EUROPE
AIRPORTS COUNCIL INTERNATIONAL

INSIGHTS INTO THE LOGIC OF AIR FARES

SYNOPSIS

This synopsis publication is produced by ACI EUROPE and aims to summarise and contextualise the key findings of the ICF Study entitled *"Identifying the Drivers of Air Fares"*, released in May 2018.

To download a copy of the Study, visit: **www.aci-europe.org**

INTRODUCTION

In the context of the evaluation of the EU Directive on airport charges currently being conducted by the European Commission, A4E (Airlines 4 Europe), an airline trade association, has made some extraordinary claims.

In order to justify their call for a tighter regulation of airports and the need for lower airport charges, A4E claims that lower airport charges *"would save European passengers hundreds of millions of euros"* as *"lower charges would have been passed onto consumers by airlines, leading to lower air fares and boosting European economies".* A4E even goes so far as to claim that lower airport charges would allow the creation of 200,000 additional jobs in Europe!

To people with limited expertise in aviation matters, these allegations may seem intuitively right. They are certainly very appealing to both consumers and policy makers. Who does not want to see air fares getting (even) cheaper – so that even more citizens across Europe can enjoy flying and that businesses and regions can reap the full benefits of air connectivity?

Yet for all their simplicity and appeal, these assertions do not stand up to scrutiny. In the absence of recent research into how the logic and science of air fares has evolved over the past two decades, we asked ICF to investigate – with a strong focus on the relationship between airport charges and air fares.

ICF's conclusions confirm what everyone working in the aviation industry knows too well. Airport charges are a relatively small and stable part of total airline costs, incurred for the use of airport facilities and services. As such, airport charges can and do influence airlines' capacity planning and network development, as airlines seek to maximise their own returns by focusing on the most profitable routes. However, **there is no one-for-one correspondence between airport charges - and any change in their level - and air fares**. Indeed, airport charges usually have a **non-significant influence** on air fares, which are constantly changing – based on dynamic pricing techniques driven by demand patterns, price elasticity and the level of competition on any given route.

1

STATIC AIRPORT CHARGES VS. DYNAMIC AIR FARES

The departing point of ICF's analysis is the way in which and the timeframe over which air fares are set, compared to airport charges:

- **Airport charges are set well in advance**, for the upcoming IATA season(s) – and often for periods of several years at a time. Once they are set, they are static and do not change for the considered period.

  Airports do not set their charges as they see fit, as they have to abide with both EU and national regulations. This involves systematic consultations with airlines and the principle of cost-relatedness – which significantly limit variations in airport charges over time. In many cases, especially at larger airports, the regulator actually ends up setting the price.

- Conversely, **air fares are based on dynamic pricing by airlines** and change constantly – by the hour, sometimes even by the minute, as anyone who has ever purchased an airline ticket online can attest.

  Airlines are entirely free to set air fares as they see fit. They use Revenue Management techniques involving pricing algorithms, aimed at optimising revenues on every single flight. Revenue managers are tasked with striking the optimal balance between yields (prices) and volumes (load factor). They do so based on actual, past and forecasted demand levels and competitor's pricing. Indeed, as ICF reveals, revenue managers often set and adapt air fares without even considering the underlying costs of providing the service - let alone the level of airport charges on the routes they are dealing with!

2

DEMAND & COMPETITION BETWEEN AIRLINES DRIVE AIR FARES – NOT AIRPORT CHARGES

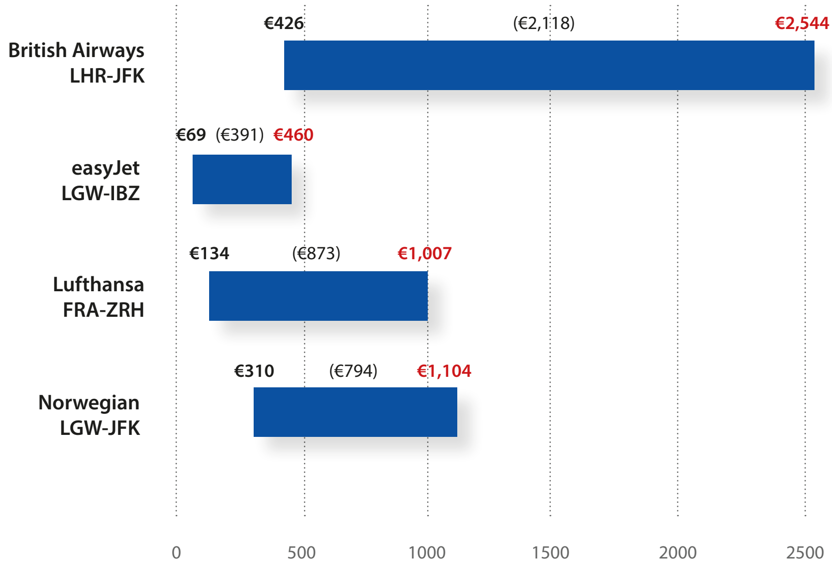
Accordingly, the ICF report clearly shows that air fares are driven by:

A) **Variations in underlying demand**, which reflect seasonality (e.g. higher demand during holiday seasons), day of the week (e.g. higher demand on Mondays/Fridays for business travel) and even time of the day (e.g. higher demand during early morning and evenings).

Airline's pricing power in periods of high demand is significant, and results from the fact that the product being sold - a seat for travel from A to B - is finite (there are only so many seats on each flight) and difficult to substitute (if you want to travel on a specific date between Brussels and Madrid, your alternative options are limited).

This is why variations in air fares are considerable – reaching **up to 700%** for the same product as illustrated in Exhibit 1. **Airport charges do not come anywhere close to influencing these variations** as airlines will always increase air fares whenever demand is inelastic and allows them to do so.

EXHIBIT 1: **PRICE VARIATIONS FOR RETURN ECONOMY CLASS TICKETS ON MAJOR ROUTES**

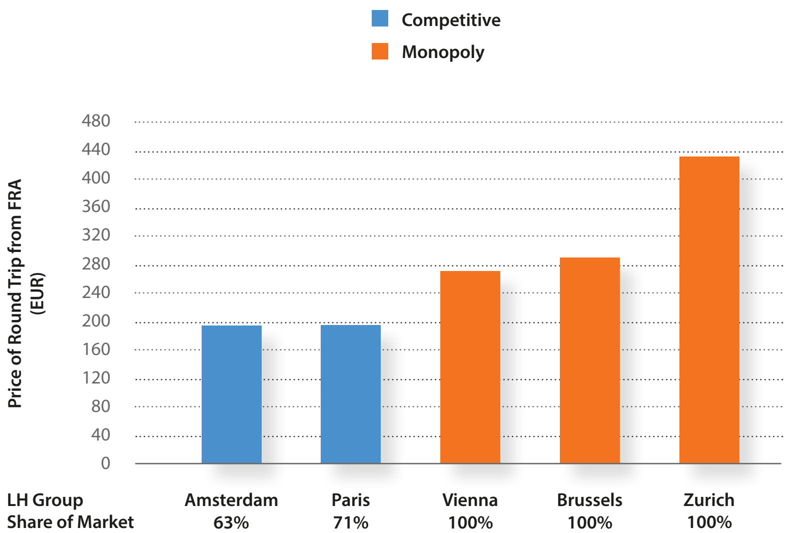


Source: Airline Websites
Note: Ticket prices shown are for the calendar year 2018 and were found on the 6th of April 2018. The lowest available fare class has been selected.

B) Airline competition

The illustrative ticket searches made by ICF reveal how air fares on **monopoly air routes are consistently higher than those on air routes where there is competition** between airlines. The table in Exhibit 2 shows that the price of a round trip with Lufthansa from Frankfurt for monopoly routes is more than **70% higher** than for competitive routes.

EXHIBIT 2: **LOWEST PRICE FOR A RETURN TICKET FROM FRANKFURT 7-11 APRIL 2018**



Source: Lufthansa Website
Note: Ticket prices shown are for an itinerary with an outbound flight on the 7th of May and inbound flight on the 11th of May 2018 and were requested on the 6th of April 2018.

Here again, **airlines will always exert their pricing power when competition on an air route is limited, irrespective of the level of airport charges**. Beyond the examples provided by ICF, many in France still remember the exorbitant air fares charged by Air France's competitors during its 14 day strike in 2014[1] or more recently, how the Bundeskartellamt in Germany became concerned at the rise in air fares on domestic routes following the collapse of Air Berlin[2].

1. https://www.challenges.fr/entreprise/greve-air-france-les-tarifs-fous-des-concurrents_80408
2. http://www.zeit.de/wirtschaft/unternehmen/2017-12/air-berlin-lufthansa-kartellamt-ticketprei-se-pruefung

3

NO CLEAR PASS-THROUGH OF AIRPORT CHARGES INCREASES

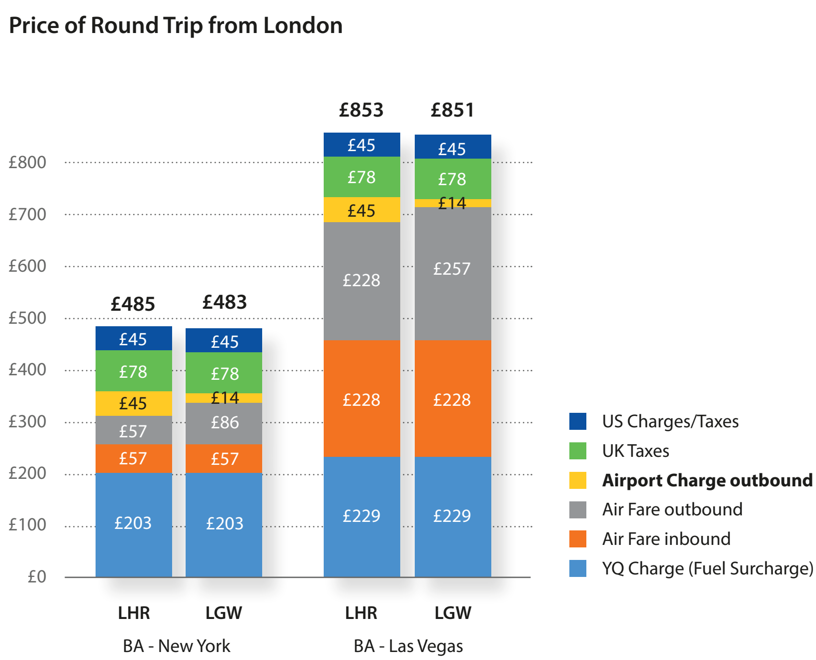
When it comes to the range of factors that influence whether airlines pass-through cost increases to consumers via higher air fares, ICF considers **the level of competition** is a key factor - as is **the timing and significance of the cost increase**. In cases where these cost increases are sudden and/or significant, there is a much higher potential for pass-through.

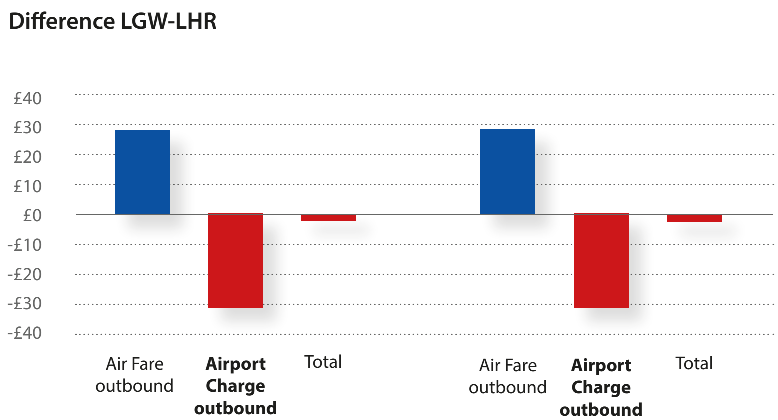
This has been the case in the past mainly with regard to increases in fuel cost. During the last oil spike in 2010, many airlines did pass-through fuel cost increases via dedicated fuel surcharges and/or higher air fares. However, it is also worth remembering that these surcharges still lingered on when fuel prices returned to pre-spike levels. This revealed a notable asymmetry in pricing decisions to the detriment of consumers – and once again illustrates how **airlines will always aim to exercise their pricing power irrespective of the underlying costs of providing the service on a given air route.**

Variations in airport charges are never sudden (as already mentioned, they are decided in advance and remain static over a significant period of time) and rarely significant (as a share of total airline operating costs, they vary from **3% to 12%** for Full Service Carriers and Low Cost Carriers). This is why, as described by ICF, changes in airport charges – be they increases or decreases – do not materially affect prices and go unnoticed by consumers.

ICF provides several case studies that further illustrate how much more important competition and market dynamics are to ticket prices than airport charges. For example, despite the fact that London-Gatwick has lower airport charges than London-Heathrow, British Airways charges a higher air fare to New York from London Gatwick than from London-Heathrow – resulting in almost the same total ticket price.

EXHIBIT 3: **BRITISH AIRWAYS PRICING COMPARISONS**



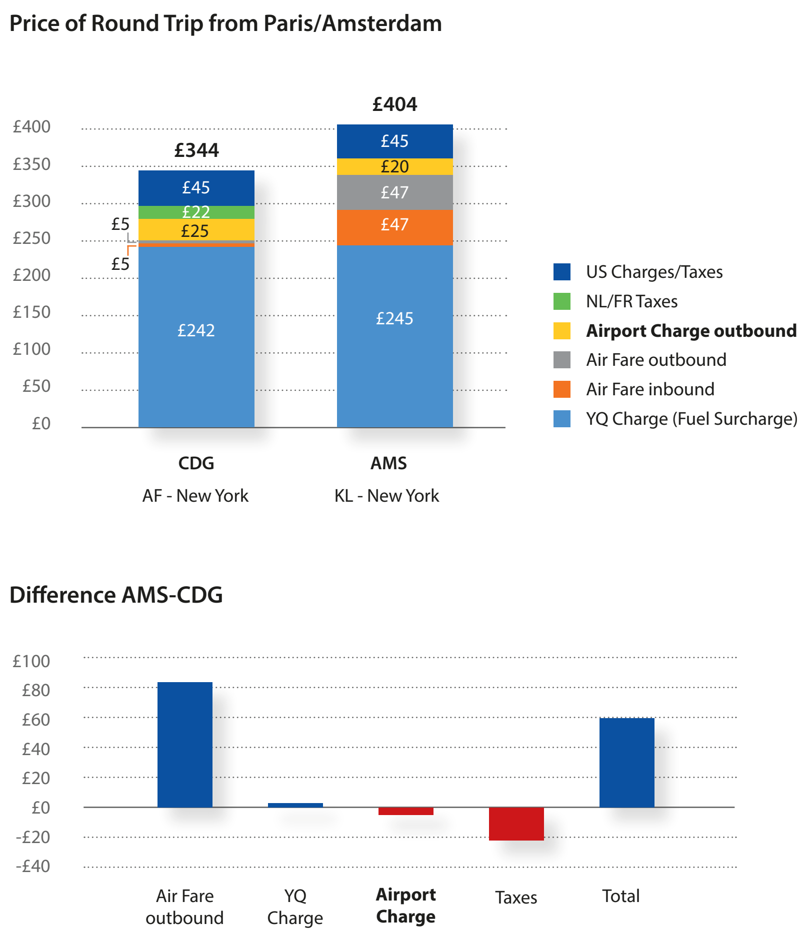


Source: ita matrix

Not passing-through lower airport charges for the almost identical product is not unique to British Airways – it is a **common practice across the airline industry**. The examples below show that:

- Air France-KLM is not passing-through lower airport charges at Amsterdam-Schiphol compared to Paris-CDG for its services to New York and Madrid.

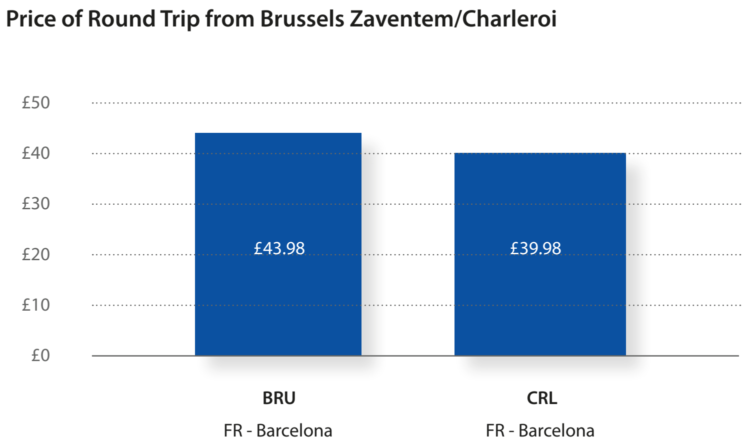
EXHIBIT 4: **AIR FRANCE-KLM PRICING COMPARISON**

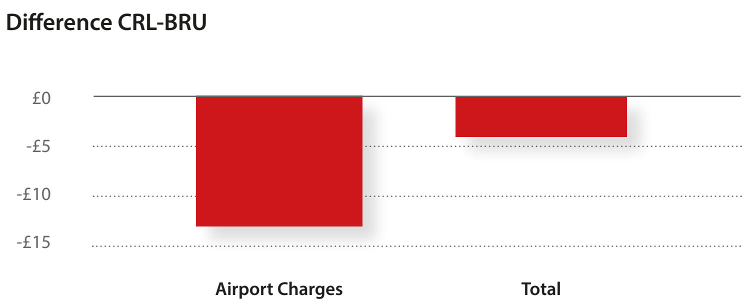


Source: ita matrix, converted to GBP natively

- Ryanair is not passing-through lower airport charges at Brussels-Charleroi airport compared to Brussels-Zaventem airport for its services to Barcelona.

EXHIBIT 5: **RYANAIR PRICING COMPARISON**





Source: Ryanair Website. Fares requested on the 20th of April 2018 for a trip from the 19th of April to the 26th of June 2018

4

CONCLUSION

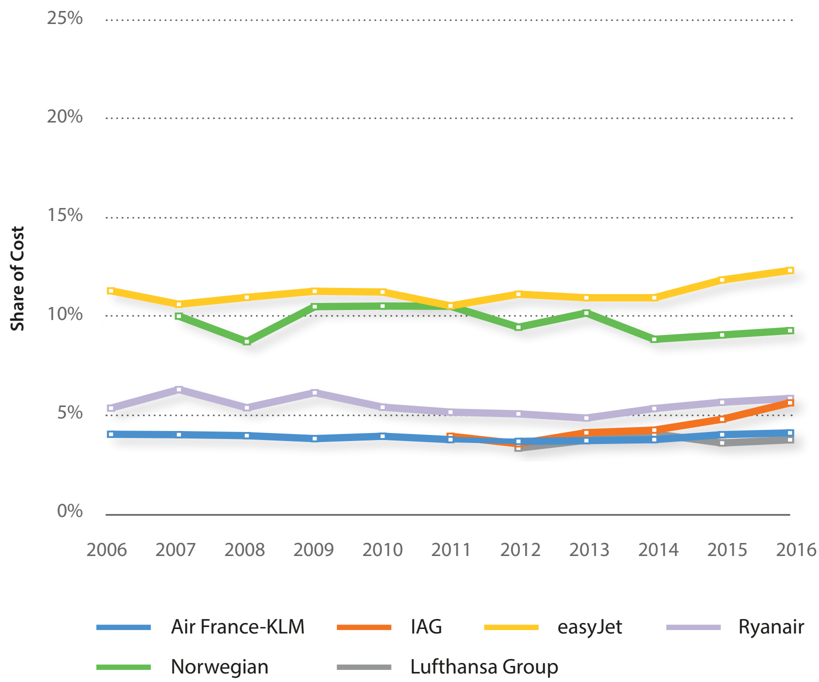
This is about airlines' bottom lines – not consumers

Overall, the data and case studies presented by ICF confirm that the levels and variations in air fares are by and large unrelated to airport charges. In particular, **there is ample evidence proving that lower airport charges do <u>not</u> translate into lower air fares**. By claiming the contrary in support of its call for tighter airport regulation and lower airport charges, A4E is misleading both consumers and policy makers.

This lays bare the fact that the A4E campaign on airport charges is **purely about boosting airline bottom lines**. That, in itself, is not surprising but there is a persistent attempt to cloak this as being about consumer benefits rather than airline profitability.

Indeed, while airport charges do not influence airlines when they set air fares, they do influence their behaviour in the medium to long terms - when it comes to where they put their capacity and how they are planning and developing their route network. As shown on the next page, airport charges have been a relatively small and stable element in airlines' overall cost base. However, as competitive businesses, airlines continuously monitor their costs and always want to reduce airport charges to achieve higher margins and boost their profitability.

EXHIBIT 6: **ESTIMATED SHARE OF AIRPORT COSTS (REGULATED CHARGES + SECURITY + PRM + COMMON USE CHARGES) BY AIRLINE**



Source: Annual reports, ICF analysis
Notes: Estimates are based on a share of the cost item containing airport charges as reported in the annual report of the airline. For Air France-KLM this is Airport Charges and Air Route Charges; Landing and Navigation for IAG; Airports and Ground Handling for easyJet; Airport and Handling for Ryanair; Airport Charges and ATC for Norwegian; Handling, Airport Charges and ATC for Lufthansa

Make no mistake, this – margins and profitability – is what lies at the core of A4E's call for a revision of the EU Airport Charges Directive. Not lower air fares and consumer interest.

The full implications of A4E's demands on airport charges therefore need to be considered carefully by policy makers. As already demonstrated by ACI EUROPE, such demands would end up constraining the ability of airports to invest in capacity and quality to meet future demand. This would undoubtedly limit airline competition and connectivity gains to the detriment of consumers & the economy – jeopardising the EU's own Aviation Strategy.

More than meets the eye – ticket price transparency needed

The ICF study proves that airlines' interest should not be assumed to coincide with consumers' interest.

This is further evidenced by the fact that airlines report on their tickets levels of airport charges, which very often **do not reflect the rebates and incentives** they negotiate with airports for these charges.

This means that airlines make passengers pay a level of airport charges that is actually more than what they are paying to the airport for the use of its facilities and services – with the **net difference amounting *de facto* to an undisclosed and untransparent fare supplement**.

More than **85%** of Europe's airports now offer rebates and incentives to airlines as part of normal commercial relationships between a supplier and a customer – so the absence of ticket transparency means yet again, that lower airport charges are not passed on to consumers by airlines. While some of these rebates and incentives are granted to airlines *ex-post* (based on the achievements of volume targets for example) others are granted up front – and should be correctly accounted for and reflected in the ticket price. A few airports have tried to link their rebates and incentives to the level of air fares (i.e. asking airlines to lower air fares as part of the negotiations of these rebates & incentives), but airlines are obviously resisting that.

Finally, let's not forget passengers who cancel their bookings or fail to show up at the airport to catch their flight ("no shows") - they are entitled to get a refund on airport charges irrespective of whether the air fare they bought is refundable or not. Yet, for non-refundable air fares, airlines often impose an **administrative fee** for reimbursing airport charges – which, given the low level of these charges, acts as a disincentive for passengers to claiming their money back.

All this shows that **there is still quite some way to go if we are to ensure effective ticket price transparency** for consumers in the air transport sector.

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In 2018, ICF was commissioned to research the components of Air Fares, to gain insights into the opaque nature of airline ticketing and the various charges that are commonly listed on your airline ticket. **In its Study, ICF also researched whether the levels of airport charges have a direct effect on the air fares airlines are charging passengers** – and conversely, whether any reductions in airport charges are indeed passed-through to air travellers. The results of their research are now available in a Study entitled *"Identifying the Drivers of Air Fares".*

ACI EUROPE is the European region of Airports Council International (ACI), the only worldwide professional association of airport operators. ACI EUROPE represents close to **500 airports** in 45 European countries. Our members facilitate over 90% of commercial air traffic in Europe: **2 billion passengers, 20 million tonnes of freight** and **23.7 million aircraft movements** in 2016. These airports contribute to the employment of **12.3 million people**, generating **€675 billion** each year **(4.1% of GDP** in Europe). Based in Brussels, we lead and serve the European airport industry and maintain strong links with other ACI regions throughout the world.

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