

From: Regulation & Planning Director

Stansted Airport Limited
Enterprise House
Stansted Airport
Essex CM24 1QW

T: +44 (0)844 335 1803
W: stanstedairport.com

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Mr Chris Hemsley
Regulatory Policy Group
Civil Aviation Authority
CAA House
45-59 Kingsway
London
WC2B 6TE

Dear Chris

Stansted Market Power Assessment: response by Stansted Airport Limited (STAL) to the CAA's Initial Views document

Introduction

The CAA's Initial Views document represents a major step forward in understanding Stansted's market power. It brings together for the first time the CAA's guidelines on the assessment of market power and substantial evidence concerning Stansted's market position.

The CAA's approach to assessing Stansted's market power and its initial analysis is largely accurate, having identified a broad range of factors that are consistent with Stansted facing strong competition for passengers and airlines.

Areas of uncertainty where the CAA considers further work is needed

There are two principal areas where further investigation is needed before the CAA can make a formal decision on Stansted's market power. The first of these is the straightforward empirical issue of the supply of capacity during peak periods at Stansted. The CAA's initial view is that scarce capacity at Stansted at peak times is the most likely source of any position of substantial market power (SMP).

For this reason it is vital that the CAA investigates whether there is, in fact, scarce capacity at Stansted at peak times to act as a source of SMP. As we set out below, limited further analysis will show conclusively that there is not a shortage of capacity at Stansted, even during peak periods.

The second related area is the possible inability of airlines to switch away from Stansted in response to a price rise if there is a lack of suitable alternative opportunities at other airports within Stansted's market. The CAA suggests that this inability could be attributable either to a lack of spare capacity at other European airports at peak times or to the fact that switching capacity to alternative routes would be less profitable for airlines.

We are confident that further investigation of these issues would lead the CAA to conclude that airlines would switch significant capacity away from Stansted in response to a price rise above a competitive level, in a way that would make such action unprofitable.

Timing of the CAA's decision on Stansted market power

At the stakeholder workshop on 27th March there was general agreement between the airport and Stansted's key airlines that the CAA should seek to conclude its assessment of market power as a soon as possible. It is clear that stakeholders see considerable benefit in significantly advancing the timing of the CAA's final decision.

As we illustrate below, the scope of the additional research required to reach a decision on Stansted's market power is limited and well defined, which will enable the CAA to carry out the research relatively quickly, and put itself in a position to reach a final decision on Stansted's market power over the next few months. We would urge the CAA to confirm to stakeholders that it intends to reach a decision on Stansted's market power as soon as possible.

Our response to the Initial Views document is intended to assist the CAA in this task by identifying the further evidence and analysis that should be considered to support a decision on Stansted's market power. Stansted is also willing to support the CAA during the course of its further work with additional evidence and analysis.

The CAA's overall approach to the Stansted market power assessment

The Initial Views document (paragraph 3.183) states that the CAA does not currently have sufficient evidence to conclude whether Stansted has SMP. We agree that the CAA has not yet identified the evidence that would be necessary to support any decision that Stansted has SMP. However, the Initial Views document does contain significant evidence and analysis to support a CAA decision that Stansted does not have SMP.

We welcome the CAA's acceptance that the onus would be on it to justify, in a positive way, any decision that Stansted has SMP. In other words, it is not for others to demonstrate to that the airport does not have SMP.

The fact that the CAA does not yet have sufficient evidence to conclude whether Stansted has SMP means that any future decision that Stansted has SMP would need to be justified and supported with reference to evidence gathered following the publication of the Initial Views document. This means that the CAA would need to identify new evidence that would reasonably support a decision that Stansted has SMP; if the CAA does not identify such evidence, the CAA should conclude that Stansted does not have SMP.

We welcome the CAA's confirmation that it will consider all factors 'in the round' in forming its view on Stansted's market power (slide 4, Stakeholder workshop slide pack). This means that any new evidence that was consistent with Stansted having SMP would need to be weighed against the considerable evidence from the Initial Views document that Stansted operates in a competitive market for passengers and airlines.

The availability of capacity at Stansted in peak periods

The CAA has identified scarce capacity at Stansted at peak times as the most likely source of any position of substantial market power (SMP). The CAA's view is that scarce capacity could create barriers to entry and give rise to market power.

The Initial Views document states (paragraph 40) that there is very little spare at peak times at Stansted and that Stansted is capacity constrained during the morning peak (paragraph 3.180). We are confident that following further analysis of the current capacity situation the CAA will be satisfied that there is not, in fact, a shortage of spare capacity at Stansted at these times.

The further analysis required is:

- an investigation of the availability of runway slots for departure movements at peak times for the Summer 2012 season;
- an investigation of the availability of runway slots for departure movements at peak times for the Winter 2011 season;
- a comparison of the availability of runway slots for departure movements at peak times for the Summer 2012 and Winter 2011 season with corresponding seasons over the last five years; and
- an investigation of the availability of equivalent runway capacity availability at Heathrow, Gatwick, Luton and London City in Summer 2012.

An analysis of Summer 2012 data will provide the most up-to-date picture of runway capacity, and confirm that Stansted has significant spare capacity at peak times. For example, ACL's Start of Season Report for Stansted's 2012 summer season shows that in the peak week there will typically be 15 unallocated departure runway slots in the two-hour morning peak (0600-0800), equivalent to around a quarter of the departures capacity at that time.¹

Similarly, the analysis of Winter 2011 data will show that there is significant spare capacity at all times during the Winter season. A comparison of Stansted's current capacity situation with the evolving position over the last five years will illustrate how the amount of capacity available at peak times has significantly increased over that period.

The cross-sectional analysis will enable the CAA to compare the availability of capacity at Stansted with that prevailing at neighbouring airports in the same scheduling season. We are confident that this will demonstrate that Stansted has more spare capacity at peak times than the other London airports. It will also show that Luton has a similar amount of spare runway capacity to Stansted at peak times.

Given the centrality of the capacity issue to the CAA's initial assessment of Stansted's market power, we would encourage the CAA to conduct this analysis as a matter of priority. The data required for the suggested analysis is readily available from ACL, and a detailed analysis of the data could be completed quickly. Stansted is willing to support the CAA with this analysis if required.

The implications of a conclusion that Stansted does not have scarce capacity

The analysis outlined above will enable the CAA to come to a definitive view on whether there is scarce capacity at Stansted. On the basis of the data we have seen we expect the

¹ ACL Start of Season report for Summer 2012:

<http://www.acl-uk.org/ACLnew/reportsStatistics.aspx?id=98&subjectId=57>

CAA to conclude that Stansted does not have scarce capacity in peak periods. This conclusion would have profound implications for its assessment of market power. In particular:

- the availability of capacity in peak periods would not be a source of SMP at Stansted;
- the availability of capacity in peak periods would not provide the airport with negotiating power over airlines; and
- it would be necessary for the CAA to establish an alternative source of market power to reach a conclusion that Stansted had SMP.

The existence of substantial spare capacity at Stansted will also have a significant impact on the CAA's view of the airport's pricing behaviour. For example:

- the high proportion of fixed costs at Stansted creates strong incentives for the airport to set prices at a level that will encourage airlines to grow passenger volumes;
- the multi-sided nature of airports means that Stansted has strong incentives to set airport charges in a way that will encourage passenger growth and enable the airport to earn additional revenues from retailing and other commercial activities;
- there are strong incentives for the airport to offer aggressive discounts for growth at all times of the day, not just in off-peak periods;
- Stansted has had the opportunity to increase prices in peak periods but has not done so, largely because there is spare capacity available even at the busiest times of day; and
- Stansted has strong incentives to price competitively to attract airlines to base additional aircraft at the airport during peak periods, given the possibility that such aircraft will operate multiple rotations during the day.

Taken together, these factors create strong incentives on Stansted to set price at a competitive level that will attract airlines to operate new services, including those requiring early morning capacity. This is consistent with the CAA's observations in the Initial Views document on the level of discounts that have been offered to airlines to grow at Stansted.

The ability of airlines to switch services in response to a price rise

The second related area is the ability of airlines to switch away from Stansted at peak times in response to a price rise. The CAA's Initial Views document states that airlines may be unable to reduce their use of Stansted capacity at peak times if:

- there is a lack of spare capacity at other European airports at similar times which would prevent airlines from moving services away from Stansted; or
- moving services away from Stansted at peak times would lead to a reduction in airline profitability.

The CAA's view is that there is currently a lack of clarity about the ability of airlines to reduce their use of Stansted at peak times. This uncertainty needs to be seen in the context of the CAA's other conclusions on Stansted's market power, and also the CAA's views on the availability of capacity at Stansted in peak periods. As highlighted above, Stansted faces strong incentives to set price at a competitive level that will attract airlines to operate new

services, including those requiring early morning capacity. These factors significantly limit Stansted's market power, and provide passengers and airlines with effective and inherent protection against the risk of Stansted seeking to price above the competitive level.

The uncertainty also needs to be set against the CAA's findings from the Initial Views document and other related evidence, including:

- Empirical evidence on capacity switching which shows that Stansted's LCCs operate particularly dynamic networks;
- Empirical evidence on the use of peak period capacity over the last five years which show how airlines have reduced their use of slots during this period;
- A study of easyJet's switch of services to Southend, including a significant reduction in the airline's use of peak period slots, and the switches by other airlines away from Stansted in recent years;
- The existence of buyer power at Stansted, the flexibility of LCC business models and the sensitivity of LCC to changes in airport charges;
- Empirical evidence on the number of LCC bases set up in the last five years, and number of new services commenced by LCCs; and
- LCC statements about the competitive nature of airports and the way they optimise yield across their route network.²

Our view is that this body of evidence already provides the CAA with a clear basis for concluding that airlines would have the ability to reduce their use of the peak at Stansted in response to a price rise above the competitive level.

The availability of capacity at European airports at peak times

The CAA has sought to understand whether other airports competing in Stansted's market have spare capacity at peak times to enable airlines to switch away from Stansted in response to a price rise. The results of this analysis would potentially indicate the extent to which airlines would face practical hurdles in seeking to move services away from Stansted.

We agree with the CAA view that Stansted operates in a European market from an airline perspective. This means that the CAA's analysis of capacity availability should look across the European market to examine whether airports have spare capacity at peak times to be able to accommodate more demand from airlines that might want to switch away from Stansted. Limiting the investigation to other London airports would not be consistent with the CAA's approach to market definition from the perspective of airlines.

² For example, see easyJet's Investor Day presentation (pages 21-31) for a discussion of the airline's approach to 'Nework Optimisation':

<http://corporate.easyjet.com/investors/presentations-webcasts/~media/Files/E/Easyjet-Plc-V2/pdf/investors/results-centre/2012/investor-day-presentation-2012.pdf>

See also transcript for Ryanair Q3 2012 Earnings Call (January 30 2012):

<http://seekingalpha.com/article/326662-ryanair-holdings-plc-s-ceo-discusses-q3-2012-results-earnings-call-transcript>

Having defined the market in this way, it seems highly unlikely as a matter of principle that spare capacity would not be available at peak times at a wide range of European airports. There are several hundred airports in Europe with the capability to accommodate LCC services and a very high percentage of these airports do not have capacity constraints.

So far the CAA has looked at runway capacity constraints at a small sample of European airports, drawn from a European Commission report on the impact of changes to the slot allocation rules that apply to congested airports. For this reason, the sample of airports does not provide a representative or comprehensive view of capacity availability at European airports.

The further high-level analysis required is straightforward:

- For 2011, identify the total level of passenger and aircraft movements at base airports used by Stansted's major airlines, including those currently not served from Stansted.
- For 2011, identify the total level of overall passenger and aircraft movements at all airports used by Stansted's major airlines, including those currently not served from Stansted.
- For 2011, identify the total level of overall passenger and aircraft movements at all airports previously (but not currently) used by Stansted's major airlines
- Analyse the growth in the number of European bases and destinations operated by Stansted's major airlines over the course of the last ten years.

This evidence is likely to show that traffic levels at the airports used by Stansted's airlines are generally well below the levels at which capacity constraints would be prevalent. The analysis should be sufficient to address any residual uncertainty concerning the capacity available at European airports to accommodate additional LCC services.

The impact on airline profitability of moving services away from Stansted

The Initial Views document highlights the further work the CAA intends to do on airline switching costs, including the impact that route profitability might have on these costs. We anticipate that this further work will involve Stansted airlines providing the CAA with primary evidence that will allow it to establish the relative profitability of services operated across their networks. Using this information, the CAA will be able to assess the likely impact that switching services away from Stansted would have on airline profitability.

The key question for the CAA to address is the effect that switching the most marginal services away from Stansted would be likely to have on airline profitability. For example, if airlines have other services that would offer similar levels of profitability to the most marginal routes operated from Stansted, then the costs of switching services away from Stansted would be low. On the other hand, if the most marginal Stansted services are substantially more profitable than the other services that the airline could operate, then the costs of switching away from Stansted would be higher.

LCCs have deserved reputations for being highly effective yield managers. Key to this ability is a sharp understanding of the relative profitability of individual services across their entire networks. This clear understanding of relative yields has been demonstrated by Stansted's

major airlines in recent public statements.³ In addition, at the recent workshop Ryanair confirmed that many of its Stansted services operated at a relatively low level of profitability.

As such, the primary yield data required by the CAA to assess the profitability impact of switching routes should be readily accessible by airlines, and could be supplied promptly in response to a well-defined data request from the CAA. We would be happy to support the CAA in identifying the information required to carry out this analysis.

Other sources of primary data would also assist the CAA in understanding how airlines make decisions on a periodic basis on the changes to their route networks. For example, Board or Executive Committee papers on these issues would be likely to identify the key drivers for recent network changes. These papers, suitably redacted, would highlight the profitability of Stansted routes relative to other opportunities open to airlines. For instance, primary information relating to easyJet's decision to withdraw aircraft from Stansted during the peak period and redeploy them to Southend would highly informative in this regard.

In the absence of this kind of robust evidence on the costs of switching capacity away from Stansted, the CAA would not be in an appropriate position to conclude that Stansted had SMP on the basis of the profitability impact on airlines, particularly in light of the substantial evidence available to the CAA which is consistent with overall switching costs being low.

Conclusion

The CAA's Initial Views document provides a very strong position from which the CAA can move forward rapidly to reach a conclusion on Stansted's market power. Such a move would be strongly welcomed by Stansted and its major airlines.

Our response has focused on the limited further work required to put the CAA in a position to make a rounded decision on the market position of Stansted. We believe that this further analysis will show that Stansted has significant spare capacity during peak periods, and that all the necessary conditions for airline switching are in place.

On this basis, we are confident that the CAA will determine that Stansted has strong incentives to behave competitively, meeting the needs of airlines and passengers.

Yours sincerely

TIM HAWKINS
Regulation & Planning Director

³ Ibid.