The economics and regulation of on-board carriage of European airport retail sales

A policy research study for the European Travel Retail Confederation
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Executive Summary

Introduction

Commissioned by the European Travel Retail Confederation (ETRC), and supported by ACI Europe, this study considers the impact that restrictions imposed by some airlines on passengers carrying airport shopping on-board are having on passengers' experience at airports and on their longer term interests in the level of service and connectivity provided by the European aviation system. The report also identifies potential detriments from this practice, considers policy solutions and recommends that proposals from the European Parliament to accord passengers the right to carry on board airport shopping in addition to hand baggage should be pursued as the most effective solution.

Report Findings - In brief

Strict enforcement of the 'one bag rule' by particular airlines risks a market outcome where, over time, there are higher costs and less connectivity for passengers as the voluntary, value-creating contribution to airports from airport retail is reduced. The impact is likely to be most marked at smaller, regional airports - precisely those which contribute to regional growth and yet, are most likely to be affected by the proposed stricter state aid regime.

Treating the 'one bag rule' as simply an issue to be settled between individual airport and airline businesses risks giving insufficient weight to these systemic impacts, including the presence of airline buyer power, and the potential for passenger confusion where there are differing approaches by airline and airports.

Recommendations

Regulating simply to improve transparency for the passenger addresses only one of the issues raised and is unlikely to be effective.

The most effective solution is to incorporate a passenger right to carriage of airport shopping in addition to their hand baggage. It would credibly deal with the information gap by restoring passenger choice and certainty regarding airport retail to that in place before the introduction of strictly enforced 'one bag rules'.

Airports - in particular those smaller regional airports facing large airlines with buyer power - would not have a legitimate area of commercial activity circumscribed.

By preventing any one airline from gaining commercial advantage through a practice which undercuts the benefit created by retail activity for all airlines and passengers, it would help the air travel sector as a whole co-ordinate around an equilibrium which creates higher value added in the sector.

A partnership approach would better safeguard the connectivity of Europe's regions at a time when this is more than ever necessary to stimulate and spread growth and prosperity.

Benefits from airport retail activity in Europe

European aviation over the last 50 years has grown in parallel with, and been supported by, the growth of airport retailing. European companies have led the way in airport retail and as a result are now the most important players in what has become a vibrant and growing global business.

For passengers, the opportunity to shop at the airport has become an integral part of the travel experience - 47% of passengers list shopping as one of their favourite airport activities and 60% of European passengers regularly make purchases at airports, a significantly higher figure than in the US for example.

These discretionary purchases have made an increasingly valuable contribution to financing airport investment and thus supporting better airports, a greater choice of routes and more connectivity for passengers.

Airlines have also benefitted from much lower airport charges and better facilities as a result of passenger retail purchases.

Impact of the 'one bag rule' for passengers

The strict implementation of a 'one bag rule' by certain carriers since 2009 effectively prevents passengers from taking retail on board unless it can be stored within their one piece of hand baggage - which in all probability will already be tightly packed given the growing and significant charges levied for hold baggage (only 38% of passengers travelling with lower cost airlines check in luggage, compared to 66% of passengers on full service carriers).

For some passengers, the disconnect between general custom and practice which has permitted airport shopping to be carried on board and this new approach, has led to the discarding of shopping at the boarding gate or hold baggage charges being incurred at the last moment.

In simple terms, for affected passengers it has substantially reduced the ability to shop at the airport.

The uncertainty created by strict implementation of the 'one bag rule' by some carriers has affected the tendency to shop of passengers even on other airlines where there has been no change. The result has been a marked reduction in retail activity and revenues at affected airports.

While this reduction in retail revenues first affects retailers and airports, there are wider, longer term implications for passengers.

Impact of the 'one bag rule' for airports

The current, high levels of European aviation connectivity are based on a well-functioning airline market, with carriers able to compete across the entire European Aviation Area. But connectivity also depends upon the ability of hundreds of European airports to provide facilities for passengers and airlines.

Many of those smaller regional airports are marginally - if at all - profitable: over 40% of European airports are currently loss making. Low cost, point to point airlines, vital to smaller regional airports, have a degree of buyer power based on their ability to switch capacity across Europe and negotiate tough commercial deals or else withdraw their capacity.

Strict enforcement of the 'one bag rule' by airlines could undermine the European airport financing system and the extent and impact of that threat could increase in the future.

Strict enforcement of the 'one bag rule' is limited at present to a small number of very significant carriers but other airlines may face commercial pressures to follow suit, if the leading 'one bag rule' airlines are seen to gain any advantage from their current practices.

Such a 'leader-follower' pattern has been seen in recent decades in the development of the European low cost airline market. The European airport market could therefore switch to a new equilibrium, where passengers' expectation is that many airlines operate a strict 'one bag rule', significantly deterring airport shopping.

The resulting reduction in demand for airport retail would result in significant losses to airports and the aviation sector as a whole. This scenario is a potential outcome given how the 'one bag rule' has worked in practice.

Some airports have successfully negotiated with a low cost carrier for it not to enforce its 'one bag rule' at that airport, thereby enabling the airport and passengers to continue to benefit more fully from retail development.

However, many other airports are in a weaker bargaining position and have been unable to negotiate such an outcome, or any form of compensation via airport charges. Passengers cannot engage in shopping to the customary extent and retail revenues have thus reduced.

The resulting divergence in experience between and within airports has served to increase uncertainty for passengers.

Passengers now have less confidence about how their airport shopping will be handled by airlines, particularly low cost carriers. As a result they are deterred from purchasing at the airport, even where the carrier they are flying with would permit retail carry on.

Policy Issues

The report considers the issues that arise for European policymakers and suggests that two main detriments are likely to arise from the current implementation of the 'one bag rule': effectively denying passengers the opportunity of shopping at the airport and jeopardising the financial viability of some airports with longer term consequences for European connectivity.

The strict implementation of the 'one bag rule' both arises from and is likely to give rise to problems in the operation of the market, including:

- Information gap for consumers between purchase of flight and experience of airport retail.
- Buyer power exercised by powerful airlines: can extract value from weaker airport suppliers, hindering investment over time and threatening financial viability.
- The potential for individual actions to undermine the common good: if more airlines adopt a 'one bag rule' then pursuit of their individual commercial interests could work against the overall airline and passenger interest in a vibrant airport sector by undermining airport retail.

Policy Solutions

Regulation can potentially play a part in improving outcomes for consumers. The costs and benefits of two different regulatory options proposed, respectively, by the European Commission and European Parliament are therefore considered:

Transparency to passengers of on-board baggage allowance: this would focus on only one of the market issues identified - the information gap for passengers. It is unlikely to be effective given the complexity of differing practices between and within airlines and airports. It would also not deal with longer term issues of financing the aviation system and would still leave passenger retail choice much reduced.

Passenger rights: this would support passengers' customary ability to use airport retail by protecting rights to take shopping on-board, in addition to hand baggage. Such regulation would restore confidence in airport retail across the EU, allowing passengers to continue to contribute voluntarily to airport infrastructure costs.

Regulation could create a level playing field for airports and airlines to develop productive partnerships to work together to grow retail activity at the airport, thereby reducing airline costs, increasing airport financial sustainability, and enhancing the passenger experience.

Introduction

Introduction

Airport retail is now a crucial part of the European aviation system. It provides passengers with opportunities for recreation and shopping at the airport, and retail revenues enable airports to provide facilities and services more cheaply than they could otherwise. Discretionary retail revenues cross-subsidise aeronautical activities, and European connectivity is thereby enhanced.

Many airports depend on retail revenues for their financial viability, and these already face significant challenges from weakness in the wider economy, as well as online shopping and regulatory pressures on some product categories.

Potentially more serious problems arise where passengers are effectively prevented from shopping at the airport by the rules of some airlines.

This study, commissioned by the European Travel Retail Confederation (ETRC), considers the impact that restrictions imposed by some airlines on passengers carrying airport shopping on-board have had on both passengers' experience and airports' revenues, the risks to both in future, and possible policy solutions.

The authors draw on their experience in civil aviation regulation at the UK Civil Aviation Authority, and at the UK Treasury, to assess the economic and policy issues that arise. The report goes on to recommend that the interests of passengers are likely to be best served by a simple regulation that permits passengers to take on-board a defined modest volume of airport shopping, in addition to their hand baggage.

Such a regulation would accord with the current practice of most European airlines and could be introduced as part of the proposed revision of Regulation 261/2004 on Air Passenger Rights.

Report Outline

Chapter 1 considers the role that retail revenues play in European aviation, in particular in supporting the financial sustainability of airports.

It shows how revenues have grown over time and their importance to the viability of many airports, a significant minority of which are already loss-making.

Chapter 2 identifies how, since the mid-1990s, increased airline competition and the development of low cost airline business models have promoted a more competitive airport market.

Low cost airlines operating across Europe have the operational flexibility and management capability to alter their routes and capacity to respond to both passenger demand and the cost and service offerings by airports which now actively compete for their business.

As a result, airport charges are usually set by what the market will bear - as determined by the most mobile airlines - rather than the cost of the services they provide. The scale of some airlines, their importance particularly to smaller, regional airports and their ability to move away if they do not get what they want, effectively amount to a degree of buyer power.

Airports thus have to take account of the retail revenues that they can make from passengers in setting their charges. Any threat to those revenues is likely significantly to undermine the already tenuous financial position of many, particularly smaller, airports.

Chapter 3 describes passengers' experience of retail at airports. Airport retail provides passengers with the ability to make competitively-priced purchases across a wide range of goods, and a means of spending the waiting time at the airport.

Some 60% of European passengers regularly make purchases at airports, some of which may be vital to their journey: many others will enjoy 'window shopping'. Chapter 3 shows how retail spend differs between types of passenger and the airlines that they use.

It suggests that the operating practices of some low cost airlines, which are an intrinsic part of their business model, already act to constrain airport retail revenues.

DATA

This study uses data provided by airports and retailers, including market research and surveys. Some of these data are inevitably commercially confidential and cannot therefore be identified to their sources - all airports, airlines and airport retailers have been anonymised in the report where it refers to unpublished commercial data sources. However, the authors have seen the original data and have only used them where satisfied as to their origin and veracity. The data provided tell a consistent story, and the study does not rely on particular, individual pieces of evidence.

The report draws on data from five airport retail companies and 24 airports, located in ten European countries.

Chapter 4 assesses the impact that airline restrictions on the carriage of hand baggage by passengers (the 'one bag rule') are having on both passengers and airports.

It illustrates the clear impact that the 'one bag rule' can have on airport retail revenues, and the 'knock on' effects of the 'one bag rule' beyond the airlines that actually enforce it.

Passengers concerned about being refused carry on of shopping may be disinclined to shop even where their own airline has no restrictions in place. And the resulting uncertainty is detrimental to the overall passenger experience at the airport.

Chapter 5 assesses the evidence presented in the study and suggests that two main harms are likely to arise from the current implementation of the 'one bag rule' - to passengers effectively denied the opportunity of shopping at the airport, and to the financial viability of some airports.

There is a risk that the pursuit by airlines of policies which constrain airport retail, which may be in their individual interests, could have an unintended collective impact on airport financing, leading to reduced connectivity and passenger choice.

This chapter considers whether and how far regulation might be a suitable tool to deal with any actual and incipient difficulties for passengers that may arise from the 'one bag rule'. It assesses that regulation would have advantages and that any costs in terms of resulting restriction on airline freedoms would be limited. Airlines would remain free, as now, to bargain with airports over charges and associated service levels. They would simply not be free to pre-empt such discussion by effectively curtailing airports' established freedom to undertake - and passengers' associated freedom to benefit from - retail activity.

This study concludes by recommending that, as part of the currently envisaged revision to the Air Passenger Rights Regulation 261/2004, passengers should be accorded the right to bring onto a plane a defined modest volume of airport shopping, in addition to their hand baggage.

Such an approach would restore to passengers the certainty they once had about airport shopping and recognise the role that airport retail activity has in sustaining airport viability. It would help to retain an important value-adding activity within the European aviation sector, which in turn helps to finance the infrastructure necessary for connectivity across Europe's nations and regions.

Chapters

1. Airport retailing in Europe

SUMMARY

- Retailing is an important activity for most European airports, which enhances the passenger experience and makes a strong contribution to airport finances.
- Retailing contributed around 15% of total airport revenues in 2011, growing from 11% in 2008.
- For most small to medium sized airports, retailing generates a revenue contribution equivalent to around €2-3 per passenger, with the largest airports generating €4-5 per passenger.
- European airport retailing today is a dynamic sector, which has weathered a number of significant shocks in the past but which faces future challenges from commercial developments and public health regulation.
- The contribution that retail revenues make to European aviation is considerable, but is not a guaranteed source of income - individual airports and retailers must work increasingly hard to attract passenger demand in a world where individuals have a much wider choice of retail options online.

1.1. This chapter sets out how airport retailing has developed over the years, the challenges it faces, the contribution it makes and how that varies by size of airport.

Historical perspective on airport retailing

1.2. Retailing at European airports is an increasingly important aspect of the experience and choice offered to passengers by airports. Revenues from retailing form a growing part of airports' overall revenues. More intensive competition across the European airport market serves to keep aeronautical charges competitive.

So the greater the contribution to revenues from retail activities, the more individual airports are able to cross-subsidise aeronautical charges, to the benefit of airlines and passengers generally.

Retailing is thus a crucial part of the market within which airports operate. They can be regarded as two-sided businesses, seeking to provide competitively priced services and facilities to both airlines and passengers. All parties benefit from a vibrant airport retail sector.

1.3. Airport retailing has evolved considerably over the past two decades. Within Europe, duty free sales available to all international passengers provided the original focal point for retail activity within the airside of airport terminals.

As more airports applied an increasingly commercial approach through the 1990s and 2000s, following privatisation and/or greater financial disciplines on them, and in response to the abolition of intra-EU duty free sales in 1999, retailing was developed more professionally as a means of enhancing passenger experience and financial performance.

This is part of the overall increase in the importance of commercial, non-aeronautical revenue to airports: in 1983, commercial revenues accounted for around 40% of total revenues for a sample of 20 European airports, rising to around 50% by 1998, before falling back slightly in the subsequent decade[1].

[1] Graham, A., How important are commercial revenues to today's airports?, Journal of Air Transport Management (2008)

Retail contribution to airport finances

1.4. Airport retailing, which is a key element of broader commercial revenues, has been subject to a number of challenges over this period. The ending of duty-free sales on intra-EU flights in 1999 removed the fiscal advantage of much of European airports' retail offering, forcing airports and retailers to re-fashion their offerings to passengers.

The accession of a further ten countries to the European Union in 2004, and two more in 2006, and most recently Croatia in July 2013, further reduced the scope for tax-advantaged shopping at Europe's airports. Retail revenues have also been subject to the same demand shocks that affected air travel in general since 2000 (such as the post-9/11 decline in traffic, and other declines related to concerns about global pandemic diseases).

Within Europe, much tighter security procedures since further terrorism threats were identified in 2006 have disrupted passengers' through-airport experience (as well as adding significantly to airports' own operating costs), in some cases reducing the time and motivation for airport shopping. Finally, there are a number of growing commercial challenges.

As high street retailing in general is changing rapidly in response to new online channels, so airport retailing is also having to adapt its own offering. Technological change is likely to remain a continuing source of commercial pressure, not least for those significant elements of airport retailing, like books and newspapers, where lighter, more convenient forms of conveyance are now available to travellers in the form of tablet computers and e-readers.

Foreign exchange is affected by the growth of cashless transactions, and there are continuing regulatory pressures on some other product categories.

1.5. So European airport retailing today is a dynamic sector, which has weathered a number of significant shocks in the past but which faces future challenges from commercial developments and public health regulation.

The contribution that retail revenues make to European aviation is considerable, but is not a guaranteed source of income - individual airports and retailers must work increasingly hard to attract passenger demand in a world where individuals have a much wider choice of retail options online.

1.6. Retail revenues contributed around 15% of the total aeronautical and non-aeronautical revenues of European airports in 2011[2], increasing from 11% in 2008. In absolute terms, they rose from €3.1 billion in 2008 to €4.1 billion in 2011. Retail is the largest single component of non-aeronautical revenues (at 43%, excluding hard to categorise 'other' revenues, as shown in Figure 2), and its share is growing.

This importance is underlined by comparison with the USA, where retail revenues accounted for 9% of total airport revenues in 2009, with car parking and ground transport accounting for the largest element of non-aeronautical revenues, at 18% of total revenues[3].

2 ACI Europe Economics Report 2012. Total revenues excludes 'other' revenues which cannot be easily categorised, and ground handling revenues, which are relevant to only a very few airports.
3 Resource Manual for Airport In-Terminal Concessions, 2011, Airport Cooperative Research Program.

1.7. The charts and tables below show the evolution of European airport aeronautical and non-aeronautical revenues over the most recent four years (for which there are figures), in absolute terms (Figure 1) and in percentage terms (Table 1). Figure 2 shows the breakdown of non-aeronautical revenues and highlights the importance of retail concessions[4].

Figure 1:
Distribution of revenues at European airports

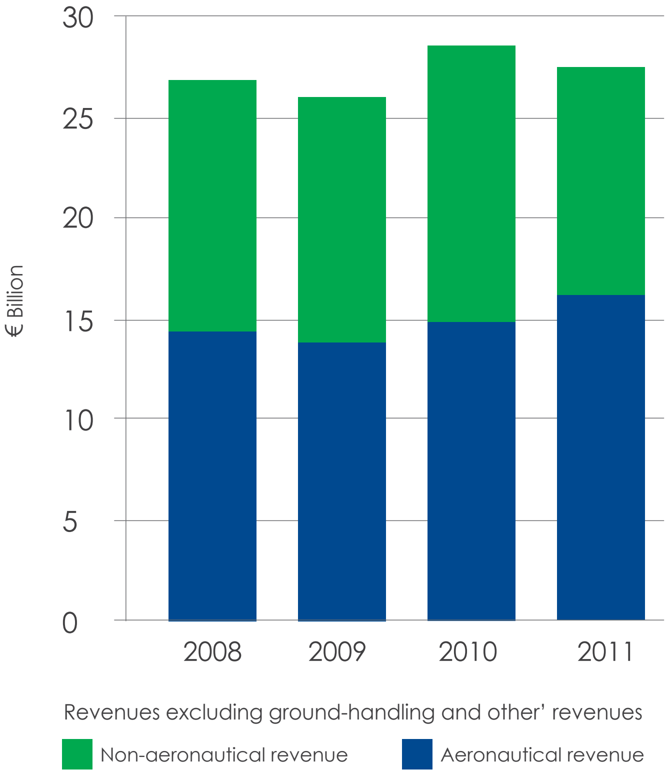
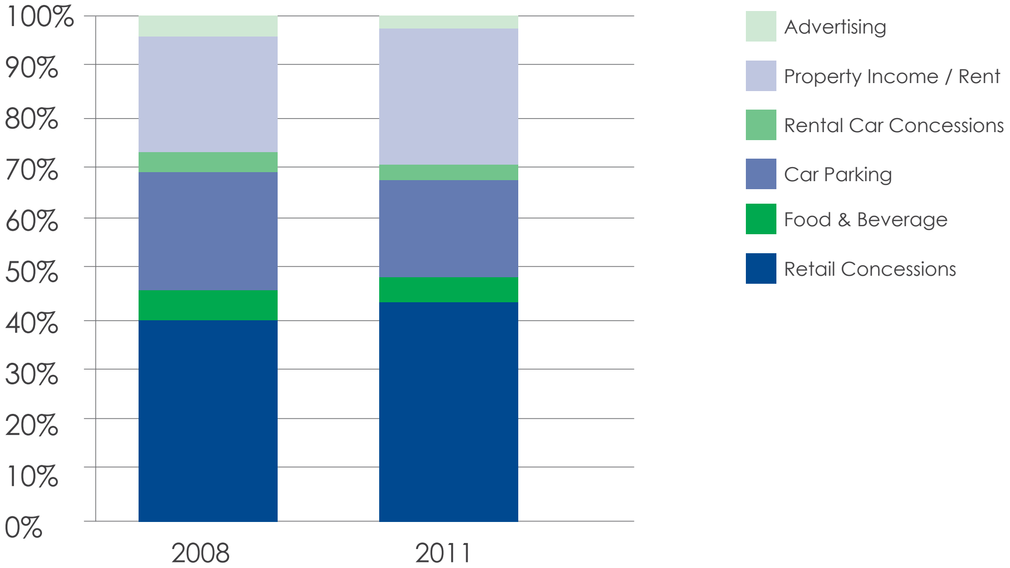


Table 1:
Distribution of revenues at all European airports

	2008	2009	2010	2011
Total (aero + non-aero), € billion	26.9	26	28.6	27.4
Aeronautical revenue % of total	53%	53%	52%	59%
Non-aeronautical revenue % of total	47%	47%	48%	41%

4 Unless otherwise specified, data from ACI Europe Economics Report 2012.

Figure 2:
Non-aeronautical revenues [1] by source, 2008 and 2011



[1] excluding non-operating income and 'other' revenues

1.8. Table 2 highlights the absolute growth in airport retail revenues across Europe in recent years, while Table 3 shows their relative growth to around 15% of total airport revenues by 2011.

Table 2:
Retail revenues, 2008-2011 (€ billion)

	2008	2009	2010	2011
Total (aero + non-aero)	26.9	26.0	28.6	27.4
of which: Non-aeronautical revenue	12.6	12.1	13.8	11.2
of which: Retail concessions	3.1	3.1	3.9	4.1

Table 3:
Retail revenues, 2008-2011 (%)

	2008	2009	2010	2011
Total (aero + non-aero)	100%	100%	100%	100%
Non-aeronautical revenue	47%	47%	48%	41%
Retail concessions	11%	12%	14%	15%

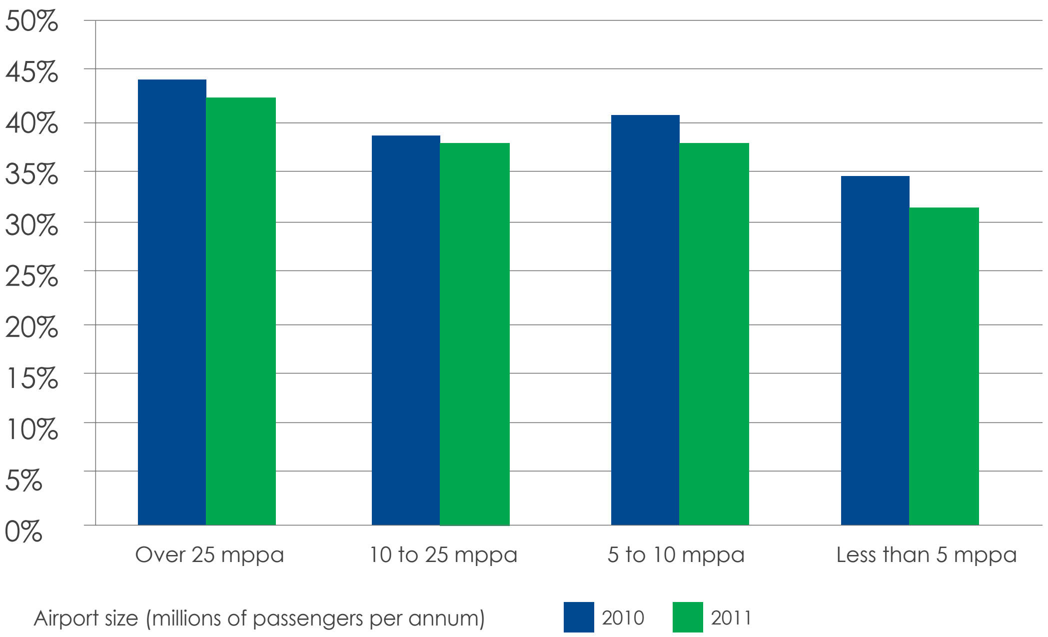
1.9. Retail activity varies significantly across the size spectrum of airports, both in scale and in revenue per passenger. The following charts illustrate the relationships between airport size, retail revenues and total revenue and profit, for the years 2010 and 2011[5]. Airports are categorised into size bands (using millions of passengers per annum - MPPA - as the metric), as follows:

Table 4:
Distribution of airports surveyed

Band (MPPA)	2010	2011
0 to 2	35	63
2 to 5	17	20
5 to 10	17	20
10 to 25	17	18
Over 25	6	9
Total	93	130

In general, larger airports are able to generate a greater share of their total income from non-aeronautical sources overall (Figure 3 below).

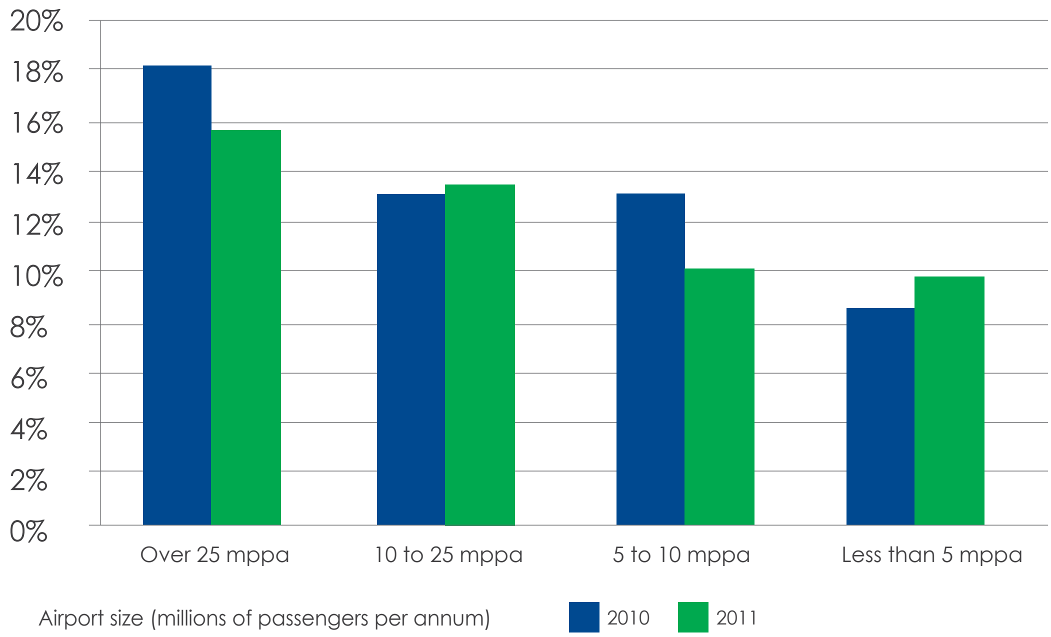
Figure 3:
Operating non-aeronautical income as a % of total operating income



5 All data in this section from ACI Europe, some of which is published in ACI Europe Economics Survey 2011 and 2012.

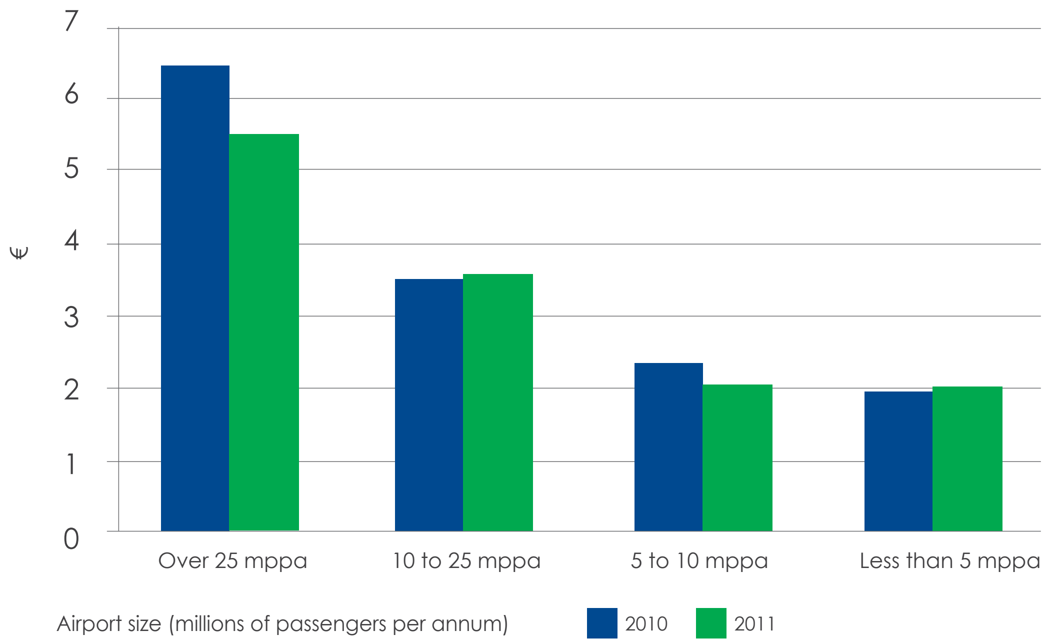
1.10. This pattern is also reflected in retail performance specifically. Larger airports are, in general, able to generate a greater share of their total operating income from retail activities:

Figure 4:
Retail concessions income as a % of total operating income



1.11. With regard to retail income per passenger, there are three distinct categories of airport. The largest airports (more than 15 MPPA) are able to generate retail revenues of around €4-6 per passenger. The middle group of airports (1-15 MPPA) generate around €2-3 per passenger. The smallest airports (less than 1 MPPA) only generate around €1 per passenger:

Figure 5:
Retail concessions income per passenger



Airport retail business model

1.12. The relationship between retail activity and airport size, particularly marked for per passenger spend, may reflect in part the composition of traffic at smaller airports and the tendency for LCC traffic, disproportionately located at such airports, to generate smaller retail revenues than other forms of traffic (an issue explored further in chapter 3) but it also reflects the lesser number and variety of retailers at smaller airports reducing choice and retail options for passengers.

This is because retailers depend on a certain footfall for financial sustainability, suggesting that airports have to reach a certain critical mass before they can attract a greater range of airport retail[6].

The largest airports are clearly in the best position to benefit from these economies of scale, which is evidenced by the variegated and often very specialised retailing activity present at such airports.

1.13. Airport retail is generally outsourced to specialist retailers on a concession model, with the airport sharing in the growth of retail activity. Selecting the right retailers and negotiating the right commercial arrangements are clearly important to successful airport retail revenues.

But the airport's role is not limited to these commercial responsibilities. Retail activity at an airport relies upon the prior investment by the airport operator in terminal facilities which are attractive to passengers and conducive to shopping. It also depends upon the airport and its airlines and their agents conducting efficient passenger processing through check-in and security, so that passengers have sufficient time and energy to consider the airport retail offer positively as part of their through-airport experience.

So while retail revenues do not require the airport to incur high levels of direct operating costs, they do rely on sustained investment by the airport in efficient security operations, cleaning and maintenance of terminal facilities, and periodic modernisation of the terminals - activities which may themselves be dependent upon successful retail revenues.

Conclusions

1.14. As the broad relationship between airport size and retail success evidenced earlier in this chapter suggests, there is something of a virtuous circle here, whereby retail revenues may be both the result of success in attracting passengers but also a platform for assisting in the finance of future expansion and improvement.

The need for such investment, combined with the pressures from airlines on airport charges (described in the next chapter), suggests a growing reliance on retail revenues.

Anything, therefore, that holds back the development of retail revenues - whether it be external economic shocks or airline commercial practices - runs the risk of impeding future airport development.

6 These economies of scale are also evident in the US airport market, where the 30 largest hub airports account for 80% of retail and other terminal concession revenue, and 70% of passengers, while the long tail of around 380 non-hub airports accounted for only 1% of terminal concession revenue and about 3% of passengers. Source: Resource Manual for Airport In-Terminal Concessions, 2011, Airport Cooperative Research Program, section 2.1.2.

2. Airport retail in the context of the European aviation market

SUMMARY

- Airport competition has been growing strongly in Europe over the past two decades. Most airports, particularly the small to medium sized ones, face significant competition as passengers are able to switch to neighbouring airports and airlines can switch aircraft across Europe as a whole.

- Facing competitive pressure on aeronautical charges, airports are seeking to develop more commercial opportunities, including retail services.

- Most airports in Europe compete strongly on price and service with their rivals. Those airports which are profitable generate on average normal returns on capital, although a substantial minority (over 40 %) are currently loss-making. With the planned reduction in state aid across the EU, there is a risk that further pressures on airport finances could lead to lower investment at or closure of smaller regional airports and loss of connectivity for passengers.

- Airline competition is also strong and dynamic, driven primarily by the continued growth of the leading low cost carriers. There has been some concentration in this market in recent years, with Ryanair and easyJet growing large pan-European fleets, two to three times the size of their next tier rivals.

- Smaller airports therefore often face a strong single airline with buyer power - over 70% of the smallest (less than 5 million passengers per year) have one airline accounting for over 40% of traffic.

- Airline buyer power can benefit passengers, if keener airport charges are passed onto passengers. But this buyer power can undermine development of the airport, for example if airline rules undermine airport retailing, at the expense of passenger experience and airport financing of facilities.

- Retail revenues make a major contribution to overall airport profits. For most small to medium sized airports, retail revenues represent at least 50% of overall net operating profit per passenger. This contribution arises from discretionary spending, at the passengers' choice, rather than any mandatory levy or charge.

2.1. This chapter assesses the interconnections between airport retail, the overall aviation market within which it takes place, and the contribution it makes to airport viability, in particular that of smaller, regional airports.

Market context

2.2. The development of a more competitive airline market alongside more commercially focussed - often privately owned - airports has driven greater competition into the airport market. Airports generally now compete with one another for airline and passenger business on the basis of service and price.

Airport retail has been both a feature of that competition and an enabler of it. As the next chapter shows, airports market themselves in part on the strength of their retail offering and the contribution it makes to passenger experience at the airport.

The retail revenues this generates enable airports to engage in tighter price competition to attract airlines, which do not therefore generally cover the costs of the aeronautical services they use in the charges they pay.

Airports take a holistic view of their revenue generation. As a result, retail revenues - existing and anticipated - play a crucial part in both growing an airport's business and underwriting its profitability.

This is particularly so for smaller airports where, although retail revenues per passenger are smaller, they form a significant part of a narrower profit margin.

AIRPORTS AS MULTI-SIDED PLATFORMS

Airports are businesses which serve two main distinct but closely related markets: airlines on the one hand, and passengers on the other. An airport's approach to one side of this market can clearly affect demand on the other, and in turn airline and passenger demands for an airport are inter-dependent.

Airports act as a platform for both markets: airlines value the airport being popular amongst travellers and passengers value the airport being able to offer a wide range of airlines and destinations. In fact an airport is a multi-sided platform. For example, passengers value a wide-range of retail outlets and hotels, while retailers and hotels also value being located where a large number of potential customers are present. This concept of the role of airports as platform businesses, serving multiple markets, is increasingly recognised by competition authorities and economic regulators, as it helps to explain different approaches to pricing in each market*.

The consequences of this model for an airport's overall financial health is that it must consider carefully the impact of changes in demand conditions for passengers at the airport which may be brought about by changes in prices and practices adopted by airlines.

For example, airport charges to airlines may be set based on one set of assumptions about airline requirements for check-in and baggage facilities, but changes in airline charges to passengers for these facilities can, as has been seen in many airports, reduce passenger demand for check-in desks and hold baggage handling.

Likewise, airports will consider passenger responses to retail and other commercial opportunities when setting charges to airlines. Where airports can generate value added revenues from retail, then this benefit can flow back to both airlines (in the form of lower charges) and passengers (in the form of better airport experience and, ultimately, lower airline ticket prices as cost savings are passed through).

* For example: Guidance on the assessment of airport market power (April 2011), UK Civil Aviation Authority, paragraphs 3.20-3.26

The development of airport competition

2.3. This section highlights key aspects of airport competition in Europe, and draws on the recent economic study on this topic commissioned by Airports Council International Europe[7].

2.4. The aviation market in Europe has been transformed over the last 20 years. The completion of the European Aviation Area in the late 1990s enabled any European airline to fly to and from any European airport. The result was to open up the airline market which had previously been dominated by nationally-focussed, often state-owned, carriers running services centred on their home country hub.

The opening up of the airline market, alongside the development and spread of the internet, generated new business models and practices. The result has been the emergence of pan-European airlines, through both mergers of hub carriers and the development of new low cost, point-to-point carriers, with a much more flexible model for deploying aircraft to the most profitable routes.

Such airlines have had a particularly sharp focus on cost and have been able to take advantage of technological developments to increase their operational flexibility and the efficiency of their distribution and information channels to potential passengers.

2.5. As a result, today's European aviation market is characterised by more 'footloose' airlines and more active, commercially-focussed airports, often privately owned or run at arms-length from government. Airports have had to respond to these airline developments.

They are fixed-cost businesses requiring major investments in runways, terminals and equipment, and a large proportion of their operating expenses varies little with scale. This means that airports are naturally incentivised to attract new airlines and more passengers. For many airports, it only takes a change of a few aircraft and/or the withdrawal of a few routes markedly to affect profitability.

7 Airport Competition in Europe, Copenhagen Economics, June 2012

As the market is growing (54% more routes and 41% more capacity were offered in 2011 compared to 2002), this means that airlines are increasingly competing to establish new routes, rather than competing on existing ones.

More single carrier routes make airports more vulnerable to airline switching because the traffic is more likely to be lost.

Such switching can involve withdrawal of many or most of an airline's routes at a particular airport, as a result of airport and airline failing to agree acceptable commercial terms.

2.6. The likelihood of such movement in aircraft occurring has been significantly increased by the more flexible operating model of the low cost, point-to-point carriers. While such carriers often differ as to the services they offer and the marketing pitch they make to passengers, they share a common characteristic - a willingness and ability to move their aircraft swiftly in order to optimise the profitability of their networks. As a result there is now significant route churn in the European aviation market, amounting to some 15-20 per cent of the stock of existing routes at any one time[8] - airlines are able to and do switch capacity between airports. Low cost carriers are also prepared, though less readily, to move their bases - and certainly to rescale them.

2.7. Airports need to compete both to retain[9] and attract this highly mobile traffic through their price and service offerings to airlines, not least because of the vulnerability of their business to the loss of routes.

This competition is reflected in the growth of routes conferences where airlines and airports are able to meet, compare offers and conclude deals.

2.8. Airports also have to compete for passengers. The increase in the number of airports (often through use of previously military airfields) and, more importantly, the range of routes now available at airports generally means that passengers have, within reasonable travelling distance, more choice of airport available to them. Nearly two-thirds (63%) of European citizens are within two hours' drive of at least two airports. This gives significant scope for airports to compete for passengers.

The increase in the number of routes flown means that an increasing number of passengers can find a comparable service at a nearby airport: on average around half of European airports' local departing passengers on intra-European routes have a choice of more than one reasonably attractive substitute airport for their chosen route, and that choice has increased significantly since 2002.

The choice for departing passengers has increased at all of the ten largest European airports[10].

2.9. In part, airports exposed to competition from near neighbours compete for passengers by competing for airlines and increasing the range and depth of routes available. But, increasingly, they also need to appeal to passengers directly through the quality of service they offer and the ease of travel through the airport.

The role of airport retail in a more competitive airport market

2.10. The next chapter explores in more detail the role that retail at an airport can play in the passenger experience. We discuss below how retail activities contribute to competition in the European airport market.

2.11. In wealthy societies where shopping is itself a major leisure activity for many, there is clearly potential for the shopping experience itself to form part of the passenger journey. The fact that airport retail has branched out considerably from its 'duty free' origins underlines that point. So it is not surprising that in designing new terminals or improving facilities airports pay close attention to the positioning and impact of retail.

Better retail performance itself can be an important contributor to financing new and improved facilities, and therefore to the resulting enhancement of the airport's competitive position. In some cases, the airport can offer new terminal facilities to passengers and airlines which

8 Around 500 more routes are opened and closed each year today compared to 2002. Roughly 2,500 routes are now opened per year whereas roughly 2,000 routes are closed per year, meaning that new route openings correspond to around 20% of the total stock of routes while some 15% of existing routes are closed every year. Source: Airport Competition in Europe, Copenhagen Economics, June 2012. 9 Traffic is not readily replaced when routes are closed. For single carrier routes, less than 20% of pre-closure capacity is regained three years after closure. For multi-carrier routes, 40% of pre-closure capacity is regained three years on. This shows that airports are vulnerable to route closures, resulting in loss of traffic and reduced airport profitability. 10 Airport Competition in Europe, Copenhagen Economics, June 2012.

are largely self-financed through enhanced retail revenues, with limited impact on airport charges[11].

Airport retail can also be a competitive differentiator for passengers in its own right, as evidenced by the prominence given the issue on many airport web sites. Retail can therefore play a significant role in an airport's quest for passengers.

2.12. The revenues that airport retail generates also play a part in facilitating airport competition for airlines. The new generation of mobile, point-to-point airlines are focussed on minimising their own costs, such as airport charges. Such airlines are generally uninterested in each airport's own input costs per se[12].

They are interested in ensuring that the airport's systems and processes match their requirements for fast plane turnaround times (which may mean lower cost infrastructure). But otherwise they tend to be focussed on the airport charges that they pay. These prices plus each airline's operational efficiency will help determine whether flying to a particular airport can be sustainably profitable.

2.13. In these circumstances, airports will be competing to demonstrate not only that demand exists to sustain a viable route but that it can be serviced at a low cost to the airline, which is likely to be comparing offers from airports across Europe. In doing so, the airport will need to take into account all the revenues that it can earn from servicing the new route.

The headline charge to the airline is usually likely therefore to be below - sometimes significantly so - the cost of providing its aeronautical services. The greater the retail revenue the airport can expect the greater the 'cross subsidy' it can potentially provide from retail revenues to aeronautical charges, and the more price competitive the airport will be.

2.14. Retail revenues are therefore an inherent part of the competitive dynamic that is increasingly playing out in Europe's airport market. That this is so owes a great deal to the continued growth of low cost carriers.

Low cost carrier development and its impact

2.15. The continuing growth in low-cost carriers is apparent from the still rising market share of capacity in the European market: LCC seat capacity has grown from 11% in 2002 to 39% in 2013[13]. Alongside the growth in low cost carrier traffic, there has been in recent years a gradual increase in the market concentration among low-cost carriers.

Although the middle of the last decade saw some increase in the number of LCCs in Europe, the subsequent financial downturn has seen a reduction in numbers as weaker carriers have left the market. At the same time, the two largest carriers, Ryanair and easyJet, have substantially increased their presence in the market.

The net result is that the concentration in the LCC market has risen from 12% in 2007 to 16% in 2013, and the number of LCCs has declined over the same period from 34 to 21[14]. Ryanair and easyJet now have very well-established pan-European franchises, with fleets of around 300 and 200 aircraft respectively, which is some way ahead of their nearest competitors.

In third place is Air Berlin, with a fleet shrinking to below 150 aircraft, followed by Norwegian, Vueling and Wizz with fleets of between 50 and 100 aircraft, each of which is looking to expand beyond its initial regional franchise.

2.16. One important result of the growth in pan-European low-cost carriers and the increasing concentration in this market has been a marked increase in the extent of buyer power facing many of Europe's smaller to medium sized airports.

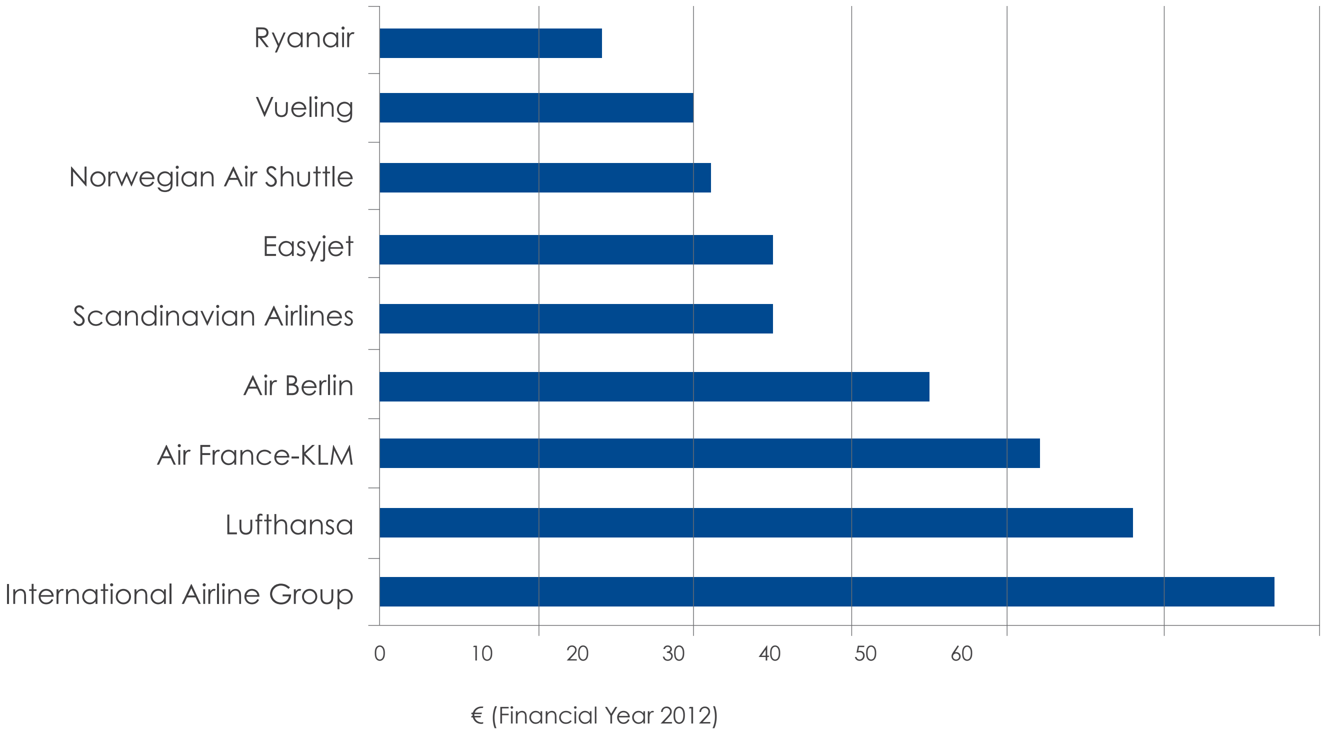
The larger LCCs have become, individually and collectively, much more important customers of these airports, which gives each LCC greater commercial bargaining power with each airport.

This bargaining power is derived from their pan-European networks and their oft-stated strategy of shifting aircraft and (where necessary) crew bases between airports to maximise their returns by closing weaker routes and bases.

11 For example, the new terminal redevelopment project at Stansted Airport (Terminal Transformation Project consultation document - March 2013), and Gatwick Airport's expansion of the North Terminal departure lounge (Revised Business Plan to 2024, January 2013) 12 The exception to this general rule can occur where the airport is subject to some form of cost-based price cap regulation, in which case airlines may engage in regulatory debate around the airport's cost base. 13 Low-cost carrier share of intra-European seat departures, source: Capstats, cited by HSBC Global Research report, Europe vs. Asia Low-Cost Carriers, May 2013 14 HSBC report. Concentration measured by low cost carrier industry Herfindahl index using Capstats seat capacity data.

2.17. LCCs have as a result succeeded in reducing substantially airport and air traffic infrastructure costs, in part through effective negotiation with airports on charges and in part through selection of lower cost airports in the first place. The most cost-efficient LCCs face airport and other infrastructure costs of around €14-25 per passenger, compared to €42-57 per passenger for the larger legacy carriers, some of which will be carrying the additional infrastructure costs associated with a major hub airport.

Figure 6:
Airport, handling and ATC cost per passenger[15]



15 HSBC report. Data sourced to company data, financial year 2012.

2.18. So, via the growth and concentration in the low-cost carrier market, many more European airports are facing greater effective competition and much stronger buyer power from one or two airlines. This issue was analysed in the recent airport competition report for ACI Europe[16] which found that airline concentration was most focussed among airports with more than 25 million passengers and amongst those with less than 5 million passengers (although a substantial minority of the small to medium airports - 5-10 million passengers - also face a sizeable single airline concentration). 43% (81 in total) of the smallest airports[17] face a largest airline customer with more than 50% of the airport's traffic, and 73% (137) of these airports face a largest customer with more than 40% of traffic. For small-medium airports[18], there is on average a more balanced share of traffic between airlines: 25% (8) of these airports face a single airline with more than 50% of traffic, while 38% (12) face a largest customer with more than 40% of traffic.

2.19. Amongst the largest airports, the concentration is explained by the presence of a hub airline which may wish in the long term to grow its core business at that hub airport: the dependence is therefore to some extent mutual, as the main hub airline relies on the airport as the base for its business and, in part, its brand.

At smaller airports there is greater likelihood that the single dominant airline is a low cost carrier and the dependence tends to be one way - airport on an airline with the scope to switch significant capacity to elsewhere within its network, and thereby exert buyer power in negotiations with the airport.

Airport profitability

2.20. This narrative of increasing competition between airports and potential airline buyer power in at least certain parts of the market is consistent with the evidence on airport profitability, although there are likely to be other factors at play such as the inherent difficulties of spreading fixed costs across a limited number of passengers at the very smallest airports. It is clear, however, that, as highlighted in chapter 1, retail revenues make a substantial contribution to airports' overall profitability.

2.21. Airport profitability is best measured by 'Return on Capital Employed' (ROCE)[19], which measures the return that a company receives on its investment, and needs to be sufficient to cover the costs of securing capital for that investment. Unlike airlines, airports generally do not have the option of leasing or selling assets. Their assets are geographically fixed and typically only of value in airport use.

In order to secure the investment necessary to maintain and expand their businesses, airports therefore require consistent and reasonable returns to remain sustainable, and to satisfy creditors and investors. This is reflected in the degree to which long-term institutional investors, such as pension funds, have become a source of funding for airports as well as other infrastructure[20].

2.22. In 2011 a representative sample of European airports reported an average ROCE of just 4.3%[21]. In a recent publication[22] the Association of European Airlines (AEA) implied that a ROCE of circa 7-10% was the minimum threshold for sustainability within the airline industry. For airports, economic regulators tend to allocate similar or higher values for the Weighted Average Cost of Capital of larger capital city airports[23]. For most other smaller regional airports, which face greater market risk, the target rate of return would be somewhat higher.

This suggests that despite positive margins, the industry as a whole made an economic loss (i.e. the returns on investments are not covering the associated capital actual costs of making those investments).

16 Airport Competition in Europe, Copenhagen Economics, June 2012. 17 Category 4, less than 5 million passengers, 188 airports. 18 Category 3, 5 to 10 million passengers, 32 airports. 19 The UK Competition Commission has stated that it will 'normally consider profit levels, usually in terms of rates of return on capital in the market or markets concerned, as a further indicator of competitive conditions'. Caution must be exercised in comparing ROCE figures as different accounting approaches can lead to different values. 20 Canadian and Australian pension funds started investing in infrastructure (including airports) more than ten years ago having built up since then a significant allocation to the sector (from 4 to 16% of total portfolio). European investors have started building up their allocation to infrastructure only in the last five years with allocations ranging from 1 to 3% of the total portfolio. Source: Della Croce, R. (2012), "Trends in Large Pension Fund Investment in Infrastructure", OECD Working Papers on Finance, Insurance and Private Pensions, No.29. 21 Profitability data in this section are from ACI Europe Economics Report 2012. This compares to 2011 ROCE figures of 12.7% for easyJet, 3.3% for Lufthansa, 5.1% for IAG, -0.3% for Air France/KLM & 3.5% for IATA airlines as a group (source: ACI Europe Economics Report 2012).
22 Sustainable European Aviation, AEA & Seabury, November 2012. 23 Dublin Airport was allocated a real pre-tax rate of return of 7% in 2009, 6.2% for Heathrow and 6.5% for Gatwick - both in 2008 - by their respective regulators. In nominal terms, these equate to ROCE of 9.2-10%. The returns for Heathrow and Gatwick are currently under review as part of a broader review of airport regulation by the UK CAA.

2.23. Profitability varies markedly by size of airport, with a clear trend towards lower profitability, tending to loss-making, for the smaller European airports. In 2011 the entire airport industry made an overall net profit of €3.3bn, which equates to €2.08 per passenger[24]. As Figure 7 and Figure 8 show, it is the larger and medium sized airports which are generally able to generate reasonable profits. When European airports are considered on a size basis, it is clear that smaller airports - and in particularly those under 3 million passengers per annum - are making very small returns on their efforts, and many airports in this size category are making losses.

Figure 7:
Average Net Profits per Passenger[25]

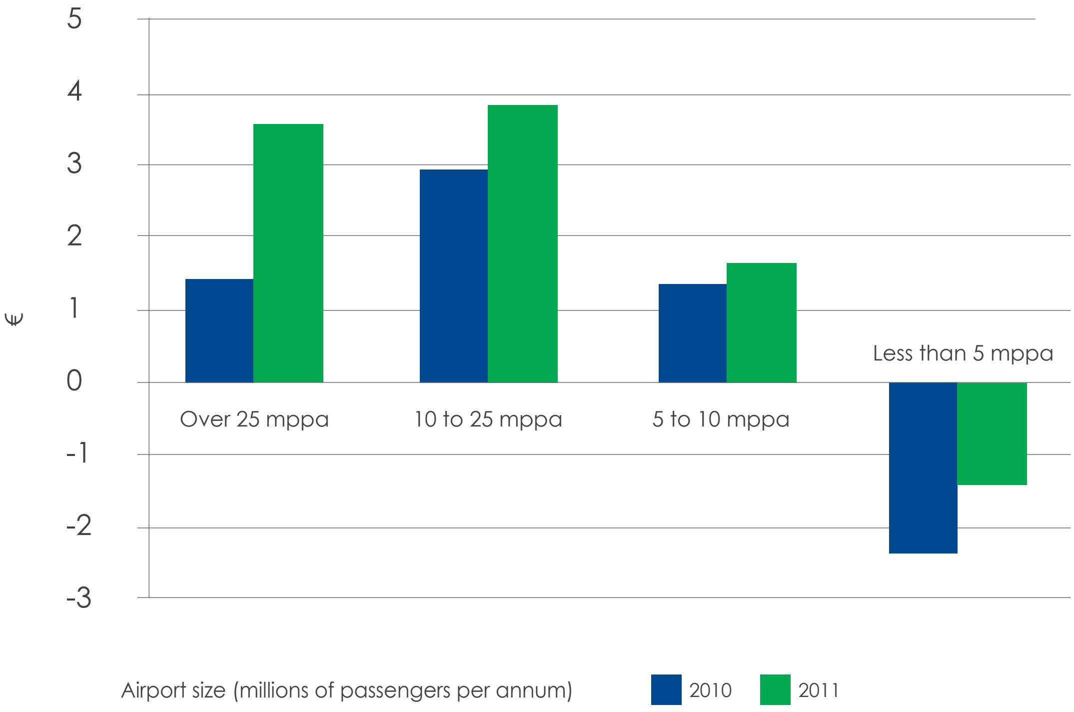
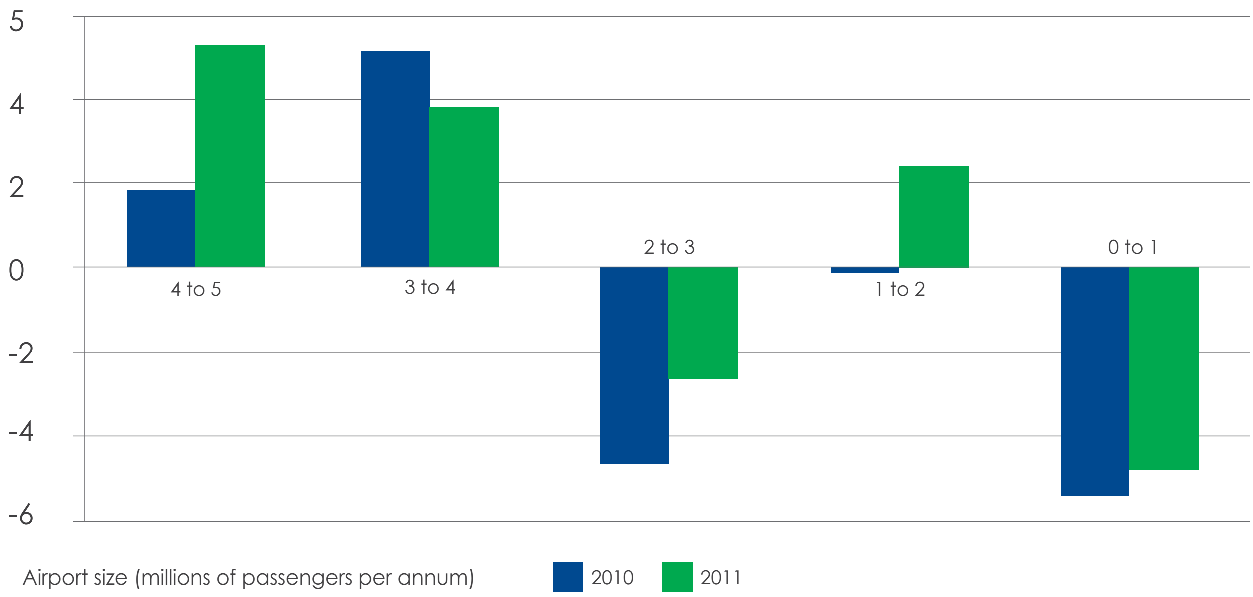


Figure 8:
Average Net Profits per Passenger at Smaller Airports



25 Source: ACI Europe.

2.24. This explains why in 2011, 43% of European airports were loss-making . This is a slight improvement on 2010 when 48% of airports were loss-making[26]. In part this continued weakness reflects the difficult trading conditions which airports faced.

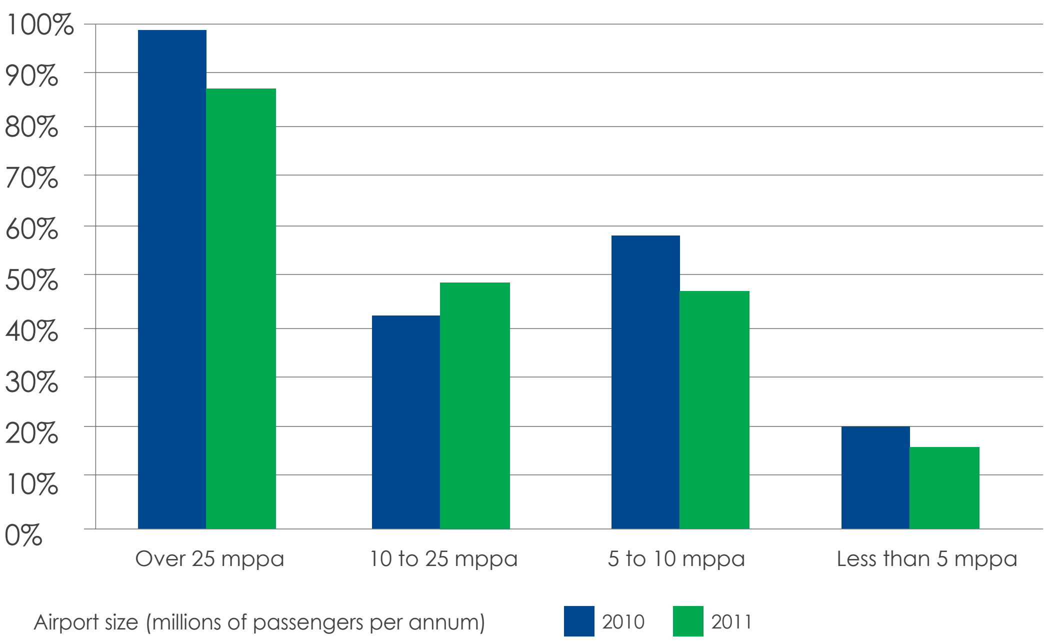
However, it is also a reflection of the reality that smaller airports are in many cases inherently unprofitable, due to their unavoidable cost structures, limited demand and vulnerability to the exercise of airline buyer power. Retail revenues, for the reasons discussed in the previous chapter, also make a smaller contribution than at larger airports.

2.25. It is apparent that in most size categories, retail revenues account for a very large proportion of the overall net profit per passenger.

This is particularly so for the medium to large airports, where the high retail revenues per passenger effectively provide a cross-subsidy to the rest of the airport's aeronautical activities.

Even for the mid-scale airports, though, retail revenues typically make up at least 50% of net profit per passenger:

Figure 9:
Retail concessions income as a % of total operating income[27]



Conclusions

2.26. Revenues from airport retail have assisted airports to compete in a market where more mobile, cost-conscious point-to-point airlines drive an increasingly hard bargain on airport charges.

The overall scale and importance of such airlines, in particular to smaller airports, means that they have potential buyer power in situations where the airports concerned are often financially vulnerable, and where retail revenues make an important contribution to operating profits.

26 ACI Europe Economics Report 2012. Profit/loss defined as: net operating income plus net non-operating income (including public subsidies) minus interest costs minus depreciation charge.
27 Source: ACI Europe.

3. Passengers' retail experience

SUMMARY

- For a majority of European passengers, shopping at airports is an expected part of their journey, and has been for over fifty years.
- Good retail facilities contribute to passengers' overall positive perceptions of a good airport experience.
- Airports actively manage other processes (such as security and car park transfer) to enhance the time that passengers have to spend, in a relaxed frame of mind, in airside departures where the bulk of airport retail is situated.
- Passengers differ markedly in their airport shopping activities, depending on the type of flight and type of carrier they are flying with.
- Where possible, airports work closely with retailers to understand these differing passenger profiles and to design the airport retail offering and marketing accordingly.
- Airlines offer a much narrower range of products for sale on board than are available in airport retail.

3.1. This chapter sets out evidence on passengers' experience of retailing at airports and on flights within Europe.

Airport retailing as part of the passenger travel experience

3.2. Browsing airport shops and picking up a bargain, a treat or items required for the journey is considered by many to be the real start of their holiday and travel experience, and has been an expected part of the passenger experience for over 50 years.

Passenger behaviour varies by country and by airport: the following survey data[28] highlight the importance of airport retail for a representative sample of European air passengers:

- According to a survey of European residents, travellers from Europe are regular Duty free / Duty Paid buyers - they buy on average every second time that they are on an international trip (5 out of 10 times). 60% of travellers from Europe regularly purchase something at Duty Free / Duty Paid shops, nearly half of whom (27% of all travellers) are frequent buyers (buying almost every time). 40% of travellers hardly ever purchase anything when flying.
- Favourite activities at the airport are shopping (47%), visiting the lounge and food and beverage consumption. Travellers of different nationalities have different favourite activities: French travellers like shopping, passengers from Germany prefer to visit the lounge, Swiss - to eat/have a drink.
- Evaluating the time spent at the airport, 16% of the time is spent on shopping. Based on the average time spent at airports before a flight, 14 minutes are devoted to shopping.

28 Source: TFWA Global airport travel retail consumer survey: Europe - 1st quarter 2011 - Airport shopping behaviour.

- A greater variety of Duty Free / Duty Paid shops (45% of respondents) as well as better restaurant/cafe offers would make travellers arrive earlier at the airport.

- 86% of European travellers visited Duty Free / Duty Paid shops the last time they went on an international trip.

- The sections most visited were Perfumes & Cosmetics (71%), Alcohol (42%) and Souvenirs (32%). Categories most frequently purchased were Perfumes & Cosmetics (51%), Alcohol (29%), Tobacco (28%) and Souvenirs (21%).

- The main reason for not visiting Duty Free / Duty Paid shops at the airport is that travellers do not want to carry any more items (24%), followed by the lack of time (23%) and the perception of the prices being too high compared to the domestic market (22%).

3.3. This Europe-wide survey data is supported by other airport-specific evidence. For example, at one major UK airport over 60% of passengers when asked have a strongly positive attitude to airport retail[29]. When considered with catering as well, over 80% of passengers make a purchase at the airport.

Looking more broadly at the experience of a major airport retailer operating at UK airports, typically around one in eight passengers on flights within Europe (13%) make purchases in the main tax-free shopping centre at European airports, rising to one in four (25%) for flights outside the European Union[30].

These figures, while lower than the survey results, reflect actual purchases, suggesting that passengers value the option of airport retail even if they do not make a purchase every time they fly.

3.4. The expectation that airport retail will be an optional aspect of their journey can affect how passengers view their journey overall, particularly their experience at the airport.

Research by one major UK airport[31] places airport shopping as the sixth most important factor for passengers at the airport in contributing to their overall satisfaction assessment, behind overall comfort, cleanliness and travel information, but ahead of security, catering and baggage handling.

Research at another major UK airport[32] also put food and shopping as the sixth most important factor in contributing to departing passengers' airport experience, on a par with overall aesthetics of the departure lounge and boarding gate, but behind terminal way-finding and appearance, and security and check-in.

3.5. Many airports market themselves to passengers and airlines by emphasising the range and quality of shopping available to passengers before they board their flights. The following are examples from various airport websites:

- Manchester Airport: "Shop before you fly - grab a bargain"

- Dublin Airport: "The big take-off-buy before you fly. … All our fragrance prices are at least 20% less than downtown"

- Gatwick Airport: "Go on … you've earned it! … Whether you're heading away on holiday or jetting off for business, our airport is the perfect place to treat yourself, or someone close."

- Copenhagen Airport: "At Copenhagen Airport there are plenty of opportunities to get a good start on the journey while you wait for your flight to depart".

- Lyons Airport: "Make your shopping on the airport and discover all the promotions of our shops!"

3.6. Airports increasingly offer innovative ways for passengers to shop at the airport. Some airports are entering on-line retailing as a complement to their physical sales outlets within terminals. In some cases, this is designed to ease the passenger's experience at the airport.

29 Source: [Airport 1] retail survey 2012-13. 61% of respondents said that they either like to browse and sometimes buy, often shop when they fly, or always shop at the airport. 30 Source: [Retailer 1], based on departing UK passengers, 2012. 31 Source: [Airport 2], first quarter 2013. 32 Source: [Airport 3], March 2013.

For example, Copenhagen Airport offers online selection and purchase of duty free products, which can then be collected when the passenger travels through the airport.

Other airports (such as Manchester, Gatwick and Edinburgh within the UK) are developing 'shop and collect' services, in which the passenger may leave purchases made at departure for collection on return from their trip, thus reducing the requirement for the passenger to carry the goods on their outbound and return flights.

However, these services do not meet the needs of passengers on out-bound flights seeking to buy items for use at their destination, or those of returning passengers seeking to buy items at the airport on the return leg of their journey to bring home.

3.7. Behind the scenes, many airports work closely with their retailers and with their airlines to ensure that the retail offering provided at the airport, in terms of scale, brands, price and location within the terminal, is best suited to the profile of the passengers using the airport.

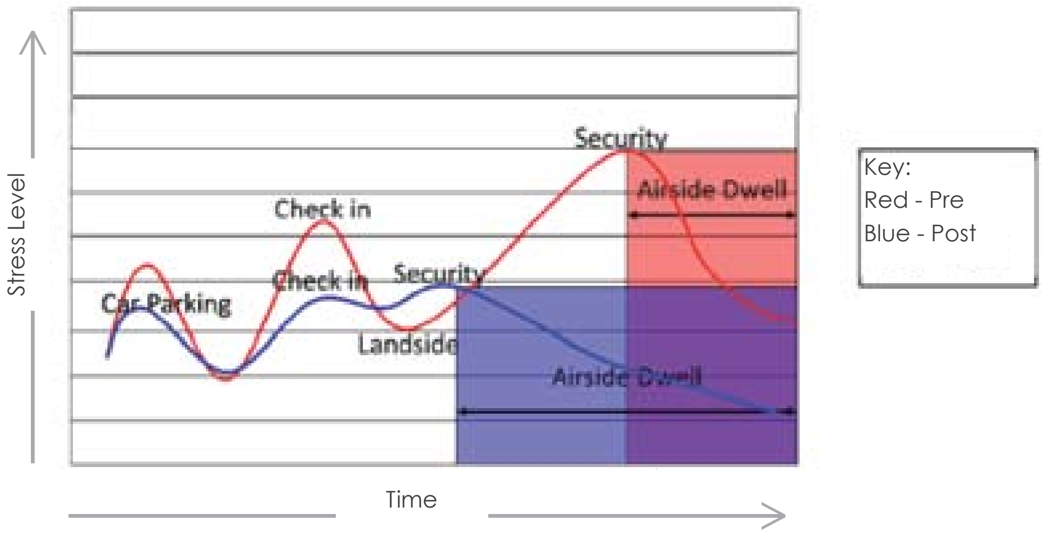
This can extend to sharing data about the retail interests of passengers flying to a certain destination, enabling the airport to align retail opportunities with the interests of specific groups of passengers, to the ultimate benefit of passengers and airline.

Airports also work closely with airlines and their own security staff to minimise the time and stress for passengers in passing through check-in, bag drop and security processing, thereby allowing more time for passengers in a more relaxed frame of mind to consider retail opportunities on the airside of the terminal.

It is well established in the industry that the greater the dwell time that passengers spend airside, and the more relaxed their state of mind (through reduced stress from smoother check-in and security processing) the greater their inclination to spend in airport retail.

The diagram in Figure 10 below illustrates this relationship, showing that an airport's commercial and operational objectives are aligned in aiming to smooth the passenger journey through the airport: the pre-and post-curves indicate passenger stress levels before and after operational improvements are made to improve passenger processing.

Figure 10:
Departing passenger experience through airport - impact of airport operations on airside dwell time and stress levels[33]



[33] Source: Manchester Airport Group, Response to CAA Market Power Assessment of Stansted Airport, Annex F

Retail activity by passenger and airline type

3.8. Retail activity understandably varies according to the passenger type and the purpose of the journey. There are several metrics for measuring this retail activity:

- Retail spending per passenger: this measures the total till receipts for a given shop or set of shops at a given airport, divided by the total number of passengers using the airport. The denominator thus includes the minority of passengers who actually make a purchase on any given journey along with the majority who do not.

- Penetration rate: this measures the number of passengers who actually make a purchase divided by the total number of passengers.

- Retail spend per customer: this measures the total till receipts for a given shop or set of shops at a given airport, divided by the total number of customers (i.e. passengers who actually make a purchase).

The relationship between these three measures is:

- Penetration rate x spend per customer = spend per passenger

All three metrics can be measured at the level of the airport, the retailer (across several airports), by airline using a given airport, or by route types.

We use each of these measures, as appropriate, in this report to illustrate different aspects of passenger retail activity and the potential impact of airline baggage restrictions.

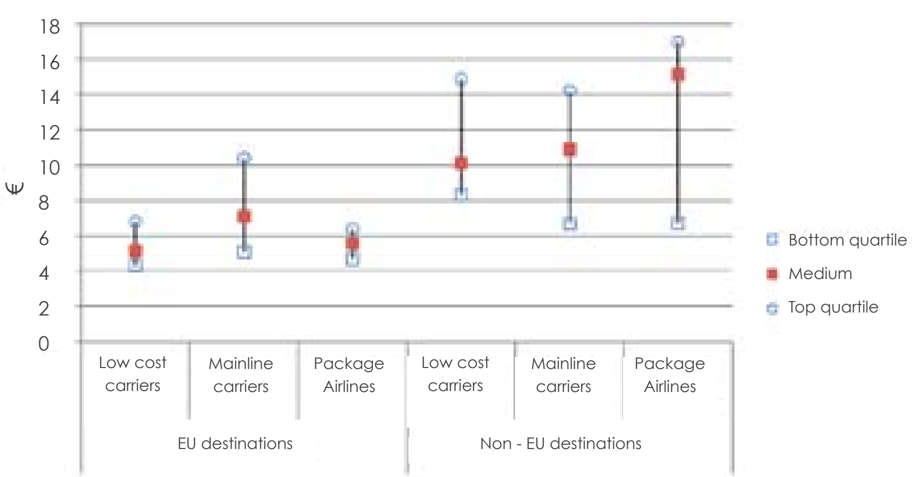
3.9. To the extent that different airlines on different routes tend to attract passengers of a common type and journey purpose, then these differences in passenger preferences show up in patterns of spending at airports by airline and by route.

As noted above, the penetration rate for airport retail tends to increase for longer haul flights to destinations outside Europe. Combined with higher rates of spending per customer on such flights, this generates significant differences in the overall spending per passenger across different types of flight.

3.10. Figure 11 below illustrates the overall finding, based on 2010 data for a major European airport retailer[34], that passengers on full service carriers tend to spend more than those on low cost carriers and on charter flights.

Passengers on short-medium haul flying outside of the European Union (e.g. to North African destinations) tend on average to spend more head than for intra-EU flights.

Figure 11:
Example of passenger spend per head by destination and airline type



Spend per passanger in 2010 by destination. Non-EU destinations are short-medium haul (e.g. North Africa). Data from a leading airport retailer

34 Source: [Retailer 1].

3.11. Within the category of low cost carriers, there are further distinct patterns of retail activity by passengers evident from the data. In part, these distinctions may be due to the differing nature of the routes operated and passenger types and preferences across different airlines.

In part, though, they will also be due to the different operating practices of different airlines, which can affect passengers' willingness and ability to engage in airport shopping. From the same source as the previous chart, the median spend per passengers on Ryanair flights in 2010 was 10% below the median for low cost carriers as a whole.

3.12. Passengers' airport shopping can also be measured by number of items in the typical purchase, as well as value of each shopping basket. As with spending per passenger, this metric varies by type of flight and carrier.

For European short haul flights, the typical number of individual items purchased for each passenger making a purchase is just over 2, with a range of 1.7 to 2.3[35].

Passengers' motivation and choice

3.13. Passengers have come to expect and appreciate choice and variety as well as value as part of their airport retail experience.

Table 5 highlights the extent of choice available within airport retail, and compares this against the more limited offering available on-board.

It should be noted that on-board sales on flights within the EU exclude three entire categories of retail: foodstuffs, alcohol and tobacco; and that on-board sales also exclude local produce from the country of departure (such as specialist foodstuffs, crafts and souvenirs).

35 Source: [Retailer 1], [Retailer 2], [Retailer 3].

Table 5:
Retail offering at selected airports and airlines

Category	[Airport 4]	[Airport 5]	Major low cost carrier
Liquor - duty free only	49		
Liquor - duty free and duty paid	404	386	7
Tobacco	151	154	-
Food & confectionery	160	543	4
Beauty	6,380	3,859	69
Sunglasses	1,035	257	-
Watches	581	178	-
Jewellery	700	81	5
Souvenirs	736	703	2
Gifts	12	268	3
Technology	11	52	2
Sub total	10,219	6,481	92
Bags	359	309	-
Clothing	-	835	-
Total	10,578	7,625	92

Note: Airport data is based on the number of stock-keeping units (SKUs), which refers to individually identified items for sale. Airline data is based on the relevant catalogue for 16 May-15 June 2011.
Source: [Airport Retailer 1]

3.14. On most airlines, passengers have traditionally faced a choice between shopping at the airport and shopping for a more limited selection of items on-board. As highlighted above, the range of goods available at the airport is typically much greater (by a factor of up to 100) than that available on-board.

Some low cost carriers have in recent years aimed to increase their revenues from ancillary services for passengers, including via on-board shopping. For example, Ryanair revenues per passenger of €62 now comprise €48 from the fare (including bag charges) and €14 (23% of total revenue per passenger) from other sources, including on-board retailing and internet-related services[36]. (This significantly exceeds the revenues per passenger from non-aeronautical sources for the vast majority of European airports).

3.15. The range of retailing now available at airports means that shopping at the airport is often undertaken on impulse, decided at the time on the basis of the choices available rather than planned in advance (just as it might be for any high street or on-line shopping experience).

For example, for one airport retailer[37] around 30-50% of all spend across a range of airport retail categories is made on impulse rather than planned in advance by passengers. Another retailer[38] reports that 50% of total spending in duty free categories is driven by impulse purchases on the day, rather than those planned ahead of time.

This has potential implications for how baggage restrictions impact on retail, and for how any regulatory remedies might work. These are explored more fully in chapter 5.

But advance notice on airline websites at the point of ticket purchase and/or check-in would not cater for a pattern of behaviour whereby many passengers consider retail activity only on the day of travel, and often then only once airside in the terminal.

Conclusions

3.16. Participation in airport retail, whether shopping or merely browsing, has become an integral part of passengers' airport experience - just as the resulting revenues are an integral part of airport finances.

The growth of retail revenues over the years clearly demonstrates that passengers positively value the opportunity they are given; and that the choice of goods now generally available is conducive to deciding on impulse whether and what to buy.

These realities of airport retailing need to be factored into any assessment of the impact of baggage restrictions and of possible policy responses.

36 Source: Ryanair investor presentations. 37 Source: passenger survey 2013 by [airport retailer 2]. 38 Source: passenger survey 2010 by [airport retailer 3].

4. Impact of the 'one bag rule'

SUMMARY

- In early 2009, Ryanair began to enforce strictly its 'one bag rule' generally at the European airports from which it operates, which effectively prevented passengers from bringing a separate bag of airport shopping on board in addition to the hand baggage allowed by the airline.

- This had a direct and material impact on retail revenues per passenger at those airports which have a significant volume of Ryanair traffic. The impact can be observed clearly for many airports affected in a sharp downward break in the trend of retail revenues per passenger between 2008 and 2009. It can also be measured by comparing passenger spending trends over the period between Ryanair passengers and comparable passengers on similar routes flying with other airlines.

- These impacts appear to be enduring, according to more recent data from summer 2012 and the first part of 2013.

- In addition to the direct financial impact on airport retail revenues, the changes in airline baggage rules (or their enforcement) have adversely affected passengers' perceptions of airport retail more generally. Passengers now have less certainty about how their airport shopping will be handled by airlines, particularly low cost carriers, and as a result appear to be deterred to some degree from making airport shopping purchases to the extent that they would otherwise desire.

4.1. This chapter sets out the available evidence on the impact to date on passengers, retailers and airports of the imposition by some low cost carriers of a strictly enforced rule limiting passengers to one item of baggage in the aircraft cabin (the so-called 'one bag rule'). Inevitably, much of the evidence of the impact is commercially confidential to each affected company. Nevertheless, the report exhibits as much detailed and relevant information as possible, given these commercial constraints.

Origin of the 'one bag rule'

4.2. European airlines have for many years imposed rules on passengers' cabin baggage, based on operating and safety requirements, and coordinated where necessary by international aviation bodies such as IATA.

The standard size of cabin bag is now reasonably well defined[39], although different airlines apply different weight limits for the bag (typically in the range 5-10kg) and some adopt their own rules around the standard[40]. Most airlines also allow passengers to bring on other small items, such as a handbag or laptop computer.

Most airlines also allow, in their terms of carriage and/or in practice, passengers to bring on board shopping purchased in the airport.

4.3. Some low cost airlines introduced charges for hold baggage in the past decade. This created a financial incentive for some passengers to increase their carry-on baggage, which in turn led the affected airlines to enforce more stringently their existing rules on the size and weight of cabin baggage.

As part of this enforcement, a number of low cost carriers (and a few of the smaller full service carriers) introduced restrictions in their conditions of carriage which reduced to one the number of items which a passenger may carry on board the aircraft.

Prior to 2009, though, this tightening of restrictions does not appear, in general, to have been accompanied by a consistent application in practice at airports across Europe. As a result, there was no major impact on passengers and airports at that time.

39 A single bag of maximum dimensions 56 x 45 x 25cm (source: IATA website). 40 For instance, easyJet introduced new rules from July 2013 that that will guarantee passengers with hand luggage no bigger than 50 x 40 x 20cm can keep their bag with them in the cabin. The current maximum size permitted, 56cm x 45cm x 25cm, will remain unchanged, but passengers with a bag of this size may find that they have to put their bag in the hold if the flight is busy.

4.4. In early 2009, Ryanair moved to enforce more stringently and consistently its own 'one bag rule', initially on flights from Ireland, and later from the UK and Spain and then across its European network. Its stated reason for doing so was "safety and not revenue" generation:

"Because Ryanair operates with very high load factors (average load factor last year was 83% or over 150 passengers per flight), and because Ryanair encourages its passengers to travel with free of charge carry-on bags in order to avoid checked in bag fees, most Ryanair passengers avail of Ryanair's (free of charge) 10kg carry-on bag policy. This means that on a regular basis, all of the overhead lockers and the storage space under the seats are fully used, and Ryanair cannot allow a second carry-on bag to be brought on board for passenger safety reasons."[41]

The wording on Ryanair's conditions of carriage now states:

"CABIN BAGGAGE
Strictly one item of cabin baggage per passenger (excluding infants) weighing up to 10kg with maximum dimensions of 55cm x 40cm x 20cm is permitted. Handbag, briefcase, laptop, shop purchases, camera etc. must be carried in your 1 permitted piece of cabin baggage."

4.5. Other low cost carriers also have put in place rules which, taken at face value, would prevent passengers from bringing a separate bag of airport shopping on board in addition to their one item of hand baggage.

Such airlines have specific statements about adherence to their policy and remedial actions to tackle excess hand baggage, e.g. carried as checked baggage for an extra fee, passengers returned to check-in desk to re-pack, or dispose of extra pieces of luggage.

Most of these airlines do not, however, appear to enforce their own rules as rigorously and consistently as Ryanair does. A summary of various airline rules is set out in the table below.

Table 6:
Airlines with specific statements about adherence to policy

Airline	Rules
Aer Lingus	strictly enforced at some airports, but handbag/laptop allowed as additional item, and airport shopping allowed at some airports
easyJet	specific instructions to keep within 1-bag rule but passengers allowed to carry on one bag of airport retail
Monarch Airlines	specific mention of laptop within 1-bag
Ryanair	strictly enforced, specific all items within 1-bag, airport shopping allowed on board, however, at some airports
Thomas Cook Airlines	specific laptop/handbag within 1-bag
Thomson Airways	specific laptop/handbag within 1-bag
Transavia	specific laptop/handbag within 1-bag
Vueling	strictly enforced, but handbag/laptop allowed as additional item
Wizz Air	small items allowed but not handbag/laptop

41 Ryanair press notice, 18 January 2013

4.6. The following observations can be made on these airlines' 'one bag rules'[42]:

- The stated online hand baggage policies of some airlines are more specific than others in terms of strict adherence and remedial actions if passengers exceed their allowance.
- Where stated, these remedial actions tend to slant towards refusal to board the extra baggage at the loading gate and transferring it to the hold for an extra baggage fee.
- Depending on how explicit and strongly-worded these adherence statements are, it is possible to glean the level of adherence standard of the airline.
- In practice, the enforcement of policy often appears to passengers to be inconsistent for a given airline, airport or ground handler. It appears to depend on individuals' training, national culture and conditions on the day.
- It is fair to say that Ryanair enforces its 1-bag rule much more strictly than many others.
- In spite of inconsistencies, the stated policies highlighted within the terms and conditions of sale allow the group of airlines to enforce to Ryanair's standard at any point if they chose to.

4.7. Notwithstanding its own policy and the stated safety rationale for introducing it, Ryanair has at a number of European airports chosen not to enforce its application. It has not been possible to determine precisely the position, not least because it has the potential to change over time.

But, for example, it appears that Ryanair passengers at Manchester, East Midlands, and Leeds Bradford (among others) are currently able to board their aircraft carrying one item of hand baggage and one bag of airport shopping, although the standard restrictions against doing so are still advertised to passengers on Ryanair's website and its conditions of carriage. It can also be observed that these airports can advertise, within the airport terminal, that all passengers (including those on Ryanair flights) are able to take advantage of airport retailing.

It appears therefore that at these airports, Ryanair has been able to reconcile its paramount safety requirements and operational efficiency with a more liberal policy of allowing passengers the flexibility to bring airport shopping on board.

At some other airports, Ryanair appears to have reached an accord with the airport to allow passengers to bring one additional bag of airport shopping on board, although this may not be advertised clearly by the airport to passengers.

Financial impact of 'one bag rule' on airports - assessment for European Commission

4.8. The European Commission considered a range of options leading up to its proposed revision of air passenger rights earlier in 2013[43]. In doing so, the Commission was informed by an impact assessment which in turn was underpinned by an economic analysis by consultants Steer Davies Gleave (SDG)[44].

4.9. SDG found only relatively limited impact on retail revenues at airports dominated by airlines which apply the 'one bag rule', compared to other airports: retail revenue per passenger was found to have increased at airports dominated by the low cost carriers but at a slightly lower rate than at other airports.

But the evidence cited by SDG appears to be rather high level and narrow, based on published regulatory accounts for two UK airports subject to economic regulation (Heathrow and Stansted).

Only two years' data were cited (2007 and 2010), and there appears to have been no analysis aimed at identifying the initial impact of the 'one bag rule' in 2009. The SDG report also draws on evidence from the UK Civil Aviation Authority that "there is no significant difference in passenger profile between low cost carriers and other carriers which would explain this trend" (identified above).

SDG conclude that the concerns raised regarding the 'one bag rule' are a commercial issue between airports and airlines, and that a European regulation to enforce passenger rights would be neither necessary nor productive.

42 Source: NYRAS report for ETRC, March 201. 43 European Commission COM(2013) 130, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 261/2004 establishing common rules on compensation and assistance to passengers in the event of denied boarding and of cancellation or long delay of flights and Regulation (EC) No 2027/97 on air carrier liability in respect of the carriage of passengers and their baggage by air. 44 Exploratory study on the application and possible revision of Regulation 261/2004 (July 2012), Steer Davies Gleave for European Commission.

4.10. We offer the following comments on the SDG report (and the resulting conclusions drawn from it by the Commission):

- The financial impact analysis did not extend to the directly attributable impact comparing one carrier with another at a given airport;
- The SDG analysis did not consider the adverse impact on passenger choice and the detriment from passenger uncertainty;
- The range of airports analysed was extremely narrow (only two, both UK), and included one (Heathrow) which is not at all exposed to the impact of low cost carrier airlines;
- The official evidence cited refers primarily to the social demographics of passengers on different types of airlines, rather than their propensity to shop at airports, which is the important aspect considered in this report;
- In concluding that any difficulties might be best resolved through commercial negotiations, SDG did not assess the buyer power position of leading low cost carriers with respect to airports, in particular smaller regional airports which, as shown in Chapter 2, are most likely to face a low cost carrier with a dominant presence.

4.11. The evidence assessed in this report goes some way beyond that presented in the SDG report. As such, we consider it is a more comprehensive analysis and thus provides a better basis for considering policy responses.

This report, in the next chapter, also considers more broadly than the SDG report how far operation of the 'one bag rule' is likely to lead to outcomes that are detrimental to passengers in both the near- and longer terms.

Financial impact of 'one bag rule' on airports

4.12. The introduction of a strictly enforced 'one bag rule' by a number of low cost airlines, and the associated confusion and loss of confidence among passengers more generally about the status of on board baggage, has had a material and persisting impact on European airport retailing in recent years.

4.13. The evidence for this is drawn from both retailers and airports. Inevitably, given that both the presence and practices of individual carriers vary significantly across airports and the issues of commercial confidentiality, there is no single European-wide data-set available.

However, the evidence below is drawn from five pan-European airport retailers, with specific data on 23 different airports and from seven different European countries.

These airports vary significantly in size and nature, so it is difficult to provide simple and meaningful summary statistics through aggregation of the available data.

The available evidence nevertheless provides a sufficiently broad perspective to suggest a more pervasive and significant impact from implementation of the 'one bag rule' than was suggested by the SDG report.

4.14. In assessing the impact of the 'one bag rule' the focus has necessarily been on Ryanair as the carrier which has, if inconsistently, been most rigorous in implementing it.

However, as indicated above, there is the potential for other carriers to follow suit, and so the analysis is intended not only to reflect what is currently going on in the market place, given Ryanair's position as the largest European airline, but also to point to what could happen were others to follow its example.

4.15. We highlight below the initial quantifiable effect on a range of European airports retailers.

Table 7:
Initial financial impact of 'one bag rule'[45]

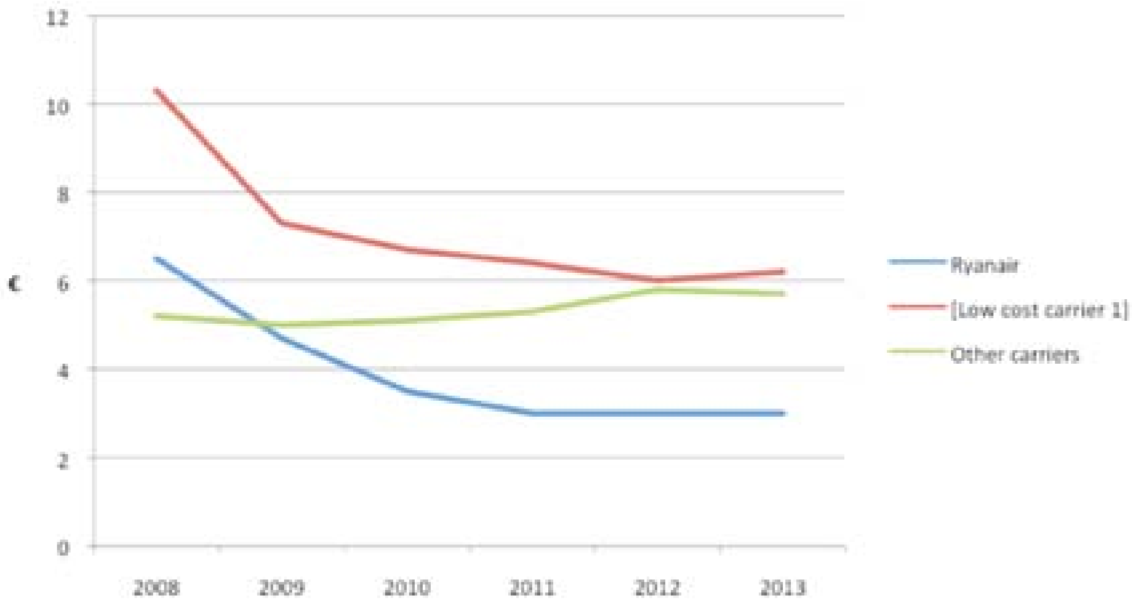
Airport / Retailer	Financial impact
[Airport retailer 1]	Average spend per passenger was up to 65% lower on Ryanair flights. Some airports where Ryanair is dominant saw a reduction of 50% in sales.
[Airport retailer 2]	Average spend per passenger reduced by 12% between January 2009 and January 2010. Spending per passenger on full-service carriers is 27% greater than Ryanair spend, despite similar passenger profile (e.g. gender, age, social class).
[Airport retailer 3]	Small airports' retail revenues reduced by 20%. Over the same period, large and medium airports' sales were down between 5-10%, giving an average loss per airport of 10%.
[Airport retailer 5]	Average spend per passenger reduced by 12% between 2010 and 2011, with penetration rate (airport retail customers per passenger) reduced by 6%. These reductions were associated with an increase in Ryanair passenger numbers of 19%.

4.16. The specific direct impact can also be measured on a route-by-route and airline-by-airline basis, which isolates the impact of the 'one bag rule' from other factors which may have affected passengers' retail behaviour over the period. The following examples all highlight the general phenomenon of a material reduction in spend per passenger for those passengers whose airlines imposed a strict 'one bag rule'.

4.17. In [Country A], passenger spend per head on low cost carriers has declined sharply since autumn 2008, as shown in Figure 12. But the decline among Ryanair passengers has been materially greater (at -47%) than that for [other low cost carrier 1] passengers. Meanwhile, spend per passenger on other airlines has grown 4% over the period.

45 Source: ETRC. 46 Source: [Retailer 1].

Figure 12:
Retail spend per passenger, [Country A] airports[46]



4.18. In [Country A], the impact of the enforcement of the 'one bag rule' is also clearly observed in marked declines in average retail spend per passenger from early 2009 onwards, compared to the previous trend of stabilisation and recovery in spending following the general economic recession starting in 2008 .

The effect was particularly marked at [Airport 6], which is one of those where a large proportion of the passenger traffic is accounted for by a single airline which enforced the 'one bag rule' strictly from early 2009.

Figure 13 illustrates the impact: at [Airport 6], sales per passenger declined by 28% overall in 2009 compared to 2008, while sales per passenger across [Country A] as a whole declined by 15% over the same period.

4.20. In [Country B], spend per passenger among Ryanair passengers at [Retailer 1] shops[47] was growing at a rate of 18% per annum in the year to January 2009.

The introduction of strict enforcement appears to have contributed to a slowdown in this growth rate to 13% over the remainder of 2009. This is equivalent to a 12% reduction in the overall sales revenue from Ryanair passengers.

4.21. At [Airport 4], the combined impact of variations in spend per passenger, the average transaction value, and penetration (the proportion of passengers that spend in the retail shops) led to overall retail revenue to [Retailer 1] from Ryanair passengers decreasing by 3% in the half year after January 2009. Revenue from [Low cost carrier 1] passengers increased by 8% over this period.

The overall 11% difference in revenue generation trends appears to arise from Ryanair's strict enforcement of its 'one bag rule' from late January 2009. Similarly, at [Airport 1], overall retail revenue to [Retailer 1] from Ryanair passengers decreased by 17% in the half year after January 2009.

Revenue from [Low cost carrier 1] passengers increased by 4% over this period. The overall 22% difference in revenue generation trends appears to arise from Ryanair's strict enforcement of its 'one bag rule' from 22 January 2009.

47 Located at [Airport 1], [Airport 4], [Airport 12] and [Airport 13].

Figure 13:
Retail sales per passenger at [Country A] airports, percentage change on 12 months previous

4.22. In [Country C], at [Airport 8], the introduction of strict enforcement of Ryanair's 'one bag rule' in January 2009 led to a 16% reduction in retail spend per passenger in the following year, as shown in Figure 15 below. This downward trend in spending has continued for some years, and contrasts with the recovery and/or growth in retail revenues experienced at other airports in [Country C] which have a much lower proportion of passenger traffic via Ryanair, as shown in Figure 14 below.

Figure 14:
[Airport 8] - retail spend per passenger, percentage change on 12 months previous[48]

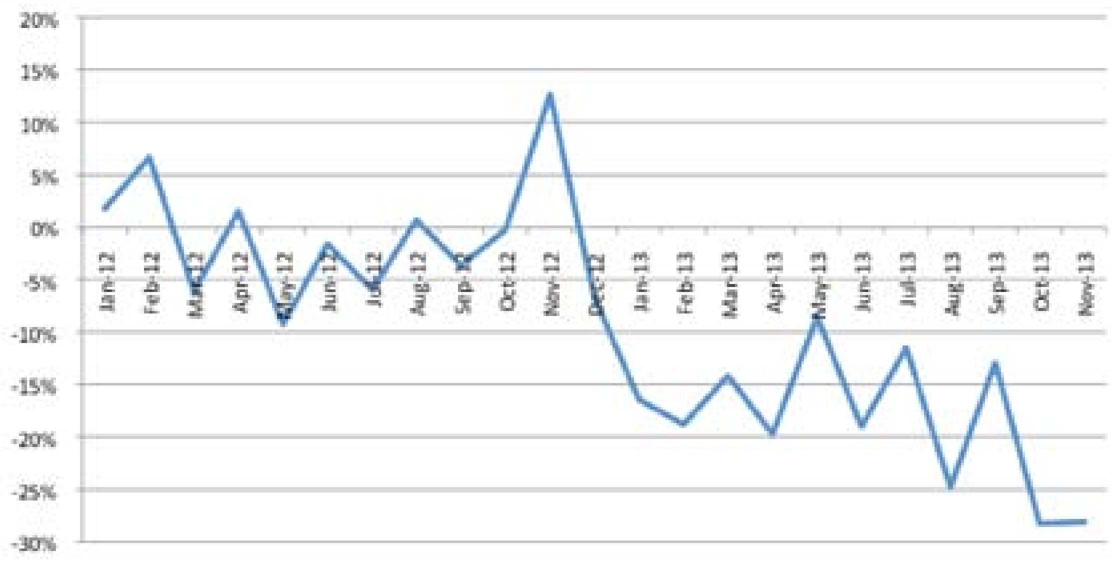
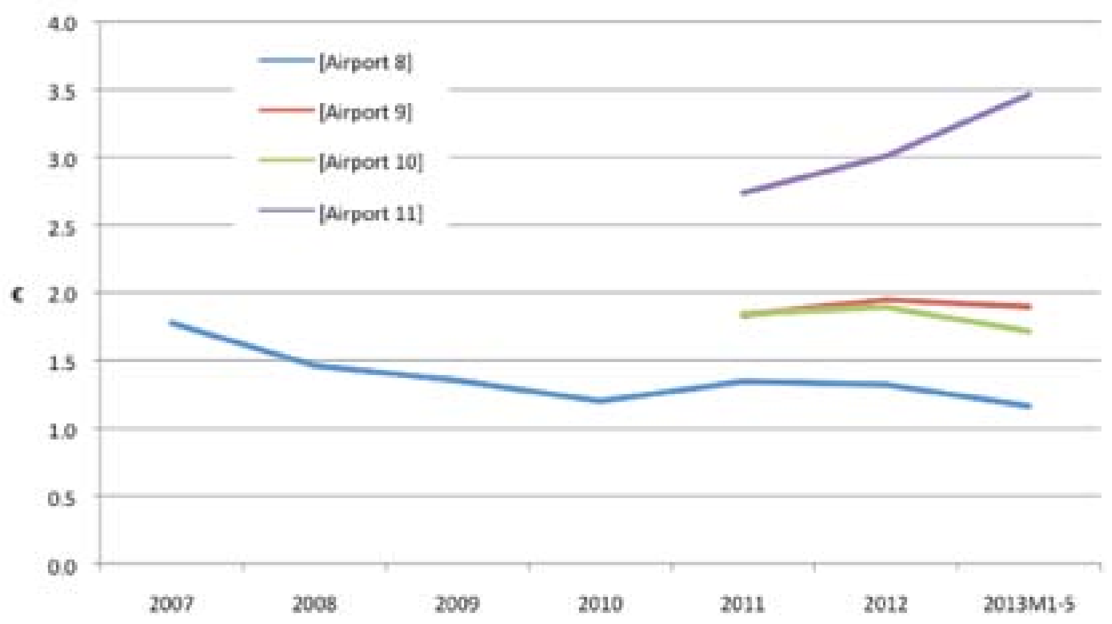


Figure 15:
Retail spend per passenger at selected [Country C] airports



48 Source: [Retailer 3].

4.23. In [Country D], there is a range of evidence about the impact of the 'one bag rule' on different airports[49].

- Only 38% of passengers travelling with low cost carriers check in luggage, compared to 66% of passengers on full service carriers. So the majority of low cost carrier passengers would be affected by strict enforcement of a 'one bag rule'.

- Penetration levels on Ryanair flights are similar to [Airline 2] - so the same percentage of passengers buy something in airport retail, whether they fly Ryanair or [Airline 2]. However, the [Airline 2] passenger spends on average 27% more per transaction than a Ryanair passenger.

- Comparing duty paid [Airline 2] flights to duty paid Ryanair flights, although the passenger profile is similar (i.e. gender, age, social class), the passenger average spend on an [Airline 2] flight is some 20% higher than the passenger average spend on a Ryanair flight.

- Taking a sample duty paid route ([Airport 14] to [Airport 7]), the [Airline 2] passenger average spend is some 45% higher than the Ryanair passenger average spend.

- Taking a sample duty free route, [Airport 14] to [Airport 15]; the [Airline 2] passenger average spend is some 70% higher than the Ryanair passenger average spend.

- Ryanair has replaced [Airline 3] on routes from [Airport 16] to [selected European airports] during 2013. [Airline 3] has a less enforced 'one bag rule'. This transition of passengers from [Airline 3] to Ryanair demonstrates the impact of the Ryanair 'one bag rule' on spend. In 2013, Ryanair passenger average spend, on the same routes as previously operated by [Airline 3] was around one quarter below the level of [Airline 3] passenger average spend in 2012.

4.24. In [Country E], the impact of the 'one bag rule' has been observed most clearly in the decline in spend per passenger between 2010 and 2011 which coincided with a significant increase in volume of traffic carried on Ryanair flights. A 13% decline in retail spend per passenger appears to have been caused by a 19% increase in Ryanair traffic over the same period. The significant differences in spend per passenger between Ryanair and other carriers on the same routes from [Country E] to other European destinations are illustrated in Table 8 below[50].

Table 8:
Retail spend per passenger from [Country E] airports

		2010	2011	% change, year on year
	Spend per passenger €	0.54	0.47	-13%
	Penetration rate	2.58%	2.42%	-6%
	Spend per customer €	20.9	19.6	-6%
	Ryanair passenger volume			19%
Destination	**Airline**	**Spend per passenger on the same route**		
[Airport 17]	[Airline 4]	0.89	0.79	-11%
	Ryanair	0.16	0.17	6%
[City 18]	[Airline 5]	2.04	2.01	-1%
	Ryanair	0.82	0.81	-1%
[Airport 19]	[Airline 6]	1.70	1.77	4%
	Ryanair	0.82	0.73	-11%

50 Source: [Retailer 5].

4.25. In [Country F], at [Airport 20], in summer 2012, spending per passenger among Ryanair passengers was one third and spending per customer was half of that of other low cost carriers. The penetration rate of Ryanair passengers (percentage who made airport purchases) at around 20%, was some two-thirds of the rate of other low cost carriers.

At [Airport 21] in the same period, spending per passenger among Ryanair passengers was 60% and spending per customer was 80% of that of other low cost carriers, and the penetration rate some three-quarters of the rate of other low cost carriers.

4.26. In [Country H] at [Airport 24], in the year to June 2013, spending per passenger among Ryanair passengers was 19% below that of the average for other airlines, and on average around 10% below that of other low cost carriers operating on the same routes and with the same passenger profiles. On several routes, though, the shortfall in spend per passenger between Ryanair and other low cost carriers was around 35%.

4.27. In [Country I] at [Airport 25], in 2009 spending per passenger among Ryanair passengers was 20-40% below the average for other flights to the same destination country, depending on the destination, and some 10-15% below the spending per passenger on other low cost carrier flights.

4.28. In [Country J] at [Airport 23], in 2012 revenue per passenger on Ryanair flights was some 40% below that for similar intra-European legacy carrier flights[51].

4.29. In assessing the above information, it is important to remember that the boarding and other operational practices of Ryanair tend to encourage their passengers to the gate rather earlier than those of other carriers, including some low cost carriers.

There is therefore potentially less dwell time in the airport for shopping and a consequent tendency to lower spend. However, what the analysis above shows is both a very significant disparity in many cases and often a clearly traceable cause in the change in enforcement of the ‘one bag rule’.

Summary of impact on airports

4.30. The data presented above cover different airports, in different countries, over somewhat different time periods. It shows that the financial impact of strict implementation of the ‘one bag rule’ varies. In some circumstances, it appears to have led to a loss of retail revenue per passenger of up to 25%.

In others the decline in revenue has been more modest. The typical impact on retail revenues per passenger for those airports most affected is around 15-25%. Standing back from these differences - which may be explained by different starting points in terms of airport commercial activity, different passenger mixes and types of destination, there is a clear directional impact.

Strict implementation of the ‘one bag rule’ has led to significant reductions in retail spend with consequential impacts for retailers and airport finances.

51 Source: [Retailer 4] for [Country I] and [Country J].

Impact on passengers

4.31. The quantifiable impact on passengers can take two distinct but related forms. There is the direct impact on those constrained from shopping by the implementation of the rule by the carrier with which they are travelling.

There is also an indirect impact on - or contagion to - those travelling with other carriers where a less strictly enforced 'one bag rule' would have permitted on board carriage of airport retail.

The uncertainty created by one carrier can deter such passengers from shopping and risking the loss of their purchases at the boarding gate.

In addition to the deterrent to airport shopping, there is also a less quantifiable adverse impact on the well-being of those passengers who experience situations of conflict at departure gates when they or their fellow travellers are forced to leave behind purchases made at the airport.

4.32. The data presented in the remainder of this chapter draw on surveys conducted by retailers and individual airports. The precise results differ but the general direction is clear.

4.33. In overall terms, according to a recent survey[52] of airports affected by the 'one bag' rule, an average of over 25% of passengers had been dissuaded from making retail purchases, which suggests average lost annual retail revenues of as much as €1.12 per departing passenger.

While the impact is highest at airports with a significant proportion of traffic subject to such cabin baggage policies (reaching €1.87 per departing passenger at one particular airport), the effect is also being felt at airports where airlines do not have such policies - an airport with a very low proportion of such traffic still had an equivalent figure of €0.89 per departing passenger.

This suggests that the confusion surrounding carry-on baggage allowances may not be limited to specific individual airports, but risks eroding passenger confidence across Europe.

4.34. Examples of passenger confusion at particular airports are highlighted below:

- At [Airport 5] in summer 2012, 19% of those interviewed did not make any purchases on some occasions because they did not know if they were allowed to take their purchases on-board along with their hand luggage without paying any supplement. If travellers were assured they could take their purchases on-board without any extra cost, 37% said they would buy more at airport stores.
- At [Airport 22], a similar survey found that 16% had refrained from airport shopping on occasion because of uncertainty about cabin baggage rules, and 19% would purchase more if they had confidence about taking airport shopping on board.
- At [Airport 12], a survey in spring 2012 found that 39% of respondents said uncertainty about cabin baggage allowances had prevented them buying something at the airport. 50% of all respondents said they would make more airport purchases if they knew for sure that they could take purchases on board, in addition to their cabin baggage.
- At [Airport 23], a survey in 2012 found that 17% of respondents said uncertainty about cabin baggage allowances had prevented them buying something at the airport.
- At [Airport 2], a survey in June 2012 found that almost one fifth of passengers (18%) claimed that uncertainty about their cabin baggage allowance had prevented them from making an airport purchase - this was particularly the case for low cost passengers (27%). Half of those who had been prevented from buying at the airport, due to uncertainty over the cabin baggage rules, were concerned about their weight restrictions. It was particularly duty free and, within that category, alcohol purchases that were not made due to passenger uncertainty. Almost one third of passengers - 41% of low cost passengers - expected to buy more at the airport if they had considered that it would be accepted in addition to cabin baggage.

52 Passenger responses to survey coordinated by ACI EUROPE & ETRC conducted at eight European airports, which collectively accounted for almost 95 million passengers in 2011.

- At the same [Airport 2], a survey in summer 2013 found continuing passenger confusion about on-board baggage allowances, despite this airport having reached an agreement with Ryanair by then to allow its passengers to carry one bag of airport shopping on board in addition to standard hand luggage. Only 7% of passengers from this airport thought that Ryanair operated a 'one bag plus one shopping bag' rule - 56% thought that the 'one bag rule' was in strict operation. There appeared to be confusion about other airlines' rules: 41% thought that low cost carrier [Airline 1] operated a strict 'one bag rule', and 16% thought that full service carrier [Airline 5] did so too.

- In Ireland, around three-quarters of passengers found airline baggage rules easy to understand. This understanding may have been increased compared to passengers in other countries given that Ryanair's home base is in Dublin and the airline has a high public profile as well as a strong market share in Ireland. Over 75% of passengers stated that the on board baggage policies had the effect of making them decrease their airport shopping by a lot or a little.

Conclusions

4.35. The range of data discussed in this chapter suggests that strict implementation of the 'one bag rule' has had a marked impact on the spending of passengers directly impacted by it (and therefore on the retail revenues recovered by the airport).

This impact is over and above any reduction that might arise due to established operating practices of the airline concerned. Implementation also appears to have had a detrimental impact on spend by passengers flying with other airlines.

This would be consistent with passengers, over a relatively short period, flying with a range of different airlines and from a variety of airports and also forming their perceptions of what is (or is not) permitted from their own and others' experiences as much as from detailed and differing airline terms and conditions.
This consumer behaviour is consistent with a complex market with many players and has implications, along with the more general evidence on impact in this chapter, for the policy approaches that are discussed in the next chapter.

5. Policy issues and proposals

SUMMARY

- Two main detriments are likely to arise from the current implementation of the 'one bag rule' - and even more so were it to become more common practice: detriment to passengers effectively denied the opportunity of shopping at the airport; and detriment to the financial viability of some airports with longer term consequences for European connectivity and passenger interest in this.

- Three potential market failures are identified:
  - Information gap for consumers: exacerbated by the complexity of the information required and fact that retail activity occurs 'on the day' rather than planned at time of booking;
  - Buyer power exercised by powerful airlines: can extract value from weaker airport suppliers, holding back investment over time and threatening financial viability;
  - 'Tragedy of the commons': if more airlines adopt 'one bag rule' then this could significantly undermine airport retail, in turn depleting revenues from the sector for sustaining European air travel connectivity and growth.

- The costs and benefits of different regulatory options are considered:
  - Transparency to passengers of on-board baggage allowance: this would still leave passenger retail choice significantly curtailed, and it is unlikely also to be effective given the disconnect in time and place between transparency at ticket purchase versus the later airport shopping experience.
  - Supporting passengers' customary ability to use airport retail by protecting rights to take shopping on-board, in addition to hand baggage: regulation would restore confidence in airport retail across the EU, allowing passengers to continue to contribute voluntarily to airport infrastructure costs. Claimed operational drawbacks for some airlines are inconsistent with their current operational practices.

- Regulation could create a level playing field for airports and airlines to develop productive partnerships to work together to grow retail activity at the airport, thereby reducing airline costs, increasing airport financial sustainability, and enhancing passenger experience.

5.1. This chapter draws together the evidence identified previously to consider three related questions. First, are the current practices of some low cost carriers restricting carriage of airport shopping likely to create a detriment to passengers either directly or longer term through their impact on airports? Second, if detriments are identified, to what extent are these detriments the result of changing business or operational practices in a well-functioning market, or may they result from or give rise to market failures? Third, to what extent could market outcomes be improved by regulation, and what are the costs and benefits of different regulatory options? The chapter concludes with a suggested approach to regulation designed to maintain passenger confidence in the availability of airport retail, thereby helping to sustain the financial viability of airports and the contribution they make to European connectivity.

This can be done without fundamentally impinging upon airlines' operational practices or freedoms to innovate in their service offering or to develop commercial partnerships with airports.

Detriment to passengers

5.2. Retail has developed as an integral part of all but the very smallest European airports - and many of these are planning to develop their retail offering in order to improve their financial position.

It has done so because passengers in general value the services offered and have come to incorporate an expectation of airport retail in planning their overall journeys. Some passengers may actively choose a given airport for its retail offer, a given airline for its on-board baggage policy, and plan to spend some time in the terminal prior to the flight in order to take advantage of the retail facilities.

For most, though, airport shopping is a helpful additional and optional aspect of their through-airport experience. The fact that passengers may not actively have planned to avail themselves of airport retail some weeks or months in advance, when they purchased their air ticket, does not detract from the utility and/or enjoyment from shopping at the airport on the day of the flight.

5.3. Passengers in Europe have, over recent decades, come to expect three aspects of airport retail:

- First, that there will be an array of retail available at the airport (above the smallest in size), primarily on the airside of the terminal;
- Second, that it is feasible for passengers to plan their arrival at the airport to allow for check-in, security and walking to the gate, thereby leaving adequate dwell time airside to engage in shopping should they wish to do so; and
- Third, reasonable handheld quantities of airport shopping can be carried onto the aircraft, in addition to passengers' hand baggage for their journey.

Passengers have also developed expectations about retail opportunities available from airlines on board the aircraft, where a very much more limited range of goods is available, with no opportunity to browse except via the airline's brochure.

5.4. As we have illustrated in previous sections, these expectations are inter-dependent. Without the clarity and certainty about on-board carriage of shopping, passengers' retail activity declines markedly, mainly for those travelling with airlines which impose strict on-board baggage rules but also affecting those on other (mainly low cost) carriers.

Passengers' uncertainty around individual airlines' specific carriage policies, and how strictly they may be enforced at a particular airport in a particular season, has served to create a broader shadow of uncertainty in passengers' minds. This impact is additional to the effect that the operational practices of some low cost carriers have, for some years now, had of reducing passenger dwell time.

A consequence of this has been a general tendency for passengers on such flights to have a lower propensity to make airport retail purchases, even compared with passengers of a similar profile on other similar flights.

However, as explained in Chapter 4, a distinction can be made between the consequential impact of operational practices which are integral to particular low cost carrier models, and a discretionary policy specifically limiting on board carriage of retail which, whatever its origins, appears to be applied in a manner differentiated by airport to suit commercial rather than operational needs.

The focus of this paper, and of the policy analysis below, is the latter because of the broader issues in relation to passenger experience and airport financing which it generates.

5.5. As indicated in Chapter 4, the imposition of a strictly enforced 'one bag rule' by some low cost carriers has, where it has been applied, markedly reduced the ability of passengers of those airlines to benefit from airport retail opportunities.

It has also effectively reduced the inclination of other passengers, travelling on other full service and low cost carriers without such strictly enforced baggage policies, to engage in airport shopping, through the shadow of uncertainty it has cast across the airline market.

The scale of this impact on passengers is material and appears to be enduring, some years after some low cost carriers first started to enforce their 'one bag rules' - for example, at some Mediterranean holiday destination airports in summer 2012, spend per passenger on airport retail by passengers affected directly by their airline's 'one bag rule' was only one-third of the spend of similar passengers on other low cost carrier flights; while at other Southern European airports, over one quarter of passengers surveyed said they would spend more at the airport if they were confident of being able to take purchases on board with them.

This impact should thus be assessed as a detriment to passengers' interests, and on a sufficient scale to justify investigation and potentially corrective action by European policymakers.

Detriment to airports and connectivity across Europe

5.6. As we have demonstrated in previous chapters, the revenues from airport retailing make an important contribution to overall income and profitability. Since European airports generally take all revenue streams into account when assessing where to set their aeronautical charges, higher retail revenues (generated through airports' commercial initiatives and the voluntary response of passengers) make a direct contribution towards keeping airport charges lower than they otherwise would be.

Or put another way, they enable airports to invest and provide services for passengers and airlines at less than cost. The growth in competition between European airports, driven in large part by the growth in the low cost carrier model, ensures that these benefits from airport retail revenues are passed on to airlines and their passengers in the form of lower charges.

Most airports, especially small to medium sized ones, are price-takers rather than price-setters in their market - competition determines the airport charges they can achieve.

The potential, therefore, to raise charges to offset the impact of reduced retail revenues is limited, not least as this would amount to replacing a voluntary contribution to airport finances from passengers' involvement in an activity which they value with a compulsory levy to which they and airlines are averse.

So any reduction in commercial revenue streams, such as retail, is likely to be offset by reductions in profits. Airports' own profitability remains moderate overall, and a substantial minority are loss-making.

5.7. European airports have, over recent decades, worked effectively in partnership with retailers (and with many airlines) to build up the breadth and depth of airport retailing, as highlighted in Chapter 3.

This has grown a substantial value-adding business in the airport sector, through attracting voluntary consumer spending which would otherwise take place on the high street or online. In turn, the revenues from this activity, undertaken by some passengers, has benefitted all passengers and airlines, both in the short term, through lower airport charges than would otherwise be possible, and in the long term, by contributing to the financing of airport infrastructure. In short, a discretionary activity on the part of passengers has become an essential element of airport finance.

5.8. Retail (along with other commercial) revenues have therefore become an important source of diversified income for most airports, which are thus less directly reliant on airport charges and are able to develop their own commercial strategies, in partnership with airlines in many cases[53].

For those small to medium sized airports which have in the past been dependent in part on financial support from regional and national governments, greater retail activity may provide a way of reducing reliance on state support In this way, airport retail can contribute directly to the overall financial viability of the European airport network, and to the creation of fair competition between airports.

5.9. This provides important context for the European Commission's drive to restrain state aids. The best way of reducing such state support is for airports to become more commercially self-reliant.

The continued growth of airport retail should therefore support the European Commission's strategy for reducing the level of state aids in the airport sector and minimising the impact of such state aids on competition.

However, to the extent that strict enforcement of the 'one bag rule' constrains retail development that is likely to make it harder for small-medium sized airports, which are disproportionately exposed to low cost carriers and (as Chapter 2 showed) likely to face a dominant single carrier, to reduce their dependence on state support.

This is a potential problem given that, under the Commission's latest proposals, they face the prospect of withdrawal of all operating aid over time.

53 For example, through sharing data on passenger profiles by route, thus enabling the airport to optimise the location and content of the retail offering in different areas of the terminal.

EU State Aids policy in the airport sector

State Aid in general is governed by the EC Treaty, which aims to foster fair competition within the single market while allowing Member States, in certain circumstances, to provide financial support to individual enterprises where this is consistent with other European Union policy goals. In particular, Article 86(2) of the Treaty allows Member States to derogate from the Community rules on State Aid in respect of undertakings entrusted with the operation of services of general economic interest if the application of such rules obstructs the performance, in law or in fact, of the particular tasks assigned to them and provided the development of trade is not affected to such an extent as would be contrary to the interests of the Community.

Article 87(3) of the Treaty lists the aid that may be declared to be compatible with the common market. Article 87(3)(a) and (c) provide for derogations for aid granted to promote or facilitate the development of certain areas and/or certain economic activities, namely under-privileged regions, important projects of common European interest that may be considered to be compatible with the common market (such as projects relating to trans-European networks), and "aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest".

In 2005, the European Commission introduced Guidelines on the application of the State Aid rules to the financing of airports and airlines. Recognising the positive benefit to citizens of European regional connectivity, the benefits to local economies affected, and the benefit to efficient use of congested European airspace, the Commission's guidelines take a positive approach to developing regional airports, but one consistent with a fair internal market. The guidelines allow, in certain circumstances, state financing of airport infrastructure, aid for the operation of airport infrastructure, and aid for airport services (such as ground-handling).

In July 2013, the European Commission issued for consultation new draft guidelines to replace the 2005 version. The Commission's new approach takes a firmer approach to state support for airport financing, and provides much greater clarity about the quantitative limits of any such support, focused primarily on the smallest regional airports. The Commission proposes that investment aid for airports be limited to those airports with less than 5 million passengers per annum, with aid intensity decreasing for airports in size range 1-5 million passengers. With regard to operating aid, the Commission proposes that this should be phased out, and should thus only be allowed for airports with less than 3 million passengers and for a transitional period of 10 years from the introduction of the new guidelinest.

Market failures

5.10. Markets naturally evolve over time, as consumer preferences, technology and costs change. The resulting changes in demand, supply and profitability are the normal outcomes of competitive markets. In general, governments should refrain from interference with such market workings.

In their nature, individuals and commercial interests will from time to time be disadvantaged but that is part of the process whereby new products and services arise and old ones are set aside, to the benefit of consumers and society. In some cases, though, outcomes in the market may be distorted to the disadvantage of consumers.

This may arise because of impediments to the working of market forces or because the result of individual actions produces an outcome clearly detrimental to consumers in the short or long terms. We have categorised these as market failures[54].

Where such market failures exist, there is a prima facie case for governments to consider the case for policy intervention to correct or offset the adverse impacts.

5.11. In the next section, we consider policy responses. In this section, we first identify three potential market failures which together combine to create the detriments to passengers and airports set out in the previous section:

- Information gap for consumers
- Buyer power exercised by powerful airlines
- Undermining of a common airport resource

Information gap for consumers

5.12. Air passengers are consumers of a range of products and services which are bundled together in a single transaction, the purchase of a ticket for a flight on a given airline from one airport to another, and usually back again. The primary service is obviously carriage of the passenger.

Other services provided by the airline include the on-board facilities and service, and carriage of baggage. Other services provided by the airports include facilities for transfer from road and rail links, for baggage handling and security, and terminal facilities to enhance the passenger experience, such as retail, catering and rest areas.

So the single product purchased has many different dimensions, some of which may be regarded as more essential (e.g. safe carriage to destination at specified time and date) than others (such as airport ambience and facilities) but all of which go to create an overall passenger experience.

54 There is an on-going debate in economic and policy circles about the precise definition of 'market failure'. We take a pragmatic approach, considering outcomes from the market which appear sub-optimal for individuals or for the market as a whole, and which might feasibly be improved through regulation.

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5.13. When choosing to buy a particular ticket from a particular airline, the passenger will be primarily focused on the information regarding the essential aspects of the journey (time, date, ticket price).

S/he may also have to consider some other aspects of the journey in advance, such as whether to purchase hold baggage allowance or preferential boarding options (depending on the airline).

The related services, such as the opportunities for shopping at the airport prior to departure, will though be part of the passenger's general expectations and assumptions about air travel, arising from their own previous experience and that of friends and family.

But the potential for airport services such as retail being differently available, depending on the airline chosen, is unlikely to be a central aspect of the passenger's choice.

5.14. This is particularly so as airport retail opportunities are an aspect of the overall journey product which the passenger is likely to make decisions about on the day of travel, depending on shopping requirements, time available, passenger sentiment, etc.

This makes it hard for the passenger to form choices about airport retail some months in advance of the experience when buying the airline ticket. There is a disconnect in time, of several weeks and months usually, between the primary purchase and the consumption of secondary services at the airport, such as retail - passengers cannot predict their desire or need for airport shopping at such a distance.

This contrasts with the actual flight itself, where the key product parameters (time, destination, seat space) are all known clearly in advance, and can - and, importantly, need to - form the basis of an informed choice. Likewise for the choice of airport, the key factors such as journey time and car parking costs are easily computed at point of ticket sale.

5.15. So information about airport retail opportunities, even if provided by the airline website at the point of sale of the ticket, is likely to be under-processed by passengers when they make their purchase. This gap in information is filled by passengers' general expectations, based upon previous air travel experience from the destination airport and others.

Until recently, these expectations were largely met - passengers could choose, at the airport on the day of travel, to engage in shopping for goods to be carried on board the aircraft.

The strict enforcement by some airlines of a 'one bag rule' has, however, in effect prevented passengers from being able to exercise their expected choices at the airport, and has caused considerable uncertainty across a broader swathe of passengers using low cost and full service carriers.

5.16. There is thus a material gap in the information that passengers can reasonably process and act upon, between the point of ticket purchase and the passengers' experience in the airport terminal.

This is combined with a growing gap between passengers' expectations about airport retail in general and the reality they experience on the day of travel. Where consumers have substantially imperfect information about the full aspects of the product they are purchasing, at the point when they can act on that information, then the market may not work as well as it should.

This can result in detriment to consumers (as we have shown previously), through restrictions on choice and freedoms, and regret at being tied into a particular product where the full consequences of the initial choice were not apparent or able to be assessed properly at the point of sale. There is evidence presented in this report that such issues arise in the European air travel market, particularly affecting passengers travelling on low cost carriers.

This disconnect between passengers' expectations and experiences is likely to be greater where the 'one bag rule' practices of airlines vary airport by airport. This can add a layer of complexity and further uncertainty to the passenger considering whether or not to use airport retail, likely to result in passengers remaining deterred from airport shopping even where on board carriage is possible.

Buyer power

5.17. The European Commission established competition guidelines in 2004 (for assessing horizontal mergers) in which it set out the following definition of buyer power[55]:

"The competitive pressure on a supplier is not only exercised by competitors but can also come from its customers. … Countervailing buyer power in this context should be understood as the bargaining strength that the buyer has vis-à-vis the seller in commercial negotiations due to its size, its commercial significance to the seller and its ability to switch to alternative suppliers."

5.18. Such buyer power is apparent in the strong negotiating position of large airlines as buyers of airport services, particularly from small-medium sized regional airports. It has its source in the ability of such airlines readily to switch routes between airports and their sizeable presence at smaller European airports.

As we have shown in Chapter 2, many such airports face a single airline which accounts for over 40% of their traffic. The trend in the European low cost carrier airline market towards greater concentration among fewer larger carriers is likely to reinforce this situation over time.

5.19. In general, the presence of buyer power in a market for intermediate goods or services can be beneficial, provided these benefits are passed on to the end-consumers. In the aviation case, airlines with buyer power can negotiate lower charges from airports, and then pass on these savings in the form of lower prices and/or greater choice of services to passengers.

55 European Commission, 2004, Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (2004/C 31/03).

However, this is not always the case. There may be circumstances where an airline can benefit itself, in the form of higher economic returns, from the buyer power which it holds with respect to an airport.

And, if buyer power is sufficiently strong and persistent it can have adverse consequences in the supply chain, leading to under-investment and ultimately withdrawal of capacity by suppliers. It is these consequences that risk arising in the context of the impact of the 'one bag rule'.

5.20. Competition authorities have examined the impact of buyer power in the European airport market, and in other European markets. The Dutch competition authority (NMa) recently commissioned a study into the effect of buyer power in various transport markets, including the airport market[56].

This market is regulated in the Netherlands under a consult/negotiate regime, that requires airports to consult with their downstream intermediate users (airlines). The analysis for the NMa highlights that buyer power in the hands of airlines should only be a means to an end, to help secure reasonable terms from the airport and in turn pass these benefits on to end-consumers (passengers) in the form of better prices and services.

There can be circumstances where the exercise of buyer power by an airline against an airport may not be in passengers' interests.

5.21. The interests of intermediate users (airlines) and consumers (passengers) may not be aligned. There can be a disjoint between the objectives of current airlines as users of airport services and of both current and future passengers.

There could be 'time inconsistency' issues, in that short term decisions do not correspond to long term optimal outcomes. In this context, pressure in the short term by some strong airlines to enforce a 'one bag rule' could serve to undermine the commercial viability of airport retailing, which in turn could (as shown in Chapters 1 and 4) significantly damage an airport's profitability, and thus its ability to invest to meet future passenger and airline requirements.

The detriments that might arise from generalised patterns of this sort are dealt with in the next section.

5.22. In the UK, the Competition Commission examined the extent to which buyer power may operate against the interests of consumers and the rest of the supply chain in the context of the groceries market[57].

As in the Dutch competition study, the Commission found that buyer power could be expected to benefit consumers in most situations, where competition between downstream retailers was effective, and so good terms which retailers were able to negotiate with suppliers would be passed on to end consumers.

However, the Commission also found that: "The exercise of buyer power by grocery retailers may, however, raise concerns in certain limited circumstances if it allows retailers to impose excessive risks and unexpected costs on suppliers, which reduces suppliers' incentive or ability to invest and innovate.

This could lead to reduced capacity, reduced product quality and fewer new product offerings, and ultimately, to a detriment to consumers".

5.23. In the context of the European airport market, it is arguable that the strict implementation by some low cost carriers of the 'one bag rule' since 2009 may represent both an excessive risk and an unexpected cost for many small to medium sized airports where a dominant low cost carrier has significant and increasing buyer power.

As discussed in chapter 4, the imposition of the strict 'one bag rule' has led to a decline in retail spending per passenger and a broader uncertainty among passengers at affected airports about their ability to take airport purchases on board.

This clearly represents a commercial risk to the affected airports, where retailing makes a significant contribution to overall profitability. The 'one bag rule' also represents an unexpected cost to the airports, as it significantly alters the

56 Buyer power and its role in regulated transport sectors, Oxera, for Dutch NMa, February 2012. 57 The supply of groceries in the UK market investigation, Competition Commission, April 2008.

established patterns of passenger experience and disrupts the retail activities which had contributed substantially to the development of European airports in recent decades.

The overall impact would be likely to reduce airports' ability and incentive to invest in terminal facilities which enhance passenger experience and also make a major contribution to overall profitability.

In the long term, a persistent reduction in revenues from retail could make many smaller airports, which are only marginally profitable now, unviable financially and thus liable to closure, especially given the context of a more stringent approach to state aids by the European Commission.

5.24. The link between airline buyer power and the position of airport retail is created by individual airline operational practices at each airport with regard to the on-board carriage of passengers' airport shopping. Some airlines, including some major low cost carriers, choose to meet passengers' expectations for on-board carriage of retail purchases at all the European airports from which they operate.

For these airlines, their commercial negotiations with airports focus on the airports' charges and facilities, and not on the airlines' own practices. On the other hand, for those airlines which do apply a strict 'one bag rule' at most European airports, it is apparent that their application of their own rule has become part of the commercial negotiations with each airport.

This is evidenced by the fact that some airports (with some countervailing commercial power of their own) have successfully negotiated with a low cost carrier for it not to enforce its 'one bag rule' at that airport, and thereby enable the airport to continue to benefit fully from retail development (although there may still be residual passenger uncertainty which impedes airport retailing). Most other airports, though, are in a weaker bargaining position when facing major low cost carriers.

They have not, therefore, been able to negotiate such an outcome, or any form of compensation (e.g. through higher airport charges) where retail revenues are reduced by airline practices, and are thereby exposed to adverse impacts on retail revenues from the airlines' baggage rules.

5.25. In effect, airports in this position are constrained from engaging fully with the retail dimension of their businesses. As identified in Chapter 1, airports are in the nature of multi-sided businesses which maximise their commercial and economic potential by engaging with a number of interdependent parties - mainly airlines, retailers and passengers.

They are not simply suppliers of services to airlines, important though that activity is to their business. So for airlines to use their buyer power effectively to constrain the commercial exploitation of the airport's non-airline business is to undermine its commercial basis.

5.26. So there is a potential issue in the airport-airline supply chain, affecting the many small-medium sized regional airports which face a dominant airline which has significant buyer power.

This buyer power appears to manifest itself in the form of differential enforcement in practice of some airlines' 'one bag rule'. Those airports which are in relatively weak bargaining positions are exposed to significant costs and uncertainty from the commercial strategies of some powerful airline buyers, which have the effect of undermining the financial base of airport retail developments and thereby the viability of the airport itself.

Undermining of a common airport resource

5.27. The actions of airlines in restricting the commercial activities of individual airports may also over time have more general consequences for European aviation. Airport retail revenues can be considered as a resource, created by the inter-actions of airports and passengers, which contribute to the financing of airport services and infrastructure development, to the benefit of all users. There is the potential for this to be undermined by the actions of particular parties.

This so-called 'Tragedy of the commons' is where the actions of one party create costs which fall outside that party (so called 'externalities') but which are borne by other parties. The result is typically behaviour which is optimal for each party individually, but which taken together creates a sub-optimal outcome for all parties.

The classic, historic example is over-grazing of livestock on common land - each farmer would benefit individually from a larger herd, but the community of farmers as a whole would lose out from over-grazing if each farmer acted only on his own narrow interests. In an EU context, an example is the risk of over-fishing to which the Common Fisheries Policy is directed.

5.28. Characteristics of such market failure include a time dimension (over consumption today may affect future productivity of the resource some period hence), incomplete property rights (no consumer has clear ownership over the common resource), and difficulty of coordination (consumers cannot readily agree and then commit to limit consumption of the common resource). Furthermore, there may also be a case of 'beggar thy neighbour', whereby if one party deviates from a previously observed norm (e.g. a social custom or standard commercial practice), then this may provoke others to respond similarly, in order to avoid being disadvantaged. This can result in the rapid shift away from a relatively benign equilibrium to a much less advantageous one.

5.29. In this case, the generation of retail revenues at airports has generally enabled, on the back of a voluntary contribution by passengers through shopping activities, greater investment and lower charges than would otherwise have obtained.

Airlines and passengers have both benefitted and many more airports are financially viable as a result of retail activity. In short, the current degree of connectivity in Europe is in part sustained by voluntary shopping activities at European airports.

This equilibrium, which benefits all, is sustained by the commercial drive of airports and the willingness of airlines to allow passengers to take retail purchases on board. There is a potential for strict enforcement of the 'one bag rule' to undermine this equilibrium, both at the level of the individual airport but more generally.

5.30. Although strict enforcement of the 'one bag rule' is limited at present to a few low cost carriers, other airlines may face commercial pressures to follow suit, if the leading 'one bag rule' airlines are seen to gain at least short term advantage from their current practices, for instance through the bargaining leverage given in dealings with airports. Such a 'leader-follower' pattern has been observed over the past two decades in the development and growth of the European low cost airline market: technical and commercial innovations pioneered by one airline spread rapidly across the sector.

In that scenario, the European airport market could switch to a new equilibrium, where passengers' expectation is that many airlines operate a strict 'one bag rule', significantly inhibiting the scope for airport shopping.

The resulting reduction in demand would result in a loss to the aviation sector as a whole of the value added by voluntary passenger shopping, an activity which is a major contributor to the economics and experience of all the parties to the European aviation system.

Market failures - conclusions

5.31. The above discussion highlights that the detriments to passengers and to airport finances from the 'one bag rule' phenomenon are not just normal aspects of a market adjusting to shifts in commercial practices, consumer demands, costs and technology. Rather, the impact to date on European passengers and airports, and the potential impact were the current practice among some airlines to become widespread in the sector, appear to arise from failures in the way that the market operates.

5.32. First, passengers find it difficult to make active choices about airport retail at the point they purchase the primary product with which it is bundled (the airline ticket), and the information gap between passenger expectations and reality has widened as a result of the 'one bag rule'.

Second, strong airlines appear to be exerting buyer power in their dealings with smaller regional airports, which are experiencing adverse revenue shocks as a result and are likely to be deterred somewhat from future development without the underpinning financing from retail revenues.

Third, while first-mover individual airlines may obtain some commercial gains from their own 'one bag rule', in doing so they create commercial incentives for others to follow, which could ultimately lead to a new equilibrium in which airport retail is no longer able to provide such valuable revenues to the European air travel sector as a whole.

Given the marginal profitability of many smaller regional airports at present, the longer term outcome of this scenario would likely be a reduced network of regional airports and higher cost travel across Europe for individuals, which needs to be seen in the context of the importance accorded to such airports by European policymakers.

European Union policy towards regional airports

The role that regional airports play in the economic and social development of the European Union is well recognised by both the European Commission and Parliament.

In its draft 2013 proposal for EU Guidelines on State aid to airports and airlines, the Commission noted that "linking people and regions, air transport plays a vital role in the integration and the competitiveness of Europe, as well as its interaction with the world. … At the same time, regional airports can play an important role for local development and the accessibility of certain regions, in particular against the backdrop of positive traffic forecasts for the development of EU air transport."

The European Parliament Report on the future of regional airports and air services in the EU (2011/2196(INI)) highlighted the positive contribution of regional airports to economic integration within Europe. It called for EU policies to support the "socially and economically viable development of regional air services", including measures to prevent the imposition of 'one bag rules' by airlines from undermining regional airports' commercial development.

5.33. Each of the impacts identified above can be argued to constitute a form of market failure. However, taken together, they more clearly amount to a risk of a material adverse impact currently on passengers and airports, and the risk of a greater adverse impact in the medium term which would also affect airlines and passengers in general.

The balance of evidence therefore suggests that the overall impact can be characterised as a market failure, in the sense that the likely outcome of current practices would result in less passenger choice, higher airport charges, and less value added in the European aviation sector than the alternative market outcome without the 'one bag rule'.

Policy response

5.34. The evidence presented in this report suggests that strict enforcement of the 'one bag rule' can have a potentially significant impact on retail revenues and that, as this chapter shows, this does not necessarily represent the best available market outcome.

There are problems and risks around information to passengers, the buyer power of airlines in certain situations and the possibility that the uncoordinated, short term actions of individual airlines could have a detrimental impact on the longer term financial viability of the aviation system and the connectivity it supports. Each of the problems identified are on their own significant but, taken together, all the impacts lead in the same direction - towards material adverse impact currently on passengers and airports, and the risk of a greater adverse impact in the medium term which would also affect airlines in general.

5.35. The issues raised here and the risks going forward are not clear cut. But they are significant enough across a number of different dimensions to prompt the question as to whether a policy response at European level would be appropriate.

However, as indicated above the problems identified are of very different types and there is therefore a question of how far policy responses are likely to deal adequately with all the different dimensions of the problem - both the issues around information given to the passenger and the potential for impacts on airport finances to translate into longer term detriment to European connectivity.

5.36. This section considers two possible policy options: first, enhanced information transparency for passengers; and second, enhanced rights for passengers with respect to hand baggage. Both have been proposed and considered previously in the context of European policy debate about air passenger rights, as summarised below.

Policy assessment - European Commission

5.37. The European Commission considered a range of options leading up to its proposed revision of air passenger rights in 2013[58]. It concluded in favour of enhanced transparency for passengers rather than rights to carriage of cabin baggage: "The proposal enhances the transparency with regard to baggage allowances. It explicitly requires air carriers to clearly indicate the cabin and hold baggage allowances, at booking and at the airport (Article 2(4) of the proposal - Article 6d of the amended Regulation (EC) No 2027/97)". In doing so, the Commission was informed by an impact assessment which in turn was underpinned by an economic analysis by consultants Steer Davies Gleave (SDG)[59].

5.38. The SDG report considered, among the options assessed, one which would give passengers rights to carry-on baggage. Under this option, passengers would be permitted to carry:

- a standard piece of hand baggage, with the dimensions determined by the carrier;
- various personal items, such as a handbag or laptop bag and coat; and
- one bag of airport retail purchases, with dimensions at least 40x60cm;
- where this could not be carried due to safety or other restrictions, the carrier would be able to place the items in the hold, but would not be permitted to charge to do so.

5.39. As discussed in Chapter 4, the SDG report provided relatively limited evidence on the impact of the 'one bag rule' on airports, and did not address the direct impact on specific airports, the impact on passenger choice and uncertainty, or assess the buyer power of leading low cost carriers with respect to smaller regional airports.

These additional factors are weighed up in this report, and the balance of argument considered in our analysis of policy options below.

Policy assessment - European Parliament

5.40. There have been several initiatives and reports by members of the European Parliament which have sought to focus political debate on the potential adverse impact of the 'one bag rule' on passenger experience and the financial health of smaller regional airports.

5.41. The first such report, on the functioning and application of established rights of people travelling by air[60], recommended inter alia:

"… the Commission to propose measures that would make it possible to harmonise commercial practice concerning hand luggage so as to protect passengers against excessive restrictions and to allow them to carry on board a reasonable amount of hand luggage, including purchases from airport shops."

58 European Commission (March 2013), Proposal for a Regulation amending Regulation (EC) No 261/2004, COM(2013) 130 final. 59 Exploratory study on the application and possible revision of Regulation 261/2004 (July 2012), Steer Davies Gleave for European Commission. 60 European Parliament (March 2012), Report on the functioning and application of established rights of people travelling by air (2011/2150(INI)), Committee on Transport and Tourism, Rapporteur: Keith Taylor.

5.42. This was followed in April 2012 by a report on the future of regional airports and air services in the EU[61] which, inter alia, included the following proposal for greater passenger rights to hand baggage:

Expresses concern that certain practices of low-cost airlines, which often operate from regional airports, lead to poorer quality of service for passengers and a deterioration in working conditions; given the current aggressive business practice of some low cost airlines operating from regional airports to take advantage of their dominant position, and given that commercial activities are a major source of income for regional airports, is concerned by 'one-bag' and other restrictions to the cabin baggage allowance imposed by certain airlines; takes the view that these practices represent a breach of competition law, and believes that these restrictions may constitute an abuse of a carrier's position; calls, therefore, on the Member States to set common upper limits to be imposed on airlines with regard to such restrictions and considers that any checks relating to luggage weight restrictions and size should be made before arrival at the departure gate."

5.43. The third relevant Parliamentary report was issued in September 2012, on passenger rights in all transport modes[62]. This included the following recommendation, along the lines of the previous Parliamentary initiatives:

"Reiterates its call on the Commission to propose measures for the introduction of common standards for the carriage of hand luggage, so as to protect passengers against excessive restrictions and allow them to carry on board a reasonable amount of hand luggage, including purchases from airport shops."

Assessment of policy options

5.44. Against the background of the above consideration by the European Commission and European Parliament this section seeks to evaluate the two main policy options put forward - namely, increased transparency to passengers and according passengers an explicit right to carry on board airport shopping in addition to a carrier's defined cabin baggage allowance.

Option 1 - Information transparency for passengers

5.45. In many areas of consumer policy, the simplest and often most effective form of policy intervention is to require a minimum level of transparency of information for consumers, above that which would otherwise be supplied by the market. In this case, the policy option considered would seek to narrow the information gap facing passengers through enforced transparency.

It would require airlines to set out clearly on their websites, prior to the point of sale and on the same web page where passengers are offered options for purchasing hold baggage, the precise terms of the on-board carriage of airport shopping.

Where the airline applied different rules at different airports, the information provided to the passenger on the website should be specific to the two airports which the passenger would travel through on the particular journey which is being booked.

The same information would also be required to be displayed on the web page when passengers check in online and print their boarding cards, which may be much closer in time to the flight itself and the airport experience.

5.46. On the face of it, such a rule could ensure that passengers made fully informed decisions on choice of airport, airline and airport retail opportunities, prior to the purchase of the airline ticket.

However, as argued above, it is not apparent that passengers would be either motivated or able to act upon the information provided at that point in time, in which case greater information disclosure would be unlikely to change their purchase behaviour.

Even a reminder of the airline's baggage rules at the point of printing boarding passes would be some days or weeks in advance of travel, and thus still disconnected from the passenger's preferences experienced on the day at the airport for shopping.

61 European Parliament (April 2012), Report on the future of regional airports and air services in the EU (2011/2196(INI)), Committee on Transport and Tourism, Rapporteur: Philip Bradbourn.
62 European Parliament (September 2012), Report on passenger rights in all transport modes (2012/2067(INI)), Committee on Transport and Tourism, Rapporteur: Georges Bach.

So enforced transparency would be likely to reduce passenger uncertainty to some degree but not to such an extent that passengers were able and willing to plan adequately in advance (e.g. through checking baggage into the aircraft hold) to allow space within the airline's rules to carry on board airport shopping.

An added complication would be the risk that the airline might, between date of booking and date of flight, alter its approach at a particular airport which would have the potential for passenger confusion and detriment as the basis on which the flight had been booked was changed.

5.47. A more fundamental problem is that this approach to transparency assumes that the passenger takes in information only from written guidance whereas there are likely also to be powerful influences from previous experience. This is more so where the approach of individual airlines towards on board carriage of shopping varies airport by airport.

A passenger who had in the recent past been able to take on board shopping with a particular airline is likely to be less receptive to the message that the 'one bag rule' would be strictly enforced than one whose experience was in line with the web page message.

5.48. In terms of implementation, this would be a relatively low cost option. All airlines are required to display their conditions of carriage on their websites prior to point of sale, and virtually all airlines provide passengers with further information on options for checking baggage into the hold.

Such webpages would require relatively minor redrafting to include the minimum information on airline cabin baggage rules. The costs might be slightly higher where such information needed to be airport-specific, as a result of the airline applying different standards at different airports at different times.

5.49. So while this option is relatively low cost in terms of implementation it is also likely to be of limited benefit. First, it is directed to only one of the potential problems arising from the 'one bag rule' - that concerning information to the passenger. Second, it is unlikely to be wholly effective in that regard given the variation in the arrangements applying to on board carriage of airport retail, even as they pertain to particular carriers. Third, given the interval between booking or check-in and the shopping opportunity on the day of travel itself, passengers would likely pay attention to their own and others' airport retail experience as much as the guidance actually given.

5.50. Overall, this information transparency option is assessed as low benefit-low cost, and ineffective in tackling the causes of the detriments to passengers and airports.

Option 2 - Enhanced rights for air passengers

5.51. This option would restore passengers' reasonable established expectations about conditions of carriage on all flights from European airports, by clarifying that a passenger can bring onto the aircraft one carrier bag of items purchased at the airport in addition to any cabin baggage allowed by the airline.

Airlines' existing rules on the size and weight of cabin baggage could continue to apply, as would their rules about whether such bags would be stowed in overhead lockers or in the hold (depending on space on particular flights). Furthermore, airlines would continue to be free to charge for hold baggage (as many already do) and for cabin baggage (as one or two are starting to do).

To reinforce the passenger right, airlines would have to inform passengers of this right prior to the point of ticket purchase, next to other baggage choices offered on the airline website, and again at the point that passengers check in online and print boarding passes.

5.52. This option would also restore the level playing field for passengers able to choose between retail on-board and at the airport. While favouring on-board retail does not appear to have been a major motivator for airlines of the 'one bag rule', recent press reports have identified the pressure on airline staff to sell to customers on-board[63].

[63] Source: Aftenposten newspapers, reported in Views and News from Norway website, 29 July 2013.

Encouraging passengers to participate voluntarily in shopping during their journey, by providing a free choice of retail at the airport and/or on the aircraft, helps generate revenues to fund the European air travel connectivity, as described in Chapter 2.

5.53. The benefits of this option are that it would credibly deal with the information gap by restoring passenger choice and certainty regarding airport retail to that pertaining before the introduction of strictly enforced 'one bag rules'.

It would also deal with the other market problems identified. It would mean that airports - in particular those smaller regional airports facing dominant airlines with buyer power - would not have a legitimate area of commercial activity significantly curtailed.

Supporting airports' positions in this regard would thereby help to secure a more balanced outcome across the European airport market and contribute to the European Commission's objective of reducing state aids.

Finally, by preventing any one airline from gaining commercial advantage through a practice which undercuts the benefit created for all airlines and passengers, it helps the air travel sector as a whole coordinate around an equilibrium which creates higher value added in the sector (by allowing airport retail to flourish) compared to the alternative risk of a 'tragedy of the commons', discussed above.

5.54. The costs of this option would be borne by some airlines in terms of slightly reduced operational freedoms. However, as highlighted above, airlines have many other options, within their conditions of carriage and using their pricing models to incentivise passenger behaviour, to ensure that the airline is able, safely and cost effectively, to board passengers and their baggage onto the aircraft.

That some airlines have demonstrated that they are willing to negotiate with some individual airports to allow for on-board carriage of passengers' airport shopping demonstrates that there is no over-riding safety or operational efficiency case which should be weighed as a cost of this option.

5.55. The evidence presented in Chapter 3 suggests that the quantities of shopping brought on board by passengers unconstrained by the 'one bag rule' are relatively modest - around 2 items per passenger actually engaged in shopping, who are typically a minority (around 15-25%) on any particular flight.

Some airlines may nevertheless respond to this proposal by curtailing existing cabin baggage allowances[64]. The fact that most airlines permit on board carriage of airport retail on all their flights, and others on some, suggests that this would be an unnecessary response.

Were it to occur it might appear that the majority of passengers were being disadvantaged to the benefit of those who choose to shop. However, as indicated throughout this report, this is to misunderstand the contribution of airport retail to European aviation: the voluntary contribution made by passengers who shop at airports contributes to the general pot from which investment and services are financed and so benefits all passengers.

5.56. Overall, this option scores highly for likely benefits, as it comes closest to restoring passenger choice and confidence in airport retail as a continuing feature of European air travel.

This should enable airports to work in partnership with their airline customers to develop retail further as an important voluntary value-adding activity at airports, the benefits of which can be shared as now between airports, airlines and passengers.

64 Airline charging for hand baggage may be under consideration in the industry, unrelated to any regulatory measures to protect carry-on airport shopping. According to press reports (The Independent, 31 July 2013): 'Asked if Ryanair would consider charging for hand luggage, Mr O'Leary said: "At some point in the future I think it's likely that airlines will do it but I can't get my head round how you would do it. I think it's unlikely that we will do it."'TTT

Conclusions

5.57. The continued strict enforcement of the 'one bag rule' by particular airlines - and, even more so, any further application of the practice by other airlines - risks a market outcome where, over time, there are higher costs and less connectivity for passengers as the voluntary, value-creating contribution to airports (and the wider aviation system) from airport retail is reduced. The impact is likely to be most marked at smaller, regional airports - precisely those which contribute to regional growth (as recognised by European Union policies) and yet most likely to be affected by a stricter state aids regime.

5.58. Against this background, treating the 'one bag rule' as simply an issue to be settled between individual airport and airline businesses risks giving insufficient weight to these systemic impacts, including the presence of airline buyer power, and the potential for passenger confusion where there are differing approaches by airline and airport.

Transparency for the passenger deals with only one of the issues raised and is unlikely to be effective even on its own terms. For these reasons, we suggest that proposals from the European Parliament for incorporation into the air passenger rights legislation[65] of a passenger right to on-board carriage of airport retail purchases are likely to be the most effective way of both restoring a better long term balance to the market and giving passengers clarity about what they are permitted to carry on board.

5.59. We are, of course, mindful of the need to assess the costs and risks of any such intervention. Overall these appear unlikely to be significant given that what is proposed accords with the practice of most airlines, and also, where they have seen commercial advantage in doing so, with that of those airlines strictly implementing the 'one bag rule'.

As now, it would remain open to airlines to negotiate with airports over charges - airlines would not, however, be able effectively to hinder airports from engaging in a well-established and legitimate part of their commercial activity.

Indeed, resolving this issue should help focus airlines and airports on the joint interest they - and the European travelling public - have in growing value-adding activities at airports. This partnership approach would better safeguard the connectivity of Europe's regions at a time when this is more than ever necessary to stimulate and spread growth and prosperity.

65 Regulation (EC) No 261/2004.

The **European Travel Retail Confederation** (ETRC) is an industry association representing the interests of the duty free and travel retail industry in Europe. Through proactive engagement and dialogue with the EU institutions, national governments, key stakeholders and policy makers, ETRC aims to create the right environment to allow the industry to operate and achieve its potential.

www.etrc.org

ACI EUROPE is the voice of Europe's airports, representing over 450 airports in 44 European countries. Our members handle 90% of commercial air traffic in Europe, welcoming over 1.5 billion passengers, 18 million tonnes of freight and more than 20 million aircraft movements each year. 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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