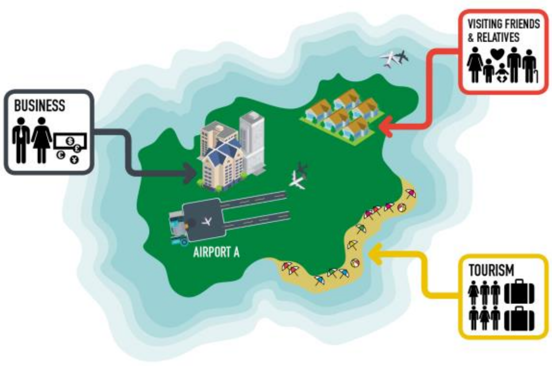
Airport market power:
IS INTER-AIRLINE COMPETITION RELEVANT?

In this series of notes we have begun to explore the issue of airport market power and to identify when direct regulation of airport charges may or may not be needed. I have argued that there is no one size fits all solution to this problem and regulators need to conduct proper market power tests before applying economic regulation. Here I dive a little deeper into the demand side factors that regulators consider and specifically how competition between airlines affects the issue.

In conversations with stakeholders I often encounter confusion as to the relative importance of passengers or airlines in assessing airport the market power. And, in particular, what bearing increasing competition between airlines has on the matter, which may come from the growth of low-cost carriers or the challenge of new regional competitors, such as the Gulf airlines. Many airports find themselves dealing with airline partners that are highly commercial, tough negotiators who emphasise their ability to go somewhere else if they don't get what they want. So how does this square with the idea that airports have market power?

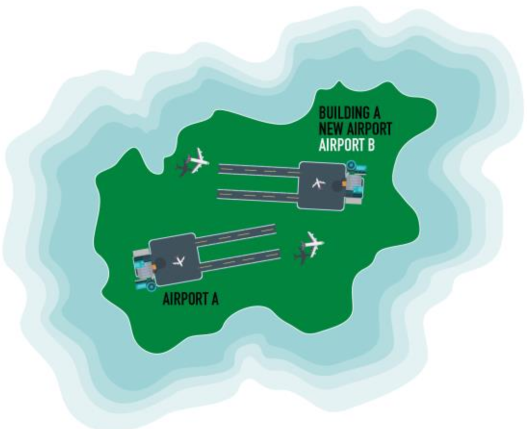


To cut straight to the conclusion: increasing inter-airline competition *does* tend to reduce airport market power, but not always and not necessarily for all airports.

To illustrate, think about an island served by a single airport, and, for simplicity, let us assume the airport is the island's *only* point of access (you can draw sharks and pirates around the island if it helps your imagination).

I discussed in an earlier briefing that even this airport cannot be presumed to have market power: it may look like the only show in town, but it may actually be primarily an optional destination for inbound passengers (especially tourists). But inter-airline competition itself changes nothing for passengers originating on the island as far as providing an alternative to the airport itself. So while more competition between airlines is likely to benefit both residents and visitors through in lower airfares, the existence of inter-airline competition *per se* does not alter the market power position of the airport. This should not be surprising to anyone familiar with network economics. You can have competition *using* a monopoly network (e.g. in fixed line telephony, or energy markets) while the network itself retains significant market power, if there is only one and no way of bypassing it.

However, what *does* make a difference to airport market power is *choice*, so the situation changes dramatically if we add a second airport



to our island example. Now passengers can choose between two airports. It does not immediately matter whether any specific service is offered from both airports, provided both airports have the facilities (surface access links, stands, terminal capacity, etc.) to be potential alternatives to each other.

34%

Increase in EU airports offering scheduled services between 1998 and 2015

And this is where more competitive airline markets *do* have the effect of mitigating airport market power. Liberalisation in aviation and the growth of low-cost point-to-point carriers has supported a huge increase in the number of airports served. So in my stylised example, the second airport has not simply appeared out of nowhere. There may always have been an airfield there. But it has been developed into a new regional airport, potentially with the support of a low cost carrier that has a vested interest in creating competition for the incumbent airport.

So airline competition *does* increase the competitive pressures that airports face, by promoting the development of more airports, and where those airports serve the same geographic market competition between airports is intensified.

But we must be careful how much we conclude from the fact that airlines can move aircraft from one base to another. All exercises in market definition need to concern themselves with the intersection of a product market and a geographic market. In this case, the relevant considerations are which alternative services to passengers are adequate substitutes for those provided by a given airport, and from where those services can be offered.

Obviously an airline operating a flight between Paris and my island can use the same plane to fly between Paris and a different island instead. But that does nothing for the passengers needing to fly to or from the island if there is no alternative. In this case, the existence of the alternative island as a competing passenger destination may be a relevant constraint, but the fact that the same aircraft could be used to fly either route irrelevant. The fact that aircraft are, by definition, mobile assets cannot be used to widen the geographic market definition applying to any give airport.

Another mistake is to suggest that airline competition leads to more “countervailing buyer power” on the part of airlines, which could reduce airport market power, or at least offset its effects. In fact buyer power in this sense is actually associated with a less, not more competition in downstream markets (in this case airlines). It is about airports themselves not having a choice with whom they negotiate. It is not about the difficulties of negotiating with large, commercially savvy airlines.

We can see this again by thinking about my island example. If the airport does in fact have market power, then its ability to exploit that power depends on whether it faces a competitive landscape of airlines or is obliged to deal with a monopolist on the airline side. With many airlines the airport is in a stronger position to make a take-it-or-leave it offer. Faced by a single potential buyer, the airport will have to negotiate.

This underlines the simple point at the heart of the market power tests: to identify the choices that exist and whether they really represent adequate alternatives to each other, in particular from the passenger’s point of view.

Market power is usually not clear cut, but rather a matter of degree. In the next edition of this briefing I will discuss how you test if an airport’s market power may pass the threshold that may require intervention.

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