Scope for competition between BAA's London airports within current constraints

1. In this appendix we set out our findings on the scope for competition between BAA's London airports in the period before new runways are developed and during which the airports remain price capped. In doing so, we focus on the degree to which competition in this period would deliver beneficial outcomes in terms of pricing or quality improvements rather than on competition's role in providing the impetus to overcome capacity and regulatory constraints. This latter aspect is discussed extensively in Section 5.

2. BAA's view is that so long as Heathrow and Gatwick are capacity constrained and subject to price caps that result in excess demand at these airports, there can be no scope for material competition on price or quality[1] between any of its London airports.

3. The CAA, on the other hand, told us that the combination of capacity constraints and regulation[2] would not necessarily or materially limit the scope for additional competition between BAA's London airports. In particular, it submitted that there could be competition in terms of:

   (a) the price terms of access (including the duration of the contract, the charging structure, the allocation of risks of volume downturns etc);

   (b) the nature of the airport and/or commercial services (which may be redefined, bundled or unbundled in different ways to suit different airline or passenger requirements);

   (c) the quality of service, whether in terms of ambience or efficiency of operation (eg minimizing delays);

   (d) investment in facilities, including ways to improve or increase terminal, or other, capacity, which may have relatively short lead times; and

   (e) other innovations, which neither the CAA—nor any other regulatory or competition authority—could reasonably be expected to predict.

4. We agree with the CAA that competition to invest and innovate, even in the short term, could be intense. There may also be scope for separate ownership to stimulate improvements in the overall quality of service offered, even at price-capped capacity-constrained airports. However, we think that the scope for competition on price is likely to be modest because of the constraints imposed by existing runway capacity shortages and price control regulation.

5. In the process of forming a view on the scope for competition during the period before new runway capacity is rolled out,[3] we had to decide whether or not it was appropriate to adopt BAA's assumption that, under separate ownership, price caps

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[1]BAA has used the term 'static competition' to describe competition on these dimensions.
[2]The CAA accepted that continuation of RAB-based price control regulation might well serve to limit competition between airports as it would involve the regulator effectively determining the price, service quality and investment of airports, thus effectively crowding out the potential for competition. However, it stated that there was scope, even under the Airports Act, for the intensity of economic regulation to be adapted to reflect the degree of competition airports face.
[3]Our latest estimates indicate that the earliest date that a new runway might be delivered at any of the London airports is 2017.

would persist at levels to which the London airports could price up. In our provisional findings, we concluded that this was an appropriate assumption to make because a lack of spare capacity in the short term would preclude competition from driving prices below these levels or alternatively, would preclude the relaxation of price control regulation. Despite the impact of the economic downturn on volume, we remain of this view. However, we note that if the downturn results in more spare capacity than we have envisaged, then the scope for competition will be larger. We also note that a relaxation of price control regulation may occur sooner if the prospect of runway developments influence pricing in advance of capacity roll-out.

6. Whilst it is difficult to predict all of the dimensions in which airports might compete during this period, we have identified a number of strategies that separate owners could employ. In doing so, we have recognized that the tools available to the operator of Heathrow are likely to be different from those available to the operators of Gatwick and Stansted. This is because Heathrow will have no spare runway capacity of any significance during this period, whereas both Gatwick and Stansted are likely to have at least some spare off-peak runway capacity.[4] In evaluating the scope for competition during this period, we have therefore considered:

(a) in relation to Stansted and Gatwick, competition to fill off-peak slots either by rebalancing peak/off-peak landing charges or by offering greater off-peak discounts to individual airlines;[5] and

(b) in relation to Heathrow and Gatwick, competition to increase passenger numbers by rebalancing the landing and per-passenger charge.

In relation to all three of BAA's London airports we have also considered:

(c) competition for users by improving service quality; and

(d) competition via different commercial strategies, eg for higher-value users such as airlines which convey a higher number of passengers per ATM or those passengers who contribute disproportionately to retail revenues.

Off-peak competition between Gatwick and Stansted

7. In principle, Gatwick's and Stansted's incentives to compete to fill off-peak slots will be stronger under separate than common ownership. This is because, under separate ownership, the operator of Stansted will no longer consider the effect on Gatwick when contemplating an off-peak price reduction at its own airport and vice versa.

8. This suggests that off-peak charges would be lower if Gatwick and Stansted competed with one another. However, it seems likely that Gatwick and Stansted would be able to offset any reductions in published off-peak tariffs with an increase in peak tariffs restoring average revenue per passenger to price-capped levels. If so, competition over off-peak tariffs will not drive average revenue per passenger below the cap. It might, however, result in a different distribution of off-peak vs peak charges and higher capacity utilization.

9. Another strategy to fill off-peak slots would be to offer enhanced discounts to individual airlines. This is a practice that already occurs to some degree under common

[4] We set out our findings in relation to capacity utilization in Section 4.
[5] We considered this scenario in Appendix B of our Stansted Q5 review.

ownership.[6] Indeed, BAA's submission on its general principles in negotiating discounts at Stansted said that one of three objectives was to increase passenger volume, where discounts are given in the form of reduced charges subject to volume thresholds being reached. This could lead to an out-turn price below the price-capped level, even in the presence of excess demand for peak slots. This would be because a reduction in off-peak prices brought about through an increase in unpublished discounts could not be offset by an increase in peak prices whilst remaining within the limit of the price cap. If Gatwick and Stansted were in competition with one another, we would expect airlines to use the existence of spare off-peak capacity at each airport during the course of their negotiations to secure more generous unpublished discounts. That could lead to lower average prices at both airports and better capacity utilization.

10. Whilst we recognize that off-peak slots may not be attractive for certain operations, there are some airlines (eg long-haul operators and LCCs operating at Stansted and Gatwick with aircraft based elsewhere) which are likely to find these slots attractive. Indeed, nearly all the growth at Gatwick and Heathrow over the last decade has been in increased take-up of off-peak slots. One south-east airport told us that it was achieving annual growth of over 5 per cent largely as a result of a strategy of focusing its efforts on selling and marketing off-peak capacity.

11. The effect of the recession on airline traffic along with the planning approval for the SG1 developments at Stansted means that there will be more spare capacity in the south-east airports than we anticipated at the time of our provisional findings.[7] As spare capacity at Gatwick and Stansted increases, so do the incentives for the two airports to compete in this way under separate ownership.

Competition to increase passenger numbers at Heathrow and Gatwick

12. Whilst Heathrow may be operating at the limit of its runway capacity, it is not operating at its full terminal capacity.[8] Under separate ownership, we would expect the operator of Heathrow to try and fill its spare terminal capacity by competing with Gatwick and Stansted for passengers. Given that it cannot increase the number of ATMs that it processes, it could only increase the number of passengers that used the airport if it could influence some airlines to carry a higher number of passengers per ATM.[9]

13. The current system of price control regulation enables Heathrow to earn a maximum amount per passenger. However, within this constraint, Heathrow can choose to balance landing charges, passenger charges and parking fees in any way that it sees fit. It would therefore be open to Heathrow to lower the per-passenger charge and offset this with an increase in the landing charge to induce airlines to carry more passengers per ATM. In doing so, it could potentially attract some passenger traffic away from Stansted and/or Gatwick and increase runway utilization whilst lowering fares.

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[6]We are aware that Stansted has in the past offered substantial discounts to fill spare capacity that have been negotiated individually with airlines, and has agreed volume-based incentive packages for 2009 with some Stansted airlines.
[7]More detail is provided in Section 4.
[8]As noted in paragraph 4.10, terminal capacity will remain constrained at Heathrow over the next few years as a result of the redevelopment of the Central Terminal Area, including HET. However, these constraints have not yet proved to be an insurmountable barrier to entry for airlines
[9]In our provisional findings we noted that there is a significant degree of spare terminal capacity, particularly at Heathrow. BAA's forecast passenger per ATM figures suggests that by 2020, passenger numbers at Heathrow and Gatwick could increase by 20 million and 4 million respectively, without increasing the number of runway movements.

14. BAA has argued that changing pricing structures at Heathrow would be unlikely to result in a material increase in passenger volumes because airlines have control of the slots and the airport has a limited ability to influence airline decisions on how the slots could be used. BAA also argued that even if it were shown that changing pricing structures would have an impact upon usage, there is no basis for linking the pricing structures that prevail to common ownership. In particular, BAA argued that tariff restructuring at Heathrow and Gatwick might result in an increase in demand at Stansted, not a decrease as we believed possible.[10]

15. We accept that it is difficult to predict how responsive airlines would be to changes in the balance of charges. However, we believe that incentives to lower passenger charges (and increase landing charges) would be stronger under separate ownership. So long as:

(a) airlines are currently profit-maximizing in respect of fares and fleet capacity, and they have some market power;

(b) the number of passengers per ATM can be expanded either, for example, by increasing load factors on existing aircraft or by airlines upgrading their fleets or by the replacement of routes operated by smaller aircraft with those operated by larger aircraft; and

(c) airports are currently optimizing in respect of the tariffs they currently charge—in other words, they are currently optimally offsetting the benefits from lowering passenger charges with any costs (including costs of negotiating with airlines on this) from doing so;

then, in principle, we would expect the operator of Heathrow to have a higher incentive to compete for passengers by lowering passenger charges (and increasing landing charges) under separate ownership than under common ownership.

16. Whether this happens in practice will depend on the ability of airlines to react to changes in the balance of charges (the assumption in paragraph 15*(b)* above). The higher the incremental costs of expanding the number of passengers per ATM, the smaller the volume effect of lowering the passenger charge will be and the smaller the incentive an airport will have to rebalance charges. In the very short term, an airline's ability to increase passengers per ATM may be confined to the scope to increase load factors on existing aircraft, which may not be possible under yield management systems (although at Heathrow load factors currently average 73 per cent and have therefore some scope for increases[11]). Over time, routes operated by

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[10]BAA submitted that common ownership cannot provide the explanation for why those pricing structures have not been adopted. Thus it argued that even under the assumption that rebalancing had an effect, this could benefit Stansted if it resulted in more long-haul traffic at Heathrow and Gatwick, with Stansted's short-haul business benefiting from demand displaced from the other airports. We note that for this to be true, the effect on Stansted of route mix changes at Heathrow arising from rebalancing would have to outweigh the effects of lower passenger numbers at Stansted on its pre-existing flights. Yet we would normally expect network airlines at Heathrow to be keen to protect their short-haul feeder flights, implying that the effect of rebalancing on route mix would be small. In any case, if the substituted long-haul route at Heathrow attracted traffic from Gatwick, this would also have to be offset against the benefit from shifting traffic to Stansted so far as a common owner of the three airports was concerned. Whilst BAA submitted that its argument also applied to rebalancing charges at Gatwick, the scope there for route mix changes towards long haul appears small given the limited range of long-haul destinations served from the airport. Nonetheless, we accept the theoretical possibility that, as BAA has claimed, if the route mix at one airport changed due to charge rebalancing, demand at another airport might increase. However, we find it implausible that this would be the case under the prevailing charging structures because of the reasons cited and because BAA might have been expected to have already taken advantage of any such opportunities for rebalancing charges at Heathrow and/or Gatwick that would also benefit any other of its airports.

[11]BAA told us that, although load factors were on average below 100 per cent, that was not an indication that there was material spare capacity available as airlines might choose to operate with load factors below 100 per cent deliberately in order to retain the possibility of accommodating late-booking business passengers or to avoid negative effects on other flights operated at the same airport; and that airlines already have a strong incentive to maximize use of their aircraft. We accept that airlines already

smaller aircraft may be replaced by routes operated by larger aircraft and airlines may also deploy larger aircraft over existing routes. Their incentives to do this will depend on the benefits obtained from passing lower passenger charges through to fares compared with the costs of operating the larger aircraft necessary to accommodate larger passenger numbers per ATM. One airline told us that if charges were to fall by 50 per cent at one of the airports at which it was based, it would replace the smaller aircraft it had there with larger ones as a priority to take advantage of increased volume potential through lower fare offerings. In the context of our Stansted Q5 review, we were told that easyJet had recently renegotiated an aircraft order so as to be able to carry more passengers per flight at congested airports, replacing a request for A319 aircraft with larger A320s.

17. The scope for competition in this way will also depend on the nature and scale of any other constraints that prevent an operator from rebalancing charges (assumption in paragraph 15*(c)* above). If airlines are resistant to rebalancing charges, then separate ownership may not have a significant effect on the structure of tariffs even if incentives changed in favour of rebalancing charges. Indeed, we have been told by BAA that the airlines are resistant to increasing landing charges and reducing passenger charges because this would shift more volume risk on to the airlines. It could be the case that airline negotiating power would therefore limit the potential for competition for passengers in this way. Indeed BAA does not appear to have discounted passenger charges in favour of higher landing fees when (albeit weaker) incentives to do so exist under common ownership; and this suggests that there may be other factors which are preventing it from doing so, which may limit the extent to which competition of this nature might deliver benefits. Nevertheless, the higher incentive to reduce per-passenger charges may eventually feed through into negotiations between the airlines and the airports even if the effect on charges, utilization and fares is modest.

18. We consider that there is some scope for Gatwick to compete with Heathrow and Stansted in this way so long as Gatwick continues to experience excess demand. Compared with Heathrow, Gatwick has fewer slots subject to excess demand and higher load factors suggesting less to be gained from competition along this dimension. However, there is a higher proportion of small aircraft operating slots, which suggests more to be gained from this kind of competition.

Scope for competition on service quality between Heathrow, Gatwick and Stansted

19. There may also be scope for separate ownership to stimulate improvements in the overall quality of service offered. As we have noted, airlines operating from different BAA London airports compete with each other and we would expect separately-owned airports to be more responsive to airline views than BAA, as a common owner, has been. We consider that good service quality is often a matter of good management and organization rather than the result of spending large amounts of money (this is relevant as even separately-owned price-capped airports do not necessarily have the incentives to spend on improving service quality, except to achieve SQR targets). Rivalry in the provision of service quality would supplement the effect of SQR targets, which are inevitably imperfect substitutes for competition. However, this rivalry would not replace SQRs, at least not in the short term.

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have strong incentives to maximize use of their aircraft and that by doing so will balance the cost and benefits from increasing load factors. Since reductions in the per passenger charge will lower the cost of an increase in load factor, with no effect on the benefit, we consider that they would likely have an impact on some, if not all, airlines.

Scope for competition through differing commercial strategies between Heathrow, Gatwick and Stansted

20. There is also scope for competition through differing commercial strategies, such as focusing on specific types of traffic. For example, there is scope for airports to compete for particularly high-value users, such as airlines which convey higher numbers of passengers per ATM or passengers that contribute disproportionately to retail revenues. The CAA told us that the volume of passengers was not the only dimension on which airports could compete—different passengers had different values according to, for example, what they spent in retail, so that would be another dimension of competition.[12]

21. New management teams may find other ways to compete for valuable users. Generally, we would expect that the different management strategies and techniques that would arise through separate ownership would tend to increase innovation and efficiency.

The impact of the next quinquennium

22. Under the current regulatory system, short-term incentives to compete would become weaker towards the end of a quinquennium because the benefits of attracting additional passengers disappear at the beginning of the next one. This applies to passenger numbers as well as to the commercial revenues that they generate. This would tend to limit the incentives for airports to compete with one another to fill off-peak slots, or to compete for passengers and for high-value customers in the later years of a quinquennium.

23. However, it would not remove them altogether. Indeed, this disincentive applies to BAA under common ownership yet its behaviour suggests that it has faced incentives to increase passenger numbers and increase retail spend in its airports. Moreover, if there is an expectation of deregulation or of a longer period between regulatory reviews, then the effect on incentives to compete may be significantly less.

24. Taken together, we consider that even in the presence of capacity constraints and price cap regulation, there is scope for service quality competition and modest price competition between BAA's London airports.

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[12]Summary of hearing with the CAA held on 23 January 2009, paragraph 4.