



Inner Thames Estuary Feasibility Study

Response to Airports Commission Call for Evidence

The Mayor of London's Submission: Supporting technical documents

23 May 2014

Title: Competition and Airline needs (Extract from responses to Airports Commission Discussion Paper 04)

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Purpose of paper:

To set out the role of competition in the London airports system. To assess airline needs and how this shapes their response to relocating.

Key messages:

- Competition is important for delivering choice, service and keen pricing
- A hub has no perfect competitors – Gatwick has proven unable to be an effective competitor to (a heavily constrained) Heathrow
- Key is encouraging competition between airlines at the hub – for the benefits of passengers and freight; this is extremely difficult when Heathrow's constraints serve as a major barrier to new entrants and new routes
- Airlines will not leave Heathrow unless they have to – i.e. only if the hub relocates

Extract from Mayor of London's response to

Airports Commission **Discussion Paper 04: Airport Operational Models on Competition and Airline needs**

July 2013

Competition and choice

A hub airport has no perfect competitors

4.4. Competition is not an end in itself, but is useful insofar as what it can deliver, in particular: passenger choice, improved service and keen pricing. Hub airports, by their very nature have no perfect competitors:

- Hubs compete to some extent with the non-hub airports in their wider region, but the range of destinations (especially longhaul) and the higher yields they can offer airlines limit the competitive dynamic. Price competition between airports should also not be overstated; for longhaul routes, typically airport charges constitute no more than 10% of total airline operating costs.
- Hubs compete with hub airports in other regions but this is limited to transfer traffic between third regions, given each hub has its distinct O/D market.
- This is why most hubs airports are regulated (or state owned) because that ensures improved service (usually underpinned by investment) and keen pricing.

Dispersed expansion is not the panacea for airport competition

4.5. The discussion paper links dispersed expansion to improved competition. But for true competition in the provision of airport capacity, two key criteria¹ must be met:

- Credible as an attractive alternative offering
Gatwick and Stansted need to be at least as attractive as Heathrow, if not more so – to overcome its brand, global connectivity, yield and surface access advantages. Even with significant sums spent on infrastructure, it would be very challenging to achieve this. *[See Response to DP04: 4.49]*
- Low barriers to entry
A truly competitive market requires low barriers to entry – i.e. for other actors to be able to set up airports in competition serving a similar catchment. But the UK's track record on delivering new airport capacity is abysmal. Without the potential for new entrants, it is not a competitive market but an oligopoly, a panacea neither for airlines nor passengers.

4.6. It is difficult to see how the "domestic competition advantages" cited for dispersed

expansion will materialise or how the customer proposition is enhanced. Moreover, by focusing wholly on domestic competition, this would undermine our international competitiveness, with no UK airport able to compete effectively with hubs abroad.

Passenger choice best served by competition between airlines not airports

- 4.7. Choice is paramount in meeting the needs of the consumer and is best underpinned by a competitive market. In industries with high fixed infrastructure costs, consumer choice is best served by competition between service providers rather than infrastructure providers. Competition has a key role to play between airlines operating at an airport – with choice supporting improved service and keen pricing. By contrast, infrastructure provision is often treated as a monopoly, as with rail and telecoms in the UK and, in many countries, for airports. *[See DP04 Response evidence base: N]*

An effective single hub ensures meaningful passenger choice

- 4.8. Providing choice between different non-hub airports is of limited value: offered a similar assortment of shorthaul routes, passenger preference is driven largely by catchment – i.e. the non-hub airport they can most easily reach.
- 4.9. Choice between airports can be meaningful when different types of airport offer the consumer a different destination proposition: the choice between a hub airport with a comprehensive shorthaul and longhaul network and a more local non-hub airport with a selection of popular routes, mostly shorthaul and leisure focused.
- 4.10. An effective hub airport ensures passengers have this choice.

Heathrow lacks the capacity to encourage airline competition and choice

- 4.11. Heathrow's severe capacity constraints have weakened competition between airlines, reduced choice and helped push air fares up. It also allowed the airport operator, BAA, to become complacent about the service and facilities it offered.
- 4.12. The regulatory response was the break-up of BAA. This partly addressed the symptom, but not the fundamental problem: that Heathrow lacks the runway capacity to foster airline competition. Gatwick and Stansted both have spare capacity and Gatwick has set out to transform its passenger offering; yet even with its efforts, Gatwick have been unable to attract anything but a handful of spillover routes from Heathrow: they are simply not meaningful competitors to Heathrow.

Better regulation, not imaginary competition, moderates a hub

- 4.13. It remains the role of regulators to ensure that the UK's hub airport is operated in the interests of passengers. If their success to date has been mixed, it is perhaps the regulatory framework that needs reforming. Certainly, there is scope for a better balance to be struck between the needs of passengers, freight customers, airlines and airport operator – as well as the wider economic and connectivity needs of the UK. This must be given serious consideration in a future aviation strategy.

Airline needs

Airlines cannot be relied on to move if not unambiguously in their interests

- 4.25. Airlines operate in a market with wafer-thin margins² – partly a result of the legal barriers to cross-border consolidation (that simply do not apply to most industries). In this context, as privately owned entities in a competitive market, they will always look to ensure the viability and maximise the profitability of their flights.
- 4.26. Some set out grand visions of how airlines will voluntarily act in different ways to comply with UK aviation strategy – and in particular, move to a different airport; but airlines cannot and will not move if not unambiguously in their economic interest.

Dispersed expansion means airlines choosing to move to airports even if it undermines their profitability

- 4.27. The dispersed expansion model relies on attracting airlines to Gatwick and Stansted while Heathrow remains open. The problem is that Heathrow as the existing hub, albeit very imperfect, has the better global connectivity and the brand. It will continue to attract the critical mass of passengers (both high value O/D and substantial transfer flows). This is an even greater problem under 3-2-2, where a third runway reduces (but not eliminates) Heathrow's capacity constraints: it is wholly implausible to think of Gatwick or Stansted as any sort of competitor for an expanded Heathrow.
- 4.28. Airlines will be hugely reluctant to leave Heathrow if it undermines their competitiveness and the viability of their services:
- Yields for airlines on flights out of Heathrow remain significantly higher than for Gatwick and Stansted – and why, for example, US airlines at Gatwick paid tens of millions of pounds for slots at Heathrow to switch following the US-EU Open Skies deal. *[See DP04 Response evidence base: Q]*
 - Heathrow is an asset degraded by its severe capacity constraints; by choosing to move out, an airline will help address those constraints – but with the airline's rivals, those who did not switch, left to reap the benefits. This is a kind of 'reverse prisoners' dilemma', where the first mover disbenefits.

- 4.29. The economic drivers that tend to keep airlines in the primary airport are considered in detail by de Neufville³.

Dispersed expansion will erode valuable inter-alliance transfer traffic

- 4.30. In the context of the airline industry's wafer thin margins, the transfer traffic at a hub remains key to the viability of very many routes and frequencies.
- 4.31. The discussion paper suggests moving an alliance en masse, on the basis that inter-alliance traffic is minimal – drawing on analysis undertaken by the CAA and set out in *Figure 4.13* of Discussion Paper 04. But this does not fully reflect the realities:
- There is significant variation in the share of transfer traffic between routes – and

indeed individual flights, which is masked in *Figure 4.13*. While for Oneworld as a whole, on average 42% of passengers are connecting at Heathrow, for the daily British Airways flights to Hyderabad, that figure is nearer 80%, to take one example. The loss of any transfer traffic from such a route is likely to have a disproportionately large effect on its viability.

- The analysis presents a significant number of inter-alliance transfers as switchable. If a passenger chooses not to stay within an alliance, it will often be a deliberate choice. The very significant risk is that if their preferred transfer option at the London hub was removed, they would just as easily switch to a rival hub abroad. *[See DP04 Response evidence base: R]*
- By including direct (O/D) passengers, *Figure 4.13* underplays the extent to which a significant proportion of the transfer traffic will be risked. *[See DP04 Response evidence base: S]*
 - » For Virgin Atlantic, Skyteam and Other aligned, the overwhelming majority connect from a different carrier (and are assumed lost in this analysis).
 - » For Star Alliance, half connect from a different carrier (including the switchable traffic); the data pre-dates the loss of Bmi from the alliance⁴.
 - » For Oneworld, as the largest grouping, the low share connecting from a different carrier still represents a substantial number of passengers.

4.32. Focusing solely on the transfer traffic loses sight of the fact that the hub operation is underpinned by both O/D and transfer traffic; the higher yields offered by the former are no less attractive to airlines than the additional volumes resulting from the latter.

Alliances are even more challenging to move than airlines

4.33. Even if an airline were convinced to sacrifice its inter-alliance transfer traffic for the sake of UK Government policy, moving a whole alliance would be deeply challenging. Alliances will only act in concert when it is in the interest of each member airline to do so. *[See Response to DP04: 3.3]*

4.34. For example, the Skyteam carriers invested in their first ever dedicated alliance-branded lounge, which opened at Heathrow Terminal 4 in 2009. But the alliance's largest carrier, Delta Airlines, announced in 2013 it will relocate to Terminal 3, to join its new strategic partner, Virgin Atlantic. If an alliance cannot keep airlines together in one terminal, it is naïve to assume they can readily move en masse to another airport.

Gatwick and Stansted will struggle to build a critical mass of transfer traffic or develop a comprehensive longhaul network

4.35. Self-connecting has been suggested for airports like Gatwick and Stansted, possibly underpinned by low-cost carriers. The non-optimised nature of these transfers limits their attractiveness and their ability to support increased connectivity. *[See Response to DP04: 3.8]*

- 4.36. Those who suggest that Heathrow and Gatwick/Stansted could specialise in longhaul and shorthaul flights respectively are not appreciating that *both longhaul and shorthaul flights are key to building a critical mass of transfer traffic at a hub*. Airlines would not accept the loss of flows implied and consequences for route viability.
- 4.37. Offering fifth freedom rights may attract a rapidly expanding carrier from outside the EU to establish a base at Gatwick or Stansted, eager to tap into the attractive London O/D market, even though at a disadvantage to Heathrow operators. However, it is unlikely that they would focus on more than a handful of the most lucrative primary routes – i.e. likely already served from Heathrow. *[See DP04 Response evidence base: T]*

A split site will not enable airlines to attract transfer passengers

- 4.38. For a split site solution to meet airlines' needs and attract passengers, it would have overcome very significant obstacles:
- A super-fast, high frequency link is required, implying very significant construction and operational costs (especially if need for maglev train speeds).
 - The link needs to be airside, while meeting UK border security requirements.
 - The inefficiencies at each end – with multiple terminals poorly laid out – will add to the total time required to move people and luggage; the minimum connection times (MCTs) at Heathrow are already amongst the worst in Europe: 60 minutes within a terminal and 90 minutes between terminals.
- 4.39. Even taking the most optimistic view on overcoming these obstacles, the MCT for a transfer between Heathrow and Gatwick will be over 2 hours. This is simply not competitive with rival airports and airlines able to offer passengers a hassle-free connection of less than an hour on a single site.
- 4.40. A split site is neither a compelling nor a competitive proposition for airlines or passengers. It will not grow hub airport capacity nor the connectivity it supports.

A new hub: attracting airlines means Heathrow cannot be a competitor

- 4.41. If it is clear that a single effective hub airport is the optimal solution, it is also clear that Heathrow's runway capacity and space constraints leave it unable to serve as an effective hub airport – and its urban location will mean it never can be. A new hub airport on a single site will be required if the UK is to secure the connectivity that will support its future economic growth and prosperity.
- 4.42. A new hub airport must be developed with its attractiveness to airlines firmly in mind, including extensive surface access links, world-class tailored facilities for the airlines and their passengers and a competitive charging regime.
- 4.43. For precisely the reasons that Gatwick and Stansted would struggle to compete with Heathrow in the dispersed model, a new hub airport for London would require a

significant reduction in Heathrow's scale and scope. *[See DP04 Response evidence base: U]*

An anchor carrier for a new hub is feasible, whether BA or another

- 4.44. An effective hub airport needs to be anchored by a single airline (or airline group), able to ensure the optimisation of the hub. British Airways as the anchor airline at Heathrow will, like other carriers, have a decision to make. Their public posturing to date has been that they would not move. *[See Response to DP04: 3.5]*
- 4.45. Following the shrinkage of Heathrow, the new hub would be the only multi-runway airport in the southeast – and the only location able to accommodate the full network of routes BA operates at Heathrow – as well as meeting suppressed demand and future growth. BA could choose to downsize, dismantle their hub operations in London and cede their market-leading position in what will remain one of Europe's most valuable O/D markets. This is unlikely.
- 4.46. In any case, if BA did withdraw from hub operations in London, that vacuum would be filled by others. The value of London's O/D market – and the proven history of hub operations in London and the southeast – would attract the interest of the major international airline groups, whether EU-based or, perhaps more likely, an ambitious emerging markets-based carrier looking for a significant European presence – possibly in conjunction with Virgin Atlantic, as the UK's second longhaul carrier.
- 4.47. Appropriate corporate structures could be established if rules around nationality of ownership need to be addressed. The timeframes to deliver a new hub airport would ensure that such arrangements could be planned several years before the airport opened. *[See DP04 Response evidence base: V]*
- 4.48. Therefore, there is every reason to expect that there will be an anchor airline ready to underpin the development of a new hub airport – whether British Airways or another carrier – given the inherent attractiveness of the London market and the absence of alternatives if Heathrow is reduced in scale and scope.

KEY CONCLUSION

The capacity and global connectivity that the UK requires can only be provided with a new single, effective hub airport serving London

Endnotes

¹ This is a subset of the 'Porter Five Forces Analysis' of industry competition; its application to the airport market is elaborated on in: *European Hub Airport Development in the face of Increasing Competition*, Annika Paul, June 2013

² "Global airline profit projections upgraded, but margins remain 'razor thin'", Travel Weekly, 3 June 2013

³ *Management of Multi-Airport Systems: a Development Strategy*, Richard de Neufville for Journal of Air Transport Management, June 1995

⁴ Bmi (British Midland International), the largest Star Alliance carrier at Heathrow, was acquired by Oneworld-member British Airways in April 2012, and as such this is not reflected in the 2011 data presented by the CAA; this suggests the Star Alliance figures for connections within an alliance (and the allegedly switchable) are in fact significantly lower today.