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## It should be terminal

### AN INNOVATIVE APPROACH TO UK AIRPORT COMPETITION

*In August 2008, the Competition Commission (CC) reached a preliminary conclusion that BAA's current airport portfolio in the UK posed a threat to competition, and that substantial parts of it should be sold. In its work for easyJet, Frontier has developed an innovative alternative approach to increasing competition in the UK airport sector.*

BAA operates the three largest airports around London - Heathrow, Gatwick and Stansted - as well as both Glasgow and Edinburgh Airports. In its inquiry, the CC focused on these two concentrations, and has proposed that that BAA should sell two of the three London airports and one in Scotland. Before the Commission reached its final judgment, BAA pre-emptively began the process of finding a buyer for Gatwick.

The CC's argument, that separate ownership of the London airports would be likely to increase the competitive pressure on these airports, is a powerful one. However, our work suggests that even if all three London airports were in separate ownership, competition could be limited – especially with respect to point-to-point air travel. In an earlier bulletin<sup>1</sup>, we demonstrated that passengers



using short-haul air services have such a strong preference for flying from their closest airport that an increase in landing charges was unlikely to cause airlines to switch airports. A linked finding was that when airports are competing, (unregulated) landing charges are very sensitive to the degree of spare capacity present in the system: when capacity is plentiful, prices tend to fall very low, towards short-run variable costs; when capacity is scarce, charges may rise to well in excess of the long-run incremental cost benchmark often used by regulators.

This creates a risk that airports will strategically restrict capacity. At the very least, in making major long-run investments in runways and terminals they will tend to err on side of caution, rather than risk creating over-capacity, which might cause landing charges to tumble. This does not imply that airports will never invest in additional capacity. But the incentive on airport operators will always be to allow capacity development to lag behind the growth in demand. These features of passenger demand and airport competition led us to conclude that regulation of landing charges would almost certainly continue to be required indefinitely at the major London airports, even if they were in separate ownership.

### CREATING NEW POSSIBILITIES FOR COMPETITION

Subsequently, Frontier prepared a report on behalf of easyJet exploring innovative ways in which competition could be extended at the London airports<sup>2</sup>. Our suggestion, backed by evidence from airports around the world, was that if it is difficult to increase competition between airports, attention should be paid to ways of increasing it within them - that is, ways of allowing different terminals to compete with each other. This approach offers several benefits.

First, it should be possible to roll back regulation to cover just those parts of the airport that truly are natural monopolies: its “access” facilities, runways and surface access. Removing the need to monitor terminal costs would be a significant benefit, since regulators have struggled to identify the efficient cost of building and operating terminals. These are so diverse in their design and size that benchmarking has proved next to impossible.

Second, inter-terminal competition could lead these to become even more diverse. BAA’s current approach is to design all terminal facilities to meet the needs of a standard full-service carrier. But airlines’ requirements vary, even within the similar groups such as low-cost carriers (LCCs). For example, Ryanair may take very different view from other LCCs as to the terminal facilities they need, a point stressed in the debates about the specification for the proposed T2 at Dublin Airport.

Finally, introducing competition into the provision of new terminal facilities may make it possible to “market test” the demand for new runway capacity. If the associated terminal investment is put out to competitive tender, but no independent operator is willing to tender, this is a clear indication that demand is currently insufficient to justify the runway development.

Our report examined the complexities of introducing terminal competition, using the proposed second terminal at Stansted as an example. The structure of the new model that we proposed is illustrated in Figure 1. The practical issues raised by such a proposal are explored in detail in our report.

**It should be terminal**

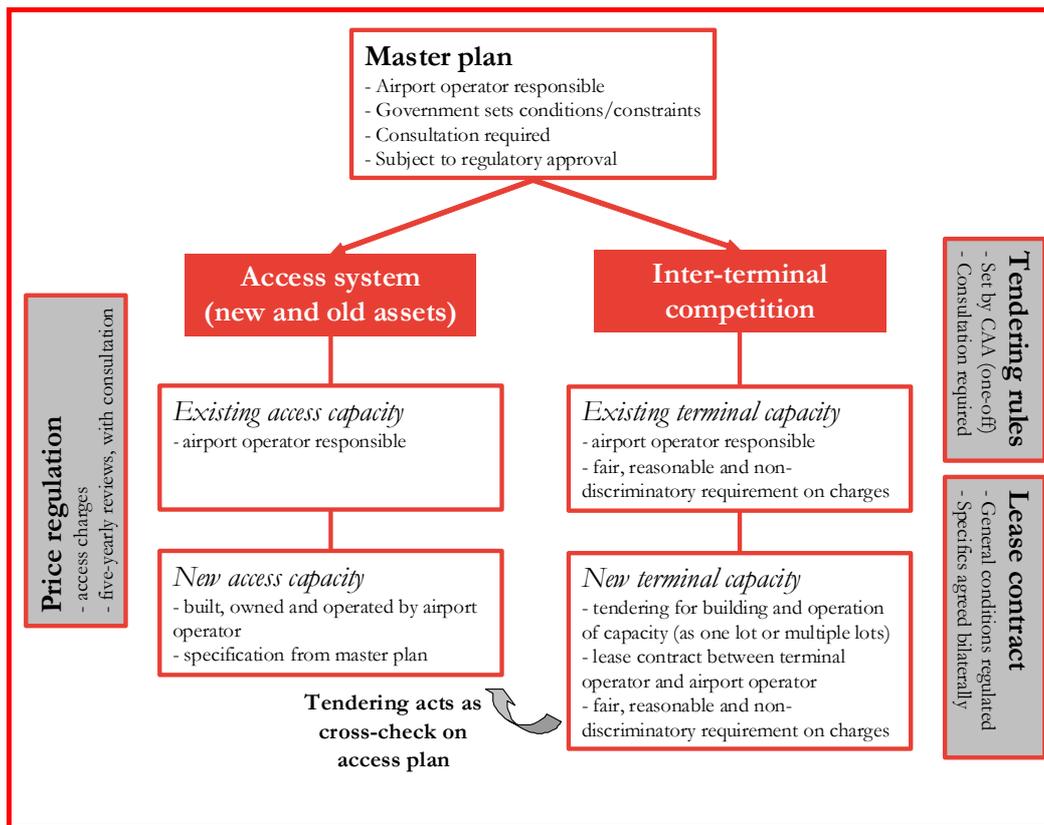


Figure 1: The proposed new model for intra-airport competition

A key requirement is sufficient terminal capacity to make competition effective. Even if there is more than one terminal operator, in the absence of spare capacity airlines will not, in practice, have a choice. To ensure true competition, the specification for new terminal capacity has to require the maintenance of a degree of spare capacity. Simply requiring BAA to outsource new terminal provision would not do the trick: it would still prefer to restrict capacity, in order to restrict the competitive pressure on terminals, which it would continue to operate.

We explored the level of spare capacity that would be needed to ensure competitive terminal charges, based on a variety of scenarios for the capital costs of terminals and the proportion of terminal operating costs that do not vary with the number of flights served. Our work indicated that 10% spare capacity would probably be sufficient to maintain competitive prices. The analysis is illustrated in Figure 2 overleaf. This shows that both higher initial investment costs and higher fixed operating costs make profits much more sensitive to airlines switching terminals, placing a greater constraint on terminal pricing.

Even when the issue of terminal capacity has been dealt with, there is still the possibility that market power might be passed to the new terminal operator, which might be an airline (or an airline consortium). This problem can be dealt with by requiring the new terminal operator to commit to providing a minimum number of “open access” gates at a published price, fixed by long-term contract.

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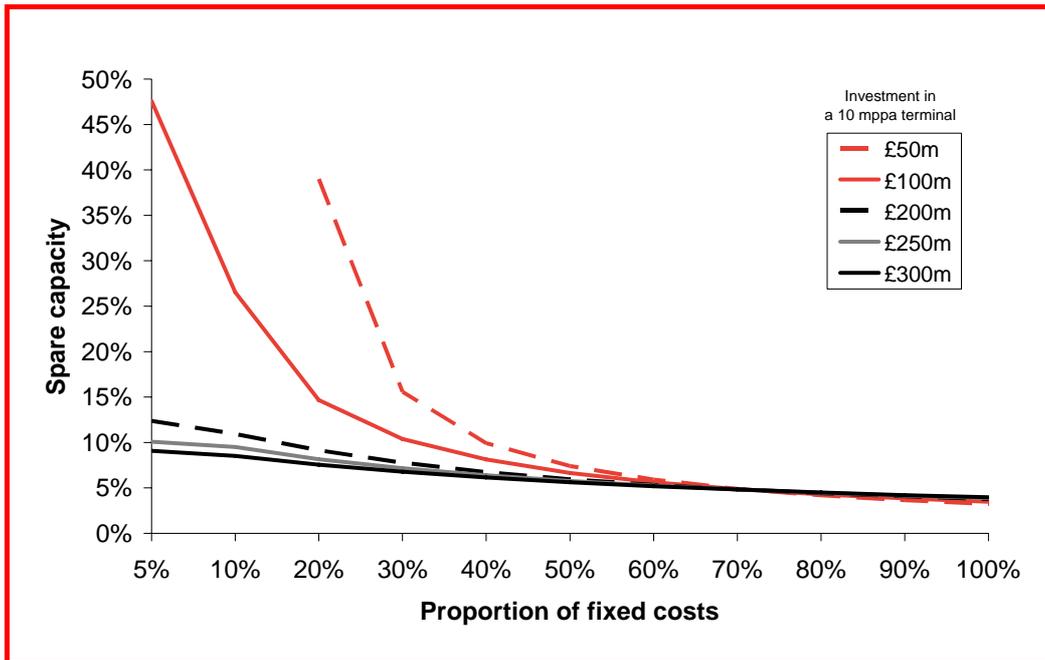


Figure 2: Minimum terminal spare capacity needed to ensure competitive prices

Source: Frontier analysis

This approach has been used in the US to ensure that airline-operated terminals cannot exclude potential competitors. Such an approach could also be used to ensure that airport owners grant terminal operating licences to the most efficient operators, not merely to those prepared to pay the most.

The CC is actively considering the merits of inter-terminal competition in parallel with its proposals to break up BAA. So it is to be hoped that ideas of this kind will feature in its final proposals.

**SOURCES**

- 1 *“Keeping The Lid On”, May 2008*
- 2 *Frontier Economics (2008), “Regulation of capacity investment at Stansted Airport”*

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