.rail-reg.gov.uk/pr13/PDF/pr13-final-determination.pdf>