

Airport Competition and Price Structures

Peter Forsyth
Monash University
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The Issues

- Secondary airports now competing with major airports for LCCs
- Competition normally regarded as efficient
- But competition can worsen allocation
- MC of using major airport often low, but it loses LCC traffic to secondary airport
- Secondary airport prices low for artificial reasons
- Reform of the environment can improve the workings of competition but problems still remain

Outline

- Responses by major airports to competition
- Incentives and responses
- Why are secondary airports cheaper?
- Improving the institutional environment for competition

Prices and Costs

- Major airports with excess capacity
- Large sunk costs (construction of runway, terminals)
- Required to cover costs over lifetime of investment
- AND each year (arbitrary allocation of costs to years)
- Achieved by weight/passenger based schedule (approximately Ramsey prices)

Response 1

- Restructure price schedule
- Make the price low for the type of aircraft flown by LCC
- Less efficient schedule than before (though efficiency loss will be small)
- Major airport is able to attract LCC

Response 2

- Implicit or explicit price discrimination
- E.g. discounts for flights to new destinations (available to all airlines)
- Explicit discounts to LCCs
- LCC uses major airport

Response 3

- ❏ Reduce costs, and lower charges all round
- ❏ Only possible if costs have been too high
- ❏ LCC chooses to use major airport
- ❏ Competition here is welfare enhancing

No Response

- ❏ Often difficult for airport to make it cheaper for LCCs
- ❏ Price for use is above marginal cost
- ❏ LCC uses secondary airport, which may have lower prices but higher costs overall
- ❏ Often this is what happens

Public Ownership/Rate of return Regulation

- ❏ Airport has little incentive to respond to competition
- ❏ Makes no more revenue or profit if it attracts LCC
- ❏ No incentive to reduce costs to enable lower charges

Incentive Regulation

- ❏ For example, average revenue per passenger price cap (popular)
- ❏ Airport has incentive to attract traffic, eg the LCC
- ❏ But can it alter its price schedule enough to attract it?
- ❏ Will also have incentive to reduce costs if feasible

Why are Secondary Airports Cheaper?

- ❏ Would expect the reverse-smaller
- ❏ Economies of scale; large sunk costs
- ❏ But secondary airports are offering lower prices to LCCs

Possible Reasons

- ❏ 1 Removing price discrimination. LCC may have been overcharged before
- ❏ Unlikely though
- ❏ 2 Greater efficiency. With large sunk costs? In terminals?

Reasons Con't

- 3 Subsidies
- Secondary airports are often subsidised by owners
- Objective- obtain more tourism, business to region
- May gain, but other regions lose
- 4 Passenger ignorance. Do not realise the high access costs to the secondary airport

Reasons Con't

- 5 Inefficient bypass
- Sunk costs are being recovered by setting prices above MC
- May be able to have secondary airport supplying at a positive cost, but lower than the price charged by the major airport
- LCC chooses the secondary airport, adding to costs
- Problem of inefficient bypass common when prices are set to recover sunk costs- e.g. telecommunications

Reasons Con't

- 6 Different asset values
- Major airport required to cover sunk costs
- Assets valued at replacement value
- Secondary airport may have been sold at a nominal amount- investment in fixed assets written off
- Can cover costs with a lower price
- Basically an artificial advantage based on accounting treatment

Reasons Con't

- 7 Different Service quality
- Secondary airport supplies a lower quality of service, which LCC wants
- Could be efficient for LCC to go to secondary airport
- But major airport may be locked into high service quality- e.g. with new terminal with ample capacity
- Again, required to cover high costs, by high prices
- MC of the good terminal may still be low- would be efficient for LCC to use it

How Competition Works

- All competitors need to be facing equal conditions
- Economies of scale, large sunk costs etc make this difficult to achieve
- Artificial advantages (eg subsidies) make this even more difficult
- Can conditions be made more equal?

Cost Recovery Pricing

- Pricing to achieve cost recovery of a sunk cost makes it difficult to achieve the conditions for effective competition
- Problem is compounded by the artificial allocation of sunk costs to each year, even when capacity is ample
- Results in prices which are well above MC, meaning use is discouraged
- Not a problem when there is excess demand

Artificial Advantages

- ❏ Secondary airport may have artificial advantages over major airport
- ❏ Subsidies
- ❏ Much lower book value of assets to be recovered
- ❏ Competition will not result in an efficient allocation of traffic

The Role of Competition

- ❏ Usually view competition favourable
- ❏ Competition can discipline the pricing behaviour of the (near) monopoly- perhaps we can rely less on regulation
- ❏ In the airport case, competition for the LCC's is not having this effect
- ❏ Competition not a substitute for regulation or monitoring

What can be Done?

- ❏ Doesn't follow that it is sensible to prohibit competition
- ❏ Can try to make the environment as favourable as possible for the working of competition
- ❏ Identify, address distortions e.g. subsidies (Charleroi, Strasbourg)
- ❏ But with cost recovery pricing there is still the risk of inefficient bypass

Thank You!