ACI EUROPE RESPONSE TO EASYJET & FRONTIER ECONOMICS PAPER ON THE SUPPOSED ECONOMIC BENEFITS OF LOWER CHARGES AT 15 EUROPEAN AIRPORTS
easyJet is one of Europe’s most successful airlines, carrying 64.8m passengers in 2014, generating profits after tax of £450m (€620m) and a Return on Capital Employed of 20.5%;

In 2013 (the latest year for which there is data available) easyJet’s net profit per passenger was almost double the top 20 European airport’s average net profit per passenger;

easyJet has built up a valuable portfolio of airport slots over several years, held at primary airports. easyJet connects more of the top European city-to-city market pairs than any other airline and has number one or two market positions at primary airports including London Gatwick, Geneva, Paris Orly, Paris Charles de Gaulle, Amsterdam and Milan Malpensa. These airports are all subject to the EU Airport Charges Directive, and many have additional extensive regulatory requirements at a national level;
EXECUTIVE SUMMARY

- easyJet commissioned Frontier Economics to calculate the supposed economic benefit of an arbitrary reduction in the level of airport charges at 15 airports across Europe (‘the easyJet analysis’)

- Frontier Economics’ analysis of the supposed economic benefit of lower airport charges is based upon the assumption that airlines pass on the cost savings to passengers;

- However another recent Frontier Economics paper (‘the London analysis’) argues that, at capacity constrained airports, airlines in fact charge a non-cost related premium on passengers – therefore any airport charges savings will be retained as airline profits. This is particularly relevant as all 15 airports identified in the analysis paper are capacity constrained airports;

- The London analysis considered air fares at the London airports and found that airlines operating at Gatwick were able to charge a £7 (€9.70) premium for each one-way passenger, without incurring corresponding costs. Given easyJet’s traffic through Gatwick in 2014, this enabled the airline to pocket almost £110m (€150m) in scarcity rents at Gatwick alone, and all at the expense of the consumer;

- In light of the above, a more realistic approach would be to assume that airport charges savings would not be passed to passengers at the 15 airports considered. Under this approach, if easyJet were to be successful in its demands for a 25% reduction in airport charges at these airports, then neither additional GDP nor new jobs would be created. Rather, easyJet shareholders would instead have benefited from an extra €94.4m in pre-tax profits in 2014;

- These figures give some insight as to the dynamic underlying airline lobbying about airport charges. Artificially lowering of airport charges at Europe’s main airports are more likely to benefit airlines’ shareholders, rather than airlines’ passengers. This will also potentially prevent airports from investing in expanding capacity – or at least make the cost of such expansion more onerous and the business case for it more difficult. As a result, such lobbying ultimately reinforces the position of incumbent airlines at congested airports and limits airline competition – to the detriment of the travelling European public.
easyJet recently commissioned Frontier Economics to estimate the supposed positive wider economic impact associated with lower airport charges in Europe. This work – ‘the easyJet analysis’ - accompanied easyJet’s policy vision for European aviation, which has more restrictive regulation of airport charges as its centrepiece.

15 European airports are identified¹ (the rationale for this choice is not stated) and an average figure of €4.60 per passenger is derived, based on high level calculations as to the impact on airport charges of implementing several traditional airline demands (e.g. dual till, arbitrary operating expenditure cuts). The paper explains how the figure of €4.60 was derived, but does not really attempt to justify these underlying demands.

The logic of the easyJet analysis is that this saving of €4.60 per passenger will be passed on by airlines to lower fares and will therefore lead to increased consumer surplus and additional passengers, which will in turn stimulate trade, foreign direct investment and tourism spend. This would apparently result in an increase in GDP of €37 billion, and the creation of 470,000 jobs.

An interesting argument, albeit one which hinges on one key assumption: that the reductions in charges at these airport will be 100% passed on by airlines to the passenger. But is this a realistic assumption?

According to another recent analysis by Frontier Economics², the answer may actually be ‘No’.

In this –‘the London analysis’- easyJet’s own advisors argue that at congested airports, regulation of airport charges will not prevent higher air fares for passengers. As we shall see below, Frontier Economics London analysis even demonstrated this effect empirically, via an analysis of actual air fare data at London airports.

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¹ Amsterdam, Barcelona, Charles de Gaulle, Copenhagen, Fiumicino, Frankfurt, Gatwick, Heathrow, Lisbon, Madrid, Munich, Orly, Oslo, Vienna & Zurich

The London analysis is based on the theory that at a capacity constrained airport, passenger demand rises while supply stays unchanged. This leads to an increase in the price that can be charged for use of the runway.

Frontier Economics: “But if we assume the airport cannot raise charges … then this increase (in demand for use of the airport) must reflect an increase in airline ticket prices. Such an increase (in air fares) can occur because the airline constraint prevents free entry of new capacity from other airlines, so reducing airline competition. Thus the “value” of the constraint is passed over to the incumbent airlines. We would expect to see this reflected in higher ticket prices and slot changing hands for positive sums.”

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3 Ibid, p. 35. ACI EUROPE emphasis
Essentially, in such a situation, regulation of an airport does not stop passengers from paying more to use that airport. It’s just that the money goes to the airline instead of the airport. Airlines serving a capacity constrained and in-demand airport face weaker or non-existent competition, because they know that the chances of a competitor airline coming in and challenging them on a particular route are less. This in turn allows the airline to exploit passenger’s willingness to pay more to fly from the airport in question by charging a premium on air fares. It also allows incumbent airlines to benefit from higher slot values.

This means that if easyJet’s advisors are correct, a reduction in charges at such airports would be less likely to lead to an increase in GDP, nor to the creation of additional jobs. Instead the money would be more likely simply to increase easyJet’s already-substantial profits, as well as to further inflate the value of its slot holdings.

Of course, the disconnect between airline costs and the fares they charge to passengers is more widely visible. Recent massive reductions in oil prices – which represent airlines’ largest cost item - do not seem to have led to a decrease in air fares. A 25% hypothetical reduction in airport charges is heralded as being a wonderful development for passengers, yet a greater than 50% drop in oil prices does not seem to have provided anything substantial for Europe’s travelling public.

More generally, there are ample individual examples of air fares which clearly have absolutely no basis upon costs. For example, during the Air France strike last autumn, easyJet was routinely charging just over €1,300 for a return flight between Paris and Toulouse.

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*For more information on airline economic power see Section 2.3 of ‘Competition in the European Aviation Sector’, ACI EUROPE, March 2014 – available at: https://www.aci-europe.org/component/downloads/downloads/3829.html

Although one commentator has observed that this has led to a shift in the language used to describe fuel surcharges – see ‘Did the Airlines Actually Eliminate Fuel Surcharges?’ Wall Street Journal – available at: http://www.wsj.com/articles/did-the-airlines-actually-eliminate-fuel-surcharges-1425488470

The arguments put forward by Frontier Economics in their London paper have been aired before and these and the more general alignment of airline and passenger interests have been considered by both the UK Civil Aviation Authority and Department of Transport.

**UK CAA**

“Airlines tend to price to the market (i.e. the strength of passenger demand) rather than to reflect their cost base. This means that an increase in airport charges may not be passed through to passengers in the short run, if at all”

**Report for the UK Department of Transport by Cambridge Economic Policy Associates (CEPA)**

“However, the overall fiduciary duty for airlines to maximise the future stream of their profits overrides passengers’ price, quality and convenience preferences and means that there can be no automatic presumption that in all circumstances airlines’ and passengers’ interests will be aligned.

Amongst the key circumstances in which there may be a misalignment of interests are when:

- Airlines have market power.
- Developments that may increase the degree of competition are being contemplated.
- Airports being used by airlines are subject to economic regulation”

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7 ‘Consultation on Gatwick market power assessment: CAP 1052’ UK Civil Aviation Authority, 2013, para 8.28 – available at: http://www.caa.co.uk/docs/33/CAP%201052%20Consultation%20on%20Gatwick%20market%20power%20assessment%20%28p%2029.pdf
WHAT DROVE THE CHOICE OF THOSE 15 AIRPORTS?

It must be emphasised that the London analysis only finds that cost savings are retained by airlines where there is a scarcity of airport capacity. Is this really relevant to the recent easyJet analysis?

Within the easyJet analysis, 15 airports across Europe are selected. There is no rationale given as to why these were specifically chosen, but easyJet operates at the majority of these airports.

One common feature of each of the selected airports is that they have been identified by IATA as being ‘Level 3’ airports where ‘Demand for airport infrastructure significantly exceeds the airport’s capacity during the relevant period’ and where ‘Expansion of airport infrastructure to meet demand is not possible in the short term.’

So every single one of the airports identified in the easyJet analysis paper is an airport where airport charges reductions are less likely to be passed onto the consumer via lower fares, and where it is in fact more likely that incumbent airlines would instead increase their own profits. Of course the situation is not black and white. Airports can be designated at Level 3, but still have different levels of congestion. This might allow some proportion of an airport charges decrease to avoid being directed straight to the airlines’ profits, to varying extents. Further analysis of individual airports would be required to establish this.

“Primary airports are becoming increasingly capacity constrained in peak periods. With long planning and investment cycles to expand existing airports, several more airports are expected to be capacity-constrained in the future. easyJet has a competitive advantage from its network driven by its well-balanced portfolio of slots at congested primary airports, which has taken a number of years to build up and cannot be readily replicated.”
Carolyn McCall, easyJet CEO, in the airline’s Annual Report for 2014

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In the London analysis, Frontier Economics empirically tested their argument that airlines are charging passengers a premium at capacity constrained airports, and focused in particular upon Gatwick and Heathrow Airports in London. They found that on average in 2012 airlines were able to charge passengers a premium of just under £50 (€70) on a one way fare at Heathrow. This £50 (€70) represents the extra money passengers are prepared to pay to an airline to travel to or from Heathrow. There is no equivalent cost to the airlines associated with this revenue\(^\text{10}\). It is pure additional profit. The equivalent premium for Gatwick was £7 (€9.70).

These are substantial sums. For example, in 2014 easyJet handled around 15.5m passengers through Gatwick. If easyJet’s advisors are correct, then the ability to charge a £7 (€9.70) premium per passenger at Gatwick alone would have netted the airline almost £110m (€150m). To reiterate, there were no corresponding costs incurred by easyJet for this revenue – it represents pure profit for the airline, at just one airport, and all at the expense of the passenger. In fact, this figure may even be conservative, as the higher the passenger demand, the larger premium the airline can charge, and demand is likely to have increased substantially since 2012.

In light of the above, a more consistent and realistic approach might have been to assume that the €4.60 per passenger saving on airport charges is not passed onto the passenger, but rather retained by the airline as profit. ACI EUROPE estimates that in 2014 easyJet handled circa 20.5m departing passengers through those 15 airports identified in the easyJet analysis\(^\text{11}\). Had the airline’s demands had been granted, and airport charges had been reduced by 25% in the airline’s last reporting period, then easyJet would have been gifted an additional almost €95m in annual pre-tax profits. Given the actual reported profits of the company, this would have led to a total of almost €900m in pre-tax profits for easyJet in 2014.\(^\text{12}\)

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\(^\text{10}\) It should be noted that the rents accrue to those airlines that hold the slots. New entrants who gained slots via trading will incur a cost. However this will be matched by equivalent inflow of revenue to the incumbent airline which is selling the slot. Therefore within the airline community as a whole, there is no cost.

\(^\text{11}\) Based on OAG scheduled data for September 2014 and extrapolated out for the year. Assuming an average load factor of 90.6% as cited in easyJet’s annual report for 2014.

\(^\text{12}\) €1 = £0.721899. Even without this additional sum, in 2014 easyJet reported a Return On Capital Employed (ROCE) of 20.5%. What would the positive economic benefits in terms of GDP and jobs, if easyJet were to price at a level which delivered them a normal ROCE?
CONCLUSION ON EASYJET’S CONTRIBUTION TO THE EUROPEAN POLICY DEBATE

When an airline as dynamic and as innovative as easyJet places airport charges at the centre of its ‘Vision for European aviation’ it is tempting to believe the argument that airport charges must in some way be of crucial importance to the passenger’s journey. Even if airport charges only make up a small fraction of airline’s overall costs. Even if the preoccupation with airport charges seems to come exclusively from airlines and rarely from consumer groups.

But the reality is that in this instance, easyJet’s demands have little to do with the passenger nor any supposed wider economic benefits, and much more to do with their shareholders. As suggested by the London analysis, tighter regulation at the 15 capacity constrained European airports identified in the easyJet analysis would be less likely to result in lower air fares, and would instead be more likely have the result of boosting airline profits.

More generally, easyJet’s calls for a revision of the Airport Charges Directive, if successful, would not have led to an improvement in the travelling experience for European citizens. Instead it would serve only to embroil EU institutions into a drawn out and contentious political process, and taken resources away from other areas where genuine improvements to passengers can be delivered.

13 Ironically, easyJet’s Policy Vision can be accessed under the ‘Corporate Responsibility’ section of its website
WIDER CONSIDERATIONS ABOUT AIRPORT CHARGES

Notwithstanding the issues within the easyJet analysis, its publication does allow the opportunity for a wider reflection on airport charges and the airport-airline dynamic.

It is not only easyJet but all airlines operating at congested primary airports which enjoy the ability to charge passengers premiums with no corresponding underlying cost. As we have seen, the potential sums involved are substantial. Lobbying for political intervention to lower airport charges and boost their own profits at the expense of passengers is a win-win strategy for airlines operating at these airports, and under the current regulatory framework, airlines will never have an incentive to desist. Most worryingly, this airline strategy is not without a wider cost:

1. The price cap regulation which airlines are incentivised to demand crowd out the possibility for mature commercial interactions between airports and airlines, with the passenger ultimately losing out.

2. Regulator’s time and attention is overwhelmingly dominated by airport charges issues, which will not actually lead to lower fares for passengers at capacity constrained airports. This leaves less resources and political will to be focused on regulatory reforms which could genuinely improve the travel experience for European citizens, such as market access liberalisation, increased airline ticketing transparency, or minimum cabin baggage allowances, for example.

3. Perhaps most seriously, airport congestion clearly plays to the advantage of incumbent airlines. Tight regulation of airport charges provides these airlines with an added incentive and a mechanism to oppose, or at least not actively support, expansion of airport capacity.

   easyJet’s support for a new runway at Heathrow for example, was believed by many to be a ruse, primarily driven by the desire to see no extra capacity being added at Gatwick14. If Gatwick were to open a 2nd runway, then the £7 (€9.70) per passenger premium easyJet currently enjoys might be eroded away by new airline competitors. In addition the value of easyJet’s slots at the airport would be significantly diminished. Supporting expansion at Heathrow would be a tacit means of protecting its own position within Gatwick.

   Insufficient capacity at Europe’s primary airports remains one of the most important long-term challenges facing Europe. To face up to this challenge both the industry and regulators need airlines on board and supportive. Rewarding those airlines which have built up strong market power at congested airports with lower charges, is not sustainable policy.

The underlying motives of the easyJet analysis are a clear example of how regulatory involvement, if it goes beyond proportionate intervention, can provide players with incentives which are not in the best interests of the ultimate customer – the passenger. There is only one sustainable, long-term solution to the seemingly endless tensions between airports and airlines over charges – the restoration of these interactions from a political to a commercial setting.

EVERY FLIGHT BEGINS AT THE AIRPORT.

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