

easyJet submission to the Competition Commission on the OFT's reference of BAA.

Introduction

1. This submission should be read in conjunction with easyJet's initial submission to the OFT's review of the airport market, and its evidence to the CAA on the market power of Stansted airport. Both these submissions provided substantial evidence; this paper summarises their main points.

The OFT reference

2. easyJet welcomes the OFT's reference of BAA to the Competition Commission. It agrees that BAA has market power, but does not believe that in the South-East the break up of BAA's airports would increase competition in the absence of any growth in capacity. easyJet also welcomes the OFT's conclusions that the regulatory regime distorts investment incentives, and believes that the regime needs to be revised so that it both properly incentivises future investment and manages existing market power.

The airport market in the South-East of England

3. easyJet believes that there are capacity constraints at all the main airports in the South-East (Heathrow; Gatwick; Stansted; and Luton). These remove the incentives for competition between the airports, and mean that the profit maximising behaviour for these airports is to increase prices. easyJet believes that the ability to increase prices above 'fair' levels means that an airport has market power.
4. The constraints at these airports, and the market power these confer, are independent of the ownership structure of the airports. Breaking up BAA's joint ownership of the three largest South-East airports will not affect this market power, or the need for continued price regulation. easyJet does not agree with the OFT's conclusions that separate ownership will lead to competition in the short term. It does agree that the benefits of separate ownership mainly relate to the future, through competition for investment.

The airline and passenger markets

5. The OFT's report provides an initial analysis of the passenger and airline markets and their interaction. The passenger market determines whether passengers choose to fly, which airports they want to fly from (and to), and when they want to fly (with for example business passengers having a preference for early morning and evening flights). The airline market seeks to satisfy passenger demand in a way that is financially viable.
6. The interrelated airline and passenger markets are the main determinants of the demand for airport capacity, and easyJet believes that the Competition Commission will need to take the OFT's analysis further to reach a complete understanding of the airport market.
7. The combination of the airline and passenger markets has significant implications for the structure of the market for airport capacity. In particular, it leads to peaks in the demand for airport capacity in the early morning and late evenings. It also determines where the demand occurs. For outbound travel, airports have local catchment areas, and when given the choice, passengers prefer to use their local airport. Inbound passengers generally prefer to use the airport with the best transport links to their ultimate destination. However, for many destinations demand is not sufficient to ensure service from all airports, and so airports will attract flights from outside their

catchment area. Again, the interaction of the airline and passenger markets determines which airports services are provided from.

8. The analysis of the market for airport capacity has often been too simplistic, treating it as single and uniform. However, in practice there are many overlapping markets for airport capacity, linked to different routes, times of day and passenger groups. Understanding these overlapping markets is key to understanding whether airports are operating in a competitive market.

The constraints in the South-East

9. There are four main types of constraints on airport capacity: slots; terminal capacity; planning constraints; and stand capacity. The existence of any one of these constraints may lead to an airport having market power. This is particularly true if it limits the ability of airlines to base additional aircraft at an airport.
10. The South-East airport market exhibits all these constraints, as shown in the table below, and noted by the OFT. The presence of constraints at each of the main South-East airports means that they have no real incentive to compete, and their profit maximising strategy is to increase prices. At each of these airports there is no room for any material increase in the number of short-haul aircraft based at that airport, either due to a lack of morning peak departure slots, or stands to park aircraft on.
11. easyJet provided the CAA with the description of a model of airport pricing incentives, which shows how these incentives operate, and when airports face incentives to increase or decrease prices.

Capacity constraints at main South-East airports

Airport/ Constraint	Slots	Terminal capacity	Planning restrictions	Stand capacity
Heathrow	Yes, throughout the day	T5 will provide some headroom in 2008	Yes, air traffic movements limit	Yes, constrain efficiency of operations
Gatwick	Yes, throughout most of the day in Summer, no room to base additional aircraft	Limited capacity in South terminal	No new runway capacity before 2019	No
Stansted	Yes, at peak times, no room to base additional aircraft as peak departure slots are not available	Yes, terminal flow constraints at peak times.	Yes, limit on total passenger numbers, likely to be reached in 2007 or 2008	No
Luton	Not currently	Not currently	Not currently	Yes, no room to base more aircraft

The effect of joint ownership on competition

12. easyJet believes that the market power of the main South-East airports is independent of their ownership structure, as it is a function of the capacity constraints at these airports. In the absence of these constraints, joint ownership might allow

BAA to create a position of dominance, but under the current conditions separate ownership would not affect the market power status of these airports.

13. Joint ownership may have reduced service quality at the co-owned airports, as BAA has had little incentive to improve quality, and it may also have made it harder for the CAA to benchmark its efficiency and service quality. But joint ownership has not changed the underlying structure of the market. Removing the joint ownership of the BAA airports would not change this structure, and easyJet believes that they need continued price regulation.

The benefits of separate ownership

14. The main benefits of separate ownership of the South-East airports lie in the creation of a proper market for future investment in airport capacity. BAA appear to continue to take a 'system' approach to investment, and have not been responsive to the demands of airline customers. easyJet supports the OFT's conclusion that separate ownership would ensure that airports compete more effectively for investment funding. It would also encourage them to move towards normal commercial arrangements, with investment linked to long-term supply contracts between an airport and airlines.
15. Separate ownership may provide some opportunity for efficiency and service quality gains, if the regulator can use this to benchmark.

The impact of price regulation on investment incentives

16. It is generally agreed that RAB based price regulation distorts investment incentives, and easyJet welcomes the OFT's conclusions on this issue. However it is less clear how the regulatory regime prevents, restricts or distorts competition. In the past easyJet has found Luton to be a competitive alternative to Stansted, and Stansted did not price up to its price cap. The level of competition in the South-East relates to capacity, and regulation is only likely to restrict competition if it restricts investment in capacity. Indeed, the history of regulated industries is generally one of innovative unregulated companies competing with traditional regulated companies.
17. easyJet would be very concerned if the OFT's conclusions on regulation were seen to justify a withdrawal of regulation. Where there is market power, regulation will continue to be needed, but where the existing regulatory tools do distort investment decisions, the answer will be to develop new regulatory tools, not to simply remove regulation.

The airport market in lowland Scotland

18. easyJet believes that in lowland Scotland there is the potential for greater competition between Glasgow and Edinburgh airports, as there is a degree of substitutability between them. This issue has been extensively covered by the OFT, which has collected evidence of the market power of these airports.
19. easyJet does not believe that Prestwick Airport is a sufficient constraint on the market power of the two jointly owned airports. Whilst Prestwick is a potential substitute for Glasgow Airport, its distance from Edinburgh means that it does not constrain the prices set at Edinburgh, and joint ownership means that Glasgow's competition with Prestwick does not spill over into pricing competition with Edinburgh.

Conclusion

20. easyJet welcomes the Competition Commission's investigation into BAA's airports. It believes that it is important to get a better understanding of the structure of markets that airports operate in. However, easyJet does not believe that the market power of the main airports in the South-East is a product of BAA's joint ownership of

Heathrow, Gatwick and Stansted. These airports, along with Luton, would have market power whatever their ownership structures. The benefits of separate ownership would come from competition for future investment, and it is in this area where new ownership structures and the right regulatory tools offer the greatest potential economic benefits.