COMMENT ON COMPETITION COMMISSION REPORT: STANSTED QUINQUENNIAL REVIEW – ASSESSMENT OF COMPETITION AT STANSTED AIRPORT, July 2008

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We have been asked by the Civil Aviation Authority to comment on the Competition Commission (CC)`s paper on Assessment of Competition at Stansted Airport (ACP) and on a paper by Dr David Starkie and Professor George Yarrow in response to the CC`s paper. Our comments are on the general approach taken by the CC and by Starkie and Yarrow.

Our remarks are intended as a constructive response to the CC`s stated reason for setting out its draft paper on the Assessment of Competition at Stansted, namely to share provisional thinking and to stimulate comment on methodology and conclusions.

1. **Assessing the effectiveness of competition**

When fully effective, competition is likely to provide the best protection for consumers in terms of price and the quality and variety of service on offer. In any given market, the case for a continuing price control in the meantime to protect consumers from the potential exercise of market power rests on how far and how fast competition has actually developed and is expected to develop over the foreseeable future. It is clearly very important, therefore, that the CC`s assessment of the state of competition is well founded so that its conclusions are robust.

Our principal criticism of the ACP`s methodology is its sole reliance on static equilibrium analysis, which deals with end-states in which, in effect, competition has been exhausted. The **process** of competition, by definition, cannot be analysed by models that concentrate only on end-states. Economists who study competitive processes move away from consideration of the end states of perfect markets to look instead at the properties of dynamic markets in which competitors are constantly seeking new, profitable opportunities, innovating in products and quality of services and taking away sales and profits from their rivals. It is through this process that the information that is assumed to be perfectly available in efficient static equilibrium models is created and revealed. The whole process tends over time towards innovation and towards lower costs and prices, as determined by markets.

The absence of a sufficiently dynamic element in the ACP suggests to us that it under-estimates the extent of competition over time. But it also has important implications for the CC`s analysis of the most suitable regulatory options.

2. **The appropriate standard of comparison**

Comparing the CC`s approach with our comments above about assessing the state of competition in a market , our concern is that the ACP uses, as its standard of comparison to assess the degree of competition, a particular type of end-state - a perfectly competitive market in equilibrium. It therefore assumes that it can judge whether or not the market is competitive by investigating

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whether or not price is close to short run marginal cost (which is described as the `standard result' in such a market). We find it surprising that the CC should use such a standard of comparison.

First, the airports market is typical of most markets investigated by competition authorities and supervised by regulators in that it is not and is never likely to be anywhere near to the perfectly competitive. In the case of the airports and associated markets, it is obvious that products are differentiated, there are small numbers of buyers and sellers, there are barriers to entry and sunk costs, and knowledge is highly imperfect . Thus an outcome close to the perfectly competitive should not be anticipated, especially considering that when the market is observed at any point in time there is no reason to assume that it will be in equilibrium. Avoided costs over the relevant time horizon can provide some guidance as to what prices might emerge in a competitive market, but that is very different from saying that competitive prices will equal avoided costs, especially if that means that the fixed costs of the activity in question are not recovered.

Second, our experience is that most economists in the competition policy and regulatory fields, including the CC in other contexts, no longer use the perfect competition paradigm when judging whether markets are `competitive' but concentrate instead on the approach outlined in 1 above – that is, investigating whether or not a competitive process appears to be underway in the relevant market. That, as we understand it, is the approach the CC is taking in its BAA Airports Inquiry in which the material produced so far does not suggest it is placing any weight on how close to `perfection' the market is. We recognise, of course, that the Airports Inquiry is legally separate from the price control issue. However, a degree of consistency is necessary if regulatory uncertainty is not to be generated.

Moreover, we had understood from statements made by the CC that assessing the strength of the competitive process is now to the fore of CC investigations . For example, in a lecture given last autumn[3], Peter Freeman said

> `The process of competition is the means by which good ideas succeed while bad ones fail, well-run firms thrive while bad ones reform or perish, and a constant pressure for innovation is maintained'

He went on to refer favourably to Adam Smith`s notion of `rivalship' and said that

> `This concept of `rivalship' (now modernized to `rivalry) is critical to the operation of the Market Investigation regime'.

Of course, the CC paper on which we are commenting is not part of the market investigation regime but we would assume it should be consistent with that regime. The clear implication of Mr Freeman`s remarks seems to be that, when considering the state of competition in any given market, the CC`s primary concern is with whether the dynamic gains from the process of competition are being realised, rather than with whether or not the market in question exhibits the static efficiency properties of an idealised `competitive' market.

[3] Peter Freeman, `Investigating Markets and Promoting Competition: The Competition Commission`s Role in UK Competition Enforcement', Beesley Lecture Series, 18 October 2007. The lecture is on the Competition Commission`s website.

The Competition Appeal Tribunal (CAT) also came down on the side of a dynamic view of competition in a relevant recent judgment in the water industry[4] in which one of us was involved. A major issue in this case was the meaning of `competition' and whether the use of the Efficient Component Pricing Rule (ECPR), a static efficiency rule, is conducive to the development of a competitive market. The Tribunal pointed to the

> `potential clash between the narrow productive effi ciency sought in theory through ECPR , and the wider dynamic competition benefits and level playing field which the Chapter II prohibition is designed to safeguard.'

It concluded that the ECPR was not a `safe methodology' to use in the case in question[5].

The approach used by the CC in the ACP therefore seems to us to be not only inappropriate in the case in question but also out of line with the approach used by the UK competition authorities in other cases. Consequently, we support Starkie and Yarrow in criticising the CC`s use of the perfect competition standard of comparison. We note also that they produce evidence that the market appears to be more competitive than the CC suggests. There are evidently competitive processes at work (for instance, in terms of service innovation) that the CC needs to investigate rather than using the apparent short cut of considering whether price is close to short run marginal cost. Incidentally, we have examined the method used by the CC to estimate marginal cost and we agree with Starkie and Yarrow that it is unlikely to produce a meaningful estimate: a multivariate analysis should have been undertaken.

3. Implications for price caps

A general danger in using perfect competition as a standard of comparison is that, since no market ever measures up to the standard, it can lead to inappropriate regulation. The CC seems to us to under-estimate a serious issue - that price caps, imposed in markets judged to be not `competitive' by static equilibrium analysis, may themselves prevent effective competition from developing by distorting market processes which would otherwise lead to innovation and the discovery of appropriate investment programmes.

More specifically, we would point out that no regulator can know what the outcome of competition will be. A regulator who assumes it is possible to know what `efficient' prices are confuses the competitive outcome with the competitive process. It is, of course, for such reasons that the UK form of natural monopoly regulation does not assume that efficient costs and prices are known, but instead provides an incentive to the regulated entity to profit from the discovery of lower cost techniques: the new information this provides can be taken into account in setting the next price control. However, it is even more important to take into account the inevitable lack of forecast ability by the regulator when considering the appropriate form of price control in a market where competition is feasible but not yet fully effective, since the form of regulation can itself inhibit competition.

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[4] [2006] CAT 23 Albion Water Limited versus Water Services Regulation Authority, see especially paras 793-803

[5] ibid paras 835-836

Thus, in our view, the price control in such a market should not seek to replicate an imagined outcome of the competitive process. In particular, it follows that, if some transitional price restraint is considered necessary, it should not be drawn so tightly that it prevents or distorts the development of competition. For this reason, we support the kind of safeguard or precautionary price cap suggested by the CAA. To the extent that there is to be any attempt to estimate an efficient price, we fully concur with Starkie and Yarrow`s argument that such a price cap needs to recognise the capital at risk if competition prevents the incumbent from pricing at the level of the cap. Otherwise, the price cap will be set too low from the perspective of the incumbent and competitors alike and the regulatory regime itself will harm the very consumers that it seeks to protect.

4. Conclusion

Starkie and Yarrow`s paper in our view demonstrates that Stansted is likely to have less market power than the ACP assumes. Particularly in those circumstances, but in any event since there is a degree of competitive pressure in place, we would argue for a more relaxed price control, with some form of safeguard or precautionary price cap in case Stansted develops enhanced market power. There would then be a degree of regulatory withdrawal which would permit the present competitive market processes to develop with more freedom. This would be consistent with appropriate analysis and evidence and help ensure that the regulatory regime does not itself hinder the evolution of competition.

August 2008