

Heathrow Congestion Premium

A NOTE FOR HEATHROW

The Airports Commission has asked respondents to its consultation for their views on the premium in ticket prices created by current and future congestion at the London Airports.

It is possible to estimate it by comparing average ticket prices at Heathrow with those at other airports, after controlling for differences in route mix and the balance of leisure vs. business traffic.

Estimating the congestion premium for the future requires us to take a view as to how unconstrained demand would grow for Heathrow services, and then measure the price increase that would be required to reduce demand to the available capacity. This requires a view both of the income elasticity of unconstrained demand in the future, and the price elasticity of demand for air services.

In *Competition and Choice* we estimated the congestion premium which exists today at Heathrow and the premium that we estimate would exist by 2030 if new capacity were not developed. If a second runway were opened at Heathrow in 2024, we believe capacity at the airport by 2030 would still be below the unconstrained level of demand, which means that a third runway would not completely alleviate the congestion premium at Heathrow by 2030. In this note we estimate the remaining congestion premium in 2030 after the opening of the third runway using the same approach adopted for *Competition and Choice*.

Estimates of the premium

Today

The basis of the current estimate was an econometric analysis of average fare data by route for Heathrow, the other London airports and the other four major hub European airports (Schiphol, Charles De Gaulle, Madrid and Frankfurt).

This econometrics¹ demonstrated that fares at Heathrow were 19% higher than would be expected on the basis of route and traffic (business/leisure) mix. This means that c. 15% of the current average fare at Heathrow is a premium for congestion². This means that if the current average return fare of c. £640, £95 is

¹ Based on 2012 data.

² The econometric analysis implies that if the average uncongested fare should be 100, it is in fact 119. So the proportion of today's actual fare that is congestion premium is 19/119, i.e. c. 15%.

congestion premium. The expected average fare, without the congestion premium would be c. £545.

2030

Our estimate for the congestion premium was based on our route simulation model for Heathrow.

Unconstrained demand was estimated by extrapolating demand from 2006, the year in which Heathrow started to operate at full capacity. This was done on a route by route basis using standard income elasticities and HSBC forecasts of country-pair GDP growth. The assumptions are stated in Annexe 3 of *Competition and Choice*.

In 2012 we established, based on standard price elasticities, that this projection of unconstrained demand was consistent with the 2012 congestion premium estimated separately by econometric analysis.

We projected unconstrained demand to 2030 using the same approach and then estimated the congestion premium required in 2030 to reduce demand in that year to the available two runway capacity³. By this method we found that the congestion premium would rise to c. £320 by 2030. This means the average return fare would increase to c. £865.

However, as noted above, projections for 2030 suggest total capacity even with three runways will fall short of unconstrained demand. Our estimate is that unconstrained demand at Heathrow in 2030 would be 143m passengers, while capacity is likely to be only 104m.

We have used the same *Competition and Choice* methodology to estimate the remaining congestion premium at Heathrow after the third runway is built. We estimate that the congestion premium in 2030 with the third runway in place would be c. £175. This means the average return fare would be £720.

Thus the saving per return passenger as a consequence of building the third runway would be c. £145 in 2030. This saving figure would be expected to grow over the following few years as more slots are released on the third runway, reducing the gap between unconstrained demand and available capacity.

³ Two runway capacity was also assumed to increase year on year by 1%, representing an increase in the average aircraft size over the period.