

Customer benefits from competition between Edinburgh and Glasgow airports

Introduction

1. We set out in our provisional findings our reasons for finding that BAA's common ownership of Edinburgh and Glasgow is a feature that prevents competition. We consider that in the absence of common ownership there would be a good degree of competition between the two airports to the benefit of customers.
2. There are many advantages of competitive rivalry (see paragraph 78 of main text). As we said in our provisional findings, competition is a dynamic process and in a competitive market we would expect firms to be constantly seeking new profitable opportunities; it is this process that drives the price reductions, capacity expansions and service quality improvements that benefit customers.
3. Because competition is an inherently uncertain process, it is difficult to anticipate precisely how it benefits customers. However, under separate ownership, we would expect Edinburgh (for which Glasgow is by far the closest competitor) to seek to attract airlines from Glasgow with better prices or other benefits (BAA does not currently have the incentive because any gain at Edinburgh is offset by loss at Glasgow), and vice versa. We would then expect this to lead the other airport to respond with a better offer to keep the airline. In the case of airlines which currently have services from both airports, we would expect both airports to try to obtain additional business from those airlines with more favourable offers (again, BAA does not currently have the incentive to do this, as any gain at one airport would be more than offset by losses at the other). The overall result of this process would be a better deal for airline customers.

BAA sale of Prestwick

4. Although it is difficult to anticipate precisely how competition will benefit customers, in this case we have the advantage of a 'natural experiment' that occurred when BAA sold Prestwick. Up to 1990, Prestwick had been the only airport in Scotland allowed to handle transatlantic traffic: when Ministers extended transatlantic rights to other airports, most transatlantic flights transferred from Prestwick to Glasgow. Subsequently in 1992, BAA sold Prestwick and the independent owners of Prestwick developed it as a competitor to BAA's Scottish airports for passenger airlines, principally by attracting Ryanair.¹

5. Figure 1 shows trends in prices (average airport charges per passenger) at BAA's Scottish airports before and after the sale of Prestwick. The figure shows that real prices,² which had been rising at both Edinburgh and Glasgow, fell rapidly after 1992.³ Of course, correlation does not necessarily imply causation and it is unlikely that the initial price reductions can be attributed mainly to the sale of Prestwick; Prestwick's volume was small and at the time of sale BAA is unlikely to have expected competition from Prestwick (otherwise, in the absence of action by competition or other authorities, it is unlikely that BAA as a profit-making company would have sold it).

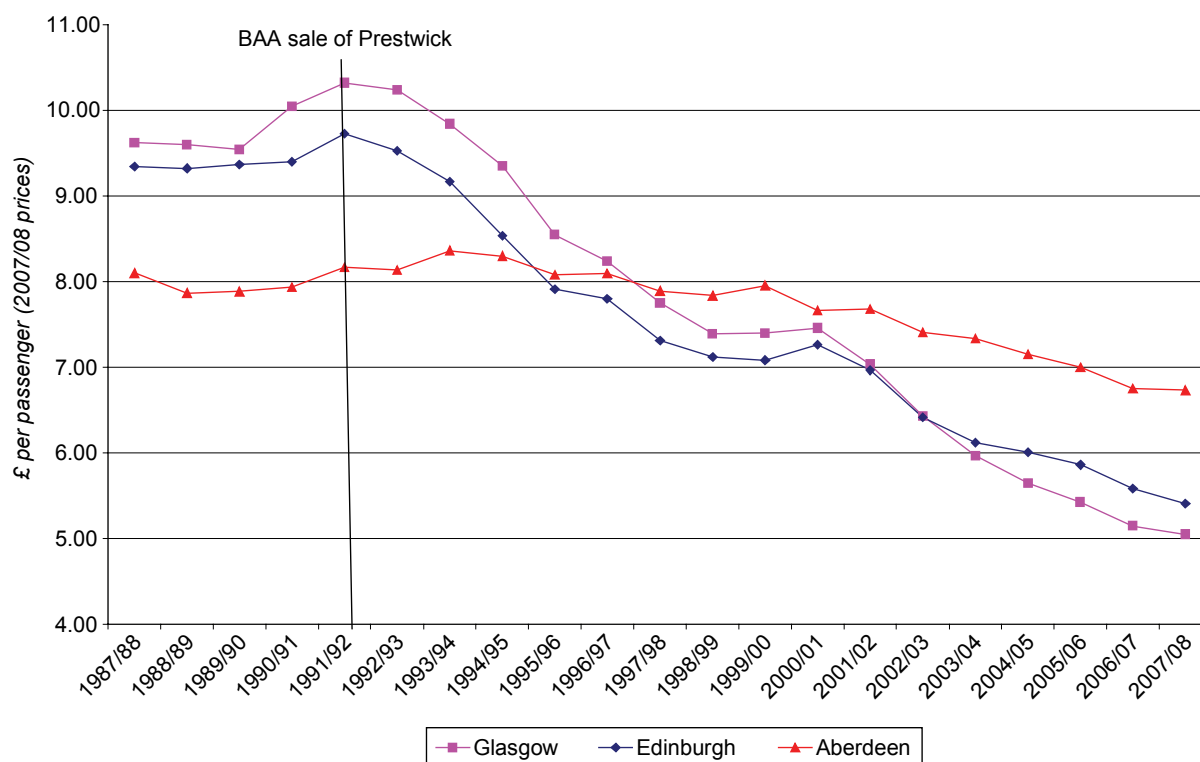
¹Competition between Glasgow and Prestwick is discussed in paragraph 4.16 of our provisional findings.

²Prices adjusted to 2007/08 prices using the RPI index excluding mortgage interest payments.

³Figure 1 does not show prices at Prestwick itself, on which we have incomplete information. However, we know that passenger airlines at Prestwick pay much lower airport charges than those at Edinburgh and Glasgow and Figure 1 therefore understates the extent to which airport charges per passenger have declined over time.

FIGURE 1

Average airport charges per passenger (2007/08 prices)



Source: CC calculations based on data from BAA and ONS.

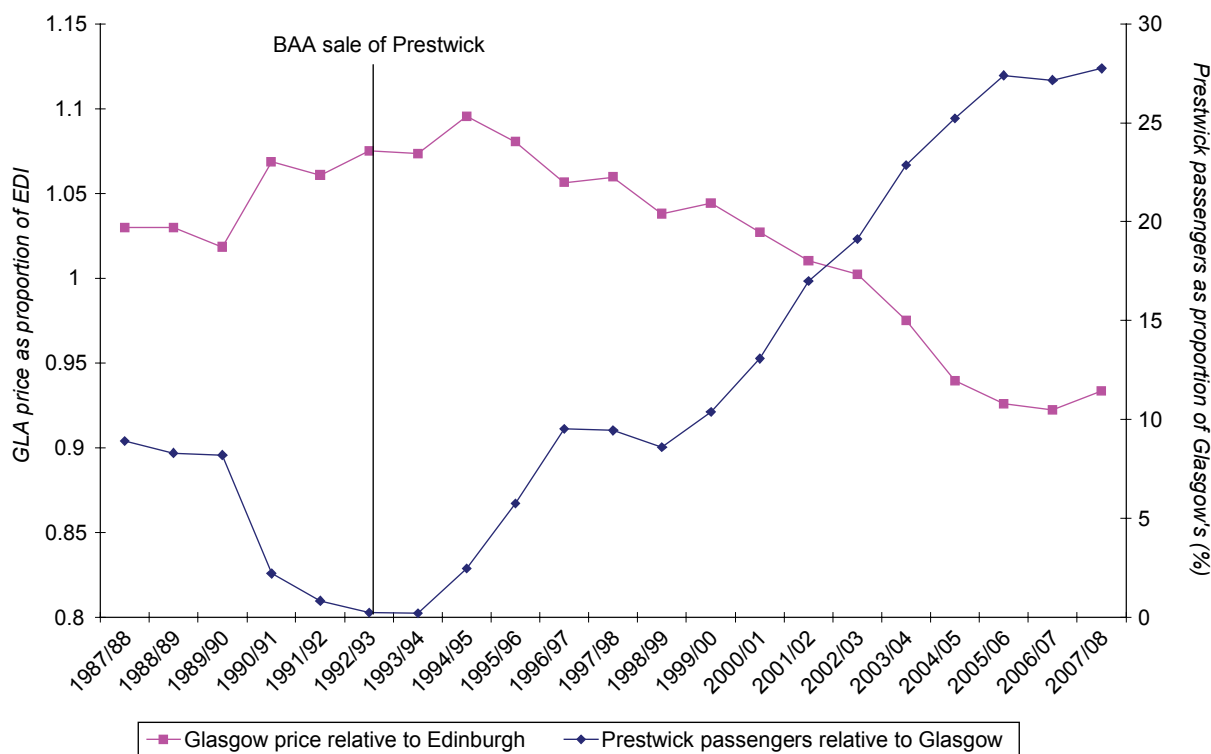
6. At its Scottish airports, BAA has since 1993 followed a policy of not increasing tariffs by more than RPI-3 at Edinburgh and Glasgow taken together, and RPI-1 at Aberdeen. As discussed in Annex 1, it appears that BAA has consistently reduced its prices across Edinburgh and Glasgow by more than required under its voluntary pricing policy (this is also the case for Aberdeen since around 2000).

7. BAA has told us, regarding its prices at Edinburgh and Glasgow, that ‘the level of airport charges at both airports reflect the reality that if BAA does not price “reasonably” to its users, regulatory or even competition law intervention would undoubtedly follow. If BAA was to raise prices substantially at either airport, or both, BAA would not expect that loss of volumes—whether by the actions of airlines or of

passengers - would make such a move unprofitable'.⁴ Although it does not put it in quite this way, BAA seems to be suggesting that it has set its prices at Edinburgh and Glasgow completely independently of the actions of its competitors (including Prestwick) and of its customers. We do not consider this plausible: first, it is difficult to regard BAA's voluntary pricing policy as imposing binding constraints on prices at its Scottish airports since, as discussed in Annex 1, it has consistently exceeded them; second, BAA has reduced its prices much less at Aberdeen, which is unaffected by competition from Prestwick;⁵ third, prices have fallen less and discounts are smaller at Edinburgh than Glasgow, which is more exposed to competition from Prestwick. In sum, we consider that BAA's prices have been affected by market pressures including competition from Prestwick.

FIGURE 2

Glasgow price relative to Edinburgh and relative growth of Prestwick



Source: CC calculations based on data from BAA and CAA.

Note: Ratio of Prestwick to Glasgow passengers based on CAA data for calendar year.

⁴BAA's response to the CC's Emerging Thinking, Annex 1.

⁵This is reflected in BAA's pricing policy which is RPI-3 at Edinburgh and Glasgow, but only RPI-1 at Aberdeen.

8. We would therefore make three main points concerning price trends following BAA's sale of Prestwick:

(a) As illustrated in Figures 1 and 2, BAA's prices at Glasgow have fallen relative to Edinburgh as Prestwick's traffic has increased. We consider that this reflects that competition from Prestwick has had more impact at Glasgow than Edinburgh. (Glasgow's prices relative to Edinburgh's increased prior to Prestwick's sale, particularly in 1990/91—this is most likely attributable to the transfer of transatlantic flights as airport charges per passenger on such flights tend to be above the average for all flights).

(b) However, there also seems an argument that the impact of competition from Prestwick is greater than suggested just by the decline in Glasgow's prices relative to Edinburgh. BAA's prices at Edinburgh seem to have fallen more than would otherwise have been expected, as illustrated by its prices at Aberdeen. In our provisional findings, we did not find much evidence that Prestwick was a good substitute for Edinburgh's existing passengers, and we said that Edinburgh faces limited competition from non-BAA airports. We did not, however, suggest that Edinburgh faces no competitive constraints and we explicitly rejected BAA's argument that it set its prices independently of market forces. Moreover, we did find 21 per cent of Prestwick's passengers came from districts in Edinburgh's catchment area.⁶ In this context, we noted in our working paper on the potential for competition between BAA's Scottish airports that 'it seems reasonable that this reflects passengers who choose to make a longer journey to benefit from either better timing or, given the prevalence of LCC airlines at Prestwick, low fares. This raises the possibility that competition for these types of passengers could be quite strong'. This is consistent with Prestwick having had some

⁶Provisional findings, Appendix 4.1 Table 2.

competitive impact on Edinburgh, and hence also with competition from Prestwick having caused BAA to reduce its Edinburgh prices.⁷

- (c) There is potential for competition to bring further price reductions since, as we noted in our provisional findings, prices at Edinburgh and Glasgow appear to be above average for other regional airports on which we have data.⁸

It is also relevant to note that, immediately before its sale, Prestwick had no passengers as BAA had had no incentive to attract airlines from Glasgow to Prestwick.

Conventional substitutability analysis before the sale would have shown no potential for competition—this only emerged after Prestwick started to compete. This illustrates the importance of the point made in paragraph 4.83 of our provisional findings about the limitations of substitutability analysis carried out under common ownership.

Impact of competition between Edinburgh and Glasgow

9. As already noted, when competition previously has been absent, it is difficult to predict the precise benefits that competition will bring to customers. Nevertheless, we consider that some useful insight can be gained from the impact of BAA's sale of Prestwick.

Prices

10. Our analysis of substitutability suggests that Glasgow can substitute for Edinburgh to at least as great an extent as Prestwick can substitute for Glasgow⁹ (while Prestwick is closer to Glasgow than Glasgow is to Edinburgh,¹⁰ this may be offset by the fact that Prestwick Airport is still considerably smaller than Glasgow whereas Glasgow

⁷Growth in passengers at Edinburgh has been lower than at Prestwick, but greater than the combined total for Glasgow and Prestwick. This is likely to be attributable to non-price factors, including the relative decline of charter which is concentrated at Glasgow and the relative move of population and economic activity from the west to the east of Scotland.

⁸Provisional findings, paragraph 2.117.

⁹See our working paper on the potential for competition between BAA's Scottish airports. Catchment analysis shows that Edinburgh's exposure to Glasgow exceeds Glasgow's exposure to Prestwick (Figure 6). Results of survey analysis (Table 10) show that on all four measures a higher proportion of Edinburgh passengers choose Glasgow as a substitute than Glasgow passengers choose Prestwick.

¹⁰For example, Ryanair noted 'I do not think they are remotely as interchangeable or substitutable for one another as Glasgow/Prestwick would be for Glasgow International, for example. That is a much more competitive situation'.

and Edinburgh are of similar size). Discounts are materially greater at Glasgow than at Edinburgh (see Annex 2).¹¹ We therefore assume that the impact of competition is just to increase discounts on Edinburgh's existing services to the average level prevailing at Glasgow over the last five years; this implies a price reduction of about 8 per cent, representing benefits of about £4 million per year, (a net present value (NPV) of £40 million over 30 years).¹²

11. This may not, however, reflect all aspects of relative pricing, for example there is a lower passenger charge in winter at Glasgow but not at Edinburgh. An alternative broad-brush assumption might therefore be that separating Edinburgh's ownership from that of Glasgow increases the competitive constraints on Edinburgh to the level already prevailing at Glasgow and hence restores relative prices to those prevailing at the time of the Prestwick sale. BAA's prices at Glasgow have fallen about 14 per cent relative to its prices at Edinburgh since the sale of Prestwick. This would then suggest that Edinburgh prices could decline 14 per cent, representing a benefit to customers of about £7 million per year on 2007/08 passenger numbers. Over a 30-year period, this would amount to a present value of about £70 million.¹³
12. However, we consider that the impact of competition will go beyond the reduction in prices at Edinburgh as Glasgow is likely to respond and this would be likely to cause a further response from Edinburgh, and so on. As one airline told us 'if they were separately owned I am absolutely certain that, not only would one have been cheaper, both would have been cheaper'. It is even more difficult to quantify the size of this effect but it is notable that Figure 1 suggests that competition from Prestwick has had an impact on prices at Edinburgh as well as Glasgow, relative to a suitable

¹¹The figures in Annex 2 exclude Ryanair (which operates from Prestwick rather than Glasgow). The calculations would not be materially different if Ryanair was included.

¹²The average effect on Edinburgh customers of increasing discounts to same level as Glasgow over the last five years is 8 per cent (see Annex 2). This illustrative calculation assumes a cost of capital of 7.5 per cent and a counterfactual increase in real revenue of zero (for example resulting from 3 per cent passenger growth per year and price change of RPI-3).

¹³Using the same assumptions as in the previous paragraph.

comparator (Aberdeen). As a rough illustration of the effect, we might take the difference between Aberdeen and Edinburgh long-run price trends¹⁴ as an indication of the further effect of competition. So we assume that, as a result of competition, prices at both Edinburgh and Glasgow reduce 2 per cent per year faster than they would otherwise have done. If this price reduction continues for ten years, the total NPV of the benefits increases to about £180 million.¹⁵

13. Table 1 summarizes the estimates of the previous three paragraphs.

TABLE 1 **Estimated consumer benefit from separating ownership of Edinburgh and Glasgow**

Paragraph	Price reduction (compared to prices under the counterfactual assumption of Edinburgh and Glasgow continuing under common ownership)		NPV of consumer benefit
	Edinburgh	Glasgow	
10	8% after 3 years—reflecting increase in discounts to similar level as at Glasgow	None	c£40m
11	14% after 3 years—reflecting restoration of relative prices before sale of Prestwick	None	c£70m
12	8% after 3 years (see above), plus additional 2% per year for 10 years (to allow for additional effect of competition between the two airports)—total reduction of 28% after 10 years	2% per year for 10 years (to allow for additional effect of competition between the two airports)—total reduction of 20% after 10 years	c£180m

Source: CC.

Note: NPV based on savings over 30 years and assumes a cost of capital of 7.5 per cent and a counterfactual increase in real revenue of zero (for example resulting from 3 per cent passenger growth per year and price change of RPI-3).

Other benefits

14. As discussed in our provisional findings,¹⁶ until about the time when the Scottish Route Development Fund was launched (2002), BAA's Scottish airports seem to have performed poorly, compared with other regional airports, in attracting new routes. We would expect separate owners of Edinburgh and Glasgow to compete vigorously to develop new routes with airlines, and in any case lower airport charges

¹⁴The compound rate of real decline in airport charges per passenger over 1993/94 to 2007/08 was 1.5 per cent at Aberdeen and 3.7 per cent at Edinburgh.

¹⁵This is based on an 8 per cent reduction in net prices at Edinburgh and additional 2 per cent per year price reduction at both Edinburgh and Glasgow for ten years, and otherwise the same assumptions as in the previous paragraphs.

¹⁶Provisional findings, paragraphs 2.100–2.104.

at the two airports would encourage airlines to launch additional services from these airports. This would bring further benefits to consumers—these are not, however, included in the above estimates.

15. As noted above, increased competition may also drive capacity expansions and service quality improvements. In this case, the two commonly-owned airports are not capacity constrained and we have not seen specific evidence suggesting that service quality improvements as well as price reductions will ensue. However, in the longer term, we would generally expect capacity developments and service levels to be more closely aligned with customer interests under competition than under common ownership.
16. The immediate customers of the airports (in regard to airport charges) are airlines rather than passengers. Assuming that there is effective competition between airlines (and we have seen no evidence to the contrary), we would expect the customer benefits to be passed through to passengers.¹⁷

Conclusion

17. Competition is a dynamic and inherently uncertain process, and it is therefore difficult to anticipate precisely how competition between Edinburgh and Glasgow will benefit customers. Based on our assumptions, we would expect discounts on existing services at Edinburgh to increase to the level already present at Glasgow, generating a present value of benefits to customers of at least £40 million. Additional to that, we would expect further benefits from each of the two airports responding to competition from the other; from new services being launched at both airports; and in the longer

¹⁷Other parties, including passengers, are customers of airports in respect of commercial services, such as car parking and retail, but we do not expect competition between Edinburgh and Glasgow to impact on these services which we found in our provisional findings are in a separate market from the aeronautical product supplied to airlines.

term from capacity developments and service levels at both airports being more closely aligned with customer interests.

BAA's pricing policy at its Scottish airports

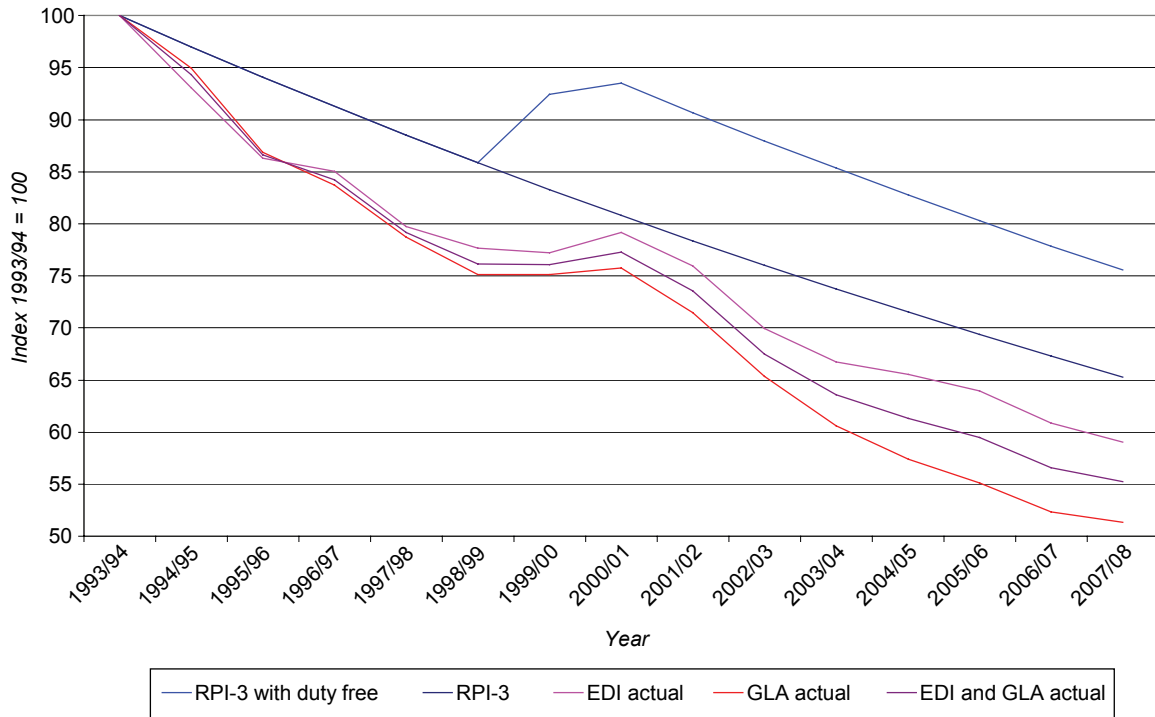
1. At its Scottish airports, BAA has since 1993 followed a policy (its voluntary pricing commitment) of not increasing tariffs by more than RPI-3 at Edinburgh and Glasgow taken together, and RPI-1 at Aberdeen. In July 1999, duty-free sales to intra-EU passengers were no longer allowed and BAA told us that, following significant consultation with the airline community, it was agreed that BAA would recover 75 per cent of its lost duty-free income by a supplement to airport charges (this was £0.90 per passenger at Edinburgh and Glasgow and £0.29 at Aberdeen).

2. During 2007 BAA told us that this voluntary price commitment had been exceeded for the last six years and that, in addition to this, discounts were available for new services. Subsequently, in its response to our Emerging Thinking, BAA said that, while there had been a few occasions where BAA had exceeded its voluntary price commitment, this had been as a direct result of RPI being greater than 3 per cent and/or changes in the structure or level of sundry charges requiring BAA to stay within the spirit of its voluntary price commitment. As regards discounts, BAA acknowledged in its response to our Emerging Thinking that airlines setting up at regional airports tended to expect discounts and failing to offer discounts could have a practical effect, but said that the majority of traffic did not receive discounts and that those discounts that were in place were for a prescribed period only, meaning traffic paid tariff when the deal came to an end.

3. The charts below compare trends in real airport charges per passenger to BAA's targets under its voluntary pricing commitments. They show that at Edinburgh and Glasgow, the reduction in real airport charges per passenger has consistently exceeded 3 per cent (even ignoring the duty-free compensation), while at Aberdeen the reduction in real airport charges has exceeded 1 per cent since around 2000.

FIGURE 1

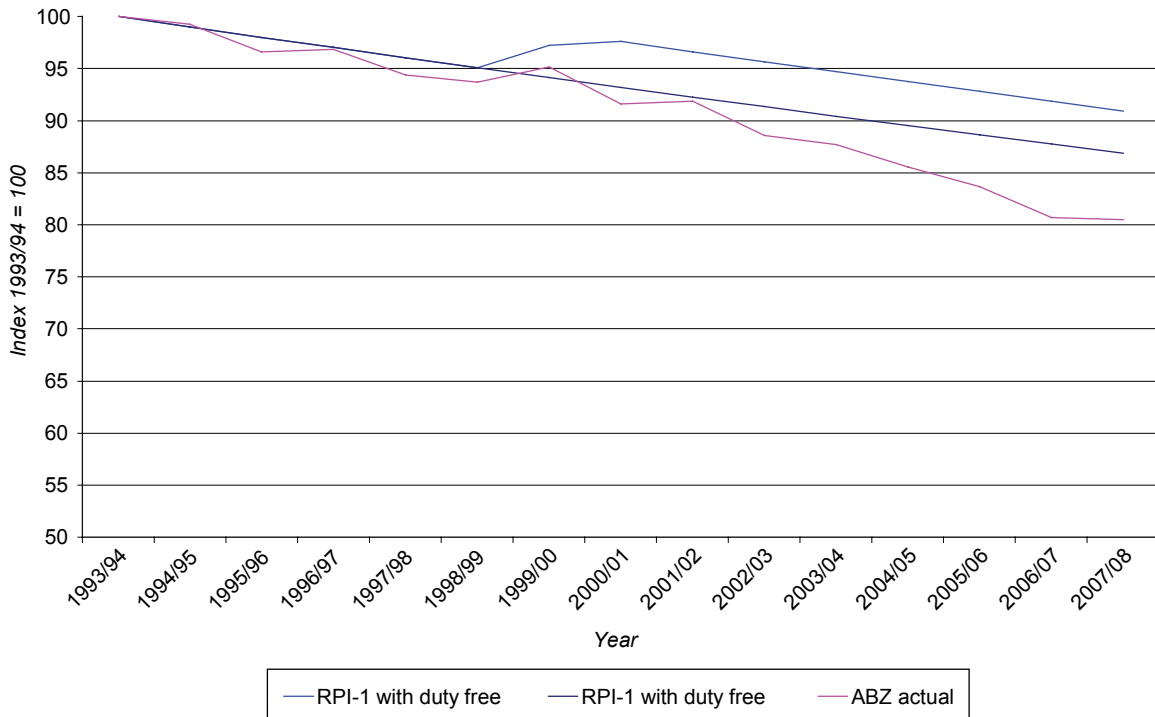
Edinburgh and Glasgow trends in real airport charges per passenger



Source: CC calculations based on data from BAA.

FIGURE 2

Aberdeen trends in real airport charges per passenger



Source: CC calculations based on data from BAA.

4. BAA told us that its voluntary pricing commitments related to the weighted average change in a basket of tariffs relative to the change in RPI for the previous September. There are three reasons why our calculation of trends in real airport charges per passenger might differ from trends in a basket of tariffs:
- (a) the volume mix may change (relevant because the weighted average change, calculated using fixed volume weights, may then differ from the change in average airport charges per passenger);
 - (b) the average change in RPI used in our calculation may differ from that in the previous September; and
 - (c) discounts and rebates may change (relevant to the extent they are excluded from the tariff basket).
5. It seems unlikely that these factors could fully explain trends in BAA's prices at Edinburgh and Glasgow:
- (a) The main relevant change in volume mix has been an increase in the proportion of international passengers; since BAA's charge per international departing passenger is higher than that for domestic passengers, this increases the average charge per passenger and goes in the wrong direction to account for reductions in airport charges per passenger exceeding tariff changes.
 - (b) Any difference in RPI measures is far too small to explain the difference and also in fact goes in the wrong direction (cumulative RPI, based on previous September figures, exceeds by about 0.6 per cent that used in our calculation¹⁸).
 - (c) If, as BAA implies, discounts are simply a normal aspect of business at regional airports, they would not be expected to change very much. In any case, changes in discounts and rebates are generally relevant to assessing price changes.

¹⁸ This reflects timing differences and that BAA uses the all items RPI while our calculation used the RPI excluding mortgage interest.

6. BAA did not provide us with contemporaneous documentary evidence showing how it had decided tariffs at each airport. It did, however, provide details of tariffs since 2002/03 (BAA said earlier years were not available due to changes in spreadsheet technology and staff). This is shown in Annex A to our working paper on the financial and investment performance of BAA's unregulated airports—in most years there was a small reduction in Edinburgh and Glasgow tariffs (except in 2003/04 the Glasgow winter passenger charge was reduced by 19 per cent), and a tariff freeze at Aberdeen. The lower passenger charge at Glasgow was, and remains, the only material difference in tariffs between BAA's two Scottish lowland airports, though as shown in Annex 2 discounts at Glasgow are greater. In Table 1, we have used this information to compute the change in a basket of tariffs for 2003/04 to 2007/08 and compare it with the change in average charges per passenger as shown in the figures. This shows that over this period the reduction in the tariff basket after inflation for Edinburgh and Glasgow was more than 3 per cent, and that for Aberdeen more than 1 per cent.

TABLE 1 **Comparison of change in basket of tariffs with change in average net charges per passenger (per cent per year after inflation)**

	2003/04	2004/05	2005/06	2006/07	2007/08
RPI (previous September)	1.7	2.8	3.1	2.7	3.6
<i>Edinburgh</i>					
<i>Tariff basket</i>					
Annual change	-3.2	-2.9	-3.8	-3.9	-3.5
Cumulative (% pa) since 2002/03	-3.2	-3.1	-3.3	-3.5	-3.5
<i>Average net charges per passenger</i>					
Annual change	-4.6	-1.8	-2.5	-4.7	-3.1
Cumulative (% pa) since 2002/03	-4.6	-3.2	-3.0	-3.4	-3.3
<i>Glasgow</i>					
<i>Tariff basket</i>					
Annual change	-4.7	-2.9	-3.8	-3.9	-3.5
Cumulative (% pa) since 2002/03	-4.7	-3.8	-3.8	-3.8	-3.8
<i>Average net charges per passenger</i>					
Annual change	-7.2	-5.4	-3.9	-5.1	-1.9
Cumulative (% pa) since 2002/03	-7.2	-6.3	-5.5	-5.4	-4.7
<i>Edinburgh and Glasgow</i>					
<i>Tariff basket</i>					
Annual change	-4.0	-2.9	-3.8	-3.9	-3.5
Cumulative (% pa) since 2002/03	-4.0	-3.5	-3.6	-3.7	-3.6
<i>Average net charges per passenger</i>					
Annual change	-5.9	-3.6	-3.1	-4.9	-2.4
Cumulative(% pa) since 2002/03	-5.9	-4.8	-4.2	-4.4	-4.0
<i>Aberdeen</i>					
<i>Tariff basket</i>					
Annual change	-1.8	-2.7	-3.1	-2.6	-3.5
Cumulative (% pa) since 2002/03	-1.8	-2.2	-2.5	-2.6	-2.7
<i>Average net charges per passenger</i>					
Annual change	-1.0	-2.5	-2.2	-3.5	-0.2
Cumulative(% pa) since 2002/03	-1.0	-1.7	-1.9	-2.3	-1.9

Source: CC calculations based on BAA data.

Note: Tariff basket is a weighted average of tariff changes using previous year's revenue before discounts as weights (2002/03 revenue breakdown is CC estimate). The source for the tariff basket is Annex A to our working paper on investment and profitability of BAA's unregulated airports, published May 2007.

Analysis of discounts at Edinburgh and Glasgow airports

TABLE 1 Discounts on airport charges

	<i>per cent</i>				
	<i>2003/04</i>	<i>2004/05</i>	<i>2005/06</i>	<i>2006/07</i>	<i>2007/08</i>
<i>Airport charges paid as % of tariff</i>					
Edinburgh*	88	88	87	86	85
Glasgow	83	80	78	78	79
<i>Comparison between Edinburgh and Glasgow</i>					
Glasgow charges relative to tariff as % of Edinburgh	94	91	90	90	93
Effect on Edinburgh customers of increasing discounts to same level as Glasgow	6	9	10	10	7

Source: CC calculations using BAA data.

*Excludes Ryanair (as it operates from Prestwick rather than Glasgow).