WHEN DO AIRPORTS HAVE MARKET POWER?

The increasing prevalence of private-sector ownership of airports has led to a debate as to whether airports require economic regulation, and if so how this should best be implemented. In this bulletin we explore some of the issues around whether an airport has market power and therefore might be a candidate for regulation in the first place.

We frequently encounter over-stretched and under-resourced regulators who privately acknowledge the limitations of what they can achieve, pointing to the huge number of airports over which they have oversight.

Yet by contrast, if we look at the UK, Australia, New Zealand, countries that have, perhaps spent more time thinking about this issue in detail than many others, we see only two airports (both in London) that are subject to any direct economic regulation at all, and only one (Heathrow) subject to the sort of explicit price cap we see in other infrastructure sectors. Add to this the observation made in my previous bulletin that many airports struggle to earn a reasonable return on the capital they employ and you rapidly come to the view that many regulators might make more effective use of their resources if they were allowed to focus their attention on the airports where there is a significant problem and allow the remainder the freedom to operate in a competitive environment.

What is needed to resolve this dilemma is a proper process that considers first whether any given airport has significant market power and second whether that market power justifies specific regulatory intervention on prices, which cannot be taken for granted even if market power is identified.

But while market power tests are commonly applied by competition authorities across the wider economy, including to airline services, there is limited experience of applying them to airports.

The central idea is relatively simple. It is about consumer choice; in this case the passenger. What do passengers want to buy (i.e. demand) and what alternative ways do they have of satisfying that demand (i.e. what alternative options are valid substitutes for each other)? And when the current alternatives may appear limited, are there new ways that can be found to meet this demand (i.e. supply side options)?

The most obvious choice for the passenger exists when a catchment is served by more than one airport, as is the case in many large cities. But the reality is more complex. In a densely populated area, like Western Europe, most passengers are within a couple of hours drive of more than one airport, so in many cases passengers may have a choice of which airport to use. But the extent to which one airport represents a viable alternative to another is a matter of degree and may vary depending on where the passengers want to travel to. For any given journey we have to make an assessment of how influential surface access time is on airport choice, which will itself depend on many other

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facets of the journeys being undertaken. Choice *per se* cannot always be interpreted as effective competition.

We see, therefore how the complications start to mount up. The services offered by an airport do not form one market because they are not all substitutes (close alternatives). For many passengers, flying from Paris to Munich is not a substitute for flying from Paris to Mumbai (if your family is in Munich or your business contact in Mumbai). So within certain limits each route will be a different market and subject to different competitive constraints. In this example, the train may be a viable alternative for Paris-Munich, but is not realistic for Paris-Mumbai. So to define the overall situation for an airport we need to know how important the different types of connection are in the airport's overall traffic mix.

But this only serves to highlight more issues: both purpose of travel and direction of travel also matter. Business travellers and those visiting friends and relatives may have limited discretion over their choice of destination (and hence airport). Holiday traffic may be significantly more flexible as many destinations may be broadly seen as substitutes for each other, while transfer traffic of any type may also be more footloose. Similarly when thinking about competition between two "adjacent" airports, business travellers may value shorter surface access more highly, meaning the set of airports considered viable substitutes may be smaller for business than for leisure travel.

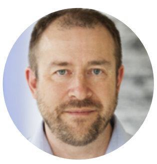
As for direction of travel, even if an airport is the only viable means of access to an island it may nevertheless not have significant market power if the majority of its traffic is inbound discretionary tourism. This is probably a familiar situation for many airports: many small relatively isolated air-ports may not have market power.

Where then do airlines fit in to all of this? Clearly passengers cannot choose to use another airport if it does not offer the destinations they want to reach. So for passengers to exercise choice it has to be possible for airlines to facilitate that choice. To do so, when a route is not already served elsewhere, airlines must be willing and able to relocate enough of their services to another airport so that the threat of this will effectively constrain airport pricing. Both capacity and operational issues now come into play. An airline may be willing to relocate to a competing airport but can only do so if that airport has the necessary capacity (e.g. available slots). So airports may gain market power because their rivals are congested.

Operational factors are also relevant. In particular, a network carrier is unlikely to relocate a small proportion of its services from its hub to a secondary airport in response to a rise in airport charges, because those flights represent part of a connected network of services. So at the margin network carriers may be captured by their hub. But we have also seen in the US that network carriers do, on occasions, relocate their entire hub.

Overall there are many facets to defining the relevant markets served by an airport. After that, we have to assess whether all these factors do or don't add up to an effective competitive constraint on the airport pricing.

In following editions of this bulletin we explore practical approaches to market power tests for over-stretched regulators as well as some more points of detail: in particular asking if inter-airline competition or the increasing importance of non-aeronautical revenues reduce the need for regulatory intervention.



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