

Gatwick Airport's comments on the York Aviation/ CTAIRA report to the CAA on the strategic importance of London to airlines

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Introduction

In October 2013 the CAA published a report that it had commissioned from York Aviation/ CTAIRA on the strategic importance of London to airlines (the Report). We are not aware that the CAA announced that the Report was being commissioned, or that it had been delivered, or that it had been published. It is also not clear how the CAA proposes to interpret the findings of the Report and incorporate it into its analysis, if at all. We are surprised by this given the importance that the CAA's analysis of airports' market power attaches to airlines' arguments that London is of "strategic importance".

In this paper we provide some initial comments on the Report. Our main observations are as follows.

First, while the Report sets out a significant amount of statistical information, comparing aviation in the London system, with other European major cities, it provides no rigorous framework within which to analyse this information. We consider that this information illustrates the undisputed strength and draw of London for passengers and airlines and illustrates why London is the largest single aviation market in the world. However, the Report does not demonstrate that there is a special "strategic importance" concept which should be considered as part of the CAA's market power analysis. In particular, it does not propose any threshold or benchmark that can be used to determine whether or not an airport system possesses "strategic importance". Consequently, its conclusions appear to be highly subjective.

Rather than analysing the evidence within a rigorous framework, the Report merely sets out a range of demand-side factors illustrating the undoubted importance of London as an aviation market, with a large population, wealthy catchment, high propensity to travel by air and substantial attractiveness for overseas and UK visitors. While these factors will clearly make London airports attractive to airlines, it is not clear how this situation differs from the existence of consumer preferences in any other differentiated product market – such as passengers' preferences for particular airlines, for example.

Second, the Report's conclusions do not, in any case, appear to demonstrate evidence to support the existence of substantial market power. While the Report concludes that some airlines (those that are UK-based) may be reluctant to cease using London, it reaches a different conclusion for all non UK-based airlines. Nor does the Report properly consider the incentives of UK-based airlines to reduce their use of London airports at the margin. Indeed, the Report appears to suggest that there would need to be the ability to withdraw from London altogether for an airport not to have

YOUR LONDON AIRPORT

Gatwick

substantial market power. For example in paragraph 6.9 the Report states that for easyJet and Ryanair “disentangling and moving from London would be hugely difficult.” However, such considerations are entirely irrelevant in an assessment of market power, where what matters is the behaviour of the *marginal* customer, which is accepted by the CAA. The Report’s conclusions do not therefore appear to support the existence of substantial market power.

Third, we note that the claimed “strategic importance” exists either at the level of all London airports or at Heathrow. While we do not believe that the Report’s conclusions are of any relevance to the assessment of market power (for the reasons set out above), to the extent that the CAA might draw any implications from these conclusions, we submit that none of the evidence or analysis in the Report provides support for a conclusion that Gatwick competes in a market that is any narrower than all London airports.

Lastly, the analysis presented in the Report appears to ignore a number of other important factors, and makes a number of serious misjudgements. The main issues are discussed in the rest of this paper.

The concept and definition of “strategic importance”

The Report explicitly recognises that the concept of “strategic importance” relied on by the CAA in its ‘minded to’ market power assessments is not currently defined within existing economic literature and that it is a new concept introduced by the CAA. Moreover, the Report notes that it is:¹

“a difficult and amorphous concept that could mean a range of things. What exists currently is really more a collection of possible effects and ideas that could be of relevance in defining such a concept.”

This view reflects our response and that of other stakeholders to the ‘minded to’ consultation. For example, MAG’s response to the CAA’s ‘minded to’ consultation on Stansted’s market power makes clear that the “strategic importance” concept, is not grounded in rigorous economics, evidence or analysis:²

“this term is not defined by reference to specific economic concepts such as barriers to entry, or high set up or exit costs based on substantial sunk capital costs. Indeed, nowhere does the Consultation Document define this term with any precision, nor does it seek to quantify it. The term does not address what would happen in response to a SSNIP, and it does not explain the substantial reduction in Ryanair’s services from Stansted which Ryanair itself has attributed to the recent increase in Stansted’s charges.”

This reflects the judgment of Professor George Yarrow and Professor David Starkie in their paper commissioned by MAG. They state:

¹ Paragraph 2.2

² See paragraph 9.42 of MAG’s response.

YOUR LONDON AIRPORT

Gatwick

“The concept of switching costs is a familiar one in economics, and references to such costs, and their relevance to competition assessments, are to be found in the guidelines of competition and regulatory agencies. The SMPA refers to such costs as “traditional” switching costs.

The adjective here arises from a need to distinguish well established theory from a wholly novel concept, introduced by the CAA for the first time in the course of the current assessment, namely ‘strategic constraints on switching’. This is not a term of art in economics, and, as can quickly be confirmed by a Google search, does not appear to figure, even as a marginal concept, in market power assessments (other than in the SMPA and related documents).”

The Report seeks to define what is meant by “strategic importance” in Section 2. However, the discussion does little to advance clarity as to what is meant by strategic importance for the assessment of market power. The closest the discussion gets to this is in relation to the opportunity cost to airlines of not serving London. The Report states:³

“For London to be of strategic importance to airlines, there must be features of London that mean that withdrawing from or reducing operations in London or ceasing to grow in London and moving the relevant capacity to other cities results in a long run reduction in profitability reflecting an opportunity cost for the airline greater than that associated with an increase in airport charges.”

This definition is, in our view, not clear. That aside, there are three observations that we have on it.

First, the implication is that airlines will continue, after a price increase, to operate routes out of London which are less profitable than those elsewhere (or at the margin even unprofitable). However, the Report does not explain why an airline would make such a seemingly irrational decision, not least where the issue is not one of total exit but of changing the balance of operations which many airlines have done in the past and continue to do.

Second, the Report does not provide concrete evidence of the phenomenon it describes. Rather the reality of airlines withdrawing and reducing operations in London, or ceasing to grow in London in response to changes in relative profitability, is readily observed in practice. The CAA has drawn attention to this possibility in the context of its recent consultation on market power at Stansted. Indeed, there have even been recent examples of more dramatic downsizing which the Report mentions and which we discuss below. The Report’s attempt to define the CAA’s concept of “strategic importance” appears to be undermined by evidence, some of it presented elsewhere in the Report.

Lastly, the Report does not in fact use this definition to analyse the evidence it sets out – or at least does not do so using any rigorous framework of analysis. For example, in Section 3, the Report

³ Paragraph 2.6

YOUR LONDON AIRPORT

Gatwick

sets out a large amount of information comparing London with other European cities. However, it does not explain how this evidence demonstrates that airlines will decide to continue to operate unprofitable services following an increase in airport charges.

The high level of demand for airlines services in London, which the Report demonstrates will affect the profitability of services at London airports, may mean that, for example, a service from London to destination X is profitable while a service to that destination from another European city is not. However, the Report provides no analysis to support the conclusion that an airline would continue to operate such a service from London following an increase in airport charges that made the service unprofitable. For example, paragraph 6.1 the Report states:

“Consequently, it is unlikely that the combination of volume and value that defines London can be replicated elsewhere and that therefore airlines are likely to face reduced long term profitability if they are forced to switch marginal capacity, either routes, frequencies or aircraft, away from London.”

This conclusion is not supported by the available facts and is directly contradicted by paragraph 6.10 in the Report, which acknowledges that Ryanair has been able to profitably redeploy capacity out of London.

Competitive price level and efficient use of available capacity

The analysis in the Report contains no discussion of whether the underlying assumption is that charges at the airports are at the competitive price level, nor of whether the current use of capacity is efficient. However, our reading of the Report is that it assumes that prevailing aeronautical charges are at the competitive level. This is despite substantial evidence that the regulated charges at Gatwick are below the level that would be expected in a competitive market. A further implication of this approach is that the analysis starts from the assumption that the current allocation of traffic is an efficient market outcome. However, no evidence is presented to support this assumption.

As we have consistently argued, at the regulated airports with capacity constraints, regulation has required airport charges to be artificially constrained below levels that would be observed in a competitive market and has transferred location and scarcity rents to airlines. We also note that the Report itself identifies as key drivers of LCC growth in London the relatively low airport charges compared to potential alternative bases, and the prevailing regulatory regime. While the existence of spare capacity at Stansted in the early 2000s did provide low airport charges, the existence of the regulatory regime provides the medium to long term prospect of prices being held to levels below the competitive price. To that extent, and particularly in relation to Gatwick, the Report in identifying the attraction of regulation is simply providing corroborating evidence of the effect of excess demand on airline profitability due, at least in part, to past regulatory settlements that have allocated economic rents to airlines in preference to airports.

YOUR LONDON AIRPORT

Gatwick

Market definition

Perhaps understandably, given the CAA's conclusions in its 'minded to' consultations, the Report considers FSCs separately from LCCs. However, given the comments submitted to the CAA in response to those consultations, we consider this an inappropriate approach. Moreover, even in taking such an approach, the Report does not explain why inbound carriers such as Norwegian, (considered to be a LCC), are treated differently from, for example, Aer Lingus, (considered to be a FSC) despite these airlines offering almost identical service propositions. This represents an antiquated view and understanding of airline business models and airline competition and could potentially distort the analysis. It is also inconsistent with the view expressed elsewhere in the Report that:

"...their [LCCs] focus for growth in London would appear to have moved towards attracting more and higher yield traffic from their full service competitors."

In terms of geographic market definition, we observe that the evidence of catchment overlaps between Stansted and Gatwick appears to strongly contradict the conclusions drawn by the CAA in its 'minded to' consultations. The analysis more properly reflects the views of Gatwick, highlighting the significant overlaps in the central London boroughs and noting, in terms of Gatwick and Stansted:⁴

"the shared districts again dominate demand in both airports' catchment areas..."

This highlights that even using observed catchment areas, which the CAA has previously suggested would underestimate the competitive interaction between airports, the York Aviation analysis suggests significant competitive interactions between Gatwick and Stansted. This provides further evidence that the CAA's geographic market definitions in its 'minded to' consultations are untenable.

Slot valuations and examples of airlines exiting London

Airport slots only have a positive value at airports where demand exceeds available capacity at the price(s) set. As such, the value of a slot represents the future expected value which can be made from the slot, including the associated scarcity rents. Therefore, if airport charges were no longer artificially constrained and allowed to increase to reflect the underlying demand and supply fundamentals, the price of slots at London airports would reduce. This view is supported by the Report⁵.

We agree with some of the points made in paragraph 3.44 of the Report e.g. that transactions can reflect participants' short term requirements, that the market is not fully liquid and, that slots will have different values to different users⁶. However, we observe that these are features of many

⁴ Paragraph 5.23

⁵ Paragraph 3.42

⁶ We do not understand the point being made in the final bullet in paragraph 3.44.

YOUR LONDON AIRPORT

Gatwick

markets and do not necessarily mean that slot values are not driven primarily by their market fundamentals – the demand and supply balance of the London airport system. Indeed, the coexistence of positive slot values and spare capacity in the London system suggests that airport charges do not reflect the full economic value at Heathrow and Gatwick and therefore results in inefficient resource allocation, contrary to the interests of passengers.

We also note that there have been many instances of airlines trading slots which have resulted in the airline substantially reducing its presence in London, or exiting serving London altogether. Recent examples include Flybe's sale of slots at Gatwick, and Star Alliance's sale of bmi's slots at Heathrow. Such examples appear inconsistent with the apparent underlying argument in the Report that airlines will continue to operate unprofitable routes out of London due to the "strategic importance" of London to airlines.

Lack of any "strategic importance" for FSCs at Gatwick

As the CAA is aware, Gatwick disagrees with the CAA's market definitions that define separate markets for i) LCCs and charters and ii) FSCs and associated feeder traffic. Without prejudice to this position, we note that the Report identifies a distinction between based FSCs at Heathrow and inbound FSCs at Heathrow (and FSCs at Gatwick) based on the network externalities present and the network effects achieved by the Oneworld alliance at Heathrow. In our view, such network externalities should not be considered as supporting a new concept of "strategic importance". The economic literature in relation to such network externalities is well developed and the CAA should use these accepted frameworks when considering the impact of the network externalities that are present at Heathrow, in its analysis of Heathrow's market power.

Nevertheless, if the CAA were to adopt the approach promoted in the Report, it is clear that any potential "strategic importance" derived from network externalities is only relevant to FSC's based at Heathrow, and possibly only to Oneworld members. It is not relevant to any assessment of Gatwick's market power.

All the other evidence in the Report which is said to demonstrate the existence of "strategic importance" does so at the level of London as a whole and the Report finds significant overlaps in catchment areas between, for example, Gatwick and Stansted⁷. Therefore, the Report provides no support for the CAA's conclusion that Gatwick competes in a market that is any narrower than all London airports. Rather the reverse.

Change of airport ownership

We consider that a further weakness of the Report is that, despite containing discussion of the potential future direction of the market, the analysis is primarily retrospective in nature and heavily influenced by the legacy of common ownership of the three main London airports by BAA. Even after the break-up of BAA, the traffic mix at the London airports is to a great extent influenced by

⁷ Paragraph 5.11

YOUR LONDON AIRPORT

Gatwick

how BAA marketed and positioned the airports as the aviation market expanded over the past decades. For example, Heathrow's greater proportion of business passengers than Stansted and Gatwick stems in part from BAA's view on how capacity should be utilised. This means that analysis of past passenger flows will in all likelihood underestimate the current and potential future competitive interactions between the London airports.

If “strategic importance” exists it appears to be limited to certain airlines and does not demonstrate the existence of substantial market power

While the Report concludes that “strategic importance” exists, it also finds that:⁸

“the extent to which this will influence decision making will vary with individual airlines”

In respect of UK airlines based in London the Report concludes:⁹

“the position is clear cut. It is highly unlikely that, whatever their operating model, they will be able to replicate the volume and value characteristics of London elsewhere. London is ultimately therefore of fundamental strategic importance to them.”

We disagree with this conclusion. While it is clear that London is a valuable market and that London-based airlines will be unlikely to cease all operations from London airports, this does not mean that they will be unable or unwilling to reduce services in response to an increase in airport charges. Moreover it is not clear how this analysis of London-based airlines differs from the position of other airlines based at other major European hubs, such as Air France at Paris, Iberia at Madrid, KLM at Amsterdam or Lufthansa at Frankfurt, for example. Under this criterion, it would appear that all major European airport cities are of “strategic importance” to at least some airlines and that at most, the concept is only applicable to such “hub” airports, of which Gatwick is not one.

The Report also concludes that:¹⁰

“For non-UK airlines, whilst London might be an important and indeed a profitable destination, it is likely to only represent a relatively small part of their business and by definition might not be material in terms of their overall business. Therefore, while London may be strategically important in the terms that we have defined, in that they may be less profitable in the long run if they do not serve London, this needs to be viewed in the context of London's overall contribution to their profitability. In other words, the strength of the strategic tie may be relatively weak in individual circumstances. Again, this position holds across the two main operating models examined in this research.”

The implication of this conclusion seems to be that the “strategic importance” of London is not relevant, or at least is a relatively weak factor, for many airlines using London airports. Moreover,

⁸ Paragraph 6.1

⁹ Paragraph 6.4. See also paragraphs 4.47-4.48.

¹⁰ Paragraph 6.5

YOUR LONDON AIRPORT

Gatwick

those airlines for which the concept is said to be most relevant (UK-based airlines) are those who are most likely to possess significant countervailing bargaining power.

Conclusion

The Report demonstrates that London is a large, important market for airlines. This is an uncontroversial and rather banal finding. It does not, however, provide either the analysis or evidence to support a previously unknown concept in competition economics – that of “strategic importance” – although it does provide evidence and opinion at variance with the CAA’s own analysis of market power analysis to date. To the extent that “strategic importance” exists, it looks to be relevant only to hub airports and there risks confusion with – and duplication of – existing concepts of network benefits and externalities.

In summary, this Report, in its belated quest for evidence to support the concept of “strategic importance”, has merely served to underline how insubstantial it is and to reinforce the expert view taken by Professors Yarrow and Starkie.