COMMENTS ON STANSTED MARKET POWER ASSESSMENT: FEBRUARY 2012

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Introduction

I submitted comments on the 14 February based on the CAA's release of a summary of its *Initial Views* document on 31 January[1]. The points already made should be read in conjunction with this further submission.

The CAA's *Initial Views* document provides an impressive compendium of information and detailed analysis of market power issues relating to the three airports and the CAA's team is to be congratulated on its efforts. However, the sheer extent of the voluminous material put forward for consultation with stakeholders and the corresponding effort required for a considered response, does go to underline the complexities and intricacies of the regulatory process and burden thus imposed on largely commercial organisations.

With this in mind, it is useful to reflect that Stansted has been subject to price regulation since the implementation of the 1986 Airports Act on the presumption that it could exercise significant market power. During the intervening period the airport has struggled to make a satisfactory return on capital. It has found it difficult to attract airlines and it had to offer the LCC's attractive deals which the CAA accepts resulted in charges below competitive levels, in order to build volume. These agreements ended in 2006 and charges increased but only to approximate competitive levels (3.127). Stansted has had little success in attracting Full Service or long-haul carriers (2.52). This state of affairs led the CAA in 2007 to support the de-designation of Stansted, since which time it has experienced significant losses of traffic. Losses continued in 2011, the only large UK airport experiencing a year-on-year decline.

The CAA's latest position expressed in its initial views document is that Stansted might have a position of substantial market power because of capacity constraints during a relatively narrow peak period: "*... the evidence is currently not sufficiently clear to reach a definitive view*" (3.247).

Thus, for more than 25 years, there has been no firm evidence that Stansted has exercised market power or has been in a position to do so, during which time the airport has been subject to detailed economic regulation. This regulation is not a costless exercise and because of information asymmetries has undoubtedly introduced distortions into market processes. In the circumstances we have witnessed a quarter of a century of growth inhibiting regulation. Has not the time come, therefore, to give the airport company the benefit of the doubt and accept that, narrow peaks notwithstanding for reasons expressed in my note of the 14 February, Stansted exercises no more market power actual or potential than is to be expected of a typical large commercial enterprise operating in a spatial market?

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1 http://www.caa.co.uk/application.aspx?catid=14&pagetype=65&appid=7&newstype=n&mode=detail&nid=2084

Critical Loss Analysis

The document states (3.78): "As an increase in charges...could take the form of higher charges for essential passenger-facing services – it is important to consider the critical loss that results from a 5 or 10 per cent increase in airport revenue per passenger, in addition to that which might result from an increase only to aeronautical revenues." However, in the calculations in Table 4 the analysis of a 5 to 10 per cent increase in revenues appears to assume that the airport has significant market power to increase revenues across the board ignoring the qualifying word "essential" in the above quote. Similarly in paragraph 3.81 there is a reference that Stansted could in principle increase "some" non-aeronautical charges but goes on to suggest that if Stansted has market power it is likely to be over "all" services connected to passengers' and airlines' use of the airport and therefore is likely to have an ability to raise prices above the competitive level for those services. There is an inconsistency here; the assumption of market power across all services is not in accordance with the points made in 2.89. Although it might be argued that the calculations are by assumption and illustrative only, there would seem to be little point in producing figures that are potentially misleading, if not spurious.

The CAA might also, as a thought experiment, consider the antithesis of the critical loss calculations by considering a scenario where instead of price increases (which are the basis of the revenue increases in Table 4) what might be the outcome of a price *de*crease and whether this plausibly could be a more profitable strategy for the airport to pursue. For example, the passenger survey results for Stansted indicate a reasonably high cross-elasticity for a fare increase. If we assume a broadly symmetrical response elasticity for a (smaller) decrease in fares, a reduction in aeronautical charges could have a noticeable positive effect on passenger volumes. On the basis of current average non-aeronautical revenues, each additional passenger would add more than £5. However, this current average might underestimate marginal revenue for reasons alluded to in footnote 28; as volumes increase and given the space constraints that operational efficiency imposes on the provision of retail services in the terminal area, it is likely that retail prices would rise with volume increases. Furthermore, because of the fixed cost element of operation (indicated by the staff-to-passenger elasticities in paragraph 3.79) it is likely the additional retail sales will be particularly profitable at high passenger volumes, even at constant prices. Thus, overall, it is quite plausible for a decrease in aeronautical charges to be a profitable strategy, particularly if it was possible to target marginal traffic by offering volume or new route discounts (2.40). This would appear to conform with observed behaviour[2].

Essential Services to Passengers

In paragraph 2.90 it is suggested that the airport could limit space available for retail offerings and/or limit competition between suppliers putting upward pressure on prices to passengers. But anecdotal evidence suggests a tendency in the opposite direction, that too

[2] See for example: "The level of discounts offered by Stansted appear – on the face of it – to be substantial" (3.172).

much of the circulation space at airports is given over to retail offerings and general comments of overcrowding because of this have appeared in the press from time-to-time. Reference is also made in the same paragraph to food and drink and its essential nature given airport waiting times[3]. But airlines potentially compete with the airport in the provision of these services and therefore, to put flesh on the bones of these arguments, perhaps the CAA would like to investigate prices charged for food and drink at Stansted outlets and onboard its user airlines. One might reflect that there is no more captive customer than an airline passenger flying at 35,000ft.

Response to an Increase in Charges

Paragraph 2.165 refers to some passenger groups being more or less price sensitive than others and: "This implies that, when an airport raises its charges to an airline, the airline may pass that increase on disproportionately to different passengers". But airlines are superb exponents of yield management techniques that enable them to explore the range of price elasticities and segment the passenger market to a fine degree. LCC's, the principal user airlines at Stansted, do this through use of the Low-High strategy, offering low fares well in advance of the departure date, increasing fares steadily and then close to departure, rapidly[4]. As a result of these and other strategies airlines are probably the best example illustrating the economists concept of 'first degree' price discrimination thus extracting much of the consumer surplus. A consequence is that the price paid by each passenger places him or her at the margin of consumption; in other words the airline will have exhausted the process of price discrimination so that it will not be in a position to pass on an increase in charges disproportionartely to different passengers. In response to a charges increase the airline is faced with either a loss of passenger traffic or a cut in operating margins leading subsequently to adjustments in capacity including the withdrawl from marginal schedules/routes. From the airports' point of view it is faced with highly elastic demand.

Supply-side Substitutability

I do not disagree with the CAA's proposal to consider the possibility of rapid entry into the airports' market as a competitive constraint operating through potential entry but I would not under-estimate the opportunities for speedy entry (vis: "...given the investment and timescales needed to upgrade an airport's facilities, it is unlikely that we would consider this kind of supply-side substitution quick and effective enough..."). For example, Ryanair have been willing to accept the erection of tent-like structures for terminals e.g. Lubeck, Germany and airlines have accepted the use of terminal facilities at Coventry airport constructed from

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[3] Mention is also made of bureau de change as another "travel essential". But bureaux at Stansted compete with the like at arrival/departure airports providing an example of competitive forces lying outside the relevant market.

[4] See for example C. Alves and C Barbot (2009), Price Discrimination Strategies of Low-cost Carriers, *Journal of Transport Economics and Policy*

modular units and industrial sheds (see Annex); such facilities can be erected quickly[5]. Although, the volumes that can be handled in this way are limited, Coventry did handle over 600,000 passengers in 2006 (2011, nil), and one is mindful that: “in terms of market definition and market power assessments, we only need to consider a switch at the margin” (2.73).

Passenger Origin

The CAA does not consider it necessary to distinguish between different passenger origins in the context of the product market (2.35) or geographic markets (2.107). Thus, no distinction is made between in-bound (foreign originating) or outbound passengers, inspite of 62 per cent of Stansted’s passengers having an overseas origin. As argued in an earlier submission[6], overseas-based business travellers and those with an overseas origin visiting friends and relatives in the UK can be expected to have a reasonably fixed destination. This does not apply to the 16 per cent of overseas passengers using Stansted for holiday purposes. For these passengers Stansted competes not only against alternative, predominantly London airports, but it also competes against a multitude of other airports as a holiday gateway (as well as competing with a multitude of competing holiday activities that do not involve air travel). This group of air passengers can be expected to have a very wide range of substitutes to choose from prior to selecting the UK (London) and a route via Stansted Airport. Although I accept that the airport is not in a position to discriminate in its charges between this (potentially very price-sensitive group) and other user groups, and this provides a reason for not distinguishing overseas originating tourists in *some* analyses, in other analyses it is perhaps important to make the distinction. For example, in 3.13 emphasis is placed upon the combined shares of Stansted and Heathrow in the UK foreign leisure market, where it is added that: “…the 60 per cent share is significantly higher than the levels that would support a rebuttable assumption of dominance”. Such a statement, of course, ignores entirely competition for such passengers from outside the relevant market. (See also 3.10).

Geograpahic Analysis and Potential Competition

The geographic analysis appears to be overly focused on a particular sub-set of London airports. It is appreciated that this focus is to some extent due to the availability of data (3.7). Nevertheless, I feel that much more could have been done to indicate the potential for competition from other airports around the fringe of the Stansted geographic market. Indeed, 3.147 is too dismissive of such possibilities[7]. For example, relatively little mention is made

[5] The temporary terminal built at Heathrow to handle Olympic participants is a further, topical example

[6] An edited version of this submission can now be found at: http://www.rpieurope.org/Publications/Letters_and_Notes/Starkie_Market_Definition_Airports_Dec_2011.pdf

[7] “Expansion and/or entry by existing aerodromes, and/or the threat thereof, may represent a source of competitive constraint. However, as with de novo entry, the cost and timescales involved in expanding to accommodate sufficient switching may still be too great to constrain Stansted’s prices in the short to medium term.”

of London City, an important airport for business travellers, inspite of 16 per cent of Stansted passengers travelling for business purposes and inspite of the travel time analysis showing that Stansted and London City share overlapping catchments. Unfortunately, Figure 8 does not distinguish between journey purposes, but one suspects that many of the 5 per cent or more of Stansted passengers that had used or considered London City in the last two years were travelling for business purposes.

Similarly, East Midlands Airport is little mentioned and perhaps should have been referred to in paragraph 2.115 as a "considered" airport alongside Birmingham, etc. The Airport continues to invest to increase its attractiveness (a luxury airport hotel has recently opened) and an isochrome analysis would have illustrated its potential in relation to Stansted's actual catchment area (Figure 12).

Other airports worthy of mention would be Manston (Kent is clearly within the catchment area of Stansted); Norwich (Figure 12, "…highlights that Stansted has drawn passengers from …much of the east of England"); Cambridge (used by ad hoc charters) and Coventry which, as recently as 2007, handled 600,000 passengers, some flying with the LCC Wizz. All these airports have runway lengths in excess of 1,800m.

It is easy to dismiss the potential of these airports simply because there has been no switching from Stansted ("there is very limited evidence of significant entry or expansion in Stansted's market", 3.148) but who would have predicted 12 months ago that easyJet would switch a tranche of aircraft from Stansted to Southend and, in so doing, "…will contribute to a significant reduction in the easyJet services operated from Stansted going forward [i.e.in the future]".

Comparison of Charges with Other Airports

The document compares charges per terminal passenger and per flight (Figures 26 and 27) for Stansted and a number of other UK airports. It is shown that Stansted's charges increased significantly after the unwinding of long term contracts in 2006. But, "the evidence does not support the view that the increase in charges from 2006 was an increase above the competitive level". Stansted charges revenue is shown to be lower than that at Gatwick and Manchester and its charges revenue per flight is below that for Gatwick, but similar to that for Manchester. However, what the document fails to point out at this juncture is that over this period Stansted has lost a considerable amount of business and continues to do so; it was the only one of the top dozen UK airports to experience a decline in passenger volumes in 2011, a decline which continues in 2012. In other words, charges have been increased to levels broadly similar to those at other UK airports but the effect on traffic volumes has, it appears, been disproportionately negative; thus indicating a weak market position.

The document also provides some comparisons with other airports at the international level (from which Stansted appears in a fairly favourable light). It is said that the ensuing information may provide a useful indicator (3.129) but in my view it does not. On the whole, international benchmarking of airports is a waste of time. As the document points out, the heterogeneity of airports across different countries poses a problem and comparisons are based on published tariffs thus ignoring discounts, volume incentives or favourable contract rates (3.135). Such comparisons particularly beg the question of the objective pursued by airport management in view of the fact that there is a mix of State-owned and private airports, with the former possibly enjoying subsidies to pursue non-commercial objectives. Moreover, the approach ignores the multi-sided nature of airports with their complex interlinking structure of charges, aeronautical and non-aeronautical. This neglect is exacerbated by focusing the analysis of aeronautical charges on two particular types of aircraft.

Capacity Constraints

The document argues that at peak times there is very little spare capacity with respect to runway departure slots. "The period over which these capacity constraints holds is somewhat limited, relating to 2 or 3 hours, …" (out of 18) (although confusingly para. 3.167 refers to "… only two of the 18 hours facing constraints,…"). But, examination of the accompanying data suggests a shorter period, with only 1 hour (during the summer) where capacity is close to fully utilised. The next busiest hour has approximately 20 per cent spare capacity and the third busiest hour has approximately 40 per cent spare capacity. This is in marked contrast to 2007 when the CAA supported de-designation; at that time utilisation during the three busiest hours exceeded 90 per cent.

Financial Performance of the Airport Company

The document dismisses the relevance of this issue in one fairly short paragraph in a overall length of 100 pages. This is rather worrying. After all, financial performance is the *sine qua non* of a commercial airport company. The CAA's argument is that, because Stansted is price regulated, its financial performance is unlikely to provide particularly strong evidence about its market position, particularly if it chooses to set its prices at or near the allowed price-cap (3.185). But, because the airport might set its prices at the allowable limit (it failed to do so for many years), this does not automatically lead to a satisfactory financial performance. The price-cap is set by the regulator to allow the company a satisfactory return on its capital, after having made a large number of assumptions about factors including the company's cost of capital and its likely traffic growth. If the company fails to achieve a satisfactory financial performance after setting prices at an allowable level, this could indicate an inability to attract sufficient traffic at those prices and thus a lack of market power. Stansted's financial performance during the last quinquennium was certainly worthy of investigation and the wording used in the Assessment document to dismiss the case for doing so seems to indicate a misunderstanding of the how a regulatory settlement is arrived at.

Reduction in Traffic

Paragraph 3.169 refers to 2010 passenger numbers at Stansted and notes that these numbers were down 7 percent on 2009 levels thus returning Stansted to 2003 numbers. Statistics that have become available since the Assessment report was compiled show that the decline continued in 2011 with a further 3 per cent fall in passenger numbers. Although most UK airports saw declines in passenger numbers during the financial crisis and for some small airports this decline was very severe, all large airports have since reverted to growth. What is remarkable about Stansted is the persistence of the decline which is surely indicative of a deep underlying problem. I am cautious about the use of econometrics (because of their easy misinterpretation) but the CAA has some first class statistical skills and I am surprised that these have not been deployed to illustrate and to throw more light on Stansted's *exceptional* decline in traffic.

Market Power in the Peak

Chapter 2 concluded that the geographic market for airlines using Stansted was likely to be European-wide and given the constrained airport capacity in parts of the London region, 3.182 looks at other European airports to see if these too are similarly constrained. But only 5 airports are considered (because of limited data available); in contrast Ryanair and easyJet use dozens of airports across Europe so that reference to the 5 (large) airports tells us virtually nothing about the constraints on switching into Europe on account of limited capacity.

It might have been useful to have discussed another switching possibility, namely switching from a peak hour to an adjacent less peaky hour, to have considered the costs of slipping schedules by a small amount of time. Of course, with apparently constant prices across the day there is little analytical basis for examining temporal cross-price elasticities at Stansted itself, but is there evidence available from other airports that have or had varying prices across the day (eg. Manchester, Heathrow)?

Concluding Comments

To return to my opening theme, one has to question whether economic regulation at Stansted has not done more harm than good. Indeed, comments to be found in the Assessment document indicate a serious failure of regulation. Paragraph 3.164 comments that "... prices have not been sufficient for the airport to earn the allowed return on its regulatory asset base for an extended period, and is not forecast to do so in the near future"[8] but the current regulatory asset base has been arrived at after a long process of regulatory scrutiny of, or at least concurrence with, past capex decisions on which the RAB is based. Bear in mind here that S39(2) of the Airports Act requires that the CAA shall perform its economic regulation functions in a manner best calculated, *inter alia*, to promote the *profitable* operations of regulated airports. In the case of Stansted it has clearly failed to do so. Inspite of this failure the CAA's current position regarding continued regulation is one of equivocation.

This is in marked contrast to its position in the summer of 2007 when the CAA advised the Secretary of State that Stansted should be de-designated. It gave this advice after an analysis of the airport's market position[9] since which time of course Stansted has experienced a considerable decline in traffic and a large increase in available capacity during the morning

[8] In contrast easyJet returned an impressive 12.7 per cent on capital employed in 2011, albeit generated across the whole of its network.

[9] http://www.caa.co.uk/docs/5/ergdocs/infocus_stansted.pdf

peak. In the circumstances I feel that it is encumbent on the CAA to explain why, in spite of the traffic trends, its assessment of Stansted's market position has changed to an extent that it no longer holds the position it did in 2007. The current Assessment document does not do this.

Finally, I would note that given the CAA's view that it is the limited availability of capacity at peak times at Stansted that is the most likely source of any position of substantial market power, the resolution of this concern does not require the type of regulatory review that Stansted has so far had to bear. The matter can be addressed by simple undertakings by Stansted regarding its temporal price structure. However I am of the view that the introduction of such a constraint is unnecessary, could be a source of serious inefficiencies and in the long run would not be in the interest of passengers for reasons explained in my response of the 14 February.

ANNEX


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BarrierGuard