



CONFIDENTIAL

Response for BAA Ltd

Response to Working Paper on  
Switching Costs

BAA/CC2008/961

BAA Limited

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## 1. Introduction

1. This paper is BAA's response to the Commission's working paper on Switching Costs. BAA has not been provided with the paper in full, as the Annexes containing airline responses were excised. Therefore BAA has not been able to comment fully on some of the issues raised by the Commission. In particular, BAA has been unable to test whether the paper accurately reflects the evidence which has been supplied by airlines; how representative the airline responses are and the credibility of the responses themselves. BAA considers that in the circumstances it should have an opportunity to review this evidence subject to appropriate confidentiality undertakings.
2. BAA's general observations on the Commission's analysis of the degree of competition between airports and the role of switching costs are included in its response to Emerging Thinking (Chapter 2). This response provides BAA's comments on the more detailed matters raised in the Working paper.

## 2. Contractual Commitments and Sunk Investments

3. The Commission suggests that the higher costs that would be incurred by airlines that enter into longer term contracts, if they were to switch during the contract duration do not meet the definition of "switching costs" since the length of these contracts is negotiated and since this cost increase only applies to the contract duration but not to contract expiry [10]. BAA notes, however, that for the purposes of appraising scope for competition between airports, it remains the case that these airlines are unlikely to switch while these contractual arrangements remain in place.
4. The Commission gives its view that at designated airports there might be implications for market power if airlines enter into long term agreements for the provision of services at the airport on the assumption that price caps continue to apply, and the price caps are subsequently removed [11]. BAA has not seen the evidence that the Commission has relied on in coming to this conclusion and therefore cannot comment fully, but notes the following points:
  - The price cap at Manchester airport has recently been lifted, and such concerns were not prominent in that case;
  - The Commission's assessment of airline costs other than airport charges relating to Gatwick and Stansted, suggests that these are relatively low compared to BAA's airport charge revenue;
  - BAA has not conducted a comprehensive appraisal of the degree to which these activities are subject to long run agreements, but many of them will not be;
    - The majority of BAA's income at designated airports is in the form of airport charges and as such is not subject to long term agreements;

- another significant element (relating to airline charges) is check-in and baggage charges. These charges are generally set on an annual basis and as such as not subject to long term contracts; and
  - the most significant remaining element of income from airlines relates to property charges. The length of contract here varies depending on the facility in questions, however the majority of terminal accommodation contract (with the exception of CIP lounges) have short notice periods.
- The lead time associated with any lifting of price caps is likely to be significant, thus limiting the likelihood of this being an issue. Further, there has always been the possibility of airport de-designation, especially so in the case of Stansted where the Government has recently conducted an appraisal of whether Stansted should be de-designated following an extended review by the CAA; and
  - Removal of a formal price cap would not eliminate constraints on an airports' pricing behaviour. Market constraints, competition law and the threat of a return to regulatory intervention might all have an impact.
5. BAA notes that the large sunk investments made by BA at Heathrow – said to be around £1 billion [16] – are consistent with the large volume of evidence that shows that airlines at Heathrow will not view switching to other London airports as a realistic alternative.
6. The Commission refers to long term commitments entered into by freight operators, specifically at Stansted, and appears to conclude that these might limit their flexibility [14]. In setting up or expanding any operation, airlines will balance the benefits they might realise from long term contracts (such as lower costs) with the potential costs (such as reduced flexibility). The evidence presented by the Commission does not suggest that these costs are any greater for freight airlines than for passenger airlines.
7. The Commission suggests that switching costs may be lower when the switch is between geographically close airports – in particular, the Commission believes that this may apply to switches between Edinburgh/Glasgow, Stansted/Luton or Heathrow/Gatwick [18]. BAA requests that the Commission set out the evidence it relied upon in coming to its view that staff relocation costs will be materially lower when switching between these airport pairs (as compared to relocating to more distant airports) and whether the costs would still be expected to be material (even if they are lower than the costs involved in switching between more distant airports).

### 3. Loss of Economies of Scale

8. BAA agrees with the Commission's suggestion that operating a given set of routes with aircraft based at two airports involves higher costs than operating them with aircraft based at only one airport [19-21]. BAA considers that in light of these higher costs, it is highly unlikely that a substantial number of airlines would decide to serve the same geographic market from two locations as the Commission suggests is the case in the Scottish lowlands.
  
9. Despite the diseconomies of scale that might be expected from operating at two airports in relatively close proximity (as recognised by easyJet and reported by the Commission) a number of carriers' operations are significantly duplicated at Glasgow and Edinburgh thereby resulting in increased costs for these airlines relative to operation from a single base. The explanation for this behaviour is that Glasgow and Edinburgh serve separate geographic markets and, thus, generate incentives for airlines to incur these additional costs in order to be able to attract passengers from substantially different catchment areas.
  
10. The Commission notes that economies of scale are likely to accrue as the size of airline bases increases [22-23]. In particular, it is suggested that economies of scale are likely to become significant at around three to five aircraft. In light of this, easyJet's decision to operate from both Glasgow and Edinburgh for around a decade before the scale of operations at the individual airports reached this range, strongly supports the view that these airports serve separate markets.
  
11. This view is further supported by the observed behaviour of the other main scheduled operators at both airports. In fact, as shown in table 1, almost all airlines which operate at both airports, have between 1 and 5 aircrafts at each. If these airports were in the same market, the airline would reasonably be expected to take advantage of economies of scale by basing these aircraft at one location. The fact that no airline has done so, strongly supports BAA's position that these airlines are in separate markets.

Table 1: Based Aircraft<sup>1</sup>

	Glasgow	Edinburgh
British Airways	5	5
bmi	1 mainline, 1 regional	1 mainline, 4 regional
Easyjet	4	4
KLM	1	1
Flybe	4	5
Globespan	5	3

<sup>1</sup> For these purposes an aircraft has been counted as based at an airport if that airport is its normal overnight base

12. This, along with other evidence provided to the Commission (see in particular BAA's response to the Commission's working paper on substitutability in Scotland; BAA/CC2008/936) strongly supports BAA's position that Glasgow and Edinburgh airports serve separate markets.
13. BAA agrees with the Commission that network effects at Heathrow are one factor that imply that other BAA airports are unlikely to be viewed as a substitute for Heathrow airlines. BAA notes that this effect is also relevant – though less prominent – at Gatwick which also serves a significant percentage of interlining passengers.

#### **4. Market Effects**

14. BAA agrees with the Commission that there is significant differentiation between its South East airports [26 et seq]. This implies that, even in the absence of capacity and price constraints, the scope for competition between these airports may be limited.
15. The Commission's analysis does not take into account the risk, faced by airlines switching to a less desirable location within the same market, of this being backfilled by another airline at the original location (especially if it has been demonstrated by the switching airline that there is established demand for and scope for profitable operation of the route). This new entrant, would then compete with the switching airline's service at the less desirable airport and could further reduce yields. This is likely to increase switching costs.
16. A related point is that in switching a proven route to a new airport, airlines are exposed to the risk that their operation at that airport may not be profitable – particularly in the initial period, as the true value of the new route will only become apparent after a significant period of time. This creates further uncertainty for airlines, related to switching, which is not addressed by the Commission. Further, there may be additional revenue losses and costs (relative to not switching) if it were necessary to terminate the new unprofitable route. In contrast, airlines that continue to operate a route with established demand are not exposed to this risk.
17. The Commission lists some issues an airline might face when considering to start services from Stansted [29]. However, the Commission misses an important point: the fact that airlines decisions are likely to be influenced by the implications of the highly concentrated LFC user base at Stansted – i.e. the risk of a strong competitive reaction by Ryanair and easyJet if an airline enters the airport with rival services.
18. BAA agrees Ryanair's London operations constitute a key part of its network [30]. However, BAA notes that Ryanair maintains substantial operations at Luton, which is not owned by BAA.