YOUR LONDON AIRPORT
Gatwick

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Tim Griffiths
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Civil Aviation Authority
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Dear Tim

GAL response to SLG Economics report on the distribution of economic rent

On the afternoon of Christmas Eve you provided GAL with a copy of a report by SLG Economics which was a response to papers by Compass Lexecon submitted to the CAA by GAL (in response to an earlier SLG Economics report), and by RBB Economics, submitted to the CAA by BA.

As the CAA is aware, Gatwick was subject to substantial passenger disruption on Christmas Eve following flooding from the severe storms that affected the south east of England. As a result, with staff out of the office assisting passengers, and the subsequent festive holiday period, we only gained sight of the most recent SLG Economics report on 2 January 2014. This means we have not had a sufficient opportunity to consider in detail the contents of the most recent report. Nevertheless, we have some initial observations.

1. We are surprised that the SLG Economics report appears to consider that the issues relevant to the economic regulation of airports is similar to that for railways, as they are both “fixed transport infrastructure networks”. This is not a comparison that the CAA has ever made. While we agree that the economics of access to airports have differences to those of the economics of spectrum allocation, our view is that they are much more similar than suggested by SLG Economics, and much more so than railway track access. The economic regulation of railway track access is concerned with the provision of natural monopoly infrastructure to largely homogeneous customers, with largely local monopolies. Airports on the other hand are not natural monopolies, compete with other airports (including, in Gatwick’s case, other airports serving the same metropolitan area) and provide facilities to heterogeneous downstream customers with different end user requirements. This is much more similar to spectrum markets.

2. The SLG Economics report does not acknowledge that the papers from Compass Lexecon were provided <u>on the basis that the CAA’s view of binding capacity constraints, as set out in its market power analysis, is correct</u>. Much of the SLG Economics report is spent either trying to prove that there are no binding capacity constraints or drawing conclusions based on the assumption that none exist. If there are indeed no such capacity constraints, and there is therefore the potential for passengers and airlines to switch capacity between

airports in the south east of England (and within the EU in the case of airlines), then the CAA's reasoning for finding Gatwick to have SMP would be substantially undermined. The SLG Economics report, combined with the CAA's 'minded to' consultation, are inconsistent. In particular, Gatwick does not agree with SLG Economics' implication (on page 3) that the ability for airlines at Heathrow to increase aircraft size or load factor would not constrain Gatwick's ability to exercise market power to a material extent. An ability to increase aircraft size or load factor would allow an airline operating at both airports to switch capacity from Gatwick to Heathrow, and would allow passengers of other airlines to switch from Gatwick to Heathrow.

3. We do not consider that the SLG Economics report substantiates the conclusions reached in the previous report. In particular, the report does not substantiate that there would be harm to passengers arising from increases in airport charges to competitive, market clearing levels, where there are capacity constraints.

4. The SLG Economics report does not explain why airlines, operating in a capacity constrained environment and pricing to underlying demand, would increase charges beyond their prevailing prices (determined by underlying demand) in the event of an increase in airport charges, particularly if such an increase impacted airlines' fixed costs. If the fixed component of the airport charges were to rise, the optimal fare would not change. However, it would affect the overall profitability of the route which would lead to airlines switching marginal routes to other airports. It is for this reason that Gatwick would not be able to increase charges above competitive levels.

5. We recognise that an increase in charges towards the competitive level may make the most marginal routes no longer profitable, but in a market with excess demand, this would make capacity available for new routes with a higher willingness to pay and hence deliver more optimal use of scarce airport capacity, in the passenger interest.

6. The SLG Economics report claims that LCCs would not switch due to sunk costs. This is in contradiction to the actual statements of the LCCs (who say it is easy to switch) and evidence in the CAA report that sunk costs for many airlines such as inbound airlines are small.

7. The empirical evidence presented by SLG Economics on pages 5 to 7 does not substantiate that fares at Gatwick have fallen, and certainly not in recent years. The data that SLG Economics uses is mostly for Heathrow, does not cover all airlines and does not control for any changes in the average journey length. The data also shows that prices have not fallen as swiftly as costs, which implies that airlines have benefited from the increase in demand. The time periods used are also arbitrary and would show a different picture if different years were used.

8. The SLG Economics report appears to imply that 17 per cent of flights being small aircraft is a small proportion. We do not agree. At an airport with capacity constraints, the use of scarce runway slots by small aircraft carrying relatively few passengers delivers sub-optimal outcomes for passengers. We consider 17 per cent to be a significant proportion of flights using small aircraft, and this further demonstrates that there is additional capacity in the south east overall.

Based on these initial observations, we continue to consider that the prior critiques provided by Compass Lexecon to the previous SLG Economics report and the RBB Economics report stand.

Yours sincerely,

Colin Garland

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