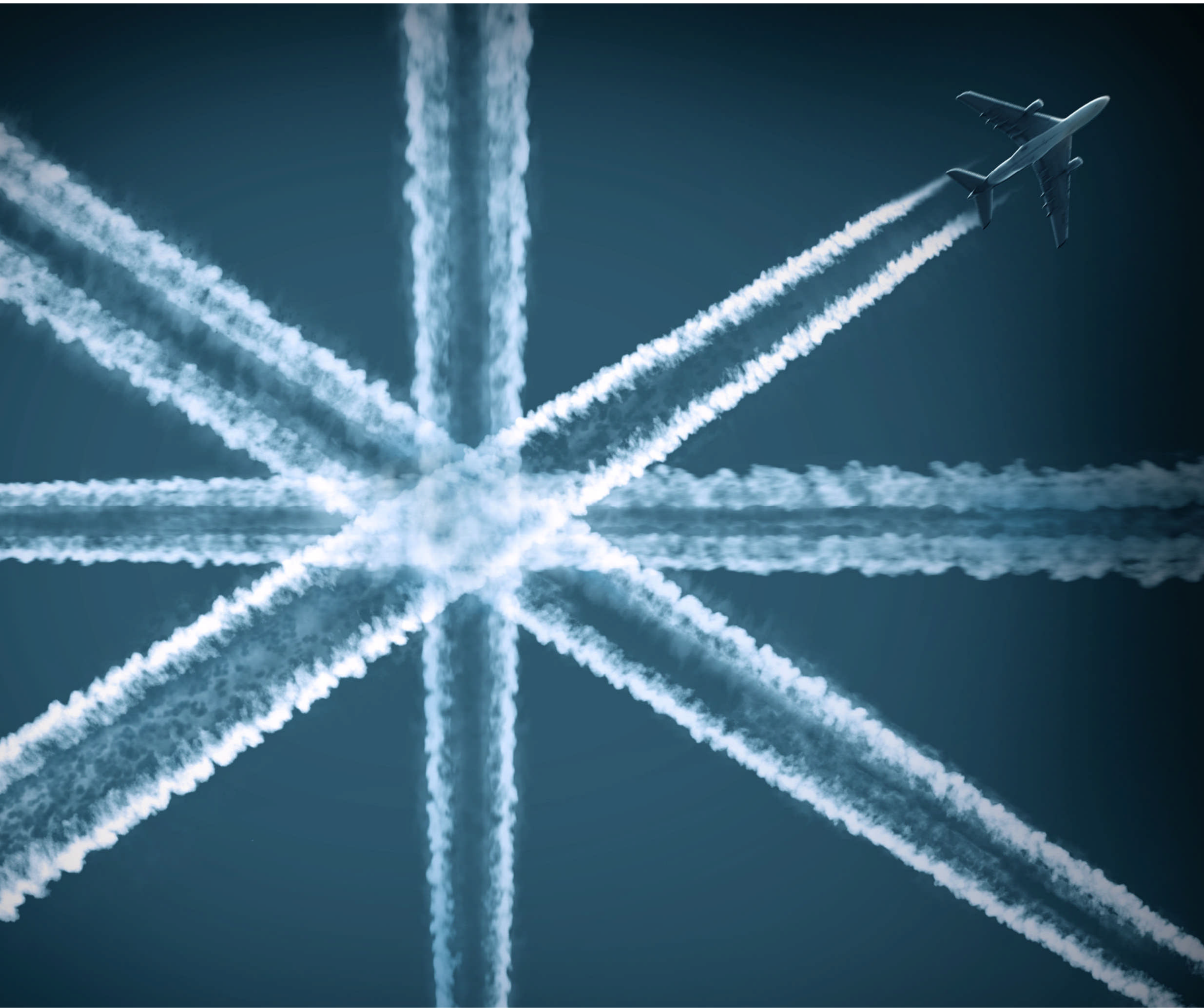
Civil Aviation Authority
Stansted Market Power Assessment

Interim response of M.A.G to the CAA's 'minded to' document

24 May 2013



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Preface

This document is the interim response (**Interim Response**) of The Manchester Airports Group plc (**M.A.G**) to the CAA's "minded to" position in its market power assessment of Stansted airport (**Stansted**) under the Civil Aviation Act 2012 (the **CA Act**), published in January 2013 (the **Consultation Document)**.

The CAA's change of approach

Between February 2012 and January 2013 the CAA fundamentally changed its approach to the issue of whether Stansted has substantial market power:

- In February 2012, the CAA's document *Stansted – Market Power Assessment: the CAA's Initial Views* (**Initial Views**) found that Stansted competes against airports across the South-East of England for passengers, and across Europe for airline customers. That document concluded by stating that, although the evidence was not sufficiently clear for it to reach a definitive view, the most likely source of market power related to a lack of spare capacity at peak times.

- By contrast, in January 2013, the Consultation Document found that Stansted:

    - currently has market power in relation to the "Stansted cargo market";

    - in relation to the "Stansted short-haul market" Stansted competes only against Luton, Southend (and possibly Gatwick) airports and that in this 'market', the Consultation Document provisionally concludes: (a) that the airport *may* currently have market power (which is not sufficient to meet the test for a finding of substantial market power); and (b) Stansted *is likely to* acquire market power in the future, because its airline customers face strategic constraints in switching away from Stansted, and that traffic will spill to Stansted from Heathrow and Gatwick as demand grows and capacity is constrained.

This gives rise to the obvious question: what happened between February 2012 and January 2013 to cause the CAA to change its approach so fundamentally? The Consultation Document does not provide a clear or adequate answer to that question.

Market developments since the publication of the Initial Views certainly cannot account for the change. The most obvious change in circumstances since the Initial Views were published is that Stansted is now owned by M.A.G, following Stansted's divestment by BAA as ordered by the Competition Commission (**CC**). All of London's major airports are now under separate ownership for the first time. The change of ownership has enhanced the competitive environment as, indeed, it was designed to do.

The fact that the change in Stansted's ownership is barely mentioned in the Consultation Document is a startling omission, particularly in view of the prominence given to the issue in the Initial Views, and the CAA's consistently-held view throughout the CC's market investigation that separate ownership would strengthen competition.

The CAA's change in reasoning between the Initial Views and the Consultation Document seems to have been driven by a radically different approach to assessing market power, both in terms of the evidence considered and the economic analysis. Our view is that the approach taken in the Consultation Document is misconceived and has led the CAA to the wrong conclusions on Stansted's market power.

Stansted's response to the consultation

The Consultation Document sets out the CAA's provisional views, and we welcome the opportunity to engage positively with the CAA ahead of its final decision. Our aim in submitting this response is to assist the CAA in reaching a final decision on Stansted's market power that is robust and sustainable. To achieve this, it will be necessary for the CAA to change its approach to a number of key issues and to undertake further work in key areas.

In this Interim Response we: (i) address the detail contained in the Consultation Document (to the extent that we are able at this stage); (ii) highlight the key available evidence that should form part of the CAA's continuing analysis; and (iii) set out the additional steps and analysis that must be undertaken before a final decision can be reached.

We also take this opportunity to highlight a number of key issues that demonstrate emphatically that the provisional conclusions in the Consultation Document cannot be supported on the evidence when the statutory tests for market power are correctly applied.

The statutory tests have not been correctly applied

It is clear from the Consultation Document that the statutory tests set out in section 6 CA Act have been misapplied:

- the Consultation Document reveals an incorrect approach to Test A by, for example, disregarding the competitive constraints that arise from marginal switching and defining the product market in terms of usage rather than the services offered;

- Test B has been interpreted in the Consultation Document as whether regulation or competition law would be preferable, whereas the test that should have been applied is whether regulation is necessary because competition law would be inadequate in this particular case; and

- the assertion that the likely form of licence regulation applicable to Stansted is not relevant when weighing the benefits and costs of that regulation to users under Test C reflects a misapplication and misunderstanding of the nature and purpose of that test.

The CAA's approach to the evidence

It is also clear from the Consultation Document that crucial information has not been obtained or properly considered, and other irrelevant or unreliable information has been relied on without adequate inquiry.

For example, the Consultation Document's provisional conclusions on the key issue of switching and substitutability are not supported by any empirical analysis of route-by-route profitability. This is despite the CAA having previously stated that such evidence would be central to the assessment of Stansted's market power.

Furthermore, the Consultation Document relies on highly tentative evidence and views about the *likelihood* of Stansted acquiring market power in the future to justify regulatory intervention now, without recognising that the CAA retains the ability to address such concerns in due course, if they materialise.

A different approach is needed

By way of summary, we set out below the main areas where the CAA needs to adopt a different approach to assessing Stansted's market power to be in a position to reach robust conclusions. Continuing with the approach taken in the Consultation Document in these areas would result in significant flaws in the CAA's analysis of market power and invalidate its conclusions on these issues.

The CAA's analysis of competitive constraints must take account of switching at the margin

The Consultation Document proceeds on the basis that the reluctance, for strategic reasons, of Stansted's main customers to switch away from serving London, in addition to capacity constraints in the London area, will give Stansted a position of market power. The Consultation Document's approach is misconceived because it takes an unreasonably narrow view of the competitive constraints faced by Stansted, leading to a significant overstatement of Stansted's position.

By way of example, an assessment of market power requires a consideration of the switching of marginally profitable routes. However, no such analysis is contained in the Consultation Document, even though it is precisely this type of switching that drives competition. As the CAA's figures demonstrate, only a small number of based aircraft - between two and four - would need to switch away from Stansted to another airport to constrain a price rise above the competitive level. As this Interim Response shows:

- there is currently, and will remain, sufficient spare capacity at Gatwick, Luton, Southend, and many other airports in the UK and Europe, to accommodate this amount of switching individually or in aggregate;

- recent switching away from Stansted conclusively demonstrates that marginal switching of the level required to constrain our pricing behaviour is possible.

The need for a forward-looking view of the potential for competition

The position set out in the Consultation Document is that Stansted currently faces little competition from Gatwick, none from Heathrow and limited competition from other London airports. Not only is this is a radical departure from established precedent and commercial reality, the CAA's analysis fails to take into account that:

- the competition between Stansted, Gatwick and Heathrow that was identified by the CC (and the CAA) is already underway, and will continue to develop and strengthen as new owners adopt new strategies to attract airlines and passengers away from other airports;

- the available evidence demonstrates that other London airports provide a significant competitive constraint on Stansted – for example, from 2006 Stansted's largest customers have, between them, reduced their use of Stansted by 323 weekly departures while increasing their use of other London airports by 659 weekly departures.

Against the backdrop of the CC's enforced break-up of BAA's London monopoly, the CAA's current position is perverse; the CC could not have found that BAA's common ownership was a feature of the market that represented an adverse effect on competition if, as the Consultation Document states, Stansted operates in separate geographic markets to each of Gatwick and Heathrow.

The CAA's view of substitutability must be informed by an analysis of LCC switching

The position set out in the Consultation Document is that UK and European airports do not compete with Stansted for Low Cost Carrier (**LCC**) customers. This position is not supported by an empirical analysis of LCC switching across the European market. This radical departure from established case law and commercial reality significantly overstates Stansted's position.

In particular, the Consultation Document does not take into account the fact that the LCC business model is based on the systematic analysis of the relative profitability of different services to optimise the use of aircraft fleets. This dynamic process drives LCCs to shift capacity repeatedly between large numbers of European routes to maximise their overall profitability, creating significant competitive constraints between airports serving these airlines.

The CAA's analysis should recognise the impact of Ryanair's significant buyer power

The Consultation Document provisionally concludes that Ryanair does not have or exercise buyer power over Stansted. This is in contrast to the conclusion that easyJet does enjoy such power even though its operations are of much smaller size at Stansted. Such a conclusion, which takes Ryanair's submissions at face value without evaluation, contradicts the available evidence and economic reality. [redacted] Even without reference to Ryanair's conduct, the figures speak for themselves: Ryanair represents more than 70 per cent of the aeronautical side of our business, whereas we are a minor and decreasing part of Ryanair's pan-European business.

The CAA's market analysis must recognise the multi-sided nature of Stansted's business

The analysis in the Consultation Document is based on a fundamental misunderstanding of the multi-sided nature of our business, and therefore disregards this key constraint. This is a departure from the CAA's previous practice, other precedent in this area, commercial reality and the established economic framework. The CAA will need to amend its analysis of competitive constraints to reflect the fact, and the economic reality, that decisions concerning the level of airport charges at Stansted take into account both the impact on passenger numbers and the impact on commercial revenues. These issues would not be considered separately by any rational airport operator.

In reality, the multi-sided nature of our business, combined with significant spare capacity, creates strong incentives for us to drive passenger growth and grow commercial revenues. This is reflected in our plans to transform the terminal building at Stansted, where we believe there is an opportunity to improve passenger experience and increase retail income. It is also evidenced by the simple fact that airlines often use the 'one bag rule' to extract concessions from airports during charges negotiations.

The CAA's forward looking analysis must recognise the inherent uncertainty at Stansted

The Consultation Document only reaches the provisional conclusion that, in relation to the "Stansted short-haul market", Stansted "<u>may</u>" have substantial market power. That is not a sufficient basis for a finding of market power under section 6 CA Act. The provisional conclusion that the market power test is met in relation to the "Stansted short-haul market" relies on the CAA's view that Stansted "<u>is likely to</u>" acquire market power in the future.

The provisional conclusions contained in the Consultation Document in this regard are – as the CAA has acknowledged in a number of different places – based on considerable uncertainties, including traffic forecasts that have proved to be highly unreliable in the past. To reach its provisional view, the Consultation Document adopts the most aggressive view of the potential market outcomes, ignoring the wide range of alternative (and inherently more likely) outcomes.

This is particularly the case in relation to spill, where the Consultation Document reaches the provisional conclusion that traffic will spill to Stansted as demand grows within a capacity constrained London system. On this basis, the Consultation Document reaches a view that Stansted "is likely to" acquire market power. However, that conclusion is reached by rejecting Stansted's traffic forecasts (which are consistent with forecasts published by the Department for

Transport (**DfT**)), but without putting forward either the CAA's own traffic forecasts, or a positive view of how the market will develop (or recognising the inherent uncertainties).

The provisional analysis is based on such uncertainties that cannot support a finding that Stansted is more likely than not to acquire substantial market power. To address this, the CAA should now consider the range of potential outcomes for traffic growth within the London system, and set out its analysis of how it sees market power developing at Stansted for each of the potential scenarios, and an assessment of the likelihood of these scenarios occurring in practice.

Our view is that this will show that the only rational conclusion that could be reached in relation to the forward looking analysis is that Stansted does not have, and is unlikely to acquire, market power at any point in the reasonably foreseeable future. It is certainly not possible to conclude, with any level of certainty, that Stansted currently has or is likely to acquire market power.

The CAA should revisit its cargo analysis from first principles

The Consultation Document adopts a novel cargo-only market definition, and concludes that cargo-only services at Stansted constitute a separate market from other aeronautical services at Stansted, and from other airports' cargo-only services. Not only is this provisional conclusion entirely without precedent – so far as we are aware, no previous competition authority has found cargo to constitute a separate product market – it is not based on any reasoned evidential, economic or legal analysis. It would be unreasonable and irrational for a final decision that Stansted has substantial market power in relation to the "Stansted cargo market" to be adopted on the basis of the (lack of) evidence and analysis contained in the Consultation Document.

In particular, this provisional conclusion is based entirely on the representations made by cargo-only airlines that operate from Stansted. The Consultation Document does not contain a reasoned analysis of the available evidence, and indeed it is clear that relevant evidence (other than the views of cargo-only airlines) has not been sought. Furthermore, key elements of the necessary analysis are simply not addressed in the Consultation Document. For example, the Consultation Document does not address the key questions of the extent to which belly-hold cargo acts as a substitute for cargo-only flights, the extent to which other UK and European airports represent close substitutes for cargo customers, or the extent to which other carrier services provide a competitive constraint.

The CAA needs to consider all relevant evidence together when considering competitive constraints

In a number of instances, the Consultation Document takes a point in isolation, without putting it in its wider context. For example, it lists many methods by which our customers could exercise buyer power and constrain Stansted's pricing. However, each method is disregarded on the basis that it is insufficient <u>on its own</u> to constrain the airport's behaviour, without any consideration of the effectiveness of those methods <u>in aggregate</u>. The competitive constraints from other UK and European airports are similarly treated. If these issues are assessed coherently as a whole, it becomes clear that we face a sufficient overall competitive constraint such that a finding of market power would be unsustainable.

Stansted is the perfect opportunity for the CAA to stand back and promote competition

Stansted has now been regulated for over 25 years in the anticipation that it will acquire substantial market power, but this market power has not materialised. Even now, in relation to the "Stansted short-haul market", the Consultation Document only concludes that Stansted *is likely to* acquire substantial market power, not that it *currently has* market power.

In our view, such market power is not likely to materialise at Stansted, certainly within the short to medium term, given the strong economic and competitive constraints faced by the business. This aligns with the CAA's own view of the uncertainty around Stansted's future prospects set out in the Q6 Initial Proposals document (*Economic Regulation at Stansted from April 2014: Initial Proposals*, April 2013 (**Initial Proposals**)), where the CAA recognises that there is too much uncertainty for it to be able to take a 'building blocks' approach to setting a price cap. This contrasts sharply with the Consultation Document, which proposes that the CAA should continue regulating Stansted in anticipation that it "is likely to" acquire substantial market power in the future.

The new CA Act regime provides the CAA with a flexible framework for regulating market power, and imposes a duty on the CAA to promote competition wherever appropriate. In our view, Stansted provides the CAA with the perfect opportunity to promote competition and adopt a flexible and proportionate approach to economic regulation.

Instead of imposing on-going regulatory burdens now, the CAA should stand back and allow Stansted's new management to compete freely against airports across London for the custom of passengers and Europe for the custom of airlines. This would be a flexible and forward-looking approach, which would recognise the CAA's ability to undertake a new market power assessment in the future if appropriate. Such an assessment can be conducted at any time – the CAA does not have to wait for the next quinquennial review.

The CAA would be fully warranted in adopting such an approach by the following facts:

- with Stansted under new ownership, there are already strong signs to indicate how competition will protect and promote the interests of consumers;

- the CAA has not concluded that Stansted currently has substantial market power;

- wider uncertainties across a range of economic and competitive factors mean that it is not possible to predict with any certainty that Stansted is likely to acquire market power or the rate at which market power is likely to be acquired;

- the regulatory framework will enable the CAA to keep developments under review, and revisit the question of market power in the future if appropriate;

- Stansted's airline customers are well resourced and highly informed, and are in strong position to alert the CAA to any issues that might arise;

- economic regulation, however well designed, always imposes costs and presents a strong risk of distorting the development of competition between airports.

The evidence and analysis contained in this Interim Response demonstrates that Stansted does not have substantial market power, that Stansted is not likely to acquire substantial market power on any rationally defined market, and that the provisional conclusions set out in the Consultation Document are not sustainable. That conclusion is apparent from the available evidence, and economic and legal analysis.

In conducting the necessary further assessment, the CAA should adopt a position that is supported by the evidence, economics and the law – and reach a final decision that Stansted does not have substantial market power. We believe that such a conclusion would be in consumers' interests.

1 Introduction

1.1 The Consultation Document provisionally concludes that "*the market power test as set out in the CA Act is met in relation to Stansted airport*".[1]

1.2 We disagree with that provisional conclusion. Stansted does not have, and is not likely to acquire, market power. The market power test set out at section 6 CA Act is therefore not met. The provisional conclusion does not reflect reality, and represents a fundamental and unjustified change to the approach previously adopted by the CAA and other competition authorities, including the approach adopted by the CAA itself in its Initial Views.

1.3 The Initial Views were broadly consistent with competition law principles and, moreover, reflected the detailed work conducted by the CC in the course of its market investigation into BAA Airports. The Initial Views found *inter alia* that Stansted competes against airports across the South-East of England for passengers and across Europe for airline customers, and that the most likely source of market power related to the lack of spare capacity at Stansted at peak times. The Consultation Document abandons those views without clear reasons or evidence, and does not set out why there has been such a dramatic change in approach.

1.4 This Interim Response demonstrates in particular that:

(a) there is no sound basis – in relation to the available evidence, economics or law – for the approach set out in the Initial Views to be departed from, or for the provisional conclusion that Stansted meets the market power test; and

(b) Stansted does not have, and is not likely to acquire, market power, and as a result should not be subject to unnecessary on-going regulation.

Why we disagree with the provisional conclusions in the Consultation Document

1.5 It is important for the CAA to understand why we disagree with the provisional conclusions set out in the Consultation Document.

1.6 The market power test set out in the CA Act consists of three individual tests, each of which must be met before finding that Stansted has market power within the meaning of section 6 CA Act. These individual, cumulative, tests are set out at sections 6(3) to 6(5) CA Act, and are as follows:

> "*(3) Test A is that the relevant operator has, or is likely to acquire, substantial market power in a market, either alone or taken with such other persons as the CAA considers appropriate ...*
>
> *(4) Test B is that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that substantial market power.*
>
> *(5) Test C is that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.*"

1.7 Our view is that none of these tests are met in relation to Stansted. In order to make a finding that Stansted has substantial market power, it is necessary for the CAA to demonstrate that each

[1] Consultation Document, Summary, paragraph 1.

of the three individual tests is met; it is not for Stansted to prove a negative. The CAA can only complete its task by *inter alia*:

(a) properly understanding and applying the statutory tests and their purpose;

(b) assessing the situation afresh, rather than starting from an assumption that market power exists and asking stakeholders to show that Stansted does not have market power;

(c) obtaining and considering all relevant and available evidence, using formal information gathering powers where necessary;

(d) taking a robust approach to testing the available evidence, in particular evidence submitted by interested stakeholders;

(e) conducting a full assessment of the situation as it is now, and is likely to develop, not by taking the past as a guide to future conduct, particularly in the light of the recent change to Stansted's ownership;

(f) considering the range of future possible likely developments, rather than adopting the least favourable view of the potential market outcomes, ignoring the alternative positive, and inherently more likely, outcomes;

(g) ignoring all irrelevant considerations, such as the conduct of Stansted's previous owners or the vague concept of 'strategic constraints'; and

(h) consulting as appropriate on issues arising from further evidence and analysis, including obtaining and providing to consultees the information required in order for them intelligently to respond.

1.8 In short, a finding by the CAA that Stansted meets the market power test under section 6 CA Act must be based on strong and compelling evidence, and be supported by robust economic and legal analysis.

1.9 In the event that the CAA demonstrates that Stansted has substantial market power, and supports this with strong and compelling evidence (supported by robust economic and legal analysis), we would be minded to accept that position because we do not believe that it would be in our interests, or those of our customers, to pursue unnecessary regulatory challenges.

1.10 However, we do not accept the position set out in the Consultation Document because it does not accord with our experience or understanding of the market in which we operate, and reveals serious evidential and analytical deficiencies. It does not put forward strong and compelling evidence that Stansted has market power. Rather, it relies on untested evidence, an inadequate assessment of the competitive environment, and a flawed economic and legal analysis. Indeed, the Consultation Document is so flawed that it effectively side-steps the CAA's obligation to demonstrate on a rational and sound evidential basis that Stansted has market power – it is not for Stansted to prove that it does not.

1.11 This response is submitted as a constructive contribution to the consultation process, with a view to assisting the CAA to reach a robust final decision. Although it focuses on those key issues and themes where we disagree with the conclusions reached or believe the analysis contained in the Consultation Document is inadequate, we have sought to highlight the further evidence gathering and analysis that needs to be undertaken before a final decision can be taken.

The structure of this Interim Response

1.12 This Interim Response demonstrates why the approach adopted in the Consultation Document is flawed in relation to each of the individual tests, and why the only reasonable and rational conclusion is that Stansted does not have market power within the meaning of section 6 CA Act. This Interim Response is therefore divided into four parts.

1.13 Part I sets out the commercial and competitive reality of the world in which we operate. This provides a summary of the essential context within which any market power assessment must be conducted.

1.14 Part II deals with the provisional conclusion that Test A is met – i.e., the provisional conclusions that Stansted "is likely to" acquire substantial market power in relation to the alleged "Stansted short-haul market" and has substantial market power in relation to the alleged "Stansted cargo market". We demonstrate that the Consultation Document's provisional conclusions are unsupportable as a matter of evidence, economics and law, and are based on a flawed assessment of the competitive situation.

1.15 In relation to the alleged "Stansted short-haul market" this is demonstrated by reference to the following critical issues, each of which is fundamental to the provisional conclusions contained in the Consultation Document:

(a) The Consultation Document does not take into account the constraint on Stansted from other European airports. In departing from previous practice by stating that the competitive constraint on Stansted from other European airports is weak, the Consultation Document significantly overstates Stansted's position. If proper regard is had to the extent to which European airports exercise a significant competitive constraint on Stansted, it is clear that Stansted is a small player in a wider pan-European market, and as a result cannot be regarded as having substantial market power.

(b) The Consultation Document does not take into account the constraint on Stansted from other London airports. By departing from previous practice by stating that the competitive constraint on Stansted from other London airports is weak, the Consultation Document again significantly overstates Stansted's position. The evidence demonstrates that Stansted has strong incentives to compete vigorously against other London airports, which currently have, and will continue to have, sufficient spare capacity to allow airline switching to occur. As a result, it is clear that Stansted faces significant competition from other London airports, and as a result cannot be regarded as having substantial market power.

(c) The Consultation Document defines Stansted's product market much too narrowly. By adopting an unprecedented narrow definition of the product market – established by reference to Stansted's customers' products and business models – the Consultation Document significantly overstates Stansted's position. If the analysis had followed established practice in this area, which accords with the evidence and economic reality, the Consultation Document would have identified a much wider market with reference to the airport's product (rather than the airlines' product). In this wider product market, Stansted cannot be regarded as having market power.

(d) The Consultation Document disregards the importance of commercial revenues to Stansted's multi-sided business model. By ignoring the clear link between passenger volumes and commercial revenues, the Consultation Document reaches the startling conclusion that the commercial side of Stansted's business (i.e., car parking, retail…etc) is unimportant to the assessment of market power. As a result, the Consultation Document misses the fact that Stansted has strong incentives to keep charges low to drive passenger growth and commercial revenues. In doing so, it significantly overstates Stansted's position.

(e) The Consultation Document adopts a novel and unevidenced concept of 'strategic constraints'. By accepting the un-evidenced assertion that London is so important to Stansted's airline customers that they would be reluctant to switch a small number of marginal aircraft away from Stansted, even if these routes became less profitable than other available routes, the Consultation Document significantly underestimates the ability and willingness of airlines to switch and therefore significantly overstates Stansted's position.

(f) The Consultation Document disregards Ryanair's buyer power. By concluding that Ryanair does not have or exercise buyer power over Stansted, the Consultation Document significantly overstates Stansted's position. If full appreciation is given to the demonstrable extent of Ryanair's buyer power, it is clear that Stansted cannot be regarded as having substantial market power.

(g) The Consultation Document overstates the likelihood of Stansted acquiring substantial market power. It is accepted in the Consultation Document that the evidence does not support a finding that Stansted currently has market power, only that it may have. The provisional finding that Stansted has market power relies on a finding that Stansted "is likely to" acquire substantial market power. The analysis supporting that conclusion is (as the CAA has acknowledged) based on considerable uncertainties and an unduly negative approach to future developments, and cannot support a finding that Stansted is more likely than not to acquire substantial market power.

1.16 In relation to each of the above issues, this Interim Response demonstrates that the provisional conclusions in the Consultation Document are contrary to the available evidence and established practice. Clearly, the CAA will need to address each of these issues in reaching its final decision. In doing so, however, it is critical that the CAA takes an overall view of Stansted's position and assesses the collective impact of these issues on its 'minded to' views. We are confident that this approach will lead the CAA to the conclusion that Stansted does not have substantial market power.

1.17 Further, Part II demonstrates that the analysis contained in the Consultation Document relating to the alleged "Stansted cargo market" is also deficient, and cannot support a conclusion that a distinct cargo market exists at Stansted, nor that Stansted has a position of market power in relation to any such cargo market.

1.18 Part III deals with the provisional conclusion that Test B is met – i.e., that competition law would not provide sufficient protection against the risk that we would engage in conduct that amounted to an abuse of any substantial market power in relation to Stansted. Again, that provisional conclusion is unsupportable. Test B has been misinterpreted, and the approach to

Test B set out in the Consultation Document (i.e., a focus on issues that would apply in all cases, rather than a Stansted-specific assessment) would render it redundant. In any event, the concerns that have been identified in relation to the airport's future conduct are highly speculative, fail to take a forward looking view and do not reflect the available evidence. As a result, they cannot form a basis on which to conclude that Test B is met.

1.19 Part IV deals with the provisional conclusion that Test C is met – i.e., whether the benefits of regulating Stansted by means of a licence are likely to outweigh the adverse effects. However, the approach adopted in the Consultation Document – which proceeds on an assumption that the licence terms will be "proportionate", thus eliminating the need for the likely characteristics of such a licence to be taken into account – reflects an irrational approach which would frustrate the statutory purpose of Test C. The CAA's approach also overstates the ability of regulators to add value in situations where firms hold limited market power, and understates the distortions to competition that can occur in such circumstances.

Looking to the future

1.20 Throughout this Interim Response, we address those areas where the Consultation Document adopts an unsupportable prospective analysis, particularly in relation to the provisional finding that Stansted "is likely to" acquire significant market power in relation to the alleged "Stansted short-haul market". We do not address those issues in this introduction.

1.21 However, there are two key forward-looking issues that the CAA should bear in mind in considering the contents of this Interim Response, and in conducting the necessary additional assessment before reaching a final decision.

Change of ownership

1.22 Stansted is now owned by M.A.G. The analysis in the Consultation Document is based on the conduct of Stansted's previous owner at a time when Heathrow, Gatwick and Stansted were under the same ownership. M.A.G's acquisition of Stansted took place shortly after the Consultation Document was published, and followed the CC's order requiring the divestment following its BAA market investigation.

1.23 Although the CAA could not have known to whom the airport would be sold, the CC's criteria for identifying suitable purchasers would have provided the CAA with assurance that the benefits anticipated from separate ownership would materialise.

1.24 Despite this, the provisional views expressed in the Consultation Document appear to be based almost exclusively on Stansted's conduct and incentives during a period when it was not independent of Heathrow, or indeed Gatwick. This change of ownership, and the fact that it will pose "*a greater competitive constraint*" on Gatwick, is acknowledged in the CAA's summary of its consultation document for Gatwick's market power assessment.[2]

1.25 In failing to take sufficient account of the likely changes to the competitive environment in the near future, the Consultation Document directly contradicts the CC's view (and the CAA's submissions to the CC) that, under different ownership, Stansted would be likely to have different incentives and show different behaviours. As explained in the report by Case Associates at

[2] Consultation on Gatwick market power assessment: Summary, April 2013, paragraph 55. The full document has not yet been published.

Annex D: "*This refusal to consider the past common ownership of Stansted is flawed in two respects. First, it cannot be correct in an exercise designed to impose ex ante regulation. Second, the probative value of past evidence will be significantly reduced as it is tainted by BAA's common ownership which has inhibited competition between the major London airports*" (Annex D, page 16).

1.26 No explanation is given in the Consultation Document as to why the impact of the change of control of Stansted, and the competition that this will bring, is not addressed. In doing so, the Consultation Document disregards the public views of our largest customer, Ryanair, who argued strongly in front of the CC in 2011 that it expected Stansted's conduct to change under new ownership:

> *"20 … divestment of Stansted will, in all likelihood, give rise to different and more competitive conduct on the part of Stansted itself - and that will, in turn, likely spark more competitive conduct by Gatwick.*
>
> …
>
> *21. In other words, the separate ownership of Stansted is likely to lead to the establishment of a beneficial competitive dynamic between the three airports. That is how competitive markets (such as the airline industry) operate.*
>
> *22. Such a suggestion is hardly novel or contentious. On the one hand, there is the possibility of leaving the current situation where there is effectively a duopoly - with one clear leader, BAA, owning 60% of London's runway capacity and GAL owning Gatwick. On the other hand there is the possibility of changing the position such that there become three competitors (Heathrow, Gatwick, Stansted) of more equal size. One does not need a degree in industrial economics to know under which market structure there is more likely to be more vigorous competition."* [3]

1.27 Now that Stansted is owned by M.A.G, the CAA has an opportunity to address this lack of prospective analysis and take into account this highly relevant consideration. M.A.G's incentives and plans, and in particular its intention for Stansted to compete vigorously with Gatwick and Heathrow and to attract long haul carriers, are (where relevant) mentioned in this Interim Response. We would welcome an opportunity to discuss our future plans for Stansted with the CAA in greater detail as the CAA moves towards making a final decision.

Deregulation is not irreversible

1.28 The CA Act is designed to be a flexible, economics-based framework for the regulation of airports that are in a position of substantial market power at the time of the assessment, or which are likely to acquire it. A finding that Stansted does not have market power within the meaning of section 6 CA Act is not irreversible.

1.29 The CAA may make an assessment under section 6 CA Act "*whenever it considers it appropriate to do so*" (section 7(1) CA Act). Market power assessments should therefore consider an airport's market power at the time of the assessment and in the reasonably foreseeable future. The CA

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[3] CC BAA market investigation, Ryanair's response to provisional consideration of possible material changes of circumstances, 30 March 2011, paragraphs 20-22: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/ryanair_response_to_mcc.pdf. See Annex G(3).

Act does not envisage that the assessment should consider the situation far into the future, which is inherently more uncertain. Instead, it provides for a new assessment to be conducted at any time, if appropriate. This ability to revisit the analysis is likely to be most useful where there is significant uncertainty about future market developments.

1.30 Given the framework of the CA Act, basing a decision on prospective events over the longer term, where there is considerable uncertainty and a lack of reliable evidence, is speculative and inappropriate. A particularly stark example of this is the reliance in the Consultation Document on an anticipated lack of spare capacity up to and beyond 2019 (which is all the more stark when one considers that the Consultation Document does not take into account immediate market developments, including the change of ownership of Stansted). It is unreasonable and manifestly disproportionate to impose the costs of regulation based on an inevitably uncertain and tentative assessment that it may acquire market power in the future. Such an assessment is necessarily based on several matters that cannot be assessed with any degree of certainty, including:

(a) the rate at which competition between the London airports will develop following the divestment of Stansted (which was of course designed, at the end of a detailed CC investigation, to promote airport competition in the London area);

(b) the evolution of competition between airlines over the next six years (including airlines' strategic business models and the anticipated growth in passenger numbers);

(c) the strength of any economic recovery in the UK and Europe over the next six years;

(d) the growth in demand for air travel over this period;

(e) the ability of airports in the London system to accommodate this growth in demand over the next six years; and

(f) Government policy as regards airports and new capacity in the South-East.

1.31 This uncertainty is acknowledged in the Consultation Document.[4] However, despite this, the Consultation Document's provisional conclusion is that Stansted is likely to gain substantial market power by 2019. Such a finding is highly speculative, wholly unreliable and is, moreover, based on an unduly negative view of market outcomes without reference to the (inherently more likely) positive market outcomes. It is particularly unreliable given that a fundamental assumption underpinning the analysis contained in the Consultation Document is that Ryanair and easyJet (airlines which trumpet the flexibility of their business models) will make no changes to their business models between now and 2019. It is also not clear on what basis 2019 has been taken as a reference period for the analysis set out in the Consultation Document: such an extended time period is unnecessary and adds further uncertainty to the prospective analysis.

1.32 If, having adopted the correct course and having found that Stansted does not have market power, it becomes apparent that market developments may result in Stansted being in a position of market power, the appropriate approach would be to undertake a new market power assessment at that point. The CAA itself contemplates in its Initial Proposals that it could conduct a further market power assessment in two or three years' time.[5] Regulating Stansted –

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4 See for example Consultation Document, paragraphs 7.26 and 7.29.

5 Initial Proposals, Executive Summary, paragraph 43.

in any form – in the meantime, on the basis that it might acquire market power at some point in the future, would be wholly disproportionate.

Further submissions

1.33 As stated above, this response is necessarily an interim response and Stansted is grateful for the CAA's recognition in correspondence that it is entitled to make further representations on the Stansted market power assessment after 24 May 2013, which the CAA will take into account in reaching its final decision. The need to do so arises in particular from the following:

(a) the inadequacies in the evidence provided to date, which has precluded Stansted from fully understanding and responding comprehensively to important aspects of the analysis set out in the Consultation Document;

(b) the incomplete nature of the evidence presented in the Consultation Document, particularly with respect to the CAA's analysis of airlines' route by route profitability and traffic forecasts;

(c) the relevance of the emerging licence proposals which cannot rationally be disregarded in applying Test C;

(d) the emerging thinking in respect of Heathrow and Gatwick, which may be relevant to the assessment of whether Stansted has market power; and

(e) the outstanding matters that have not yet been properly considered, including the impact of M.A.G's acquisition of Stansted.

1.34 Much of the reasoning contained in the Consultation Document remains unclear. We have sought to understand and respond to the Consultation Document as far as possible, but this has been hampered by unclear reasons, excessive and unnecessary redactions and a lack of underlying information, despite attempts in correspondence to obtain the necessary information.

1.35 We have particular concerns about the analysis carried out by Leigh Fisher in the report entitled "Comparing and Capping Airport Charges at Regulated Airports", dated 5 December 2012. The CAA has accepted that there are a number of deficiencies in the Leigh Fisher analysis, specifically in relation to how regression has been calculated and the data that has been used to support the analysis. We share the CAA's concerns as to the accuracy of the Leigh Fisher analysis, and had intended to explain these concerns fully in this Interim Response. However, we are not yet able to make such representations because we have not been provided with the information necessary to do so. In addition, we have serious concerns as to the appropriateness of using the Leigh Fisher analysis in developing the initial proposals for Stansted's licence terms, not least because the Leigh Fisher analysis cannot be used for the purpose that the Consultation Document claims. Indeed, it would be irrational and unfair for this analysis to form the basis of a final decision, given that the CAA has accepted there to be a number of flaws in that analysis and we have been unable intelligently to respond to it.

1.36 In these important respects, the Consultation Document does not provide a sufficient opportunity for us to make intelligent representations, and this needs to be remedied before the CAA makes its final decision.

PART I

The Competitive Market in which Stansted Operates

2 **M.A.G's acquisition of Stansted**

2.1 The disposal of Stansted by BAA marked the culmination of the CC's market investigation of BAA which started six years previously in 2007. The CC decided in 2009 that BAA's ownership of the three largest London airports was a feature of the market that had an adverse effect on competition.

2.2 To remedy this competition problem, the CC required BAA to divest both Gatwick and Stansted into separate ownership. The CC demonstrated that separate ownership would significantly increase competition between London airports, which would result in considerable benefits for consumers. Gatwick was sold to its new owners in 2009.

2.3 M.A.G completed its acquisition of Stansted at the end of February 2013. Together with our investment partners, Industry Funds Management (IFM), we share the CC's view that there is significant scope for a separately owned Stansted to compete successfully with other airports, particularly those in London.

2.4 Stansted is a superb airport with high quality assets, lots of spare capacity and the best on-time performance of any major airport in the UK. In April 2013, for example, Stansted won the Skytrax award for the world's best airport for low-cost airlines for the third year running. Under our ownership, we are confident that we can build on this strength by improving service levels and attracting new airlines and passengers to Stansted. By doing this, we will quickly reverse the long decline in Stansted's traffic that started back in 2008.

2.5 M.A.G has a proven track record in operating airports of differing sizes and characteristics in the UK and this expertise is supplemented by IFM's experience as an investor in major international airports. For example, Manchester airport has been successful in the competing against airports in the North West since it was deregulated in January 2008. IFM has over £7 billion of investments in airports, railway stations, ports and other infrastructure assets including the airports of Melbourne, Perth, Brisbane and Adelaide.

2.6 We are looking to succeed at Stansted by competing more vigorously against other airports in London and across the UK and Europe. Our vision is to make Stansted the best airport in London, measured in terms of customer service and value to airlines. However, we recognise that we will face strong competition from the other London airports, including Gatwick airport, which has been under new ownership since 2009. Although we have only been in control of Stansted for a short time, our detailed transition planning over the last twelve months has allowed us to 'hit the ground running'. We recognised that a clearly defined plan would enable us to accelerate Stansted's emergence as a strong competitive force, and start delivering benefits for airlines and passengers as quickly as possible.

2.7 In the twelve weeks since the acquisition was finalised, we have already made good progress in implementing our strategy for Stansted. For example:

(a) [redacted]

(b) we have consulted airlines on our plans to transform the terminal building to improve passenger experience, reduce operating costs and drive commercial revenues (discussed in more detail below and in Annex F)

(c) we have engaged with local and national stakeholders to set out M.A.G's vision and plans for Stansted in new ownership and sought to establish a wider network of support for the airport

(d) we have sought buy-in from service partners to our vision for the Stansted, such as the UK Border Force and handling agents

(e) we have personally briefed over 1,000 members of staff on M.A.G's vision and plans for Stansted in new ownership

(f) we have made a number of positive contributions to the Airports Commission, particularly in respect of the measures that would help make more effective use of Stansted's spare capacity in the period before new capacity can be delivered

(g) we have been encouraging key stakeholders to work with the airport to deliver significant improvements to the rail service to Stansted, in particular to build consensus around the need to achieve a 30 minute journey time to London; and

(h) we have driven forward functional and operational separation from BAA, and we are progressing ahead of programme with the critical aspects of the transition into M.A.G ownership

2.8 These initiatives represent just the beginning of our plans for Stansted. Building on Stansted's core strengths, we are confident that there is a significant opportunity for growth, and over time we expect to [redacted]

2.9 As the new owner of Stansted, our view is that competition between London's airports will emerge more quickly than envisaged by either the CC or the CAA, and manifest itself in ways that currently cannot be predicted. This local competition will reinforce the intense competition that already exists between airports across Europe to attract LCC services, and bring significant additional benefits for consumers.

The opportunity for growth at Stansted

2.10 From 2008, Stansted has experienced a significant decline in passenger numbers (from 23.7 million passengers in 2007 to 17.4 million in 2012). Our view is that this decline in passenger volumes was driven by a range of factors, the most significant of which are:

(a) increased competition from other London airports and other UK and European airports, all of which have been seeking to attract airlines away from Stansted as passenger demand has fallen over the last five years;

(b) increased focus of LCCs on the development of new markets across Europe, with a particular focus on competing against high-cost full service carriers in their respective domestic markets (e.g., Iberia, Alitalia, Lufthansa, etc);

(c) the impact of BAA's protracted appeals of the CC's market investigation decisions, which created considerable uncertainty about Stansted's future and made airlines reluctant to agree new long term deals during this period;

(d) weak economic conditions since 2007 have also had a significant impact on passenger demand, although Stansted's competitor airports across the UK and Europe have not experienced the same reductions in traffic as Stansted.

2.11 This reduction in Stansted's traffic levels has resulted in significant spare capacity. With limited further investment, Stansted could grow to handle between 40 and 45 million passengers per year. As a result, Stansted is well positioned to make a significant contribution to meeting growth in passenger demand over the next 15 years.

2.12 However, we reject the suggestion that Stansted will benefit in a passive way, as demand 'spills' to it from Heathrow and Gatwick as capacity constraints bite harder. The commercial reality for Stansted is completely different to this imagined model of the London system.

2.13 In our view, demand no longer spills round the London system in the way that it was once thought. Airlines have developed in ways that give them much wider choices and opportunities – they are much more footloose than they once were. Their efficient operating models, their sophisticated analysis of route profitability and their negotiating strength enable them to identify and exploit new markets and new bases. For example, Stansted's two largest airlines, accounting for over 90% of Stansted's traffic, have shifted significant amounts of traffic away from Stansted in favour of other UK and European airports in recent years.

2.14 In short, to succeed in this market Stansted will need to compete energetically with other London airports and other UK/European airports to attract new services, and offer a winning combination of service and value to a range of different customers groups. To suggest that Stansted has significant market power is to misunderstand the competitive reality of the market in which Stansted operates. We believe that the real opportunity for Stansted lies in competing successfully against other airports to win the business of passengers and airlines. We are confident that our strategy for Stansted will enable us to do this.

M.A.G's strategy for Stansted

2.15 M.A.G has an excellent track record for customer service and value. Following the deregulation of Manchester airport, we have increased traffic levels and driven up customer satisfaction levels. Over the past two years, the M.A.G airport system has experienced growth at rates exceeding the UK traffic averages. This can be seen in a M.A.G passenger increase of 6.7% 2011 to 2012, while the overall UK passenger increase over these years was lower at 4.4%.

2.16 This was achieved by improving business relationships and business approaches with airline clients. M.A.G has excellent relationships with 80 airlines, serving 225 destinations around the world. M.A.G has been successful in the development of expanding long and short-haul routes with premium carriers. More specifically, Manchester airport has recently grown with:

(a) the addition of long-haul flights to Washington (United Airlines) and Las Vegas (Virgin Atlantic);

(b) the introduction by Emirates of a third daily service on its Dubai route; and

(c) the addition of 30 new short-haul destinations, 39 new short-haul services and 7 new airlines.

2.17 Further growth is expected following Flybe's decision in March 2012 to select Manchester airport as its new UK and European hub. M.A.G has also signed an agreement under which Manchester airport is to become a sister airport to Beijing Capital International, which M.A.G anticipates will accelerate the introduction of a direct passenger service to mainland China.

2.18 Terminal redevelopments undertaken by M.A.G at Manchester airport have positively impacted Airport Service Quality (ASQ) scores, with the score increasing from 3.5 to over 3.9 during the last few years. Additionally, M.A.G has successfully increased retail revenues as a result of improvements in Terminals 1 and 2 at Manchester airport and is in the process of implementing an improved retail configuration at East Midlands airport.

2.19 M.A.G is recognised as a leading UK airport operator. In October 2012 Manchester airport won the Airport Operators Association award for the best UK airport with over 6 million passengers (an award voted for by airlines) on account of its security and high levels of customer satisfaction as well as its efforts to introduce new routes. Manchester airport also won the "Best UK Airport" award at the 2012 Travel Weekly Globe Awards.

2.20 As we set out below, we intend to apply a similar strategic approach to Stansted, focused on delivering better customer service and value to airlines.

<u>Building on positive airline relationships</u>

2.21 Critical to Stansted's success will be a new approach to engaging with the airlines. We will return to growth by offering value to airlines, [redacted] M.A.G intends to win back a significant portion of Stansted's recently lost market share (5.8 million lost customers since 2007) through [redacted]

2.22 We aim to build on the positive relationships we have with our airlines at Manchester airport, including those airlines that do not currently use Stansted, such as [redacted] and the long-haul airlines. These airlines are familiar with M.A.G and how we are open to agreeing commercial arrangements that support the growth of our respective businesses. We believe this is a critical success factor for M.A.G – we already know the customers we want to attract, they know us, and together we have the opportunity to build on these relationships. This knowledge, trust and familiarity with the our commercial model will be an important factor in reaching agreement on commercial deals, breaking through the deadlock that previously existed between them and BAA.

2.23 [redacted]

[redacted]

2.24 We have also commenced discussions and negotiations with a wide range of other airlines, including long haul, charter and full service carriers. Stansted's distinctive passenger profile, presents significant synergy and growth opportunities through the introduction of new airlines to the Stansted platform. The opportunity to work with existing airline partners from other M.A.G airports, such as full service schedule (**FSS**), chartered and low cost, as well as establishing new relationship with other airlines will not only diversify and expand the mix of carriers at Stansted but also offer a wider range of choice to customers.

2.25 In connection with charter traffic, M.A.G intends to use its existing relationships with a number of major and specialist tour operators to grow the London/South East market by, *inter alia*, increasing capacity on a number of charter routes. In particular, M.A.G has identified a number of charter routes with significant growth opportunities at Stansted; for example, [redacted]

2.26 M.A.G's strategy for FSS traffic is [redacted]

2.27 This strategy is designed to restore Stansted's competitiveness within the London aviation market and we expect it to deliver growth and a more diverse mix of airlines.

Terminal Transformation: better passenger experience, improved efficiency, stronger retail offer

2.28 M.A.G intends to build upon the above growth in passenger volumes by increasing the size of the departure lounge to offer a better passenger experience and improve retail yield. We have a good track record of terminal transformation projects, having recently invested £100 million in redeveloping the three terminals at Manchester airport, and hugely increasing passenger satisfaction as a result (see page 12 of Annex F).

2.29 As such, one of our core early decisions was to take forward a transformation of the terminal at Stansted to better serve the way in which airlines and passengers now use the terminal. Passengers now use the check-in facilities much less than they used to, and they spend more of their time in the departure lounge. We believe that transforming the way the terminal operates is a critical element in our short to medium term strategy to win passengers back to Stansted; both for existing airlines and to put the airport in the strongest competitive position to attract new ones.

2.30 Through a re-configuration of the retail space (as recently achieved within Manchester airport's Terminals 1 and 2), M.A.G intends to improve retail income per passenger while catering to a larger expected flow of traffic within the terminal. Key to this initiative will be the move to reduce landside retail operations and increase the airside offer, achieved primarily through the expansion of the departure lounge and the development of a walk-through duty free offering. A full description of the project is in the customer communication at Annex F.

2.31 With continued pressure on aviation charges from the marketplace, [redacted]

[redacted]

2.32 [redacted]

Strengthening Stansted's competitive position

2.33 Through a combination of service improvements, operating efficiency, value for money and an increased focus on commercial revenues, we will make Stansted more competitive and return the airport to the levels of traffic it had in 2007 as quickly as possible, and then grow from there.

2.34 In particular, we are looking to [redacted]

2.35 We know from our experience elsewhere that generating traffic growth will also require us to take a long term view of the Stansted business, and to work closely with airlines to identify potential new services. [redacted] We believe that these existing relationships with airlines will provide a strong platform for growing the Stansted business.

2.36 In attracting new airlines, including long-haul carriers, full service carriers and LCCs, and in bringing growth back to our existing carriers, we aim to attract a greater share of passengers from central London (with the help of rail improvements), from key marginal areas around London, and from Stansted's own catchment area where its service offer has not been strong enough in recent years.

Conclusion

2.37 We are confident that our approach to operating and developing Stansted, based on delivering excellent customer service and value to airlines, will succeed in a market where airports across the UK and Europe are competing to attract new business. We believe that the strength of this competition will protect and promote the interests of consumers. Our approach is far removed from the approach of a dominant airport resting on its laurels: we need to compete in order to survive.

PART II

Test A – Substantial Market Power

3 **Introduction to Test A**

3.1 Section 6(3) CA Act sets out the requirements of Test A as follows:

> "*Test A is that the relevant operator has, or is likely to acquire, substantial market power in a market, either alone or taken with such other persons as the CAA considers appropriate.*"

3.2 The Consultation Document sets out two provisional conclusions under Test A:

(a) In relation to the alleged "*Stansted short-haul market*", that Stansted has a degree of market power "*which **may** currently be substantial, and **is likely to** become substantial*" (emphasis added).

The Consultation Document does not provisionally conclude that Stansted currently has substantial market power, only that it may have. That is not a sufficient finding to meet this aspect of Test A.

As a result, the provisional finding in relation to Test A in relation to the alleged "Stansted short-haul market" is based solely on a finding that Stansted "is likely to" acquire substantial market power. However, for the reasons set out in this Interim Response, the prospective analysis contained in the Consultation Document on this issue is fundamentally flawed and is based on an unduly negative view of future developments. Such an analysis is, as the CAA acknowledges (including in its Initial Proposals) subject to considerable uncertainties.[6] No reliable conclusions can be based on such an uncertain prospective analysis.

(b) In relation to the alleged "*Stansted cargo market*", Stansted currently has substantial market power.

There is no reasoned analysis offered in the Consultation Document to support this provisional conclusion. Rather, the conclusion appears to rely on assertions from cargo operators at Stansted that they have no alternative airport base from which to serve London. This completely misunderstands the cargo market that Stansted serves and, for the reasons set out in this Interim Response, the analysis contained in the Consultation Document on this issue is also fundamentally flawed.

3.3 Both provisional conclusions represent a significant reversal from the approach taken in the Initial Views. The analysis in the Initial Views as to whether Stansted has substantial market power under Test A was broadly consistent with established competition law principles and

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[6] Initial Proposals, Executive Summary, paragraph 10. See also paragraph 35: "*the CAA is concerned that despite its attempts to develop reasonable projections, the confidence level it can realistically expect to obtain in the resulting calculations for STAL, given its specific market uncertainties, for example around traffic growth, is far below that which it considers appropriate. This is further complicated by the recent acquisition of STAL by MAG in March 2013, which could lead to a different business strategy and different projections compared to those provided by STAL*".

previous cases including, most notably, the CC's market investigation into BAA airports. For example, the Initial Views correctly found that:

(a) London airports compete against each other for airline (including cargo) customers[7];

(b) the geographic market relating to the supply of services to airlines is likely to be Europe-wide[8];

(c) LCC customers operate flexible business models that enable them to redeploy aircraft and exercise buyer power[9];

(d) LCCs are much more important to Stansted than Stansted is to them[10];

(e) Prices and profitability do not suggest that Stansted has market power[11]; and

(f) Stansted operates in a multi-sided market whereby commercial revenues and aeronautical revenues are interlinked.[12]

3.4 It is not clear why there was such a dramatic change between February 2012 and January 2013 in the approach adopted, or why the approach taken to many issues in the Initial Views has been abandoned in order to reach a provisional conclusion that Test A is met. The Consultation Document does not provide an adequate explanation for that change of approach. Moreover, the available evidence, when properly tested, does not provide an adequate basis for such a change.

3.5 The change of approach is all the more surprising as the CAA has not carried out the additional work it identified in its Initial Views as being necessary to reach a conclusion on market power. In particular, the Initial Views stated that a final decision on whether Stansted has substantial market power for the purposes of the CA Act would depend on two factors:

"• *the evidence available on the barriers to airlines reducing their use of Stansted at peak times, including the impact on airline yields; and*

• *whether, and to whom, the airport is sold by BAA.*"[13]

3.6 The Consultation Document presents no evidence to suggest that either of these two factors has been considered in any detail since the Initial Views, and no rationale for the changes in approach has been given:

(a) In relation to the first factor, following correspondence with the CAA, we understand that the CAA has sought but not obtained (and therefore has not considered) the route yield evidence that it (rightly) said should be central to its assessment. Absent that highly relevant information, a rational analysis of the competitive constraints faced by Stansted from other London and European airports cannot be undertaken (see Sections 4 and 5 below). The CAA has not explained why it has not obtained this information using its

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7 Initial Views, Executive Summary, paragraph 10.

8 Initial Views, Executive Summary, paragraph 17, paragraph 2.143, paragraph 2.159.

9 Initial Views, Executive Summary, paragraphs 24-26, paragraphs 2.66-2.68, 2.72, 2.75, 2.142. 3.213.

10 Initial Views, Executive Summary, paragraphs 33-34, paragraphs 2.51 and 3.22-3.25, 3.222.

11 Initial Views, Executive Summary, paragraphs 37 and 42-45, paragraphs 3.160-3.168, 3.226, 3.231, 3.244.

12 Initial Views, Executive Summary, paragraph 6, paragraphs 3.66-3.73.

13 Initial Views, Executive Summary, paragraph 56.

statutory powers. Public law requires, and the Airports Act 1986 permits, the CAA to obtain the necessary information, and it must now do so in order to reach a rational and legally robust conclusion.

(b) In relation to the second factor, the analysis contained in the Consultation Document does not take into account the fact that Stansted was about to be sold shortly after the Consultation Document was published, following the divestment imposed by the CC at the end of its BAA market investigation. The views set out in in the Consultation Document are therefore based on conduct and incentives during a period when Stansted was not independent of Heathrow, or indeed Gatwick, and also during a period of great uncertainty while Stansted was being divested. The Consultation Document pays no meaningful attention to this important change of circumstances and this should be remedied in the CAA's further consideration.

3.7 Instead of conducting the analysis that the CAA itself considered to be essential, the Consultation Document presents a radical and unprecedented analysis, coupled with a selective use of evidence, which does not take account of the considerable body of research that the CAA and other competition authorities, such as the CC, have built up over recent years.

3.8 There are a number of serious flaws in the analysis contained in the Consultation Document that have led to a change in approach, and a divergence from established competition law principles and common sense. A proper consideration of the relevant evidence would clearly show that Stansted does not have substantial market power, nor is it likely to acquire such a position in the foreseeable future. In our view, Test A is not met.

3.9 This is demonstrated by reference to the following critical issues, each of which is important to the provisional conclusions contained in the Consultation Document in relation to the alleged "Stansted short-haul market":

(a) <u>The Consultation Document does not take into account the constraint on Stansted from other European airports</u>. In departing from previous practice by stating that the competitive constraint on Stansted from other European airports is weak, the Consultation Document significantly overstates Stansted's position. If proper regard is had to the extent to which European airports exercise a significant competitive constraint on Stansted, it is clear that Stansted is a small player in a wider pan-European market, and as a result cannot be regarded as having substantial market power.

(b) <u>The Consultation Document does not take into account the constraint on Stansted from other London airports</u>. By departing from previous practice by stating that the competitive constraint on Stansted from other London airports is weak, the Consultation Document again significantly overstates Stansted's position. The evidence demonstrates that Stansted has strong incentives to compete vigorously against other London airports, which currently have, and will continue to have, sufficient spare capacity to allow airline switching to occur. As a result, it is clear that Stansted faces significant competition from other London airports, and as a result cannot be regarded as having substantial market power.

(c) The Consultation Document defines Stansted’s product market much too narrowly. By adopting an unprecedented narrow definition of the product market – established by reference to Stansted's customers' products and business models – the Consultation Document significantly overstates Stansted's position. If the analysis had followed established practice in this area, which accords with the evidence and economic reality, the Consultation Document would have identified a much wider market with reference to the airport’s product (rather than the airlines' product). In this wider product market, Stansted cannot be regarded as having market power.

(d) The Consultation Document disregards the importance of commercial revenues to Stansted's multi-sided business model. By ignoring the clear link between passenger volumes and commercial revenues, the Consultation Document reaches the startling conclusion that the commercial side of Stansted's business (i.e., car parking, retail…etc) is unimportant to the assessment of market power. As a result, the Consultation Document misses the fact that Stansted has strong incentives to keep charges low to drive passenger growth and commercial revenues. In doing so, it significantly overstates Stansted's position.

(e) The Consultation Document adopts a novel and unevidenced concept of 'strategic constraints'. By accepting the un-evidenced assertion that London is so important to Stansted's airline customers that they would be reluctant to switch a small number of marginal aircraft away from Stansted, even if these routes became less profitable than other available routes, the Consultation Document significantly underestimates the ability and willingness of airlines to switch and therefore significantly overstates Stansted's position.

(f) [redacted]

(g) The Consultation Document overstates the likelihood of Stansted acquiring substantial market power. It is accepted in the Consultation Document that the evidence does not support a finding that Stansted currently has market power, only that it may have. The provisional finding that Stansted has market power relies on a finding that Stansted "is likely to" acquire substantial market power. The analysis supporting that conclusion is (as the CAA has acknowledged) based on considerable uncertainties and an unduly negative approach to future developments, and cannot support a finding that Stansted is more likely than not to acquire substantial market power.

3.10 The overall provisional conclusion that Stansted has market power within the meaning of section 6 CA Act is severely undermined by each one of the critical issues identified above. Our view is that, when all of those issues are considered as a whole, a final decision along the lines of the provisional conclusions would be irrational.

3.11 In order to address the above critical issues, and other issues which undermine the analysis contained in the Consultation Document, this Part II:

(a) Considers each of the critical issues identified at 3.9(a) to (f) above, and:

(i) compares the position adopted in the Consultation Document to established practice to demonstrate the fact that the new approach constitutes a radical and unsupportable departure from that established practice;

(ii) demonstrates that the provisional conclusions are contrary to the available evidence and, in particular, demonstrates that the available evidence in relation to each issue does not support a finding that Stansted currently has a position of market power (which the Consultation Document accepts), nor that Stansted "is likely to" acquire market power in the future;

(iii) where relevant, sets out the further evidence and analysis that is required before the CAA can reach a final decision.

(b) Addresses other issues which undermine the analysis contained in the Consultation Document, including:

(i) the approach taken to pricing and profitability;

(ii) lack of analysis in relation to the ability and incentives of airlines to switch from Stansted; and

(iii) the failure of the Consultation Document to review the evidence as a whole.

(c) Demonstrates that the assessment contained in the Consultation Document leading to the provisional conclusion that Stansted currently has substantial market power in relation to the alleged "Stansted cargo market" represents a departure from established practice which has no basis in reality or economics.

4 **Constraint from European airports**

4.1 The extent to which airports across Europe compete with Stansted to attract airline customers is a fundamental issue. If European airports collectively exercise a material competitive constraint on Stansted, Stansted could not have substantial market power because the airport would be a small player in a fragmented pan-European market.

4.2 This Section will show that the LCCs operate flexible business models that are based on relocating aircraft throughout Europe to take advantage of the most profitable routes, with the result that Stansted competes directly against airports all over Europe for their custom.

4.3 A report by Case Associates at Annex D contains a detailed assessment of this issue. However, key points on this issue are set out below.

The CAA's established views

4.4 As shown by the chronology of the CAA's views at Annex E, the CAA's views on this issue were previously well-established. These views were made plain as part of the CC's BAA market investigation in particular:

(a) The CAA stated in its initial submissions to the CC that no-frills carriers have demonstrated "*an ability to compare route options across the single European market*".[14]

(b) In a summary of a hearing held with the CC in June 2007, the CAA emphasised that LCCs are pan-European businesses, so if they cannot make money at a particular UK airport they would not necessarily be locked into serving that catchment area from another local airport. The CAA also stated that LCCs could decide to operate completely different services between other airports in Europe.[15]

(c) In the CAA's comments on the CC's Competition Working Paper in August 2008, it indicated that the CC had demonstrated significant evidential shortcomings by dismissing the role of pan-European competition.[16] The CAA quoted an article in the Financial Times to demonstrate the cumulative competitive constraints caused by the low cost point to point model in the context of the European Aviation Area:

> "*While [Ryanair] is reducing its flying programme at some airports for part of the coming winter season to reduce lossmaking operations - chiefly at London Stansted and Dublin, its main European bases - it is increasing its overall capacity in the winter by 8-9 per cent following an expansion of 18-19 per cent during the current summer months.*"[17]

(d) The CAA made further submissions in the CC's Q5 price control review, in which it stated that "*the larger airlines at Stansted operated on a pan-European basis and, therefore, could*

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[14] Initial Submissions to the Competition Commission in the BAA Market Investigation (**CAA Initial Submissions**), May 2007, Paragraph 2.24: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/third_party_submission_caa.pdf.

[15] Summary of hearing with Competition Commission, 28 June 2007, paragraph 5: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/hearing_summary_caa_3.pdf.

[16] CAA's comments on the Competition Commission's Competition Working Paper, August 2008 (**Comments on the CC's Working Paper**), paragraph 1.4: http://www.caa.co.uk/docs/5/ergdocs/cccompetitionpaper.pdf.

[17] Comments on the CC's Working Paper, paragraphs 4.17-18. This statement is at odds with the CAA's central argument that all current Stansted routes are strategically special such that the LCCs can no longer render a price rise by Stansted unprofitable.

switch routes out of Stansted to many unconstrained airports across Europe in response to a charge increase at Stansted".[18]

(e) The CAA also published advice to the Secretary of State which pointed out that "*the emerging evidence suggests that airlines are able to modify their growth plans, and switch some of their existing aircraft, between airports over a very broad area, comparing the returns that can be earned operating to/from Stansted with those that can be earned by serving other airport pairs across the European Aviation Area. Stansted appears, therefore, to face significant competitive pressure from UK and other European airports outside its immediate geographic market*".[19] The CAA concluded that Stansted faces significant competitive pressure from other UK and European airports.[20]

The Consultation Document

4.5 The Consultation Document incorrectly states that the competitive constraint on Stansted from European airports is weak. The Consultation Document is therefore at odds with the Initial Views, the CAA's previous views on the issue (discussed above), the CC's findings in the BAA market investigation, and with the established principles of competition law.

4.6 The Consultation Document does not claim, and certainly does not provide evidence to show, that the factors leading to the CAA's previous views on a pan-European market have changed. It is therefore unreasonable to disregard the CAA's own extensive body of work on this issue, without giving reasons.

4.7 This error is fundamental to, and sufficient on its own to invalidate, the 'minded to' position that Stansted may currently possess market power. Clearly, if it is accepted that Stansted competes directly against many European airports, this would have profound consequences for the findings in the Consultation Document.

4.8 The rest of this Section assesses the flawed approach set out in the Consultation Document and shows that Stansted faces strong competition from airports across Europe.

Failure to gather the appropriate evidence

4.9 We are concerned that the CAA appears to have failed to gather appropriate evidence from the airlines – in particular the route yield data that the CAA itself had said was central to its market power assessment. For example, the Executive Summary of the Initial Views stated that:

"*56. Looking forward, the CAA's view on the market power at Stansted will likely depend upon the following:*

- *The evidence available on the barriers to airlines reducing their use of Stansted at peak times, including the impact on airline yields; and*
- *Whether, and to whom, the airport is sold by BAA.*

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18 Competition Commission report on Stansted Airport Ltd - Q5 Price Control Review (October 2008), Appendix B, paragraph 37: http://www.caa.co.uk/docs/5/ergdocs/ccstanstedb.pdf.

19 CAA's advice to the Secretary of State on De-designation of Manchester and Stansted airports for price control regulation, June 2007, (**De-designation Advice**), paragraph 33: http://www.caa.co.uk/docs/5/ergdocs/de-designation_advice.pdf.

20 De-designation Advice, paragraph 8.106.

57. *Whilst the second of these factors is outside of the control of the CAA, we would hope to be able to work with airlines and the airport to obtain better information to reach a firm view on the former."*[21]

4.10 Both of these issues on which the CAA's decision was stated to "*likely depend*" have been neglected in the Consultation Document without explanation.

4.11 The route yield data, had it been obtained, would have assisted the CAA in assessing the extent to which the airlines can switch away from Stansted. It is expected that this evidence would have shown that:

(a) airlines operating at Stansted, in common with other airports, have some more profitable routes and some marginally profitable routes;

(b) it would be rational for the airlines to switch these marginally profitable routes away from Stansted to another European airport in response to a 5-10% price rise, thus making the price rise unprofitable for Stansted;

(c) airlines operate on a Europe-wide basis optimising their use of aircraft by redeploying them throughout Europe – in line with their frequent public statements and submissions to competition authorities on the issue; and

(d) Stansted's main customers have significant buyer power.

4.12 The above are key issues that are fundamental to an analysis of Stansted's market power. The failure to gather this evidence calls into question the processes followed, and seriously undermines the analysis set out in the Consultation Document.

4.13 Following a chain of correspondence with the CAA on this issue, the CAA provided a limited explanation on 23 April 2013 of the information that it had gathered from Stansted's two largest customers, Ryanair and easyJet. The CAA explained in this correspondence that the information was required "*[t]o understand the cost of switching a marginal route from one airport to another in terms of loss of yield*". However, this correspondence confirms that:

(a) Ryanair provided no information on its route yields, despite having been asked to provide "*data on the yields achieved at each of your bases by month, route and service*", including "*data for the last five years, for each service (i.e. sector flown)*" and "*profitability, contribution, operating profit and revenue for each sector, averaged over each calendar month*".

(b) Although easyJet provided some of the route yield data requested, the CAA's response to Stansted states that this data was relevant to paragraphs 4.112 to 4.114 of the Consultation Document. Paragraph 4.114 is redacted such that the CAA's reasoning is difficult to follow and the yield analysis is impossible to replicate. Nevertheless, two points are clear:

(i) these paragraphs refer only to route yield data for the London airports, suggesting that the data received from easyJet did not include information relating to European airports; and

[21] See also (for example) Initial Views, paragraphs 2.74, 3.112, and 3.143.

(ii) such data as was provided led the CAA to state that it "*tentatively concludes that there are signs of airline competition for passenger demand at and across London airports*", a conclusion in direct contradiction to the 'minded to' conclusion set out in the Consultation Document (but in line with previous findings).

(c) Ryanair did not provide the internal documents requested by the CAA, despite having been asked to provide "*board papers, executive committee papers and other papers*" that assess "*the profitability of services operating to/from Stansted and Gatwick*" and "*the commercial case for adding and/or removing capacity from Stansted and Gatwick*" and "*the costs, revenues and commercial justification for opening services at Southend*". Ryanair makes frequent decisions about where to base its aircraft and these decisions, and the rationale behind them, must be documented internally. These internal documents would therefore be directly relevant to an assessment of any market power that Stansted possesses in relation to its largest customer.

4.14 The CAA has therefore failed properly to inform itself. On an issue as central as route profitability, it has failed to gather the relevant information from Stansted's largest customer, and it gathered inadequate information from our second largest customer, thus making a rational analysis of the Europe-wide market impossible.[22] This is especially concerning given that the CAA has statutory powers to compel the provision of the information. There has been no explanation as to why the CAA has not gathered the information necessary to enable it to perform its statutory functions. The CAA should now use its statutory powers to obtain this information in order to reach a rational and legally robust conclusion. It is instructive to note that, where the CAA received some relevant data from easyJet, that data pointed towards the opposite conclusion to the one reached in the Consultation Document.

Switching away from Stansted

4.15 Stansted's largest customers operate flexible pan-European networks and respond quickly to the changing profitability of their routes by relocating aircraft throughout Europe. This shows direct competition amongst European airports, including Stansted.

4.16 A new environmental tax imposed in Germany in 2011 provides a specific recent example of Ryanair's flexibility. Ryanair's weekly departures in August (this is the peak summer month) from German airports increased by 33% from Summer 2008 to Summer 2009, by a further 4% from Summer 2009 to Summer 2010, and then dropped by 30% from Summer 2010 to Summer 2011 in response to the new environmental tax.[23] As Ryanair's overall number of aircraft was increasing at the time, these aircraft must have been relocated to other countries in Europe.

4.17 The changes in Ryanair's overall aircraft allocation since Summer 2006 can be seen in Figure 1 below.

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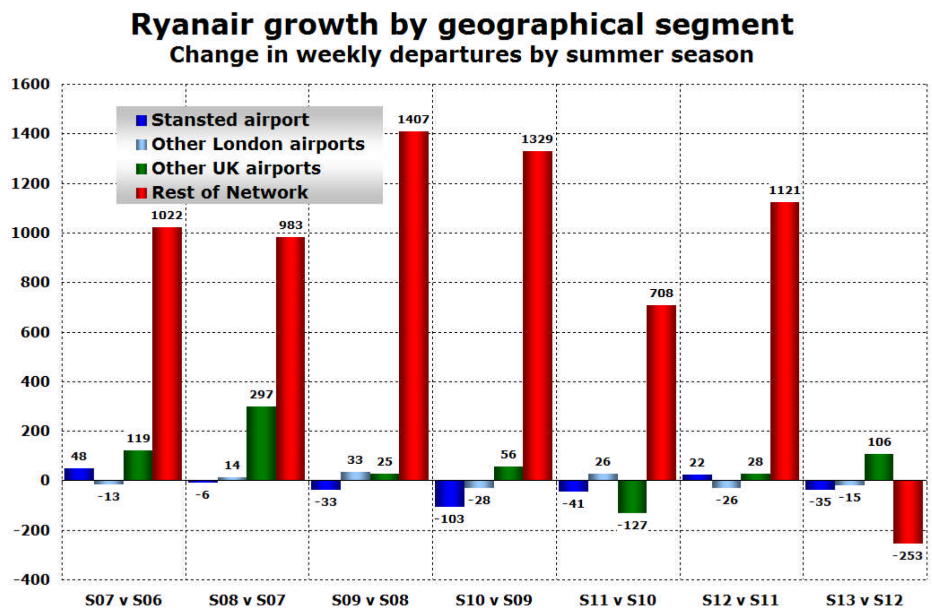
[22] Note also that this data appears to be readily available. See, for example, slides 10 and 12 of this recent investor presentation made by Ryanair: http://www.ryanair.com/doc/investor/present/quarter4_2013.pdf. See also easyJet's investor day presentation of January 2012, where it was confirmed that routes are reviewed monthly against ROCE targets and the worst performing routes are assessed and reallocated: http://corporate.easyjet.com/~/media/Files/E/Easyjet-Plc-V2/pdf/investors/results-centre/2012/investor-day-presentation-2012.pdf.

[23] Source: M.A.G analysis of airline schedules.

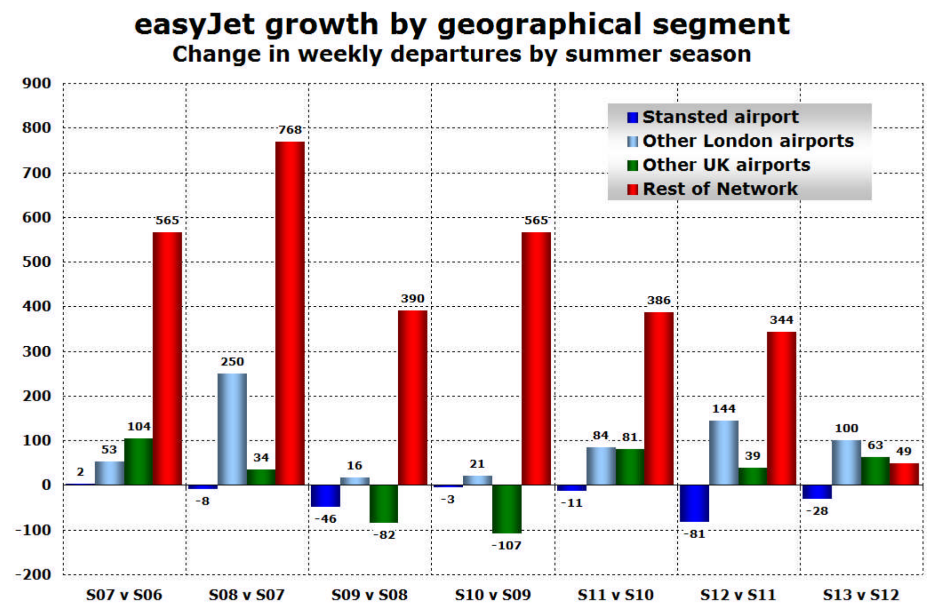
Figure 1: Ryanair switching aircraft away from Stansted since Summer 2006



Source: M.A.G analysis of airline schedules

4.18 The changes in easyJet's aircraft allocation since Summer 2006 can be seen in Figure 2 below.

Figure 2: easyJet switching aircraft away from Stansted since Summer 2006



Source: M.A.G analysis of airline schedules

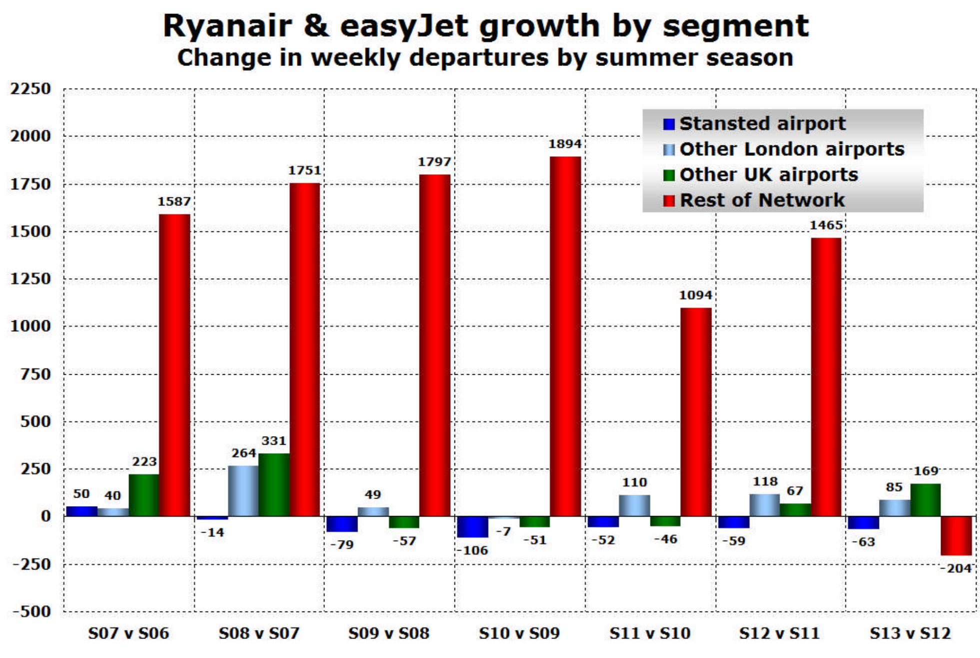
4.19 Figures 1 and 2 show the pan-European flexibility of Ryanair and easyJet, and their shift of focus (for new and existing aircraft) away from Stansted.

(a) **Ryanair**: From Summer 2006 to Summer 2013, the number of weekly departures from Stansted in a peak summer week dropped by 148 departures from 1,033 to 885 (a 14% reduction). Over the same period, its weekly departures from other UK airports increased by 495 departures, and its weekly departures from European airports (outside the UK) increased by 6,317 departures.

(b) **easyJet**: From Summer 2006 to Summer 2013, the number of weekly departures from Stansted in a peak summer week dropped by 175 departures. Over the same period, its weekly departures from other UK airports increased by 800 departures (668 of which were at other London airports), and its weekly departures from European airports (outside the UK) increased by 3,067 departures.

4.20 Figure 3 below shows the position when the switching (and new aircraft) decisions of Ryanair and easyJet (who represent over 90% of Stansted's business) are combined.

Figure 3: Ryanair and easyJet aggregate switching of aircraft away from Stansted since Summer 2006



Source: M.A.G analysis of airline schedules

4.21 Switching evidence such as this is the most clear and unequivocal evidence of a competitive constraint being exercised on Stansted from airports across Europe (and, indeed, across the UK). Aircraft have been, and are being, relocated away from Stansted in favour of other European airports. When deciding where to allocate new aircraft, it is clear that the airlines have chosen other European airports in preference to Stansted. These figures clearly demonstrate that Stansted competes in a Europe-wide market.

4.22 Further evidence of switching and the ability of and incentives on airlines to switch is set out in Section 9 below.

The pan-European approach of airlines

4.23 As shown above, Stansted's airline customers take a pan-European approach to the allocation of their aircraft, putting Stansted in direct competition with European airports. This is well documented in airlines' submissions to competition authorities and courts, and in their press releases, stock market announcements, annual reports and interviews. Yet this evidence seems, without justification, to have been disregarded in the Consultation Document. This position ignores the clear public statements of Stansted's largest customers, a selection of which are set out below.

4.24 In particular, the airlines' pan-European approach is succinctly summed up in Ryanair's recent submission to the OFT in connection with its acquisition of a minority stake in Aer Lingus:

> "*The airline industry is generally characterised by low barriers to entry. Low sunk costs make it feasible for existing airlines to enter, expand, contract and/or exit from individual routes. This is because virtually all of the assets required to operate an airline can readily be re-deployed to other routes or leased out in response to changing market circumstances. The EU exhibits especially low barriers as a result of deregulation and aircraft can be shifted quickly from one route to another to take advantage of profitable opportunities. Tickets for new routes can be advertised and distributed via the Internet without incurring significant costs.*"[24]

4.25 More colloquially, Ryanair explained to investors in January 2012: "*So we continue to be very opportunistic. We go wherever the airports give us the best package of efficient facilities and low costs*".[25] M.A.G's analysis of airline schedules suggests that between 15% and 22% of Ryanair routes in recent years are new routes not operated in the previous year.[26] This is a significant number of routes that are either new or switched each year.

4.26 Further examples relating to Ryanair include:

(a) Ryanair's investor conference call on 20 May 2013 in which Ryanair's Chief Executive stated:

> *"I think if we are trying to communicate anything today, it is that there is an enormous opportunity for us and our shareholders, I think, over the medium term, to expand Ryanair off a unique unit cost platform that no other airline in Europe can touch. But we have made the same kind of traffic growth offers today to a number of the German airports, a number of the Spanish airports, to Stansted and to Dublin. If*

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[24] Ryanair Submission on SLC Question to OFT (31 August 2011), paragraph 4.8: http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/ryanair-aer-lingus/ryanair_submission_to_the_oft_on_the_slc_test.pdf. See Annex G(4).

[25] Ryanair, investor conference call, January 2012, http://www.media-server.com/m/p/h7g37293.

[26] Ryanair's number of added routes in recent years have been 1,247 out of a total of 6,386 (Summer 2007), 1,402 out of a total of 7,674 (Summer 2008), 1,976 out of a total of 9,106 (Summer 2009), 1,852 out of a total of 10,360 (Summer 2010), 1,699 out of a total of 10,926 (Summer 2011), 1,812 out of a total of 12,071 (Summer 2012).

all of those airports were to agree to the terms of our proposal today, we would not be able to handle that growth for about three or four years, so whoever kind of steps up first will likely win and get the immediate traffic growth and the others would simply have to wait in line."[27]

"*I would, however, point to the fact that we have been constraining and cutting traffic at expensive airports like Dublin and Stansted in recent years. The kind of airports we are talking to, whether it is Dublin or Stansted, or AENA Spanish airports, or Polish airports or even German airports are airports that are currently suffering a meaningful decline in particularly their short-haul traffic.*"[28]

(b) reports from March 2013, which show that Ryanair is increasing its fleet by a third;[29]

(c) further press releases which indicate that Ryanair continued to cut down flights from Stansted this year;[30] and

(d) Ryanair's statement in 2009 that it was withdrawing 16 aircraft to other European bases in response to the charges at Stansted.[31]

4.27 This publicly-available evidence suggests that other profitable route options are in fact available to Ryanair, and are considered by Ryanair when deciding where to place marginally profitable routes. A selection of such evidence is included at Annex G.

4.28 easyJet also consistently states that it redeploys its aircraft across Europe. For example:

(a) easyJet's Annual Report for 2012 states that the "*strength of easyJet's business model is based around a pan European network to primary airports, delivered with friendly service, efficiency and at the lowest cost*"[32];

(b) Similarly, its 2011 Annual Report states: "*easyJet has built flexibility into its fleet planning arrangements such that it can increase or decrease capacity deployed, subject to the opportunities available and prevailing economic conditions. The Company also has flexibility to move aircraft between routes and markets to improve ROCE*"[33]; and

(c) It is also evident from easyJet's recent investor presentation that redeploying aircraft across Europe continues to be an important part of its business plan.[34] For example:

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27 Ryanair, investor conference call, 20 May 2013, at around 19 minutes: http://www.ryanair.com/en/investor/investor-relations-news.

28 *Ibid*, at around 21 minutes.

29 BBC website report http://www.bbc.co.uk/news/business-21845831. Ryanair's order for 175 new Boeing aircraft was confirmed, for example, in the investor conference call on 20 May 2013, *ibid*, shortly after 3 minutes. See Annex G(11).

30 Telegraph website reports http://www.telegraph.co.uk/finance/newsbysector/transport/9904233/Ryanair-to-cut-down-flights-from-Stansted-over-landing-fee-row.html (see Annex G(10)) and http://www.telegraph.co.uk/finance/newsbysector/transport/9901242/Ryanair-cuts-capacity-at-Stansted-by-one-million-passengers.html (see Annex G(8)).

31 BBC website report http://news.bbc.co.uk/1/hi/business/8160923.stm. See Annex G(2).

32 easyJet Annual Report 2012, Chairman's Introduction, page 6: http://corporate.easyjet.com/~/media/Files/E/Easyjet-Plc-V2/pdf/investors/result-center-investor/annual-report-2012.pdf.

33 easyJet Annual Report 2011, page 11. http://corporate.easyjet.com/~/media/Files/E/Easyjet-Plc-V2/pdf/investors/result-center-investor/annual-report-2011.pdf. This quote is included in the Consultation Document at paragraph 5.36.

34 Investor Presentation, February 2013: http://corporate.easyjet.com/~/media/Files/E/Easyjet-Plc-V2/pdf/investors/results-centre/2013/2013-q1-roadshow-presentation.pdf.

(i) easyJet has "*[i]ntroduced tools to evaluate network ROCE and capital allocation*" (slide 8). This shows that easyJet looks at marginal returns in deciding fleet deployment.

(ii) easyJet has "*[r]eviewed network returns and decided to downsize Liverpool and close Madrid*" (slide 8). This shows that easyJet takes action to move aircraft away from underperforming bases, including capital cities.

(iii) easyJet has "*[r]eallocated capacity to higher returns and growth opportunities e.g. France and Italy*" (slide 10). This again shows that easyJet looks at marginal returns in deciding fleet deployment on a pan-European basis.

(iv) Slide 12 shows that easyJet evaluates all of its routes on a ROCE basis and frequently alters its routes throughout Europe accordingly. (Note that a large number of its routes represented in the graph on this slide are less than 3 years old, showing how frequently easyJet's routes are amended and added to.)

4.29 The Consultation Document does not address this key issue, and as a result ignores significant primary evidence about how Stansted's customers make decisions that are directly relevant to the question of market power. This compounds the failure to gather the yield data (discussed above) on the important issue of airline substitution and switching behaviour.

London is not unique

4.30 A central factor in the 'minded to' position set out in the Consultation Document is the assertion that London is unique and that other European airports do not constrain Stansted.[35] On this view, Stansted has a special hold over its LCC customers so that airports in other European cities do not exercise a sufficient constraint and do not belong to the same geographic market. This assertion is not supported by evidence and is incorrect. It is also unprecedented.

4.31 The testimony of Ryanair seems to form the basis of the Consultation Document's provisional conclusion that London is uniquely important to its network. Yet the figures in Figure 1 above suggest that London has become less attractive to Ryanair in recent years compared with other UK airports and continental European airports. Those figures certainly do not suggest that London is uniquely important such that the LCCs cannot reduce their use of Stansted in response to an attempted price rise. Figure 1 above shows that Ryanair has reduced its weekly departures in a peak summer week from London airports by 157 departures between Summer 2006 and Summer 2013 (148 of which were switched away from Stansted). Over the same period, Ryanair has increased departures from other UK airports by 504 departures and its departures from airports outside the UK by 6,317 departures.[36]

4.32 Case Associates explain in their report at Annex D that:

> "*Indeed it is a feature of the CAA's market definition analysis that it fails to properly appreciate that the SSNIP and other tests for market definition are based on the reaction of a subset of marginal customers, airlines, or routes rather than some representative reaction of what the average passenger or airline would do. At other times the CAA argues that the action needs to be 'all or nothing' – either the airline operates invariably out of Stansted*

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35 Consultation Document, Summary, paragraphs 11 and 17 and paragraphs 5.55 to 5.70.

36 Source: M.A.G analysis of airline schedules.

making Stansted the geographic market, or it must move its entire base away from Stansted in response to a SSNIP to widen the geographic market. This is patently wrong" (Annex D, pages 32-33).

4.33 A large European airline might well wish to operate flights in and out of a large European city such as London. However, the analysis in the Consultation Document is incorrect in assuming that an airline must be able to switch a large proportion of its fleet away from London to other European airports in order for those airports to represent a sufficient constraint. Instead, the CAA ought to have assessed whether airlines (in aggregate) would be willing and able to switch marginally profitable routes to non-UK European airports, sufficient (in aggregate, and together with other airline switching of capacity within the UK, and passenger switching of demand) to make a 5-10% price rise by Stansted unprofitable. It is notable that the Initial Views document seems to have correctly addressed this issue. For example, at paragraph 2.73 of its Initial Views, the CAA states: "*It should be noted, that in terms of market definition and market power assessments, we only need to consider a switch at the margin, i.e. it would not be necessary for Ryanair to switch its whole operation at Stansted (which may be considerably more costly) to another airport, but just a share of its business*". The CAA must address this correct question before reaching a final decision.

4.34 This incorrect approach is evident in several paragraphs of the Consultation Document.[37] For example:

(a) Paragraph 4.119: M.A.G's view that European airports compete with Stansted is seemingly disregarded because this competition is said only to occur for "*network carrier growth*". This is precisely the type of marginal purchasing decision by airlines that dictates the boundaries of competitive constraints.

(b) Paragraph 4.120: Birmingham Airport's view that European airports provide a competitive constraint "*only at the margins*" is also cited as evidence that European airports do not provide a constraint on Stansted. Again, this is precisely the type of competition that should be analysed.

(c) Paragraphs 5.54 to 5.59: The Consultation Document sets out various reasons why an airline would want a number of London routes, but fails to relate the evidence to the issue of marginal switching. In paragraph 5.59, the Consultation Document sums up the evidence as follows: "*Based on this evidence, it appears likely that Stansted's based LCCs would consider switching to another substitutable London airport before considering relocating aircraft away from the London airports*". This may or may not be true, but more importantly it fails to address the relevant question. Even if the airline would first consider another London airport when switching a marginal route away from Stansted, this does not mean that European airports do not also exert a competitive constraint. In any geographic market, nearer competitors may exert more constraint, but this does not mean the market should only ever encompass a firm's nearest competitors if more distant competitors also exert a sufficient constraint, or if there is a chain of substitution. In this regard, the reference in footnote 265 of the Consultation Document is misleading. The CC report referred to does not support the conclusion at paragraph 5.59 of the Consultation

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[37] The CAA repeats this misdirection in its Initial Proposals (Executive Summary, paragraph 9).

Document. Indeed, although this report (in addition to the CC's main 2009 report) states that European airports exerted a weaker constraint than the other BAA airports at that time, the CC decided that "*non-neighbouring airports do impose a degree of constraint on Stansted*".[38]

(d) Paragraph 5.87: A crucial point in the provisional conclusions set out in the Consultation Document is that Gatwick is capacity-constrained. However, the CAA itself acknowledges that Gatwick's expansion plans will increase its capacity at the margins (although, with plans to expand its capacity by 6.4 million passengers per annum by 2021/2022, some 37% of Stansted's total passenger traffic in 2012, it is clear that this is significantly more than a mere marginal increase). Gatwick also has the ability to use its current capacity more efficiently (see Section 5 below for more details).

4.35 Another fundamental misdirection is the Consultation Document's conflation of the different levels of the supply chain in the industry. The Consultation Document frequently and inappropriately uses the downstream market where passengers purchase airline seats directly to make findings in relation to the upstream market where Stansted sells airport services to airlines, without explaining how the link operates. For example:

(a) At paragraph 4.120 of the Consultation Document it is stated that airline switching to a European airport is akin to leaving the market. It is of course correct that the aircraft, having been moved to a different European airport, will serve different passengers, but the CAA ought to be assessing the upstream market in which Stansted operates – where Stansted's airline customers are making decisions about where to purchase airport services – not the downstream market. Marginal switching such as this is the best possible evidence of a competitive constraint, yet it has been discounted.

(b) The same error is repeated in paragraphs 4.121 to 4.122 of the Consultation Document, where direct evidence of airline buying decisions is discounted on the indirect and unpersuasive basis that the CAA has seen no evidence of Stansted monitoring these airports. This fails to reflect the fact that other airports' actual charges are confidential between the airline and the airport, so Stansted is not able to monitor them. Furthermore, there is little benefit in monitoring the published tariffs of other airports because airports may discount their prices heavily in their confidential agreements with airlines. The only reliable indicator to Stansted of the prices actually charged by competitor airports is thus the behaviour of airlines responding to Stansted's charges.

(c) The same error is repeated in paragraph 4.123 of the Consultation Document, where a statement in the CC's BAA market investigation report regarding the downstream market

[38] BAA market investigation, Consideration of possible material changes of circumstances, 19 July 2011, paragraph 180: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/final_report_excised.pdf. This report is, in any case, the wrong report to reference. It was concerned with whether there had been a material change of circumstance since 2009, rather than whether there was a competitive constraint from European airports per se. The CC's conclusion on this issue is in paragraph 185: "*In our view, the evidence on the constraint from non-neighbouring European airports shows that there is a degree of constraint—but we recognized that in 2009. In the 2009 report we noted that there had been intense competition between airports for LCCs (see paragraph 169, citing paragraph 3.10 of the 2009 report). We have not seen evidence that leads us to conclude that there has been a significant change in the intensity of competition creating this constraint.*"

is taken out of context[39] and used to show that airlines switching their aircraft between airports throughout Europe are hopping between different markets, as if the revenues lost by Stansted as a result of that activity could not discipline (i.e., render unprofitable) a price rise.

4.36 This incorrect approach inevitably leads to a finding that London is unique – that no other city is suitable for a passenger wishing to fly to or from London. However, that is irrelevant. The Consultation Document admits in paragraph 4.124 of the Consultation Document that Stansted's own airline customers view the market as pan-European and base their buying decisions on network yield optimisation. It is the buying decisions of these airline customers which dictate the proper boundaries of the competitive constraints on Stansted.

4.37 The assertion contained in the Consultation Document that London is unique is based on fundamental misdirection and irrelevant considerations. The CAA should revert to the rational findings contained in its Initial Views in taking a final decision.

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39 *Ibid.* The CC's statement in this instance was part of its assessment whether the constraint of European airports had materially changed since the publication of the CC's 2009 final report. It was also related to the fact that airlines were obliged to deal with BAA, which owned the three major London airports.

5 Constraint from other London airports

5.1 The extent to which airports across London compete with Stansted to attract airline customers is a fundamental issue. If the other London airports exercise a sufficient competitive constraint on Stansted, Stansted cannot have market power because airlines could readily switch to one of the other London airports in response to a price increase.

5.2 This Section will show that Stansted competes vigorously with the other London airports, which currently have (and will continue to have) sufficient spare capacity to allow airline switching to continue. This Section will also show that UK airports outside London exercise in aggregate a significant competitive constraint on Stansted.

5.3 Reports by Yarrow and Starkie at Annex A and Case Associates at Annex D each contain a detailed assessment of these issues. However, a number of key points are highlighted below.

The CC's BAA market investigation

5.4 The CC's market investigation into BAA represents the most detailed regulatory investigation into this issue. The CC found that the scope for competition between Gatwick, Heathrow and Stansted was significant:

> "*...the evidence we have seen suggests significant substitutability of passenger demand between the BAA London airports, with significant overlaps between their catchment areas, although to an extent that varies between different categories of passenger: evidence that, in the absence of common ownership, there would be competition between them.*"[40]

5.5 Having investigated the industry, the CC forced the sale by BAA of both Gatwick and Stansted. This was on the basis that all three BAA-owned airports in London would have been in competition with each other absent their then common ownership. The CC believed that competition would be quick to materialise between Gatwick, Heathrow and Stansted once they were all under separate ownership:

> "*We would expect the benefits from competition to manifest themselves straight away (particularly in relation to planning and capacity development) and to increase over time as the prospect of additional capacity is realized and price control, at Gatwick and Stansted at least, is withdrawn as competition develops.*"[41]

5.6 The CC went on to state that:

> "*We ... expect that separate ownership at Stansted would result in significant competitive interaction between it and both Heathrow and Gatwick.*"[42]

> "*Gatwick is the closest substitute for Stansted and Stansted is the second closest substitute for both Heathrow and Gatwick.*"[43]

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40 BAA airports market investigation, final report, 19 March 2009 (**BAA Final Report**), Summary, paragraph 10: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/545.pdf.

41 BAA Final Report, paragraph 5.15.

42 BAA Final Report, paragraph 5.17.

43 BAA Final Report, paragraph 5.17(a). See also paragraphs 5.6 and 3.123.

5.7 In this context, it is also instructive to consider Ryanair's testimony to the CC, explaining one of the major arguments for forcing BAA's sale of Gatwick and Stansted, which was summarised by the CC as follows:

> "*Ryanair favoured breaking up the BAA monopoly and replacing it with separate ownership of the three BAA London airports. Ryanair believed that if the airports were separately owned all three would be continuously pushing to grow their own businesses. There would be a much faster pace of development of new capacity, eg runways and terminals for airlines, both new and existing. The three would be in competition with each other to provide this additional capacity. Ryanair also thought that if there was separate ownership there would be more capex, and more efficient capex, because each owner would be more focused on each airport delivering additional capacity without the cross-subsidization of which was going on, for example, in relation to T5. If there were three competing London airports, Stansted could be offering discounts to the likes of BA in Heathrow and Gatwick in order to attract their short-haul traffic.*"[44]

5.8 It should also be noted that, following the remedies imposed by the CC, effective competition between London airports is now underway (M.A.G's acquisition of Stansted was completed on 28 February 2013, and Gatwick was divested in 2009). Now that each of the three largest London airports is under separate ownership, the nature of competition can be expected to change significantly compared with the previous situation where they were all owned by BAA.

Other competition authority precedent

5.9 As set out in the report by Case Associates at Annex D, it is well established in European Commission merger decisions that, from a demand-side perspective, the airline market should be defined on a city-pair basis at least for point-to-point customers.[45] This implies that, for passengers, all London airports are substitutable. One would expect the upstream market for aeronautical services provided by airports to their airline customers to be wider than the downstream passenger market – and certainly not narrower as the Consultation Document suggests. The Consultation Document frequently conflates passengers' preferences for those of Stansted's airline customers without identifying a link (see, for example, paragraph 4.54 of the Consultation Document), yet the proposed market definition is even narrower than passenger preferences suggest.

5.10 In 2007, the CAA advised the Secretary of State that Stansted should be de-designated. In its advice the CAA argued that the geographic market included not only Greater London and East Anglia but also Birmingham and East Midlands airports.[46] This was despite the fact that BAA owned Gatwick, Heathrow and Stansted at the time.

5.11 These issues are discussed in more detail in the report by Case Associates at Annex D.

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44 Summary of hearings held with Ryanair, 26 July 2007, paragraph 15: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/hearing_summary_ryanair.pdf. See Annex G(1).

45 See, for example, COMP/M.4439 Ryanair/Aer Lingus, COMP/M.5747 Iberia/British Airways, COMP/M.6447 IAG/BMI.

46 De-designation Advice, paragraphs 8.110 and 8.131.

The Consultation Document

5.12 The Consultation Document states that the competitive constraint on Stansted from other London airports (particularly Gatwick and Heathrow) and other UK airports is weak. This is an unsupportable position, which represents a significant failure of analysis. This error is fundamental to, and sufficient on its own to invalidate, the 'minded to' position that Stansted may currently possess market power.

5.13 The Consultation Document is at odds with the CAA's previous views on the issue and it is inconsistent with established European Commission practice. Most crucially, however, the Consultation Document is at odds with the CC's recent findings in the BAA market investigation at the end of its in-depth inquiry, findings which were subsequently sustained by the Competition Appeal Tribunal and Court of Appeal through appeals over three further years. If Stansted operates in a separate geographic market to Gatwick and Heathrow, the CC's decision to force the sale of Stansted by BAA would have been irrational. The analysis in the Consultation Document ignores this central issue. In this sense, the analysis has failed to take into account highly relevant information, with the result that the conclusions set out in the Consultation Document have been arrived at on a false basis.

5.14 The rest of this Section assesses the flawed approach in the Consultation Document and shows that Stansted faces fierce competition from airports across London and the UK.

Market shares

5.15 The Consultation Document's discussion of market shares for London airports (see paragraphs 6.5 to 6.15 of the Consultation Document) is inadequate. It omits to consider what Stansted's market share would be on a London-wide market, a UK-wide market or a Europe-wide market, which are the most plausible candidate markets.

5.16 This is in contrast to the Initial Views document, which stated: "*even under the narrowest definition [short haul flights from the London area], Stansted does not have a high market share, when viewed as a stand-alone airport, and certainly below the level at which there would be a rebuttable presumption of dominance*".[47]

5.17 The figures set out at Table 6.1 of the Consultation Document show that Stansted's market shares have declined by around 8 percentage points since 2004, across each of the market definitions. The latest data available shows this trend continuing for all definitions of market illustrated in this table (for example, market share as measured by EU and domestic passenger numbers in Market 1 fell to 64% in 2012 from 67% in 2011, in Market 2 on the same metric fell to 33% in 2012 from 34% in 2011). However, the Consultation Document does not address the reasons for this decline and its impact on the extent to which Stansted has market power. Since the CAA recommended to the Secretary of State in 2007 that Stansted should be de-designated, Stansted's market shares have decreased materially (and available capacity in London has increased – as discussed further below – for example, in 2012, air traffic movements (**ATMs**) at Gatwick, Stansted, Luton, Southend and London City totalled 515,000, some 16% below the 2007 level).

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47 Initial Views, Executive Summary, Paragraph 22.

5.18 Such a steady decline would ordinarily be adduced as evidence of a lack of market power, and as evidence that the case for de-designation is now even stronger, because airline customers clearly have alternatives and have chosen those alternatives. Yet the Consultation Document ignores this. The implicit assumption seems to be that the market has reached the precise and unique moment where Stansted's market share will now remain constant (a position which is undermined by the latest data for 2012 and 2013, showing a continuing decline in absolute and relative traffic levels), although no reasoning is given to support this assumption. Indeed, despite strong evidence to the contrary, this seems to be Ryanair's assertion – it admits that it has switched away from Stansted in recent years[48] but it says it cannot remove any further aircraft (although it does not provide any factual basis for this assertion).[49] Ryanair's weekly summer departures in a peak summer week from Stansted have fallen by 14% in recent years, from 1,033 in Summer 2006 to 885 in Summer 2013.[50] No reasons are given as to why 885 departures should be taken as Ryanair's minimum possible number of departures from Stansted. Indeed, in this context, it is instructive to note that Ryanair has recently announced plans to reduce its Stansted traffic by a further 9%.[51]

Switching from Stansted to other London and UK airports

5.19 As shown by Figures 1, 2 and 3 in Section 4 above, even if airports outside the UK are excluded, it is clear that other London airports and other UK airports exert a significant constraint on Stansted by attracting aircraft away from Stansted:

(a) easyJet: From Summer 2006 to Summer 2013, easyJet reduced its weekly departures from Stansted by 175 departures while increasing its departures from other London airports by 668 departures, and its departures from other UK airports (outside London) by 132 departures.

(b) Ryanair**:** The corresponding data for Ryanair also shows year on year relocations of aircraft from London to other UK airports, although the overall narrative is of Ryanair refocusing away from Stansted while keeping its use of Gatwick broadly stable. From Summer 2006 to Summer 2013, Ryanair reduced its weekly departures from Stansted by 148 departures, while reducing its departures from other London airports by 9 departures and increasing its departures from other UK airports (outside London) by 504 departures.

5.20 In aggregate, therefore, Stansted's largest customers have reduced their use of Stansted by 323 weekly departures while increasing their use of other London airports by 659 weekly departures in the period Summer 2006 to Summer 2013. In Ryanair's case, the other UK airports appear to be especially attractive. This evidence of switching is sufficient to constrain prices at Stansted – see Section 9 below.

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48 See for example Consultation Document, paragraph 5.110: "*Ryanair said that it has previously decided to move some capacity from Stansted because of 'BAA's refusal to offer competitive terms'*."

49 See Consultation Document, paragraph 5.55: "*Ryanair also indicated that it was unable to materially reduce frequencies to/from Stansted from its current levels (to reduce its overall use of the airport without closing down routes), having already reduced frequencies over the past few years, as this would make its routes [REDACTED].*" See also paragraph 5.110: "*Further, Ryanair said that it would now not be able to reduce route frequencies beyond its current level without ceasing certain routes, as this would make schedules unattractive to passengers*".

50 Source: M.A.G analysis of airline schedules.

51 http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail.html?announcementId=11504116. See Annex G(9).

5.21 Switching evidence such as this is clear and unequivocal evidence of a competitive constraint being exercised on Stansted from other London and UK airports. Aircraft have been, and are being, relocated away from Stansted in favour of other London and UK airports, and growth is also being allocated elsewhere.

5.22 Evidence submitted by Gatwick suggests that a number of airlines – including easyJet – have been successful in developing significant slot holdings at the airport over the last ten years. These positions have been developed through a combination of taking slots from the ACL pool as they become available and the targeted acquisition of slots (or airlines which hold slots) as they come to market. The CAA should consider evidence on this issue to establish the ability of airlines to switch away from Stansted to Gatwick (and other airports) in response to a price rise.

5.23 These figures provide clear evidence to support a view that Stansted's geographic market includes other London and UK airports. There is certainly no sign of capacity constraints impeding the ability of airlines to switch. Despite this, the Consultation Document adopts a narrow view, but does not address the evidence cited above.

Cumulative constraint from other UK airports

5.24 When assessing competitive constraints and whether they are sufficient to prevent a firm from having market power, it is important for a competition authority to consider the various individual constraints and also to consider their effect in aggregate. This has not been achieved in the Consultation Document, which seems to disregard the constraint exercised by airports outside London, presumably because the CAA considers that no single airport is a significant constraint when considered in isolation.

5.25 However, the Consultation Document fails to assess the aggregate competitive constraint that other (regional) UK airports exert on Stansted. The CAA previously accepted that this would be the proper approach in its submission to the CC during the BAA market investigation:

> *"…evidence suggests that regional UK airports could collectively impose a discipline that is similar in magnitude to that of Luton."*[52]

5.26 The CAA's submission strongly criticises the CC for failing to understand the significance of the cumulative competitive constraint from non-London airports:

> *"2.38 However, the CC goes on to summarise this evidence by stating that it "…showed little, if any, evidence of a competitive constraint being imposed on Stansted from non-BAA airports outside London." It is difficult to understand how this evidence – albeit evidence that is not definitive or without some shortcomings – can reasonably be viewed as showing "little, if any" evidence of competitive constraints. The fact that around 40 per cent of passengers indicated some preference for a non-BAA airport outside London suggests that this summary is both unreasonable and untenable, not least given the growth in recent years of regional airports relative to those in London.*
>
> *2.39 Indeed, this example provides a useful illustration of the overall construction of the CC's argument: dismissing individual pieces of evidence in their entirety whenever they are not individually sufficient to indicate that Stansted faces competitive*

[52] Comments on the CC's Working Paper, paragraph 2.21.

constraints. Such an approach inevitably leads to overly definitive conclusions on individual aspects of the analysis which, when all of these individual conclusions are assimilated, will tend to lead to into [sic] an overly definitive conclusion that is out of line with the overall balance of the evidence, whereas a balanced assessment of each individual aspect would lead to a more balanced and appropriate overall conclusion. The CAA also notes that the CC's current approach stands in stark contrast with the reality that market power is always a matter of degree rather than absolutes."[53]

5.27 The CAA's view that regional airports exert a constraint on London airports is further explained later in the same document:

> *"It is clearly important to understand the reasons for excluding regional (and other) airports from the CC's analysis in light of the fact that cumulatively these airports appear to offer a competitive constraint similar in magnitude to Luton, based on:*
>
> - *the CC's catchment analysis (Table 2) which shows regional airports with a greater overlap than Luton (10 versus 9 per cent);*
> - *the CAA's survey evidence (which indicates that 40 per cent of Stansted passenger [sic] have some preference for a non-London airport);*
> - *BAA's survey evidence which shows that 13 per cent of BAA's passengers expressed a second choice of Luton whilst 12 per cent gave a regional airport."*[54]

5.28 The Consultation Document contains no consideration of this issue, which the CAA previously viewed (correctly) as being important to its analysis. This omission must be remedied before the CAA makes a final decision, including by ensuring that non-London airports are included in all aspects of the CAA's assessment.

Capacity

5.29 A core element of the Consultation Document's provisional conclusion that Stansted "is likely to" gain market power in the future is that the London system will begin to suffer from scarce capacity such that Stansted's airline customers will find it difficult to switch aircraft away from Stansted. However, the Consultation Document's treatment of these capacity issues is internally inconsistent, unduly negative, and does not take into account relevant evidence on current and future capacity.

5.30 The issue of capacity constraints is also discussed in Section 9 below. However, we make the following points here.

Current capacity

5.31 There is currently far more unused capacity (and forecast future spare capacity[55]) in the London area than there was in 2007, when the CAA recommended the de-designation of Stansted. This was noted by the CC in its 2011 decision on whether there had been a material change of circumstances following its BAA market investigation decision.[56] The CC stated that it had "*found*

53 Comments on the CC's Working Paper, paragraphs 2.38 to 2.39.
54 Comments on the CC's Working Paper, paragraph 7.7.
55 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/183931/aviation-forecasts.pdf.
56 BAA market investigation, Consideration of possible material changes of circumstances, paragraphs 106 – 113.

that since the 2009 report the scope for competition between airports within existing runway capacity has increased".[57] The Consultation Document does not explain why the scope for competition has reduced significantly, given that the facts point to the opposite conclusion.

5.32 London City airport is almost entirely omitted from the Consultation Document's discussion of spare capacity in London. This is a significant omission, as London City has significant amounts of spare capacity and competes directly against Stansted[58]:

(a) London City would have to increase its ATMs by 34% (24,000 ATMs) to reach the number of ATMs it had in 2008;

(b) if ATMs at London City grew to the 2008 peak and passengers per ATM were maintained at current average, then London City could handle an additional 1 million passengers (assuming terminal capacity is sufficient); and

(c) London City traffic is more concentrated around peak times than other airports but, despite this, its 2012 ATMs in peak morning and evening hours were still 5 slots per hour below its 2009 high point in peak ATMs. This means there is room for around 15% growth in peak hour ATMs to reach the 2009 high point.

5.33 The Consultation Document also fails to consider the ways in which current capacity would be expected to be altered or reallocated to accommodate increased demand from airlines. For example:

(a) The Consultation Document ignores the possibility of re-allocating runway capacity at Gatwick, where small (less profitable) aircraft still use some of the capacity.[59] Gatwick is now using its charging structure to incentivise airlines to use its runway more efficiently, with larger aircraft. Indeed, the CAA itself considered the validity of such a change in charging, as part of an investigation in 2011-2013 of a complaint under section 41 of the Airports Act 1986 about Gatwick's charges. The CAA concluded in January 2013 that Gatwick's charging structure was not unreasonable, that "*[t]o the extent that GAL's policy leads to higher passenger numbers at the airport as intended this is likely to further the reasonable interests of airport users*", and that it "*is likely to promote the efficient, economic and profitable use of the airport*".[60] If the Gatwick price structure revision has the desired effect, then this could make material extra capacity available. If some 40% of slots currently used for domestic flights were switched to European flights (at the average passengers per ATM of each class of flight in 2012) then this would allow Gatwick to serve an additional 1 million passengers per annum, using existing airfield and terminal infrastructure. Indeed, it has recently been reported that Flybe has sold 25 of its Gatwick slots to easyJet, which would allow for greater passenger numbers to be served at Gatwick

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57 BAA market investigation, Provisional consideration of possible material changes of circumstances, March 2011, paragraph 5: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/provisional_decision_final-excised.pdf.

58 The report by Yarrow and Starkie at Annex A considers the issue of business passengers, who represent 17% of Stansted's passengers, for whom London City is an attractive alternative. Clearly, 17% is a large cohort of marginal passengers who potentially could switch to London City, but it is not only business travellers for whom Stansted and London City directly compete – they compete for leisure travellers too.

59 BAA Final Report, Appendix 4.2, paragraph 68.

60 Investigation under Section 41 of the Airports Act 1986 of the structure of airport charges levied by Gatwick Airport Limited – CAA decision 17 January 2013, paragraphs 5.2 and 5.4: http://www.caa.co.uk/docs/5/S41GatwickFlybeDecision.pdf.

using the same number of ATMs as currently.[61] Other airlines, including Ryanair, also bid for the slots.[62]

(b) The Consultation Document also ignores Gatwick's improved runway capacity and therefore the increase in ATMs per hour. At the time of the CC's report, Gatwick reported 50 movements per hour in the peak hour. Now, Gatwick achieves 53 movements in peak times and has plans to achieve 55 movements.[63] If it were to achieve this 4% increase in ATMs, then (at the average passengers per ATM achieved in 2012) this would allow Gatwick to serve an additional 1.3 million passengers per annum. This capacity increment would be additional to the capacity increment from incentivising larger aircraft through changes to the pricing structure, as described in (a) above.

5.34 These changes to the way in which current physical capacity is used could all be achieved in the short term, and could together allow an additional 2.4 million passengers to be served from Gatwick, equivalent to 13% of Stansted's total passenger traffic in 2012. Even if it were to be accepted (which it is not) that Stansted has or may acquire market power in the future, these alterations at Gatwick alone would be sufficient to offset this market power entirely. Even without taking possible alterations at other airports into account, these alterations at Gatwick would enable Stansted's airline customers easily to switch enough capacity away from Stansted (either in the form of based aircraft or passenger capacity), and/or Stansted passengers to switch to Gatwick services, to render a price rise unprofitable.

5.35 Further, the sale of Flybe's Gatwick slots shows that airlines, including LCCs such as easyJet and Ryanair, are willing and able (at the right price) to profitably use slots which do not allow them to operate in the first wave morning peak time, which are not ideally spaced throughout the day, and/or which require the first flight in the day to be inbound. The Flybe slots at Gatwick exhibit these characteristics, yet both easyJet and Ryanair bid for them.

Future capacity

5.36 Moreover, the Consultation Document assumes, without justification, that no infrastructure developments will happen during the Q5 period (for example, Luton's lack of overnight parking stands will not be addressed), or that developments will not be completed in time to offset Stansted's possible future market power. In doing so, the Consultation Document adopts an unduly negative view of future developments. For example, the Consultation Document states at paragraph 5.141:

"*The Initial Views also considered that the tightening capacity constraints might lead to infrastructure development at other London and regional airports which could erode the market position of Stansted. While other London airports, such as Gatwick and Luton, have*

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61 See for example: http://www.telegraph.co.uk/finance/newsbysector/transport/10075367/Flybe-sells-Gatwick-slots-to-easyJet-for-20m.html.

62 See for example Ryanair's investor call, 20 May 2013, in which Michael O'Leary said (at 27 minutes), "*We think Gatwick is a unique situation. We are not particularly small at Gatwick, I think we are the fourth or the fifth largest airline at Gatwick despite the fact that we do not have a base there. The point is, I think what is attractive about Flybe is that they have generally bought arrival slots for their aircraft that are not based at Gatwick... we have 57 bases all over Europe... we can connect Gatwick to a number of our European airports if our offer is successful... We do not have to own slots at Gatwick. If we get them at the price we have offered we will be very happy to take them and I think we would make very profitable use of them...*": http://www.ryanair.com/en/investor/investor-relations-news.

63 Gatwick Masterplan, July 2012, paragraphs 4.2.13 and 4.2.17: http://www.gatwickairport.com/Documents/business_and_community/Gatwick%20master%20plan/2012-07-18-GAL_Masterplan.pdf.

developed plans to expand capacity, these are unlikely either to constitute sufficiently large increases or be completed in sufficient time as to create significant additional constraints on Stansted."

5.37 The Consultation Document therefore fails to consider London airports' announced plans to increase throughput and capacity. This is a significant failure to consider relevant evidence. Stansted's competitors have ambitious plans, including:

(a) Luton Airport's operator has forecast to increase its passenger numbers from 9.5 million passengers per annum (**mppa**) in 2011/12 to 12.9 mppa by 2019, and then to 18 mppa by 2030.[64] The DfT's forecasts state that Luton will reach 14 mppa by 2020.[65] In particular, Luton is planning to invest in a range of physical infrastructure: to increase the effective capacity of the airfield; provide more car parking; increase the number of aircraft parking stands; build a new passenger pier; bring fallow areas of the existing terminal complex into use; and increase the size of the terminal in some areas. It is also planning to enhance the passenger experience within the terminal and to improve surface access connections.

(b) Gatwick is forecast to increase its passenger numbers from 33.8 mppa in 2011/12 to 35.9 mppa in 2018/2019, to 36.6 mppa in 2019/2020, to 38.1 mppa in 2021/2022, and then to 45 mppa by 2030.[66] Similarly, the DfT's forecasts state that Gatwick will reach 37 mppa by 2020.[67] It should be borne in mind that this large increase in passenger capacity is against a backdrop of Gatwick currently utilising some 83% of its potential runway capacity.[68] Gatwick's planned incremental expansion of 2.8 mppa from 2011/12 to 2019/20 is supported by plans to enhance passenger service experience and to improve airline operating efficiency at the airport, rather than through investment in additional airfield capacity.

(c) Southend has plans to grow traffic by 2 mppa by 2020, supported by investment to expand the existing terminal capacity to cater for additional traffic. The DfT's forecasts predict that Southend will likely handle 1.5 mppa by 2020.[69]

(d) Birmingham Airport is currently in the construction phase of an extension of its runway to cater for long-haul traffic. This is due to be operational from 2014. The airport currently operates with 9 mppa. The airport is on record as stating that it already has some spare capacity, and that it plans to double traffic to 18 mppa and in the longer term to have

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[64] Luton Masterplan, September 2012: http://www.london-luton.co.uk/en/content/8/1171/revised-masterplan.html.

[65] DfT UK Aviation Forecasts – January 2013: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/183931/aviation-forecasts.pdf.

[66] Gatwick Revised Business Plan to 2024, January 2013: http://www.gatwickairport.com/Documents/business_and_community/Business%20plan/Gatwick%20ten%20year%20business%20plan.pdf, and Gatwick Masterplan, July 2012, Figure 4.7: http://www.gatwickairport.com/Documents/business_and_community/Gatwick%20master%20plan/2012-07-18-GAL_Masterplan.pdf.

[67] DfT UK Aviation Forecasts – January 2013.

[68] In its January 2013 business plan, Gatwick assumes an ATM cap of 290,000 per annum. ATMs in 2012 were 240,447, which is around 83% of the assumed cap.

[69] DfT UK Aviation Forecasts – January 2013.

capacity for 36 mppa.[70] The DfT's forecasts state that Birmingham will reach 12 mppa by 2020.[71]

(e) London City has applied for planning permission to expand capacity at the airport including infrastructure to allow for larger aircraft and more efficient aircraft movement. In 2011 London City Airport handled 70,000 scheduled aircraft movements and 3 mppa. By 2021 this is expected to increase to just over 100,000 scheduled aircraft movements and 6 mppa.[72] The DfT's forecasts state that London City will reach 5 mppa by 2020.[73]

5.38 In aggregate, these plans represent around 11 mppa of additional capacity in the London region by 2020[74], which represents some 63% of Stansted passenger traffic in 2012. Even if it is accepted (which it is not) that Stansted would otherwise acquire market power by 2020, these plans are sufficient to entirely offset any market power during this timeframe because there is sufficient additional capacity to enable Stansted's airline customers easily to switch sufficient aircraft away from Stansted to render any attempted price rise unprofitable. Further, even on the airlines' economists' own figures, between 0.7 and 1.5 mppa (which are the passengers represented by 2 to 4 aircraft) would need to be switched away from Stansted to constrain a price rise, so it is clear that each of these plans on its own would be sufficient.[75] By failing to consider these highly relevant infrastructure developments, the Consultation Document adopts an unduly negative view of the future. There is therefore no rational basis for a conclusion that Stansted "is likely to" acquire market power.

Incentives to invest

5.39 Even if London capacity is, or will be, scarce (which is not accepted), the Consultation Document seems to ignore the CAA's established (and correct) view that:

> "*... A well-functioning market that involves significant investment in sunk infrastructure will tend to exhibit periods where capacity is relatively unconstrained – with access (slot) prices and airport returns that are relatively low – followed by periods where capacity is more constrained – with access (slot) prices and airport returns that are relatively high.*"[76]

5.40 This issue is addressed in detail by Yarrow and Starkie at Annex A, whose views accord with the CAA's established views:

> "*The [Consultation Document] attaches considerable significance to the existence of capacity constraints at Heathrow, and to the chilling effect this has on competition among London airports. The reasoning is, however, of the do-it-yourself economics kind, and, whilst it is the case that the competition for extra volume might be temporarily more*

70 Birmingham Airport press release, 28 November 2012: http://www.birminghamairport.co.uk/meta/news/2012/11/work-starts-on-birmingham-airports-runway-extension.aspx.

71 DfT UK Aviation Forecasts – January 2013.

72 London City Airport development programme: http://www.londoncityairport.com/aboutandcorporate/page/cadp.

73 DfT UK Aviation Forecasts – January 2013.

74 11 mppa = 3.4 mppa at Luton, 2.8 mppa at Gatwick, 2 mppa at Southend and around 3 mppa at London City.

75 These are the figures given by the CAA is its critical loss analysis at Annex 2 of the Consultation Document. Paragraph 5.24 of the Consultation document also quotes Ryanair's economists as saying that the withdrawal of one based aircraft would result in around 400,000 passengers per annum being lost to Stansted, and easyJet's economists saying that the equivalent figure for easyJet would be 350,000.

76 CAA Initial Submissions, paragraph 20. This view is repeated in many submissions to the CC, including the Q5 review.

intense if all London airports had excess capacity, a moment's reflection will indicate that the concept of a long-run competitive equilibrium is, in fact, difficult to reconcile with persistent excess capacity in a particularly industry or market. Even in the most competitive of markets, capital needs to be scarce some of the time in order to generate positive returns on investments. Capacity constraints cannot, as a matter of general economic principle, be inconsistent with competition in a market. Nor can it be right that, in those periods when capacity constraints do bite, and when some companies might be capable of earning supernormal returns on capital, this be taken as a reasonable reason for imposing price controls. Markets simply cannot operate effectively in such adverse policy conditions" (Annex A, page 39).

5.41 It is not clear from the Consultation Document whether the CAA now considers that its previous view was incorrect, or whether it is simply not addressed in the Consultation Document. The CAA must now consider this issue before making a final decision: it would be irrational now to find that, although Stansted does not have market power now, "is likely to" acquire market within the next six years without considering how the allegedly impending capacity constraints have affected, and will affect, airports' incentives to invest in new infrastructure in the meantime. As the CAA has itself stated:

"*The CAA has also highlighted that a tightening of the supply-demand balance and rising price levels is not necessarily a sign that a market is not functioning in a competitive manner. Indeed, rising prices would provide a signal and incentive to competing airports to expand.*"[77]

Competition within capacity constraints

5.42 Even if London capacity is, or will be, scarce (which is not the case), the CAA has failed to consider whether other types of competition could compensate for the lack of spare capacity pending the necessary investment in new capacity. As the CAA itself has said in its response to the CC's Provisional Findings Report and Notice of Possible Remedies:

"*In summary, there is the potential for competition between airports to take place in many different ways in advance of investment in new runway capacity. Moreover, it should be recognised that any natural capacity constraints could be expected to stimulate – rather than inhibit – the competitive process.*"[78]

5.43 If this statement was correct at a time when BAA owned all three of the large London airports, it would be expected to be even more correct now, given that they are all under different ownership. If it was never correct, or is no longer correct, the CAA should explain why it has changed its view.

5.44 Even at Heathrow, runway slots are available to airlines who wish to pay a market price. For example, slots can be traded or airlines can acquire other airlines (e.g., IAG's acquisition of BMI). At all airports, even if slots are not currently available, airlines will be looking for strategic opportunities to switch to defeat any price rise.

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77 De-designation Advice, paragraph 8.123.

78 CAA's response to CC Provisional Findings Report and Notice of Possible Remedies, September 2008, paragraph 5.12: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/response_pf_caa.pdf.

5.45 In short, the available evidence (which the CAA has not considered) clearly shows that there is sufficient capacity in the London system. However, even if that were not the case, we believe that competition can function effectively within a capacity-constrained system. As highlighted above, this position accords with the CAA's strongly held view during CC's market investigation.

5.46 This issue is discussed in more detail in the report by Yarrow and Starkie at Annex A.

Summary of London capacity analysis

5.47 In summary, the analysis of London capacity contained in the Consultation Document is flawed because:

(a) it is incorrect to say that there is currently insufficient capacity in London to allow Stansted's customers to switch sufficient aircraft to constrain Stansted's prices;

(b) it is incorrect to ignore the significant constraint that can be imposed by reallocating current capacity;

(c) it is incorrect to say that capacity expansion plans at other London airports will not be completed in time to constrain Stansted's prices over the medium to long term;

(d) it is incorrect to ignore airports' incentives to invest in new infrastructure in a well-functioning market when capacity becomes scarce; and

(e) it is incorrect to ignore the possibility of competition between airports even where capacity is scarce.

Spill

5.48 In concluding that Stansted is likely to acquire substantial market power[79], the Consultation Document relies on the CAA's view that traffic will spill to Stansted as demand grows within a capacity constrained London system. However, the Consultation Document does not set out the CAA's own traffic forecasts for Stansted to support this position or the CAA's analysis of the quantum of passenger traffic that it expects to spill to Stansted over the period to 2019.

5.49 As a result, the view set out in the Consultation Document that sufficient traffic will spill to Stansted is nothing more than speculation about what might happen over this period. The lack of evidence and analysis makes it almost impossible for interested parties to penetrate the reasoning and conclusions set out in the Consultation Document, or to provide an intelligent response to the consultation.

5.50 On such a significant issue – one that is critical to support the provisional conclusion that Stansted is likely to acquire market power in the period to 2019 – this approach is completely inadequate.

5.51 The Consultation Document does not even set out the CAA's reasoning as to why traffic spilling to Stansted from other London airports should be the source of the airport's market power. In our view, Stansted's success in attracting passengers and airlines away from other London airports in the period to 2019 will be the product of competition, not market power. As we set

79 Consultation Document, paragraphs 5.130 to 5.141.

out in Part I above, attracting passengers and airlines will require us to offer lower prices and better service.

5.52 Stansted's traffic forecasts show a small difference between the level of demand when Heathrow and Gatwick are capacity constrained, and the level of demand when no capacity constraints are applied. This suggests that the level of traffic spilling to Stansted as a result of capacity constraints at other airports is not likely to be significant.

5.53 The Consultation Document seems to suggest that Stansted's traffic forecasts deliberately understate the likely scale of traffic that will spill to the airport over the period to 2019, and that the real amount of spill will be greater (without providing any indication of what this is likely to be). We disagree with the CAA's critique of Stansted's traffic forecasts. We would also draw attention to the fact that the Stansted traffic forecasts referred to in the Consultation Document were based on important assumptions (provided to the CAA) about significant discounts that would be offered to stimulate growth. Put another way, the level of likely growth projected to 2019 depends on the level of discounts; if average charges remained in real terms the level of growth would be significantly lower.

5.54 However, having made this suggestion, the Consultation Document does not then set out the CAA's own view. The CAA's views on this critical issue are based on an un-evidenced assertion that Stansted's forecasts are not right, rather than putting forward its own positive view of how the market will develop over the next six years. The weakness in the Consultation Document approach is clear and must be rectified.

5.55 To address the weakness in the Consultation Document's approach, it will be necessary for the CAA to develop and consult on its own traffic forecasts so that it is in a position to evidence its views on spill in the period to 2019. These forecasts would need to reflect the CAA's more recent views, set out in the Initial Proposals, that the level of uncertainty in the key building blocks, particularly traffic forecasts, is too great to be able to follow a building blocks approach to setting a price cap.

5.56 Since the publication of the Consultation Document, the DfT has published its new long term forecasts for the UK for the period to 2050. These forecasts are broadly in line with Stansted's previous traffic forecasts, and show traffic growing to 25 million passengers a year by 2020 (compared with 23.3 mppa for 2018/2019 in Stansted's January 2013 Business Plan). The DfT's forecasts show the level of traffic at Stansted would be 2 million passengers a year lower by 2020 if Heathrow and Gatwick did not face capacity constraints.

5.57 In other words, the DfT forecasts are consistent with Stansted's traffic forecasts in projecting a low level of spill in the period to 2020. The level of spill to Stansted is clearly insufficient to be considered as the source of the airport's substantial market power. To sustain its provisional conclusion, the CAA will need to set out why it held a different view to Stansted and the DfT on the prospects for Stansted to benefit from capacity constraints at other London airports.

5.58 On such a critical issue – one that has effectively determined the CAA's thinking on Test A – it is important that the CAA shows how the impact of uncertainty has been taken into account in the development of its traffic forecasts and its projections of spill in the period to 2019. As identified above, the CAA has recently acknowledged that there is a high degree of uncertainty around traffic forecasts for Stansted and it has not produced its own traffic forecasts the Q6 period.

5.59 The CAA should have regard to the accuracy of Stansted traffic forecasts that have been produced in the past, particularly in connection with past regulatory reviews. For example, the CAA's Q5 traffic forecasts projected that Stansted would be handling 27 mppa in 2013/14, compared with current traffic levels of 17 mppa. It should also have regard to its own traffic projections for Heathrow and Gatwick that have been developed in connection with the Q6 price control reviews.

5.60 Even if it could be shown that there are some scenarios where Stansted will benefit from significant amounts of additional traffic in the period to 2019, the CAA will need to demonstrate that:

(a) given the range of potential outcomes, it is more likely than not that significant amounts of additional traffic will materialise at Stansted in this period;

(b) the additional traffic is the direct result of capacity constraints at other airports, and not the competitive behaviour of Stansted.

5.61 Setting aside the fact that the Consultation Document does not establish the economic connection between growth, spill and market power, our view is that the most the CAA could conclude is that it is possible that Stansted could benefit from capacity constraints at other London airport over the period to 2019. On this basis, it is not possible to sustain an argument that it is likely that Stansted will acquire substantial market power, and Test A is not met.

5.62 Furthermore, the issue of spill is discussed in the Consultation Document as a way in which Stansted will attract airline customers from other London airports that will be capacity-constrained in the future. Forecasts of 'spill' are (incorrectly) adduced as evidence that there will indeed be capacity constraints, and that airline customers who value slots at London airports will therefore be increasingly tied to Stansted (see paragraphs 5.130 to 5.141 of the Consultation Document).

5.63 However, as there is sufficient spare capacity in the London area now and for the foreseeable future, it is incorrect to label any customers won by Stansted from the other London airports as mere 'spill'. The Consultation Document disregards the dynamic and competitive nature of attracting aircraft to Stansted. The description of spill and Stansted's behaviour given in the Consultation Document creates the impression of a passive process. In fact, spill is about persuading passengers and airlines to alter their decisions about which airports they use. It is part of the competitive process and, following M.A.G's acquisition of Stansted, it can be expected to increase.

5.64 The Consultation Document's assessment of spill in this regard reveals an inconsistency in reasoning. It is argued that Heathrow and Gatwick are not part of the same relevant market as Stansted, but the Consultation Document then proceeds to take these airports into account when assessing spill. To attract spill away from Heathrow and Gatwick, Stansted must be offering the same product and be operating within the same geographic market. In paragraph 5.130 of the Consultation Document, the CAA states:

> "*In addition to traffic recovery from improving macroeconomic conditions, "flat real" charges and discount-led growth, and increasing relative charges at Heathrow and Gatwick, STAL says in its October 2012 Information Memorandum that Stansted is expected to benefit from the growing capacity constraints at other London airports, in particular at Heathrow and Gatwick.*"

5.65 A more balanced approach would be to use this evidence to show that Stansted competes vigorously against two of its stronger competitors on price, amongst other things.[80] Instead, the Consultation Document takes the contrary position and adduces it as purported evidence of Stansted's market power. This, of itself, suggests an unbalanced and inconsistent approach to the assessment of the available evidence.

Airline route overlap decisions

5.66 The Consultation Document states that "*it is important to consider airlines' decisions on route planning*".[81] The CAA therefore discusses (at paragraphs 4.86 to 4.92 of the Consultation Document) to what extent the same routes are served by an airline at selected UK airports, and uses this information to speculate as to whether the airports are close substitutes from the airline's point of view. However, as Yarrow and Starkie state in Annex A: "*the analysis of overlaps is superficial and based on a cherry-picking approach to the economics*" (page 11).

5.67 The airlines themselves do not appear to have been asked about the basis for their decisions, even though this data is relied upon to demonstrate that (according to the Consultation Document) Gatwick and Heathrow do not compete with Stansted.

5.68 The central untested assertion on which the analysis contained in the Consultation Document is based is that there is greater route overlap at airports that are not substitutable. This is not necessarily the case and, even if the data shows what the Consultation Document suggests it shows, the CAA has failed to assess alternative explanations such as:

(a) strategic behaviour by airlines in a market with few players and high concentration, whereby it is economically rational to put rivals at a disadvantage by operating overlapping routes from different airports precisely because the two airports are good substitutes;

(b) the fact that demand around London for travel to certain destinations is large enough to support services from multiple airports, with all airports serving demand to/from central London and individual airports focusing on serving more local demand that originates closest to them; and

(c) the possibility that the route overlaps are more apparent than real because the flights could be taking place at different times of day or on different days (for example, Ryanair has many routes that it operates 2, 3 or 4 times per week).

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80 A balanced discussion of the Information Memorandum would also point out that it cites the expansion of LCCs in Southern Europe as a contributory factor in Stansted's reduction in passenger numbers in recent years, thus suggesting a Europe-wide market: Information Memorandum, page 11.

81 Consultation Document, paragraph 4.86.

5.69 Clearly airports to the north of London are better placed to serve demand that originates from areas north of London, just as airports to the south are better placed to serve demand that originates from that area. This simple logic cannot then be used to justify a conclusion that these airports operate in different geographic markets. This is particularly true when a high proportion of passenger journeys have central London as their origin or destination. For example, analysis of CAA passenger data would show that a high proportion of passengers using Gatwick and Stansted either start or end their journey in places that have broadly similar travel times to both airports.

5.70 Table 4.1 of the Consultation Document shows that Ryanair has fewer routes that overlap with Stansted at Luton than at Gatwick (although the sample sizes are relatively small). Even on the logic adopted in the Consultation Document, this merely shows that Luton is a closer substitute for Stansted than Gatwick. It is not determinative of whether Gatwick is or is not in the same geographic market as Stansted. Clearly, it is not the case that, for competitors to be included in the same relevant market, they must exercise an identical degree of constraint on each other.

5.71 The Consultation Document appears to show that this data has been used selectively and inconsistently to support a particular view. For example, the data shows that there is a 79% overlap between easyJet's routes at Gatwick and Stansted, whereas there is a 74% overlap between Ryanair's routes at Luton and Stansted. Luton is regarded as substitutable by the CAA, whereas Gatwick is not. The Consultation Document does not explain why the apparently similar levels of substitutability are not adduced as evidence that all three airports operate in the same geographic market.

5.72 Furthermore, the Consultation Document is not internally consistent on the subject of route overlaps. For example, Table 5.3 shows that 33% of Stansted's routes are available at Heathrow, whereas 42% of its routes are available at Luton and 65% of its routes are available at Gatwick. On the logic adopted by the Consultation Document, this should mean that Heathrow is a closer competitor to Stansted than Luton and Gatwick, and Luton is a closer competitor than Gatwick. Only 16% of Stansted's routes are available at London City – on this logic, this would provide evidence that London City is Stansted's closest competitor.

5.73 These issues are considered in more detail in Yarrow and Starkie's report at Annex A.

Catchment areas

5.74 The Consultation Document adduces evidence of airports' catchment areas as a means to estimate from where airports' outbound passengers tend to originate. The Consultation Document states that the extent to which catchment areas overlap provides evidence of the potential for competition between airports (paragraph 4.97 of the Consultation Document).

5.75 However, the passenger catchment area analysis does not directly answer the question of whether airlines would switch sufficient marginal routes away from Stansted in response to a 5-10% price rise so as to render the price rise unprofitable.

5.76 This type of analysis is frequently employed in merger investigations by the OFT and CC, who explain the use of catchment areas as follows:

> *"Catchment areas are a pragmatic approximation for a candidate market to which the hypothetical monopolist test can be applied; the use of catchment areas is not an alternative*

conceptual approach. However, the geographical market identified using the hypothetical monopolist test will typically be wider than a catchment area."[82]

5.77 In any case, the OFT and CC use catchment areas (which are said to be typically narrower than the true geographic market) based on the area within which 80% of customers are located. For Stansted, this gives a 90 minute travel time as the relevant catchment area. This travel time means that all other London airports are within Stansted's catchment area.[83] It also means that the catchment areas of East Midlands and Birmingham overlap materially with Stansted's catchment area.[84] Referencing 60 minute travel times (e.g., paragraph 4.104 of the Consultation Document) is irrelevant, and only applies to a segment of passengers against whom Stansted cannot discriminate (an issue ignored in the Consultation Document).

5.78 Further, a catchment area analysis ignores those passengers for whom Stansted is the destination rather than the point of origin for their journeys. For inbound (overseas) passengers destined for London, which represent around 42% of Stansted passengers, it is the distance between the airport and central London that matters, not the distance from their home to the airport. This important issue tends to increase the extent to which the London airports compete with each other, but there is no analysis of this issue in the Consultation Document. This issue is addressed in detail in the report by Yarrow and Starkie at Annex A.

5.79 Nevertheless, even if the validity of a catchment area analysis is accepted, the analysis contained in the Consultation Document is superficial. The analysis wholly excludes any discussion of London City or Southend airports, both of which are important constraints on Stansted. It also seems to ignore the much more extensive analysis undertaken by the CAA in 2011, which shows significantly longer travel distances to Stansted.[85] This more detailed working paper shows, for example, that 20% of UK business passengers travel more than 120 minutes to the airport. As explained by Yarrow and Starkie in Annex A, the Consultation Document does not discuss important differences between types of passenger, such as business and leisure passengers, and inbound and outbound passengers, resulting in average figures that fail to reveal the precise nature of competition.

5.80 The discussion of catchment areas in the Consultation Document (paragraphs 4.97 *et seq*) is also infected by a fundamental flaw. The Consultation Document seems to focus on the average or typical passenger (i.e., the majority of customers) and fails to take into account of the marginal passenger (note that there is a significant margin of 20% of Stansted's customers who travel more than 90 minutes). As stated by Yarrow and Starkie in Annex A:

> "*Here the CAA again fails to recognise the significance of substitution at the margin for the analysis of market power. The attention is focused on average or typical passengers, but it is not their decisions that are the most relevant/important for assessment of market definition*" (Annex A, page 12).

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82 Paragraph 5.2.25 of the OFT/CC Merger Assessment Guidelines: http://www.oft.gov.uk/shared_oft/mergers/642749/OFT1254.pdf.

83 From Stansted, Gatwick is 68 minutes' drive, Luton is 59 minutes' drive, and Heathrow is 69 minutes' drive (according to Google Maps).

84 From Stansted, East Midlands is 127 minutes' drive and Birmingham is 121 minutes' drive (according to Google Maps).

85 CAA Catchment Area Analysis Working Paper, October 2011: http://www.caa.co.uk/docs/5/Catchment%20area%20analysis%20working%20paper%20-%20FINAL.pdf.

5.81 As stated above, marginal passengers are the most important type of passenger for a competition assessment because they are most likely to switch and therefore drive competition. The CAA must assess competition at the margins before reaching a final decision, because in any market there will be some customers who are reluctant to switch supplier even if the price rises significantly. The Initial Views document reflected a clear understanding of this point; it is not clear why this understanding does not feature in the Consultation Document.[86]

5.82 The repeated misunderstanding of this issue has resulted in evidence that shows passengers exercising choice at the margins being disregarded. For example, paragraph 4.101 of the Consultation Document indicates that passengers are less willing to make longer drives to Stansted when the same flight destination can be reached from other London airports. We are therefore concerned that other evidence showing similar marginal switching by passengers may have been omitted altogether from the Consultation Document because there has been a misunderstanding as to the correct question to ask. Given the information available to us, we are not in a position to determine which such further relevant evidence has indeed been disregarded.

5.83 It should also be noted that the catchment area analysis set out in the Consultation Document focuses on a time when the three London airports were in common ownership, and it is therefore based on historic traffic patterns that may no longer be relevant. In particular, one would expect Stansted under new ownership, separate from each of Heathrow and Gatwick (which itself was divested by BAA in 2009) to face significantly stronger commercial pressures than in the past to seek to expand its catchment area. Historic patterns of catchments under BAA's ownership of the three largest London airports are not therefore a good guide to the future. It is disappointing that this point is not mentioned in the Consultation Document, and reflects an inconsistency of approach. This is particularly true given that the provisional conclusion that Stansted is likely to acquire market power is based on unduly negative speculation about how competition may look in six years' time.

5.84 These issues are considered in more detail in Yarrow and Starkie's report at Annex A.

Prices faced by passengers

5.85 The discussion in the Consultation Document of the average prices faced by passengers (paragraphs 4.106 to 4.108) is presented as evidence that Heathrow, London City and, to a lesser extent, Gatwick belong outside the relevant market because their airline customers charge higher average fares to passengers.

5.86 This discussion is both irrelevant, because it reveals nothing about whether Heathrow and Gatwick exert a competitive constraint on Stansted's pricing for airlines, and flawed, because it focuses on differences in average price levels rather than the reactions of marginal passengers to changes in relative price levels.

5.87 As Yarrow and Starkie state in Annex A:

> "*The argument made in the [Consultation Document] therefore reflects yet another basic misunderstanding of the assessment required, which concerns the degree of substitutability.*

[86] See for example Initial Views, Executive Summary, paragraph 31: "*to render a 5 to 10 per cent price rise unprofitable the airport would need to experience a fall in passenger numbers of between 3 and 11 per cent.*"

The relevant questions to ask concern the reactions of passengers and airlines to changes in relative prices, not to differences in price levels" (Annex A, page 14).

5.88 The discussion of this issue in the Consultation Document suggests that the offerings of airports differ along a quality spectrum, but it does not address whether the higher and lower quality offerings exert a competitive constraint on each other and therefore belong in the same relevant market.

5.89 The treatment of average short haul fares is also inconsistent with the product market definition provisionally adopted, which (incorrectly) is that non-LCC short haul flights exercise little competition constraint on LCC short haul flights (see Section 6 below). In order to be internally consistent, if a discussion of different price levels for passengers at different airports is considered relevant, the analysis contained in the Consultation Document ought therefore to exclude non-LCC fares.

5.90 This Section shows again the inadequate approach to the evidence. The analysis appears to have been presented with the sole aim of supporting assertions that Heathrow, London City and, to a lesser extent, Gatwick do not compete with Stansted. If similar average price levels in the downstream passenger market are truly an indicator of competition between airports, then the evidence set out in the Consultation Document should not have been limited to those airports that support the CAA's view. The CAA should have presented evidence relating to other UK airports such as Birmingham and East Midlands, and other European airports, in order to investigate the boundaries of Stansted's competition.

5.91 These issues are considered in more detail in Yarrow and Starkie's report at Annex A.

6 Product market definition

6.1 The definition of the product market in the Consultation Document frames the assessment of the competitive constraints faced by Stansted. It is therefore essential to approach the issue in a detailed and balanced way. In particular, if constraints are wrongly omitted from the assessment of the relevant product market, this will overstate Stansted's position.

Competition authority precedent

6.2 In its final report following its BAA market investigation, the CC concluded that there are two product markets relevant to airports – commercial services and aeronautical services.

6.3 In its final report, the CC defined aeronautical services as "*the provision of airport infrastructure*" and *"the coordination and control of the activities performed on or in airport infrastructure and the provision of associated services including security."*[87]

6.4 In that final report, the CC decided that "*there is a single product market for all services covered by airport charges*", on the basis that there are significant interdependencies between demand for primary services such as landing, and secondary services such as passenger handling, and that the prices of the secondary services are constrained by their interaction with primary services.[88] The CC also included aeronautical services not included in BAA's airport charges (such as check-in desk rental) in this market, on the basis these charges also affect the demand of an airline for an airport.[89]

6.5 The CC therefore concluded as follows: "*Accordingly, we see no reason to define separate markets for the aeronautical product according to user or type of use.*"[90]

6.6 It is therefore clear that the CC, following a detailed investigation, found no reason to segment the market as regards:

(a) passenger airlines and cargo operators[91];

(b) short haul and long haul; or

(c) airline business models (e.g., LCC and non-LCC).

6.7 Our firm view is that the CC's approach to product market definition was, and remains, correct. There is no reasonable basis for an alternative view.

6.8 The CC's approach is consistent with that of other competition authorities. The UK and EU authorities have consistently found that LCCs and other airlines are directly substitutable.[92] For example, the European Commission, in its *Ryanair/Aer Lingus decision*, stated: "*For the purpose of*

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87 BAA Final Report, paragraph 2.13. See also Appendix 1.1 to the BAA Final Report.

88 BAA Final Report, paragraphs 2.16 – 2.17.

89 BAA Final Report, paragraph 2.18.

90 BAA Final Report, paragraph 2.24.

91 Although the cargo segment of the aeronautical market is considered below (see Section 11), that should not be taken to mean that we believe it should be analysed separately from aeronautical products for other customers.

92 For EU cases, see for example COMP/M.4439 *Ryanair/Aer Lingus*, COMP/M.5747 *Iberia/British Airways*, COMP/M.6447 *IAG/BMI*. In the UK, see paragraph 84 of the OFT's 2012 decision in *Ryanair/Aer Lingus*: http://www.oft.gov.uk/shared_oft/mergers_ea02/2012/Ryanair.pdf.

the assessment of the proposed transaction it is not appropriate to define separate markets according to the type of airline operations or the level of service offered."[93]

6.9 The CC's approach is also consistent with the CAA's recent guidance on market power, which notes that traditional distinctions between 'no-frills' and full service airlines are becoming blurred.[94] This guidance document reflects the CAA's established view, which was described to the CC in the CAA's initial submission to the BAA market investigation as follows:

> "*The airline market is dynamic and has seen significant evolution in terms of airline business models and route networks over the last decade, notably with the emergence of no-frills carriers. However, there has also been some significant blurring in the traditional distinctions between the new entrant "no-frills" and incumbent airlines and between scheduled point-to-point and charter operations. For example, BA has recently adopted a "no-frills" fares structure on its short-haul routes, whilst easyJet now offers a number of services (for example, fixed price flexible fares, optional business lounges, flexible departure times, priority boarding etc) including, on certain routes, high frequencies and departure schedules that are designed to appeal to business traffic more usually associated with full-service incumbents. A number of charter carriers have also adapted their business models and now sell tickets on a "seat only" basis. More recently, long-haul point-to-point dedicated business carriers have entered the market at Luton and Stansted serving a segment of passengers previously the domain of formal network businesses.*"[95]

6.10 Competition authorities have therefore treated this issue with coherence and consistency over a long period of time.

The Consultation Document

6.11 By contrast, the analysis in the Consultation Document adopts a new approach that is inconsistent with previous analyses. This approach leads the Consultation Document to define markets that are significantly narrower than previous decisions. In particular, the Consultation Document defines the following two relevant product markets:

(a) aeronautical services for LCCs; and

(b) aeronautical services for cargo-only airlines.

6.12 The Consultation Document correctly identifies the need to define one or more relevant product or service markets. However, this is not achieved in practice because the Consultation Document does not define a specific product or service relevant to <u>Stansted</u>. Instead, it defines unprecedented narrowly defined product markets by reference to Stansted's <u>customers'</u> products and business models (cargo and passenger). The markets defined in the Consultation Document are therefore at a different level of the supply chain to the level at which Stansted operates. This is another fundamental flaw in the Consultation Document, which invalidates its conclusions. Its effects can be seen throughout the reasoning contained in the Consultation Document. For example, in the discussion of catchment areas, passenger switching, and the

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93 COMP/M.4439 *Ryanair/Aer Lingus*, paragraph 51.

94 CAA, Guidance on the assessment of airport market power, April 2011, paragraphs 3.39 – 3.41: http://www.caa.co.uk/docs/5/Final%20Competition%20Assessment%20Guidelines%20-%20FINAL.pdf.

95 CAA Initial Submissions, paragraph 2.18: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/third_party_submission_caa.pdf.

prices faced by passengers, the Consultation Document focuses on passengers' expected reactions rather than Stansted's airline customers' reactions, without explaining how the reactions of passengers are linked to the upstream market.

6.13 The flaw is so entrenched in the Consultation Document that it affects the treatment of third party evidence. For example, at paragraph 4.69, the Consultation Document notes evidence of Ryanair switching aircraft between a number of UK airports, which is direct evidence of Ryanair being willing and able to switch aircraft between airports. It suggests the geographic market is at least UK wide. Yet Ryanair's assertion that "*these airports served different markets to Stansted*" is uncritically accepted. This is, of course, true for passengers – for a passenger wishing to fly from (for example) Edinburgh to Milan, a flight from London to Milan is not likely to be a particularly close substitute. However, downstream passenger markets are not relevant to the CAA's current task in this context.

Length of passenger journey and airline business model

6.14 The Consultation Document (at paragraphs 4.19 to 4.44) segments the short-haul LCCs from other types of airlines based on manifest errors of analysis. The Consultation Document fails to define the product market in terms of the product being offered by Stansted, and arbitrary distinctions are made between airline business models without addressing the relevant questions and without any quantitative analysis of the reactions of marginal customers to small but significant price rises.

6.15 The Consultation Document draws a distinction between short-haul and long-haul without recognising that there is a continuum of routes of different distances. The Consultation Document dismisses Stansted's long-haul capability on the ground that there is a "perception" (at least by the anonymous airline quoted in paragraph 4.38 of the Consultation Document) that it is a short-haul airport.[96] There is no attempt to define the term "short-haul" – or indeed to explain in which category medium-haul flights are included. There is no established definition of these terms (although the UK Government charges Air Passenger Duty according to four categories of flight).[97] The Consultation Document makes no attempt to assess, for example, to what extent an increase of price of 5-10% of the price offered by Stansted to airlines flying (for example) a 1,900 mile route would result in airlines switching to (for example) 2,100 mile routes instead. This is the question that would need to be addressed and quantified if the CAA wished to segment the upstream market for airport services in relation to route length.

6.16 The Consultation Document also draws a distinction between the LCCs and other short haul airlines. Without attempting any quantitative analysis, the CAA has therefore assumed (for example) that an easyJet flight from London to Milan does not compete with a British Airways flight from London to Milan. In addition to being at odds with UK and EU precedent on the issue, this distinction between LCCs and other short haul airlines is not recognised by the airlines themselves. For example:

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96 See the report by Case Associates at Annex D for more detail on this issue.

97 Band A (0-2000 miles), Band B (2001-4000 miles), Band C (4001-6000) miles and Band D (6001 miles and over).

(a) easyJet clearly regards itself as competing against a wide range of other airlines in a European short haul market, not just a low cost market;[98]

(b) easyJet and Ryanair have introduced service-related enhancements to their products in recent years to improve their positioning with respect to full service carriers (e.g., priority boarding, allocated seating and corporate sales);

(c) many full service carriers have introduced innovations in recent years to bring their service on short haul routes closer to that offered by LCCs;

(d) Ryanair argued to the OFT as part of the Ryanair/Aer Lingus merger case that all short haul airlines, including LCCs and charter airlines, belong to the same product market;[99] and

(e) Ryanair consistently identifies a wide range of full service 'flag carriers' as potential targets for taking market share in the short haul market.

6.17 The Consultation Document notes that there are some differences in the services required by short haul and long haul carriers, and also by LCCs and non-LCC airlines. However, there is no attempt to quantify these differences. Clearly, there is some product differentiation in most product markets, but without some quantitative analysis of the reaction of marginal customers to a price rise it is not possible to state where the boundaries of the market should be drawn. As Yarrow and Starkie state in Annex A:

> "*The fact of product or service differentiation is very far from sufficient to establish the existence of different markets, and it is a major error to suggest otherwise*" (Annex A, page 4)

6.18 The CAA ought to have asked itself whether or not Stansted is able to charge higher prices for short haul LCCs than for other users. Although some relevant evidence is cited, there is no rational assessment of this question.

6.19 The Consultation Document is also inconsistent on the issue – for example, in paragraph 5.31, third bullet, the fact that the NAPALM model treats LCC and full service flights as not being substitutable is listed as a failing of the model. As with much of the Consultation Document, the conclusions are at odds with the CAA's previous views, without reasons having been given for the change of view.

6.20 The Consultation Document's very limited analysis of this issue is also evident in its brief discussion of supply-side substitutability. The Consultation Document notes that Stansted could offer long haul services (paragraph 4.41), which places Stansted in the same product market as Heathrow and Gatwick. The fact that Stansted does not have long haul services is evidence that it faces strong competition for these from Heathrow and Gatwick; it does not show that these airports currently belong in different product markets. Likewise, the Consultation Document does not consider the possibility that BAA strategic policies did not encourage the airports to compete fully for long haul services (something that the CC considered would occur under separate ownership). As Yarrow and Starkie state in Annex A:

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[98] See for example slides 20 and 25 of this recent investor presentation in February 2013: http://corporate.easyjet.com/~/media/Files/E/Easyjet-Plc-V2/pdf/investors/results-centre/2013/investor-presentation-march-2013.pdf.

[99] See paragraph 85 of the OFT's decision: http://www.oft.gov.uk/shared_oft/mergers_ea02/2012/Ryanair.pdf.

> "*The CAA appears to believe that the assessment should only take account of supply side substitutability at airports other than Stansted. This is an error*" (Annex A, page 8).

6.21 Perhaps the most important consequence of the inadequate product market definition is that Heathrow, and to a lesser extent Gatwick, are automatically found to be essentially outside the market in which Stansted operates. This flaw therefore has wide ranging effects throughout the Consultation Document, particularly because the analysis of capacity and switching fails to take account of constraints from outside this (narrowly defined) market.

6.22 The treatment in the Consultation Document of the product and geographic markets means that the errors are compounded to form an extremely narrow frame of reference – covering only LCCs in north London.

6.23 These issues are considered in more detail in Yarrow and Starkie's report at Annex A.

7 Multi-sided nature of Stansted's business

7.1 The issue of whether Stansted is a multi-sided business is important because it is directly relevant to our incentives to raise aeronautical charges. If commercial revenues are important to Stansted (which they are), then we have the incentive to make the airport attractive to passengers in order to increase passenger numbers. It would tend to reduce our incentives to raise aeronautical charges to airlines, and would therefore reduce the extent to which the airport may have market power. The Consultation Document dismisses this consideration.

The importance of commercial revenues

7.2 The Consultation Document's treatment of the multi-sided nature of Stansted's business shows a fundamental misunderstanding of Stansted's business. Stansted's non-aeronautical revenues are central to its business model. They represented 44% per cent of revenues in 2012.

7.3 This misunderstanding leads the Consultation Document to depart from the CAA's current position on the issue. The multi-sided nature of airports forms the basis of the CAA's consistent policy of single till regulation. This is reflected in the CAA's most recent statements. See, for example, its Q6 initial proposals for Heathrow:

> "*The CAA continues to consider that the single till approach remains appropriate for HAL. This replicates what is commonly seen in competitive airport markets. It derives a net revenue requirement from airport charges after deducting a contribution from commercial revenues and other charges.*"[100]

7.4 As the CAA's established position acknowledges, it is not possible to assess Stansted's business without taking fully into account the relationship between its aeronautical activities and its non-aeronautical activities (such as retail concessions, car parking, advertising and property). Non-aeronautical revenues are fundamental to Stansted's negotiations with airlines, just as the number of passengers passing through the terminal is fundamental to Stansted's negotiations with retailers. A full and balanced assessment of the multi-sided nature of Stansted's business leads to the conclusion that any market power that Stansted may otherwise have (or might acquire) as regards its airline customers is negated by the potential loss of revenues associated with a fall in passenger volumes.

7.5 Stansted is currently operating at around 61% of its capacity. The 17.4 million passengers served by Stansted in 2012 is around 6.3 million passengers fewer than were served in 2007. This has had a significant effect on Stansted's commercial revenues, and M.A.G will be seeking to remedy this position as quickly as possible.

Starkie and Yarrow criteria

7.6 In its brief discussion of Stansted's commercial revenues, the Consultation Document misapplies the Starkie and Yarrow criteria for a multi-sided market (paragraph 4.7 of the Consultation Document). The CAA seems to have accepted Starkie and Yarrow's analytical framework, which was commissioned by the CAA, but has misdirected itself in its application. Annex A contains a

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100 CAA, Economic regulation at Heathrow from April 2014: initial proposals, paragraph 26: http://www.caa.co.uk/docs/33/CAP%201027%20Economic%20regulation%20at%20Heathrow%20from%20April%202014%20initial%20proposals.pdf.

report by Yarrow and Starkie which sets out these issues in detail. Their view is that the Consultation Document:

(a) asks itself, and answers, the wrong questions in considering whether the number of airline services developed by Ryanair and easyJet made Stansted more attractive to other airlines (rather than passengers) and whether Stansted approaches passengers and airlines as two separate user groups (paragraphs 4.9 and 4.10 of the Consultation Document);

(b) fails to ask, and answer, relevant questions regarding the influence that non-aeronautical revenues has on aeronautical pricing decisions (and *vice versa*);

(c) misunderstands the meaning of “network effects” in this context (paragraph 4.9 of the Consultation Document), which should refer to demand interdependencies between the aeronautical and non-aeronautical side of Stansted’s business;

(d) misunderstands the issue of complementarities between aeronautical and non-aeronautical revenues (paragraph 4.12 of the Consultation Document), despite this being a core issue of the Starkie and Yarrow paper;

(e) introduces irrelevant considerations such as an alleged lack of direct marketing activity (paragraph 4.10 of the Consultation Document), which fails to understand that marketing can also be indirect;

(f) acknowledges that demand interdependencies exist at competitive airports (footnote 89 of the Consultation Document), but fails to understand that they must therefore also exist at unregulated airports with market power; and

(g) argues that the demand interdependencies are of limited influence despite their being implicit in the whole notion of the CAA’s single-till approach to airport regulation. If the 'minded to' position were to be adopted by the CAA, its continued use of the single-till approach to regulation would therefore be inconsistent and irrational.

7.7 In summary, Yarrow and Starkie state:

> "*What appears to have happened is that the CAA, whilst accepting the relevant analytic framework, completely misdirected itself in its applications, and this has happened because of a quite fundamental failure to understand that analytic framework (notwithstanding that that framework has informed its own guidelines on competition assessment)*" (Annex A, page 24).

7.8 The claim made in the Consultation Document is that the CAA has seen no indication that Stansted considered the impact on its commercial operations of an increase in aeronautical charges (paragraph 4.13, first bullet), which is adduced as evidence that Stansted did not consider it. This does not reflect commercial or economic reality. As Case Associates state in their report at Annex D:

> "*It simply cannot be maintained that there is no inter-dependence between commercial revenue and passengers’ numbers. Non-aeronautical revenue represents 44% of Stansted’s total revenue. Given its magnitude, it is inconceivable on any rational basis that this could be ignored by the airport, or how it would not influence the profitability of a price increase, notwithstanding other factors will have at times a greater impact on Stansted’s pricing decisions, e.g. when its prices are well below costs*" (Annex D, page 28).

7.9 Indeed, the Consultation Document's analysis of Stansted's profitability shows how implausible this proposition is. The Consultation Document notes at paragraph 6.23 that declines in retail and car parking revenue as a result of the drop in passenger numbers contributed to a drop in Stansted's EBITDA. Given M.A.G's stated plans to increase commercial revenues by investing in a transformation of the terminal building, any prospective analysis on this issue must acknowledge the influence of commercial revenues on the setting of prices for aeronautical services.

7.10 In addition, the discussion contained in the Consultation Document includes illogical statements, such as the suggestion that a flat concession fee paid by retailers to Stansted bears no relation to the number of potential customers (paragraph 4.13 of the Consultation Document, second bullet). In reality, the number of potential customers is the single most important factor in setting this concession fee.

The development of Stansted's commercial revenues

7.11 It is notable that the Consultation Document speculates about the future on the issue of London airport capacity (which it assesses to Stansted's detriment because it finds that capacity may become scarce by 2019), but does not consider how the commercial side of our business will evolve over a much shorter time period (for example, the next couple of years). This mismatch must be remedied before a final decision is made.

7.12 We have ambitious plans to increase the commercial side of Stansted's business, [redacted] See, for example, the consultation document which we sent to airlines to set out our proposals for Terminal Transformation at Annex F. We intend to increase the airside retail area of Stansted from the current 5,980 square metres to 10,660 square metres by 2015. These changes will cost in the region of £40 million. Our consultation document states that one of the aims of the changes is to increase retail yield per passenger (see page 19 of Annex F), and it also states that the cost of the changes will not need to be funded through higher airport charges paid by airlines of passengers, whatever the regulatory framework that applies to Stansted in the future (see Annex F, page 22). It is clear that these changes (in addition to other changes proposed) will have a significant impact on our incentives to increase passenger numbers and therefore limit spare capacity, thus reducing our incentives to increase aeronautical charges.

7.13 It is also notable, in this context, that the Consultation Document refers to Ryanair's 'one bag rule' as resulting in suppressed demand for non-aeronautical services at Stansted (paragraph 4.13 of the Consultation Document, third bullet). [redacted]

8 Airline buyer power

8.1 The issue of buyer power is important. If Stansted's customers have bargaining strength, that would tend to reduce any market power that Stansted could be regarded as having. As the CAA is aware, Ryanair and easyJet currently represent around 90% of Stansted's business. As a result, any analysis of buyer power at Stansted will naturally focus on these two customers.

8.2 The issue of buyer power is considered in more detail in the report by Yarrow and Starkie at Annex A.

The Consultation Document

8.3 The Consultation Document concludes that easyJet has buyer power *vis-à-vis* Stansted. As we agree with this conclusion, the buyer power of easyJet is not considered further in this Section. However, should the CAA alter its views on easyJet's buyer power, we will make further representations on this.

8.4 In contrast, the CAA concludes that, although Ryanair is by far Stansted's biggest customer, any buyer power that Ryanair has in relation to Stansted is "*more limited than its share of overall Stansted traffic would suggest*", and that Stansted has a stronger negotiating position than Ryanair.[101]

8.5 This Section assesses the Consultation Document's analysis of Ryanair's buyer power, and demonstrates that the provisional conclusion on this issue is unsustainable.

Ryanair's buyer power

8.6 The conclusion that Ryanair does not have buyer power at Stansted is unsupportable. It contradicts the available evidence and economic reality, and appears to be based on untested evidence provided to the CAA by Ryanair. Ryanair demonstrably holds considerable buyer power over Stansted and, as the evidence shows, is proactive in exercising that buyer power.

8.7 As the CAA is aware, Ryanair now represents nearly three-quarters of the aeronautical side of Stansted's business (and its passengers would be expected to account for an equivalent proportion of the commercial side too – although possibly less currently, given Ryanair's current one bag rule). By contrast, Stansted is a minor and decreasing part of Ryanair's pan-European business (less than 20%). Those figures should speak for themselves.

8.8 As explained by Yarrow and Starkie in Annex A, Ryanair also operates a large number (108) routes from Stansted that are not operated by any other airlines. This represents 73% of Stansted's total number of routes. This gives Ryanair a unique power at Stansted, because the withdrawal of any of these routes would have a larger impact on Stansted than the withdrawal of other routes (and, indeed, a larger impact on consumer welfare).

8.9 Indicators of buyer power vary between industries, and buyer power can be manifested in a number of ways. However, two key principles in determining buyer power are as follows[102]:

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101 Consultation Document, paragraph 5.112.

102 See, for example, Oxera, *Buyer power and its role in regulated transport sectors: Report prepared for the NMA*, March 2012. These key features are also highlighted as being relevant in the OFT *Assessment of market power guidelines*, OFT 415, paragraph 6.2.

(a) Buyer power is higher where the buyer has more outside options – i.e., the buyer is able to switch supplier.

(b) Buyer power is higher if the seller has few outside options – i.e., there are fewer alternative buyers.

8.10 The evidence available in relation to each of the above key indicators clearly demonstrates that Ryanair has considerable buyer power. Furthermore, [redacted] provide clear evidence of Ryanair exercising that buyer power – not, as the Consultation Document has suggested[103], Stansted's indifference.

Availability of alternatives for Ryanair

8.11 Ryanair has the benefit of a number of alternative airports at which it could base its aircraft. As a result, any threats that Ryanair makes to switch are credible – indeed, Ryanair has acted on such threats in the past:

(a) As set out in detail at Sections 4 and 5 above, there is sufficient capacity at competing airports – including airports within London – to enable Ryanair easily to switch sufficient aircraft away from Stansted in order to render any price increases unprofitable.

(b) Ryanair has switched existing services away from Stansted to other UK and continental European airports, and it has allocated growth in its overall fleet size to airports other than Stansted. See, for example, Figure 1 in Section 4 above.

8.12 The above factors clearly demonstrate, contrary to the view adopted by the CAA, that Ryanair can and does switch, and can make credible threats to switch, away from Stansted. This is reinforced by Ryanair's public statements, including the statements given to investors in January 2012 and May 2013:

(a) "*So we continue to be very opportunistic. We go wherever the airports give us the best package of efficient facilities and low costs*".[104]

(b) "*Growth in Eastern Europe, yes, we are continuing. Again, it kind of reflects where we are looking at very meaningful growth opportunities in countries like Poland, the Baltic states in particular, the Czech Republic, Slovakia, and again we have more growth opportunities than we can handle. I think if we are trying to communicate anything today, it is that there is an enormous opportunity for us and our shareholders, I think, over the medium term, to expand Ryanair off a unique unit cost platform that no other airline in Europe can touch. But we have made the same kind of traffic growth offers today to a number of the German airports, a number of the Spanish airports, to Stansted and to Dublin. If all of those airports were to agree to the terms of our proposal today, we would not be able to handle that growth for about three or four years, so whoever kind of steps up first will likely win and get the immediate traffic growth and the others would simply have to wait in line.*"[105]

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103 Consultation Document, paragraph 5.112.

104 Ryanair, investor conference call, January 2012, http://www.media-server.com/m/p/h7g37293.

105 Ryanair, investor conference call, 20 May 2013, at around 18:40 minutes: http://www.ryanair.com/en/investor/investor-relations-news.

Limited availability of alternative customers for Stansted

8.13 As stated above, Ryanair represents nearly three-quarters of the aeronautical side of Stansted's business, whereas Stansted is a minor and decreasing part of Ryanair's pan-European business. The consequences for Stansted if Ryanair switched even a small number of aircraft to other airports are significant – [redacted]

8.14 [redacted]

8.15 [redacted]

(a) [redacted]

(b) [redacted]

(c) [redacted]

8.16 Furthermore, the unfounded assertion in paragraph 5.112 of the Consultation Document that we appear indifferent to losing further traffic from Ryanair is absurd. Stansted is currently operating at around 61% of its capacity. The 17.4 million passengers served by Stansted in 2012 is around 6.3 million passengers fewer than were served in 2007. In other words, Stansted requires growth of 36% merely to return to its 2007 peak. It is worth noting here that it is rare for a firm with

106 [redacted]

market power to suffer from a growing amount of spare capacity. Stansted's infrastructure is currently being under-utilised and this represents a very strong incentive to grow passenger numbers. We have every incentive to maintain the customers we currently have at Stansted.

8.17 The Consultation Document also raises the issue of why Stansted did not reduce its prices when demand fell after 2007. In our view, this is not relevant to the CAA's current market power assessment because the prices in question were set by Stansted's previous owners, BAA, at a time when the three largest London airports were under common ownership. What is relevant is a forward looking view of pricing behaviour under new ownership. In any case, economic theory shows that firms operating in an effectively (but not perfectly) competitive market do not necessarily reduce prices in the face of a reduction in market demand, and may in a number of contexts, including some directly relevant to circumstances in the airport sector, increase prices. The immediate corollary is that, by and of themselves, price responses to demand reductions cannot safely be used to make inferences about the effectiveness of competition.[107]

Negotiations between Ryanair and Stansted

8.18 At paragraph 6.91, the Consultation Document concludes that the inability of Stansted and Ryanair to agree a new long term contract is evidence of Stansted's market power. That conclusion is misconceived.

8.19 [redacted]

8.20 [redacted]

8.21 [redacted]

107 If the CAA would find it helpful, we would be happy to provide more detailed economic analysis on this point.

108 [redacted]

9 **Airline Switching**

9.1 This Section assesses the ability of, and incentives for, airlines to switch away from Stansted. In doing so, this Section highlights a number of issues in relation to switching where the Consultation Document accepts, without question, the self-serving assertions of airlines. In each case, a failure to obtain and test the evidence has led to erroneous conclusions. Before reaching a final decision, it is incumbent on the CAA to fully test all of the evidence available to it.

9.2 This Section deals with the following issues:

(a) the absence of capacity constraints, showing that airlines have the ability to switch;

(b) the fact that, if evidence of airline switching is taken as a whole, it is clear that the scope for switching is sufficient to constrain Stansted's pricing;

(c) the evidence of actual airline switching shows that the costs of switching are relatively low;

(d) the grounding of aircraft (which, in practice, constitutes a form of switching);

(e) the fact that the 'natural experiment' discussed in paragraphs 5.90 to 5.103 of the Consultation Document relating to the time when the LCCs' discounts expired in 2007 provides clear evidence of switching;

(f) the flawed critical loss analysis in the Consultation Document, which does not support the Consultation Document's provisional conclusions on switching;

(g) the fact that Consultation Document's reference to "backfill" as a fact – which reduces the effect of switching - is unsupportable and contradicts the CAA's earlier position;

(h) conclusions relating to airline route profitability and the importance of London are flawed, and understate the constraint imposed by the threat of switching; and

(i) the novel concept of 'strategic constraints' used in the Consultation Document as a factor which constrains switching is ill-thought through and, moreover, not supported by the evidence.

9.3 A number of the above issues have been addressed elsewhere in this Interim Response. They are further addressed here, albeit briefly, to highlight the fact that the analysis of airline switching set out in the Consultation Document is wholly inadequate.

Absence of capacity constraints

9.4 The Consultation Document estimates that Stansted's customers would need to switch the equivalent of between two and four based aircraft away from Stansted to make a price rise unprofitable. This estimate is flawed, not least because it fails to adequately take into account the consequences of a reduction in passengers on Stansted's commercial revenues, which amplifies the disciplining effect on Stansted. However, even if it is accepted that the estimate is valid, the Consultation Document itself demonstrates that airlines easily could switch such a small number of aircraft away from Stansted. Furthermore, the Consultation Document ignores the fact that Ryanair has already demonstrated an ability to switch significant passenger capacity away from Stansted, even though the number of its Stansted based aircraft during the summer traffic season has fallen only by approximately 5% since summer 2007. Its based aircraft at

Stansted in winter seasons have been reduced by over 35% between 2006 and 2012.[109] Since 2009, easyJet has reduced its based aircraft at Stansted by 36%. Both of these represent sufficient aircraft to constrain a price rise. In addition, it should be noted that this is not by any means the only way airlines can reduce the passenger capacity they operate at Stansted.

9.5 This highlights that relying on the metric of the number of based aircraft is highly misleading. Moreover, an assessment of this issue by reference to based aircraft significantly understates the extent of Ryanair's and easyJet's switching. These two airlines' ATMs at Stansted in summer months have decreased considerably since 2007:[110]

(a) April 2007 – April 2012: 33% reduction by easyJet, 21% by Ryanair.

(b) May 2007 – May 2012: 33% reduction by easyJet, 24% by Ryanair.

(c) June 2007 – June 2012: 34% reduction by easyJet, 21% by Ryanair.

(d) July 2007 – July 2012: 37% reduction by easyJet, 17% by Ryanair.

(e) August 2007 – August 2012: 36% reduction by easyJet, 15% by Ryanair.

(f) September 2007 – September 2012: 36% reduction by easyJet, 20% by Ryanair.

9.6 These reductions in the airlines' use of Stansted have occurred at a time when they have been expanding their operations elsewhere (particularly at Gatwick). Clearly, as shown by Figures 1 and 2 in Section 4 above, the airlines have been able to find capacity at other substitutable airports around London.

9.7 The airlines' bold assertions about their inability to switch from Stansted are also contradicted by their increased use of Gatwick, where there are significant changes each year to the airlines using the airport. This is clear evidence of a vibrant competitive market where airline customers switch regularly and do not encounter insurmountable capacity constraints in doing so. Stansted understands that easyJet has grown its use of Gatwick such that it now represents over one-third of Gatwick's traffic (in terms of ATMs and passengers), having been less than one-fifth of its business five years ago. Similarly, Stansted understands that Ryanair has doubled its presence at Gatwick over the last five years in terms of the proportion of Gatwick ATMs represented by Ryanair. A more sophisticated analysis of London capacity than that contained in the Consultation Document would have revealed that sufficient capacity is available.

9.8 There is no reason given by the Consultation Document as to why the airlines could not continue to reduce their based aircraft and ATMs at Stansted, and increase them at other airports in London and elsewhere, in response to a future price rise. Instead, the CAA prefers to rely on the airlines' unsubstantiated and unquantified assertions, such as:

(a) "*Ryanair has told the CAA that neither Gatwick nor Luton have sufficient early morning capacity to allow for an efficient use of Ryanair's based aircraft*" (paragraph 5.86).

(b) "*Ryanair has stated that*:

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109 These figures are taken from Consultation Document, paragraph 5.62. We note, however, that the CAA gives the lower figure of 30% for the same winter season statistic in paragraph 5.21.

110 Source: M.A.G analysis of airline schedules. See also Figures 1 and 2 in Section 4 above for statistics that show a similar picture.

'Ignoring capacity constraints in any consideration of airport substitutability only leads to incorrect conclusions. In the case of London airports, LHR, LGW, LTN and LCY are substitutable but are fully utilised (or fully utilised in peak periods in the case of LTN), and where planning and policy constraints prevent the addition of new airport capacity at these airports, airport substitutability cannot be assessed in ignorance of these facts.

...The European Commission has ruled that LHR, LGW, LTN and LCY are substitutable but capacity constraints mean that Ryanair cannot move there'" (paragraph 4.66).

(c) "*Further, the airline says that capacity constraints at Gatwick and Luton meant that its small operations at these airports could not be supplemented by switching marginal aircraft away from Stansted, as this may result in the loss of economies of scale*" (paragraph 5.109).

9.9 As is shown in the above paragraph, and in Section 5 in particular, there is sufficient capacity at other airports (in addition to the possibility of buying slots as evidenced by Flybe's recent sale of slots) to support switching at sufficient levels to constrain Stansted's prices, and the conduct of our main customers bears this out.

The need to consider the aggregate constraint arising from airline switching

9.10 When assessing competitive constraints, and whether they are sufficient to prevent a firm from having market power, it is important for a competition authority to consider the various individual constraints and also to consider to what extent they result in a cumulative constraint in aggregate. The evidence must be viewed as a whole. That is particularly the case when considering an issue that is as highly relevant to the CAA's analysis as switching.

9.11 A significant deficiency in the Consultation Document is to note evidence of individual constraints on Stansted and then disregard each one as being insufficient on its own to constrain Stansted's pricing, without assessing whether they are sufficient in aggregate to constrain Stansted's pricing.

9.12 The Consultation Document therefore adopts the same approach for which the CAA criticised the CC during its BAA market investigation – i.e., the CAA "*fails to assess the cumulative impact of all the competitive constraints, instead dismissing individual constraints unless they are individually capable of disciplining Stansted.*"[111]

9.13 A key example of this approach is where the Consultation Document lists several methods by which the airlines could defeat an increase in aeronautical charges (see paragraph 5.8 of the Consultation Document), but then proceeds to list the difficulties associated with each. The Consultation document does not consider the possibility that each method could be used to a small extent to defeat the price rise in aggregate. The Consultation Document also wholly ignores Stansted's incentives to grow passenger numbers and increase commercial revenues.[112]

[111] Comments on the CC's Working Paper, paragraph 1.3.

[112] This failing is particularly important to the critical loss analysis at paragraphs 5.27 to 5.32 of the Consultation Document. The CAA notes the numbers of passengers that would be lost as a result of certain events, yet fails to note that this would also result in a reduction of commercial revenues. As the CAA knows Stansted's average commercial revenues per passenger, this would have been a straightforward calculation.

9.14 For example, the Consultation Document is not clear about whether an airline's response to a price rise needs to be in the short term, the medium term, the long term, or all three:

(a) Airlines' ability to allocate volume growth to other airports is said not to be able to defeat a price rise in the short term and therefore disregarded (paragraphs 5.9 to 5.11 of the Consultation Document).

(b) Airlines' ability to reduce the frequency of existing services or fly W-routes or triangle routes is said to be able to defeat a price rise in the short term, but not in the medium term, so it is disregarded (paragraphs 5.12 to 5.19 of the Consultation Document). There is no reasonable basis for this position, especially considering that the CAA adduces evidence that shows the airlines choosing to fly these types of routes voluntarily to utilise their aircraft as efficiently as possible rather than simply to constrain an airport's price rise. Indeed, easyJet has said publicly that triangle routes enable it to "*hit the most appropriate times for different customer types*".[113] There is no analysis of the extent to which reduced frequencies could be, or are currently, employed (although there is a suggestion in paragraph 5.23 that Ryanair did this at Stansted during the 2011 winter traffic season). Although there is some discussion of the use of triangular and W-routes, there is no consideration of whether this would be sufficient to constrain a price rise.[114]

(c) Airlines' ability to switch marginal aircraft away from Stansted is said to be difficult in the short term, but possible in the long term (paragraph 5.46 of the Consultation Document), although it is noted that this is directly contradicted by the CC's finding in the Q5 price control review that switching aircraft to European airports would be a constraint in the short term, quoted with approval in the Consultation Document.[115]

9.15 The Consultation Document fails to consider whether a combination of these three broad categories of disciplining actions by airlines (or credible threats of such action), would be sufficient to render a price rise unprofitable.

Evidence of switching

9.16 The Consultation Document notes many instances of historic airline switching away from Stansted, while suggesting that we have now reached the point in time (or will do in the near future) when switching, or the credible threat of switching, is no longer a credible constraint on Stansted's pricing. This is highly implausible and directly contradicted by the available evidence (as discussed above in Section 6). For example, in February 2013, Ryanair made a regulatory stock exchange announcement that it "*will cut its London Stansted traffic by 9% over the coming year (from 12.5m to 11.4m)*". Ryanair's regulatory announcement stated that: "*Ryanair, which had planned to grow its Stansted traffic by 5% from April 2013, will now cut frequencies on 43 of its routes and reduce its weekly operations by over 170 flights, with the loss of 1.1m passengers (-*

113 See slide 23 of easyJet's investor day presentation, January 2012: http://corporate.easyjet.com/~/media/Files/E/Easyjet-Plc-V2/pdf/investors/results-centre/2012/investor-day-presentation-2012.pdf.

114 In addition, the CAA has clearly failed to gather appropriate data from the airlines on the issue. Paragraph 5.15 states that 0.5% of easyJet's routes are triangular or W-routes, but paragraph 5.17 then states that between 5% and 7% of easyJet's routes are triangular routes.

115 Consultation Document, paragraph 5.67.

9%) and over 1,100 jobs at Stansted, in direct response to this unwarranted and unjustified 6% price hike."*[116] [117]

9.17 In addition to ignoring examples of actual switching or threats of switching the CAA has failed to gather quantitative data on the switching costs the LCCs would face if they withdrew an aircraft from Stansted. Instead, the Consultation Document relies (without critical assessment) on the LCCs' vague, unquantified and self-serving assertions, such as:

(a) "*Ryanair indicated that the opportunity cost it faces for suspending routes and grounding aircraft during the summer traffic seasons is very high. As a result, it is only viable for it to consider grounding aircraft during the Winter traffic seasons, where the cost of leaving the aircraft idle on the ground is lower than losses that would be generated on many routes.*"[118] This statement is highly misleading. Ryanair has reduced the number of Stansted based aircraft during the summer traffic season by approximately 5% since summer 2007. However, data shows its reduction in summer ATMs is between 15% and 17% in peak summer months since 2007. Ryanair may or may not wish to ground aircraft during the summer season, but it is clearly willing and able to switch them away to other UK and European airports, which is arguably more of a disciplining action because it will not even incur Stansted's parking charges.

(b) "*For example, following our enquiries about the increase the [sic] number of based aircraft at Gatwick in the 2010/11 winter traffic season, Ryanair told the CAA that it allocated four additional aircraft to Gatwick in the 2010/11 winter traffic season to take advantage of a growth discount at the airport, and this had not resulted in a shift of capacity from Stansted, as supported by statistics provided by Ryanair on the number of aircraft based at Stansted. These aircraft were withdrawn from Gatwick for the 2011/12 winter traffic season.*"[119] Ryanair does not deny that the aircraft were switched from Stansted to Gatwick; it merely notes that Stansted's overall capacity was not reduced as a result. There is no indication as to where the four aircraft were switched from Gatwick. If they went to Stansted, this would show exactly the type and extent of competition for marginal aircraft between Gatwick and Stansted that the CAA states would be sufficient to constrain a price rise. If they went to another European airport, this would show exactly the type of switching that would prove there is a pan-European geographic market. It is not clear from the Consultation Document whether the CAA probed Ryanair's evidence on these relevant points.

9.18 The Consultation Document also contradicts itself on the issue of airlines' sunk costs. In paragraph 5.36, it says the Stansted airlines make "*relatively limited investments in facilities*" and that Ryanair and easyJet "*stress the flexible nature of their operations*". However, at paragraph 5.109, the Consultation Document quotes without comment Ryanair's self-serving statement that its sunk costs at Stansted "*undermine its ability to make a credible threat of a disciplining response*". In reality, in line with the airlines' frequent public statements, the airlines' sunk costs

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116 http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail.html?announcementId=11504116. See Annex G(9).

117 We note Ryanair's suggestion in paragraph 5.22 that statements of its intentions in its press releases do not always materialise, but this statement is taken from a stock exchange announcement, and is therefore subject to strict rules regarding the veracity of forward looking statements.

118 Consultation Document, paragraph 5.21.

119 Consultation Document, paragraph 5.23.

are relatively modest and are no impediment to switching marginal routes away from Stansted. This is an important failing in the Consultation Document's analysis.

9.19 The Consultation Document has also omitted any consideration of the effect of credible threats of switching. It is not necessary (for example) for Ryanair actually to switch at all. Evidence such as its misleading public announcements of switching (see paragraph 5.22 of the Consultation Document), and Ryanair's press release of 28 February 2013 show the use of threats to defeat price rises before they even happen.

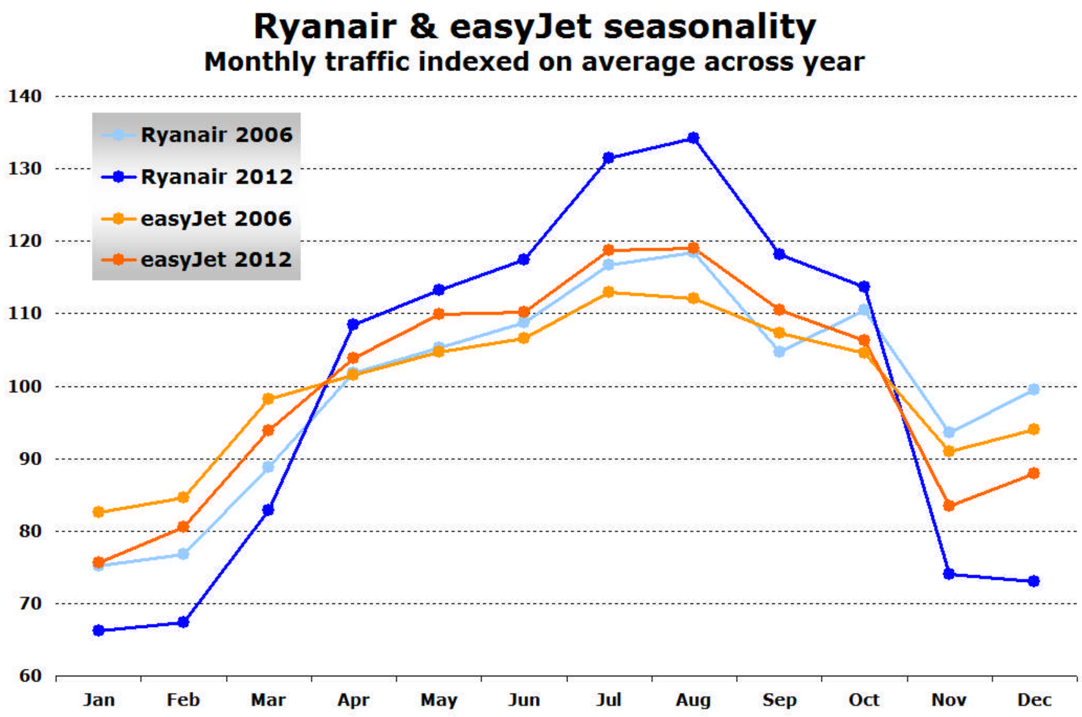
9.20 Overall, on an issue as important as switching, the CAA does not present relevant costs data and fails to show consistent and coherent reasoning. Relevant evidence on switching and the costs involved is disregarded, but unsubstantiated and inconsistent statements from airlines are relied on without question.

The grounding of aircraft

9.21 The grounding of aircraft by airlines represents a clear form of switching that could make an attempted price increase unprofitable. The Consultation Document's misconceptions of what constitutes switching lead it to accept misleading statements by the airlines on this issue at face value. This misunderstanding is repeated in paragraph 5.26, and indeed also in the Consultation Document's executive summary at paragraph 13 (third bullet). For example, in paragraph 5.22, the Consultation Document discusses direct evidence of Ryanair disciplining Stansted's price rise by grounding aircraft as if it were not a form of switching. The Consultation Document quotes Ryanair's view without criticism that it "*has no disciplining effect on the airport as it has failed to deliver reductions in airport charges*". The issue of grounding aircraft is one which must be addressed before a final decision is made: as is the question of whether the grounding of aircraft by Ryanair in response to a price rise was sufficient to render Stansted's price rise unprofitable.

9.22 Ryanair and easyJet increasingly ground aircraft in the winter months. Fuel prices have risen in recent years to around 45% of LCC costs, and the LCCs have moved many of their staff onto variable contracts, both of which have resulted in the LCCs' variable costs increasing, and their fixed costs decreasing, as a proportion of their total costs. The shift between fixed and variable costs means that it is now more profitable to ground aircraft during winter months rather than continue to fly them when average yields are lower. As it costs the LCCs less to ground aircraft, this can be used to put pressure on airports to reduce the level of airport charges in an effort to encourage airlines to continue to operate (rather than ground) aircraft during the winter season. Figure 4 below shows how the profile of monthly traffic for easyJet and Ryanair has changed between 2006 and 2012, emphasising the degree to which the two airlines have grounded significant capacity during the winter season.

Figure 4: The increased grounding of LCC aircraft in winter



Source: M.A.G analysis of airline schedules

9.23 The grounding of aircraft significantly affects Stansted's revenues and profitability because no aeronautical charges are payable, the parking fees associated with a grounded aircraft are minimal, and Stansted's commercial revenues are adversely affected by the reduction in passengers. The grounding of aircraft is a quick and effective way in which airlines can discipline Stansted, and must be analysed in full before a final decision is made by the CAA.

Natural experiment

9.24 In paragraphs 5.90 to 5.103, the Consultation Document discusses the events in 2007 surrounding the expiration of discounts granted by Stansted to Ryanair and easyJet. The Consultation Document describes this as a 'natural experiment'. Although whole paragraphs of this section are redacted, such that the CAA's reasoning is very difficult to follow, we make the following points.

9.25 Most significantly, this 'natural experiment' is flawed because the expiry of a time-limited discount is not the same as an unexpected price rise. Both the airport and the airline knew from the beginning when the discount would expire and could be expected to have planned ahead. The level of the charges after the discount expired would have been taken into account in both parties' decisions from the beginning. Further, as the Initial Views makes clear:

> "*On balance, it appears that the increase in charges around 2006 was an increase towards, rather than above, the competitive price level – in which case, we would not expect there to*

have been a particularly significant response from airlines switching away from the airport".[120]

9.26 In any case, the 'natural experiment' shows that both Ryanair and easyJet reduced passenger numbers at Stansted following the expiration of the deep discount – i.e., the end of the discounts led to switching. Contrary to the CAA's summary statement at 5.100 that "*easyJet did not decrease its services at Stansted following the increase in prices in 2007*", the CAA's own data (presented in Figure 3.5) show that easyJet's ATMs from Stansted declined from around 40,000 in 2007 to 30,000 in 2010, a 25% reduction. Ryanair even admitted that it had reduced its operations at Stansted and had relocated several based aircraft away from Stansted because "*it was forced to do in light [sic] of the doubling of airport charges*" (paragraph 5.103 of the Consultation Document). The evidence also shows the adverse effect on Stansted's profitability (see for example Figure 5.3 of the Consultation Document). Yet, these facts have not been taken into account in the Consultation Document. It seems that the 'natural experiment' has been disregarded because of the adverse macroeconomic environment at the time, without noting that these two airlines were expanding their operations elsewhere in the UK and throughout Europe (see for example Figures 1, 2 and 3 in Section 4 above).

9.27 Again, a misunderstanding of the relevant economic terminology is evident. In paragraph 5.103, the CAA states that the airlines' reduction in passenger numbers "*does not appear to have significantly constrained STAL's pricing behaviour*". Stansted's pricing behaviour was constrained because the airlines were able to engage in switching behaviour which reduced Stansted's profitability.[121]

Critical loss

9.28 easyJet commissioned a paper by Frontier Economics to support its arguments on the difficulties of switching away from Stansted. These arguments have been accepted without being critically examined. The Consultation Document merely summarises some limitations involved in the NAPALM model (which is only part of Frontier's evidence), yet these limitations do not prevent the Consultation Document from concluding that "*the available evidence highlights the difficulties of disciplining the airport operator in this way given existing capacity constraints*" (paragraph 5.32). The limitations on the NAPALM model, set out at paragraph 5.31 of the Consultation Document, are in fact fundamental obstacles to the use of this model for the purposes of estimating switching responses to a Stansted price rise. Notably, by ignoring the possibility of switching to Southend, which easyJet has actually practised in recent years, the model underestimates materially the switching response. Also, the fact that the model treats flights by LCCs, charter and full service carriers as not being substitutable from the point of view of the passenger, means that it fails to capture exactly the commercial dynamics exhibited by easyJet itself, which is competing for passengers against both full service carriers and charter flights. These limitations are so fundamental that the CAA should have concluded that the Frontier Economics analysis could not be relied upon.

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120 Initial Views, paragraph 37.

121 Consultation Document, paragraph 5.93.

9.29 Furthermore, Frontier Economics' analysis gives a misleading picture. For example:

(a) Paragraph 5.28 of the Consultation Document shows that Frontier analysed the critical loss for Stansted on the basis of a 10% price rise. This figure, rather than the standard 5-10% price rise, was clearly chosen because it gives the result that the airlines are not able to defeat the price rise by switching a sufficient number of based aircraft away. It is clear from the evidence presented that (even on Frontier's figures) the airlines would indeed be able to defeat a 5% price rise.

(b) Frontier assumed that whole aircraft would need to switch away from Stansted. They ignore marginal passengers on aircraft that continue to fly, choosing not to fly, or choosing to fly from a different airport.

(c) Frontier's evidence seems to suggest that the reduction in passengers as a result of switching based aircraft is the only way in which airlines could defeat a price rise. It seems to suggest that the 10% price rise would have no effect on (for example) the airlines' decisions on where to locate future growth (for example, Ryanair had 36 bases in January 2010, whereas it had 50 bases by January 2013) and it would have no consequences for non-based aircraft or inbound passengers. There are a suite of other feasible consequences and responses that would defeat the price rise in aggregate.

9.30 It seems that Thomson Airways also estimated the critical loss (see paragraph 5.30 of the Consultation Document), but Stansted has not been given the opportunity to see or comment on this important piece of evidence that seems to have been relied upon in the Consultation Document. It is not clear why this information has been redacted in full.

9.31 The more general flaws in the critical loss analysis contained in the Consultation Document are discussed in detail in the report by Case Associates at Annex D. Their discussion of the subject, including critiques of the RBB and Frontier papers, concludes: "*we are confident that overall the elasticity faced by Stansted for passengers services is above unity. This means that Stansted is not able to profitably raise its charges*" (Annex D, page 44).

Backfill

9.32 The CAA's uncritical acceptance of third party submissions in some cases even occurs when these submissions directly contradict the CAA's own published views. For example, in paragraph 5.46, the possibility that another airline would take the place of ("backfill") an LCC who switched an aircraft away from Stansted is said to be one of the two reasons why airlines are not able to switch away in the short-run. This issue had apparently been raised by third parties (see paragraphs 5.45 and 5.49 of the Consultation Document).

9.33 The CAA's previous view is to be found in its submissions to the CC as part of the Q5 review:

> "*4.19 The CC argues that:*
>
> > *'If Ryanair were to move from Stansted to East Midlands in response to a substantial price increase, it is very likely that another airline would enter Stansted to fill the gap ('back-fill') because these passengers without a choice would continue to want to travel. As a similar argument applies to Luton, it cannot be argued that regional airports constrain Luton's pricing.'*

> *4.20 This argument appears to be premised on a failure to understand the impact of a price increase at Stansted. If prices rose at Stansted this would alter relative prices at Stansted and other airports. If it were not profitable for Ryanair to operate its service at Stansted at these relative prices then it would, presumably, also not be profitable for another operator to offer this route.*
>
> *4.21 This argument would not, of course, hold if Ryanair were not the most efficient operator of the service in question, and a more efficient operator existed. However, in such circumstances, the question remains as to why this operator had not already opened the service at Stansted and used its cost advantage to compete away Ryanair on this route.*
>
> *4.22 Finally, it is perhaps worth noting that Ryanair is widely reported to have the lowest unit costs of any European short-haul airline, questioning whether such a 'more efficient' operator actually exists.*
>
> *4.23 Overall, therefore, the CC's assumption that back-fill will happen appears flawed and, as a result, the conclusion that "it cannot be argued" that regional airports compete (to some degree) with Luton is not supported by the analysis."*

9.34 The view presented to the CC was correct. The Consultation Document provides no explanation of why the CAA's view has changed on this issue. The CAA should revert to its previous position when reaching a final decision, or (at the very least) explain early it has changed its view.

9.35 Further, Stansted has plenty of spare capacity, so an airline could always return to Stansted if it wished to do so.

Route profitability and the importance of London

9.36 The failure of the CAA to gather appropriate route yield data, notwithstanding the fact that the CAA commented that this data was essential in its Initial Views, is addressed in Section 4 above. As a result of the CAA's lack of empirical data and internal documents, the Consultation Document simply accepts the self-serving assertions of airlines that Stansted has such unique characteristics that they are unable to switch the small number of aircraft away from Stansted that would constrain a price rise.

9.37 The airlines' (and therefore the CAA's) arguments hinge on all Stansted routes being materially more profitable than other possible routes that could be operated with the same aircraft. However, the switching data (including grounding, etc) suggests the airlines were and still are operating marginally profitable routes from Stansted.

9.38 In reality, Stansted, in common with most other European airports, has some profitable routes, which the airlines are unlikely to cease operating, and some marginally profitable routes, which the airlines can and do regularly switch. London is a large European city with a large pool of potential passengers, but it is also served by a number of competing airports. There is nothing unique about the profitability of Stansted's routes (although we note that the CAA lacks the data to assess this).

9.39 The Consultation Document accepts Ryanair's assertions that London is in some way unique (see, for example, paragraph 5.56), yet the CAA fails to compare Ryanair's assertions to its actions in practice for marginal routes. See, for example, its reduction in summer ATMs by significant amounts (15% in August, 24% in May) at Stansted over the period 2007-2012.

9.40 The CAA has also failed to ask why Ryanair's assertions in the context of this market power assessment differ so markedly to what Ryanair tells its own investors. For example, Ryanair said in January 2012 that it was considering withdrawing some aircraft from Stansted (even in the absence of a price rise) thus showing that there must be some marginally profitable routes at Stansted:

> "*I think there's an opportunity for us to maybe cut back some capacity around the edges in the UK. We might take another aircraft of 2 out of Stansted. We might – but really that's about it. I think Dublin and Stansted will be the focus of where – if we have to come up with a couple of spare aircraft for really good deals at other airports, I think it's Dublin and Stansted where they'll come from.*"[122]

9.41 Instead, at paragraph 5.62 of the Consultation Document, the CAA quotes without comment Ryanair's assertion that switching a route from Stansted to a European airport would reduce the schedule quality at Stansted, despite later in the same paragraph recording that Ryanair has done precisely that.

Strategic constraints

9.42 The Consultation Document employs a novel argument (seemingly coined by Ryanair for the purposes of the current market power assessment) that airlines are unable to switch from London airports as a result of 'strategic constraints'. As explained in the reports by Yarrow and Starkie at Annex A and by Case Associates at Annex D, this term is not defined by reference to specific economic concepts such as barriers to entry, or high set up or exit costs based on substantial sunk capital costs. Indeed, nowhere does the Consultation Document define this term with any precision, nor does it seek to quantify it. The term does not address what would happen in response to a SSNIP, and it does not explain the substantial reduction in Ryanair's services from Stansted which Ryanair itself has attributed to the recent increase in Stansted's charges.

9.43 The Consultation Document gives some suggestions as to what 'strategic constraints' might include. However, these are not persuasive. In particular, it is not clear how a presence at Stansted could be crucial to Ryanair's brand image (asserted by Ryanair in paragraph 5.56), nor why the allocation of aircraft as a result of marginal route profitability is a strategic matter (the second and third reasons given in paragraph 5.56).

9.44 If Ryanair is indeed subject to strategic constraints, Yarrow and Starkie explain in Annex A that this would imply that Ryanair would serve London routes even when they are less profitable than an alternative non-London route. This seems unlikely given Ryanair's active route yield allocations and its significant reduction in the use of London airports in recent years while growing elsewhere. If Ryanair's assertions are correct, the 'strategic' value of London ought to have at least sustained its use of London airports during this period.

9.45 The CAA uses this novel argument effectively to state that Ryanair is a captive customer for Stansted. This leads the CAA towards a finding of market power vis-à-vis a single customer,

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122 Ryanair investor conference call, January 2012.

which is meaningless from an economics point of view unless it is accompanied by evidence that Stansted would be able to price discriminate against Ryanair. The proposition that Stansted would be able to impose higher prices on Ryanair than on other smaller customers is absurd and shown to be false by the evidence. As set out in Section 8 above, Ryanair is a strong negotiator and insists on the lowest prices.

9.46 In paragraphs 5.33 to 5.74, the Consultation Document relies on the (unquantified) strategic costs of switching away from Stansted, yet it ignores the strategic benefits of doing so. For example, showing Stansted, and Ryanair's other 179 airports (56 of which are bases), that Ryanair is willing to switch away to discipline the airport is very valuable to Ryanair.

10 Price levels and profitability

10.1 The issue of Stansted's price level and profitability is important. It affects the analysis of airline switching, including the critical loss analysis, and market definition. In particular, if it could be shown that Stansted were pricing above the competitive price level, or making excess profits, this may be evidence of market power.

Critique of Leigh Fisher

10.2 In its Initial Views document, the CAA found that "*the increase in charges around 2006 was an increase towards, rather than above, the competitive price level*".[123] However, subsequent to its Initial Views, the CAA commissioned a report by Leigh Fisher, which purports to benchmark Stansted's prices with other airports worldwide. The Consultation Document inappropriately relies on this report to assess the competitive price level at Stansted. The Consultation Document recognises that the assessment of a competitive price is formidably difficult in this market, and this is a reason given for not having carried out a full SSNIP test.[124] Despite this, a core element of the 'minded to' conclusion is that Stansted is already pricing above the competitive level.[125]

10.3 This represents a change of view since the Initial Views. This change of position seems to derive wholly or substantially from the flawed Leigh Fisher report, even though that report explicitly states that it was not designed to measure the competitive price.[126] Indeed, as Yarrow and Starkie point out in their report at Annex A, to use the Leigh Fisher report as evidence of a competitive price is to accept that (for example) Melbourne and Hong Kong airports belong to the same geographic market as Stansted, which is patently absurd.

10.4 Even if the CAA were to use the report to assess the competitive price, the report does not show what the CAA appears to think it shows. When comparing Stansted in terms of total revenues per passenger, Leigh Fisher conclude that "...*Stansted is exactly at the level that would be expected for an airport of its characteristics*".

10.5 In addition to the futile nature of attempting to assess a competitive price in such a heavily regulated industry, and the fundamentally inappropriate use of the results, we have significant concerns with Leigh Fisher's methodology, including:

(a) the simplistic approach to deriving summary statistics from the data which gives misleading results (over emphasis on smaller airports) and does not reflect the average passenger experience of charges across the sample. This is a fundamental flaw in the analysis, and is directly at odds with the CAA's statutory duty to regulate in the interests of passengers;

(b) misinterpretation of the statistical "noise" from a small sample set to draw the erroneous conclusion that the data provide a statistically significant "signal" that Stansted's aeronautical charges are above the competitive average;

(c) the lack of availability of aeronautical charges data for comparator airports;

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123 Initial Views, Executive Summary, Paragraph 37.
124 Consultation Document, paragraph 4.4.
125 Consultation Document, Summary, Paragraph 13.
126 See for example the stated aims of the report at paragraph 1.2 and the statement at paragraph 8.5.

(d) the lack of disclosure about the adjustments that have been made to the charges data to ensure consistency between airports;

(e) the unexplained inconsistency of price data between the emerging findings and the final report, and the apparent bias in removing data from higher charging airports between the emerging findings and the final report;

(f) the potential for multi-collinearity between the criteria used to identify comparators;

(g) the inconsistencies in the approach to selecting criteria for determining comparators;

(h) the inclusion of insignificant factors in the weighting of criteria;

(i) the approach to the weighting airport charges data which overlooks the significant differences in the benchmark results depending on the approach taken; and

(j) the inappropriate focus on single point estimates, ignoring the high level of uncertainty which is inherent with such analysis.

10.6 Please see Annex B for a more detailed analysis of the Leigh Fisher report. These issues are also discussed in the Yarrow and Starkie report at Annex A.

Further submissions relating to Leigh Fisher

10.7 The comments of the CAA in relation to the Leigh Fisher analysis, as set out in Tim Griffiths' email dated 4 April 2013, are welcomed. In particular, it is noted that the CAA has identified a number of deficiencies in the Leigh Fisher analysis, specifically in relation to how regression has been calculated and the data that has been used to support the analysis. In our letter of 12 April 2013, it was made clear that we share the CAA's concerns as to the accuracy of the Leigh Fisher analysis, and set out in detail both the data and methodological flaws that had been identified at that stage (based on the limited information made available).

10.8 We continue to have serious concerns as to the appropriateness of using the Leigh Fisher analysis, many of which were raised in our letter of 12 April 2013. Our initial intention was to address these concerns fully in this response. However, that is no longer practicable:

(a) The CAA has still not provided a full copy of the Leigh Fisher report (entitled "Comparing and Capping Airport Charges at Regulated Airports" and dated 5 December 2012). As acknowledged in the CAA's letter of 18 April 2013, the data provided by the CAA on 9 April 2013 was not, despite the request in our letter of 22 February 2013, a fully executable version of the model and supporting data used by Leigh Fisher. The data that was provided to us is so heavily redacted that it is virtually unusable.

(b) In any event, the CAA's email of 4 April 2013 and subsequent letter of 18 April 2013 make it clear that the updated version of the report is not yet finalised and is unlikely to be so for some time, a situation that the CAA acknowledges is "not ideal" from our perspective.

10.9 Under the circumstances, and because the Leigh Fisher report is plainly not suitable to be used in the way the Consultation Document purports to use it, it would neither be cost- nor time-effective for us to include in this Interim Response our detailed critique of the Leigh Fisher analysis. Equally, it would be irrational for the CAA to rely on the Leigh Fisher analysis, given that it has accepted there to be a number of flaws in that analysis, and given that we have been unable to respond to it intelligently. If the CAA intends to rely on this, or a revised, model then it must say so and provide us with a fair opportunity to make representation on the basis of sufficient information.

Critique of Europe Economics

10.10 The Consultation Document also relies on the report by Europe Economics to estimate the competitive price at Stansted. This report sets out an estimate of the long run incremental cost (**LRIC**) for Stansted. However, there are a number of fundamental flaws with the approach which invalidate the conclusions even without a detailed critique of the methodology.

10.11 Annex C contains a detailed analysis of the Europe Economics report. However, we take this opportunity to set out a key flaw in the analysis. Europe Economics estimate that LRIC for Stansted, based on the cost of redeveloping the existing airport, would be around £1 per passenger below the current level of charges. Crucially, however, they assume that the airport would operate at full capacity (35 mppa) from the day it reopens. This assumption is to be found in Increment Four of the report, which Europe Economics states is the most credible increment. Adopting a more realistic approach, where demand grows over time, increases the LRIC by around £1 per passenger (i.e., to broadly the same level as Stansted's current charges). Despite this, the Consultation Document uses the Europe Economics report as evidence that Stansted's charges are too high. This is irrational.

10.12 We also note that the margin of error stated by Europe Economics brings the LRIC measure set out in the Consultation Document within pennies of Stansted's current charges.

10.13 If the CAA intends to continue to rely in its final determination on the Europe Economics report, we ask that we are notified in advance and given the opportunity to submit a more detailed analysis on the methodology adopted.

The analysis of Stansted's profitability and the prevailing economic conditions

10.14 The Consultation Document states that Stansted's profitability is a relevant factor in assessing whether it has market power (see paragraph 7.13 of the Consultation Document). The Consultation Document concludes that "*its performance across the profitability benchmarks has been mixed, but in general its recent performance has been in line with other UK airports*" (paragraph 6.21 and 7.13 of the Consultation Document). However, this assessment of Stansted's profitability is superficial and opaque, thus further undermining the 'minded to' conclusions. Moreover, even in its own terms, the Consultation Document's summary of the comparison of return on capital employed (**ROCE**) is highly misleading. Based on the data presented in Figure 6.1, Stansted's ROCE over the period 2006-2011 was consistently and significantly below the mean and the median of the group of airports which are compared. Stansted's ROCE averaged 4% over the period, compared with 10% for the arithmetic mean for the whole group and 7.5% for the median. Thus Stansted's profitability, on this measure, was 60% below the mean and 46% below the median of the comparator group. This cannot, on any reasonable grounds, be described as "*recent performance … in line with the other UK airports*".

10.15 Furthermore, the Consultation Document states:

"*The CAA has also examined (and calculated where necessary), a number of financial metrics, including EBITDA margin, EBITDA per passenger, operating margin, and revenue per passenger for Stansted and 14 other UK airports.*"[127]

10.16 This analysis is not included in the Consultation Document, nor has Stansted been involved in its preparation. Stansted has therefore been denied the opportunity to respond intelligently to this analysis, which is stated to be a relevant factor. This is a clear violation of public law standards.

10.17 In addition to the above errors of commission, the Consultation Document is guilty of an error of omission in failing to present any analysis of Stansted's actual return on capital compared with the regulatory return set at each successive price control review. Under the Regulated Asset Base approach to setting price caps, the weighted average cost of capital (**WACC**) was set by the CAA, subject to review and amendment by the CC, and was designed to represent the two regulators' best judgment on a reasonable return, given the prospective risks facing the business and the requirement to attract capital for future development, and to adequately reward prior investment in the airport. It is therefore a relevant factor to consider when trying to assess Stansted profitability. In recent years, from 2007 to 2012, Stansted's actual WACC (before exceptionals) has been consistently <u>below</u> the WACC set by the CAA in its price control decisions of 2003 and 2009. Over this period, Stansted's WACC has averaged 4.7%, compared to 7.3% for the regulatory estimate of the WACC.

10.18 The Consultation Document claims that its analysis of Stansted's profitability is supported by the CC's market investigation findings. In particular, the Consultation Document states:

"*This finding on the overall profitability of the airport is consistent with the CC's 2011 study into possible material changes of circumstances of BAA, which found that the airport's 'financial results were healthy when compared with other, non-BAA airports', notwithstanding a decline in passenger numbers in recent years.*"[128]

10.19 This is another example of inappropriate use by the Consultation Document of the CC's findings to lend weight to the CAA's analysis:

(a) The CC's analysis of Stansted's profitability was conducted for an entirely different purpose – to assess whether there had been a material change of circumstances since its 2009 report was published. This was made clear in the CC's defence to BAA's judicial review proceedings before the Competition Appeal Tribunal.[129] In these proceedings, the CC stated that it was not carrying out a thorough review of profitability for its own sake, but in order to determine whether the fall in Stansted's profitability (which was accepted by the CC) was a barrier to selling the airport. This is quite different from the task the CAA should have been undertaking in the present market power assessment – i.e., an assessment of profitability relative to the cost of capital.

(b) In its judgment, the Competition Appeal Tribunal found that the CC was entitled to undertake a superficial assessment of Stansted's profitability because it was sufficient for those specific purposes. Paragraph 90 of the judgment refers to the CC's analysis as "*a simple and inevitably rather crude check*", and states that:

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127 Consultation Document, paragraph 6.21.
128 Consultation Document, paragraph 6.27.
129 *BAA v Competition Commission*, Judgment of 1 February 2012 [2012] CAT 3.

"*The CC was entitled to make reference to the accounts to give comfort on that score, and was entitled to assess that the rather superficial comparison which was possible and was undertaken was as far as its investigations needed to go to give it the necessary degree of comfort in relation to an assessment already supported by other parts of its reasoning.*"

10.20 The CAA is proposing to rely on its analysis of Stansted's profitability to impose a burdensome regulatory regime on Stansted. It is entirely inappropriate for the CAA to use the CC's "*crude*" and "*superficial*" analysis out of context to support its own analysis, which is required to be considerably more thorough.

11 The analysis of cargo services in the Consultation Document

11.1 The discussion of the cargo sector in the Consultation Document is brief and does not reflect the reality of the sector. This section therefore begins by providing some background information on the cargo industry, showing that:

(a) air cargo is a small part of the cargo industry and in many cases is constrained by other modes of transport;

(b) within air cargo, most goods are carried in the belly-hold of passenger aircraft; the rest are carried in cargo-only aircraft;

(c) cargo-only carriers of goods that are not time-sensitive ("non-express") have an array of alternatives to Stansted;

(d) in the remainder of the air cargo segment, the carriers of time-sensitive ("express") are sophisticated logistics companies;

(e) airports play a number of different roles within the express goods segment (main hubs, sub-hubs and gateway airports). It is only the latter group – gateway airports – that need to be close to the final destination for the goods and therefore enjoy any degree of geographical scarcity; and

(f) even within the very narrow segment of gateway airports for express goods, there are many airports within an acceptable distance of London who provide a competitive constraint on Stansted.

11.2 The section will then discuss the unprecedented approach in the Consultation Document, which is based on limited and unbalanced evidence, an incomplete analysis, a failure to consider key economic factors, and a failure to obtain key evidence.

Air cargo is a small part of the cargo industry

11.3 Cargo comprises freight and mail which can be transported by air, rail, road and/or sea. However, the Consultation Document does not properly address the extent to which carrier services provided by other modes of transport provide a competitive constraint on Stansted.

11.4 Cargo carried within Europe by air accounts for less than 1% of the total tonnage of European cargo. Around 16 million tons of air cargo is transported into, out of and within Europe each year. Of this, around 2.5 million tons is transported by air into, out of or within the UK. However, despite the fact that it is established (including in European Commission decisions)[130] that intermodal transport such as road (and, to a lesser extent, rail) exert a competitive constraint on air cargo, it is notable that the Consultation Document does not properly address the extent to which carrier services provided by other modes of transport provide a competitive constraint on Stansted.

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130 See COMP/JV.19 - *KLM/Alitalia* (1999), paragraph 25, COMP/M.3280 –*Air France/KLM* (2004), paragraph 36, COMP/M.3770 – *Lufthansa/Swiss* (2005), paragraph 19, COMP/M.5141 - *KLM/ Martinair* (2008), paragraphs 29-30, , COMP/M.5403 - *Lufthansa / BMI* (2009), paragraph 20 and COMP/M.5440 - *Lufthansa/ Austrian Airlines* (2009), paragraph 29.

11.5 The substitution possibilities between air and road are highlighted in the recent Steer Davies Gleave report commissioned by the DfT, cited in the Consultation Document.[131] This shows the extent to which road haulage supports, and is a substitute for, air cargo services.

11.6 Before reaching a final decision, the CAA must consider the extent to which other forms of transport (for example road and rail) exert a competitive constraint on air cargo – generally, and in relation to Stansted.

Air cargo

11.7 Cargo carried by air generally comprises high value, low weight items that benefit from the speed of transport by air. There are various different segments within the air cargo sector. Cargo can be transported in the belly-hold of passenger aircraft or in dedicated cargo aircraft. Of the 2.5 million tons of UK cargo, the majority (around 70%) is belly-hold cargo. Stansted handles only a small volume of this (less than 0.3%). The remaining 30% of cargo is carried by dedicated cargo-only aircraft.

11.8 Within the dedicated cargo-only segment, some of this cargo is time sensitive ("express"); the rest is not ("non-express").

<u>Non-express cargo</u>

11.9 Non-express cargo represents around 8% (200,000 tons) of the total cargo transported by cargo-only aircraft in the UK. Non-express cargo is generally shipped by HGV from main continental hub airports, such as Amsterdam or Paris Charles de Gaulle, to its destination area. Indeed, a significant amount of intra-European air freight (97,000 tons annually) is actually transported by road between the UK and Continental Europe via HGV.

11.10 Non-express cargo carriers generally have a high level of flexibility concerning their choice of airport, including airports on the Continent, from which cargo can be transported to the UK by road/rail. Within 12 hours' drive time of Stansted, there are at least 27 airports with significant cargo activities, including in Amsterdam, Frankfurt and Luxembourg, as well as a number of UK airports. There is strong competition for non-express cargo over a broad geographic area, which the CAA must analyse before reaching a final decision. The Consultation Document does not address the potential for non-express cargo to be switched from Stansted.

11.11 Within a broad market encompassing all of the UK, and at least the entire northern aspect of Continental Europe, the market position of Stansted is minimal.

<u>Express cargo</u>

11.12 Express cargo tends to be higher value, more urgent air freight, for example documents, certain pharmaceutical products and high value engineering components. This means that the scope to use HGVs is lower. We estimate that express cargo represents around 25% (640,000 tons) of total UK air cargo. The key features of express cargo are that:

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131 Steer Davies Gleave, Air Freight – Economic and Environmental Drivers and Impact, Final report, March 2010: http://webarchive.nationalarchives.gov.uk/20120606174609/http:/www.dft.gov.uk/publications/air-freight-eonomic-and-environmental-drivers/.

(a) There are only a small number of customers, all of whom are sophisticated and well-resourced. In the UK these are the integrators: DHL, Fedex, and TNT/UPS, together with Royal Mail which operates in a similar way.

(b) Integrators own or control the assets, employees and information systems necessary to offer unbroken control from the time the shipment leaves the shipper's facility to the time it arrives at the consignee's location. The service provided usually guarantees a particular delivery time, for which customers pay a premium.

(c) Integrators' networks are designed to achieve guaranteed speed of delivery and maximum flexibility and resilience. They use "hub and spoke" networks which comprise main hubs (typically one on each continent); sub-hubs (usually a handful on each continent); and gateways, which provide the point of entry / exit to air transportation. Gateways have to be relatively close to the ultimate point of origination / destination and so there will be a reasonable number of gateways across an integrator's network.

(d) An airport is thus reliant on retaining a small number of customers who each account for a reasonably large volume of business, whilst the customers specifically design their networks so as not to be dependent on any one airport.

(e) Stansted competes with airports across Europe to act as a sub-hub in an integrator's network (including Cologne, Leipzig, Liege, Paris CDG, Brussels, and Bergamo). As feeder flights (typically operated by smaller aircraft such as Boeing 757s or ATR-72s) typically operate flights of up to two hours, any user of sub-hub cargo airport services at Stansted has the option of reconfiguring its network so as to use a sub-hub within (on a conservative basis) a two hour flight time of the relevant gateway airport. We estimate it would cost an integrator no more than £12.5 million to move a sub-hub operation. There is history of integrators doing so.

(f) In terms of gateway services for express cargo, the amount of cargo transported via a UK gateway represents only around 6% (150,000 tons) of the total cargo transported in the UK. The choice of gateway airports available for an integrator is less than hub or sub-hub airports. Some of this express cargo has to be collected late in the day or has to travel long distance overnight, and so the time that the time the integrator is able to transport cargo to/from a gateway by road may be no more than around two hours.

(g) Some integrators do therefore need a gateway operation around London for a proportion at least of their express cargo. The costs involved in setting up as a gateway operator are typically low (a modest runway for a feeder aircraft – which tend to be smaller; hard standing for parking; a sorting/screening building – e.g., an existing hangar, or indeed it may be possible to load pre-screened cargo directly from a truck). It is thus relatively easy for an integrator to switch gateway operations from one airport to another.

(h) A large number of airports fall within a two hour drive time of London, and could therefore act as a gateway airport, including:

  (i) Stansted;

  (ii) Heathrow;

  (iii) Gatwick;

(iv) Luton;

(v) Manston;

(vi) Southend;

(vii) Cambridge;

(viii) Oxford; and

(ix) Birmingham.

(x) By way of example of the choices available to the integrators, Fedex and TNT/UPS have gateway operations at Stansted, but DHL serves this market from Luton and Heathrow. The other airports listed above are potential suppliers of gateway services.

11.13 The Consultation Document does not address the question of the extent to which belly-hold cargo is at least a partial substitute for cargo-only flights and thus whether other airports are in the same market, or at least exercise a competitive constraint. This is a significant failing. As the Case Associates report at Annex D explains, there is a significant overlap in the carriage of express cargo by both belly-hold passenger airlines and integrators and other dedicated airlines based at Stansted. This suggests that even if express freight were treated as a separate product market, there is likely to be a strong competitive interaction between express cargo carried as belly-hold cargo by passenger airlines and integrators. In the provision of cargo handling services, there are no practical supply-side differences between handling dedicated and belly-hold cargo or types of cargo with the exception of livestock, fragile and precious goods, and refrigerated cargo. However these types of cargo cut across the different types of air cargo carriers, and do not warrant further segmentation of the product market.

11.14 In summary, Stansted operates in a competitive environment in which it plays several different roles serving sophisticated customers. As explained below, these dynamics are not taken into account in the Consultation Document.

Other constraints

11.15 There are some other key issues in the cargo sector which are not analysed in the Consultation Document – but which would have to be analysed before any rational final decision could be made that Stansted has a position of market power. These include:

(a) Pricing constraints. The Consultation Document fails to address the extent to which Stansted's aeronautical charges to cargo-only flights could be constrained by the greater degree of competition which the airport faces for LCC passengers. Hitherto, the CAA's price control at Stansted has focused on charges for passenger flights, with a simple restriction that published charges for equivalent cargo-only flights (equivalent by weight, time of day and season) should be no higher than those for passenger flights. Such a non-discrimination limit (which may be enforceable under the terms of the Airport Charges Regulations) would constrain Stansted's pricing power in relation to cargo-only flights. By this reasoning, Stansted's market power for cargo-only airlines could be no higher than for LCC passenger airlines.

(b) Growth in spare capacity at Heathrow to accommodate increased belly-hold freight. As the mix of traffic moves increasingly to long haul services, the overall belly-hold capacity at Heathrow will increase, as the aircraft on these routes have significantly more freight capacity than the aircraft typically used on short haul routes. The impact of this increased capacity at Heathrow on Stansted's competitive position will need to be assessed to reach a view on Stansted's market power.

(c) Buyer power. The Consultation Document provides no information on whether Stansted's charges are considered to be out of line with market comparators. At paragraph 5.174 of the Consultation Document it is stated that Stansted does not appear to be facing significant pricing pressure in relation to cargo operators. In reaching this provisional conclusion, the Consultation Document relies uncritically on BA World Cargo's assertion (with no supporting evidence) that although BA World Cargo had negotiated a price discount from Stansted, such a discount has not been repeated and is unlikely to be repeated. There is no analysis of what may have changed in their relative bargaining positions since the last discount was agreed. A more balanced approach would be to treat the extraction of a discount by a buyer as evidence of buyer power, on the basis that a dominant seller would not need to grant the discount.

(d) Stansted's responsiveness to the needs of cargo airlines. The Consultation Document does not contain any analysis of Stansted's conduct or performance in meeting the needs of its customers. For example, no mention is made of the recent investment carried out by Stansted to enable it to accommodate the new fleet of aircraft operated by BA World Cargo and Panalpina. Stansted invested several million pounds in the widening of taxiways and other new infrastructure so that its facilities could handle the new Code F Boeing 747-800F. Without this investment, Stansted risked losing this business to other competitor airports.

The approach in the Consultation Document

11.16 The Consultation Document provisionally concludes that:

(a) cargo-only services at Stansted constitute a separate market from other aeronautical services at Stansted and from other airports' cargo-only services (the alleged "Stansted cargo market"); and

(b) Stansted currently has market power in relation to the "Stansted cargo market" as narrowly defined.

11.17 The report by Case Associates at Annex D contains a critique of the approach taken in the Consultation Document that has resulted in such a narrow market definition, and which bears little relation to the commercial reality of the sector.

11.18 However, our primary position on this issue is that the case set out in the Consultation Document is simply not made out. It is based on limited and unbalanced evidence, an incomplete analysis, a failure to consider highly relevant economic factors, and a failure to obtain key evidence. A final decision based on the position set out in the Consultation Document would be irrational.

11.19 The evidence and analysis contained in the Consultation Document is not sufficient to support a conclusion that Stansted has substantial market power. In particular, the Consultation Document does not set out the necessary evidence or analysis to demonstrate, on a rational and sound evidential basis, that Stansted has substantial market power – instead, the Consultation Document appears to set out a preliminary "back of the envelope" view. Furthermore, given the limitations of the analysis, and the fact that key paragraphs are excised, it is not possible fully understand and respond to the case as set out in the Consultation Document.

11.20 This remainder of this section, which should be read alongside the relevant sections of the report by Case Associates at Annex D, is therefore limited to highlighting:

(a) the narrow market definition adopted in the Consultation Document is without precedent; and

(b) the absence of the necessary detailed analysis of the relevant market, and applicable competitive constraints, on which sound position on market definition and market power must be based.

The narrow market definition adopted in the Consultation Document is without precedent

11.21 As far as we are aware, no previous competition authority has found air cargo to constitute a separate product market. We are also not aware of any previous findings that a separate cargo-only market exists by reference to a single airport.

11.22 As explained in the report by Case Associates at Annex D:

(a) The CAA's previous view was that market was air cargo market was significantly broader than cargo-only services at Stansted. For example:

(i) In its Initial Views, it stated that "*the geographic market is likely to be at least national, with aspects that are competing on an intercontinental market*"[132];

(ii) The CAA's advice on the de-designation of Stansted also reflected a significantly wider market definition, stating that "*Stansted is likely to compete with a number of cargo hubs in northern Europe … In addition to this hub-on-hub competition, some cargo flows could be redirected through other UK airports*".[133]

Thus the CAA's view to date was that Stansted competes both with other major cargo hubs for intercontinental cargo flows, as well as with other UK airports for the routing of cargo through the UK.

(b) The European Commission has also consistently found very broad geographic and product markets in this area.[134] In particular, the European Commission has stated that "*the peculiarities of the cargo sector justify a wider definition of the relevant market*"[135], and has included intermodal transport (including road and rail) in its assessment.

11.23 As stated, the Consultation Document defines the Stansted cargo market as "*core cargo aeronautical services provided to cargo-only airlines at Stansted*"[136], which reflects a much narrower approach to market definition than any previous authority (and one in relation to which Stansted would be the only supplier). As a result, and without even attempting a SSNIP test, or similar, the Consultation Document:

132 Initial Views, paragraph 2.149.
133 De-designation Advice, paragraphs 8.60 and 8.61.
134 See, for example, COMP/M.5141 *KLM/Martinair* (2008); COMP/M.5181 *Delta Air Lines/Northwest Airlines* (2008); COMP/M.5403 *Lufthansa/BMI* (2009); COMP/M.5440 *Lufthansa/Austrian Airlines* (2009); COMP/M.5335 *Lufthansa/SN AirHolding* (2009).
135 IV/M.0019 *KLM /Alitalia* (1999).
136 Consultation Document, paragraph 7.2.

(a) sub-divides even the cargo segment such that it includes only the cargo-only carriers; and

(b) limits the geographic scope of the market to Stansted.

11.24 As explained in more detail in the report by Case Associates at Annex D, this market definition simply assumes that the relevant product market should be defined by the customers that are currently served by Stansted. That is a fundamental flaw, and is an approach which gets close to the "*reductio ad absurdum*" mentioned by the CC in its discussion of market definition.[137]

11.25 The narrow alleged "Stansted cargo market" as defined in the Consultation Document is therefore contrary to precedent (as summarised above) and does not reflect reality.

The absence of the necessary detailed evidence or analysis

11.26 The evidence and analysis cited in the Consultation Document does not provide a sound basis for the proposed approach to market definition. Indeed, there is no reasoned analysis and very limited evidence is cited in the Consultation Document to explain the unprecedented market definition adopted, and the provisional finding (which has significant consequences) that Stansted has substantial market power.

11.27 These issues are addressed in detail in the report by Case Associates at Annex D.

11.28 The Consultation Document states that, "*evidence on this market has not been tested previously by public consultation*", and it is clear that the CAA has based its provisional view only on the representations made by cargo-only airlines that operate at Stansted.[138] It therefore appears that the entirely new approach to market definition is justified on the basis that the CAA has received "*evidence from Stansted's cargo customers that access to London is essential to their operation and that they have no ability to switch to other airports*".[139] In relying on this (untested) source of evidence, the Consultation Document dismisses, for various reasons, credible competitive constraints on Stansted.

11.29 As set out above, there are many international and domestic substitutes from an air cargo perspective, and the global distribution networks of air cargo companies allow them to make a flexible use of a range of different networks. Moreover, many carrier services are provided by other competing modes of transport, including transport of cargo by sea, road and rail. In not addressing these (or other) issues – but instead adopting the assertions of the cargo-only operators at Stansted that access to London is essential to their operation and that they have no ability to switch to any other airport[140] – the CAA has effectively sidestepped the necessary market definition exercise.

11.30 The CAA must now conduct this exercise to define the relevant market before reaching a final decision, and we will be happy to assist the CAA in this exercise. In our view, it is clear that Stansted competes in a broad market in relation to cargo, from both a product and geographic perspective. In this context, it will also be clear that a conclusion that Stansted has substantial market power is not credible and could not be sustained.

137 BAA Final Report, paragraph 2.23.
138 Consultation Document, Summary, paragraph 18.
139 Consultation Document, Summary, paragraph 17.
140 Consultation Document, paragraph 7.28.

Competitive constraints

11.31 The Consultation Document does not fully address the constraints on Stansted, which are set out above. This is clear from the paucity of empirical evidence and analysis, as well as the fundamental flaws in the approach set out in the Consultation Document.

11.32 In particular, the Consultation Document makes no attempt to assess:

(a) The amount of cargo business that would need to switch from Stansted in order to constrain the airport. This is despite the fact that an analysis of switching is fundamental to any market definition or market power assessment.

(b) The ability of cargo customers to discipline Stansted through switching or the threat of switching. The analysis that is contained in the Consultation Document on this issue is particularly cursory and incomplete. Moreover, much of the evidence cited has been redacted, making it difficult to assess or comment on the evidence relied on.

11.33 We set out above a selection of the constraints faced by Stansted but which the Consultation Document does not fully address. These issues – which include issues as fundamental as alternatives to air cargo and the ability of customers to switch air cargo away from Stansted – must be considered by the CAA (taking into account all available evidence) before a final decision is reached.

Conclusion

11.34 By taking a market which includes only a segment of Stansted's customers, at a time when Stansted was under BAA ownership and therefore could not be expected to have been in full competition with Heathrow, and without any detailed consideration of constraints from outside this very narrowly defined market, the Consultation Document states that the CAA is "*minded to conclude that Stansted currently has substantial market power in the Stansted cargo market*".[141] Such an approach to market definition and an assessment of market power is simply not credible.

11.35 The analysis of cargo services in the Consultation Document is inadequate. Fundamentally, it fails to take account of the various aspects of the industry and various competitive constraints on Stansted. In fact, it appears that the provisional conclusions in relation to cargo services have been reached without conducting the necessary market definition analysis or a credible assessment of market power.

11.36 This must be remedied before a final decision is taken by the CAA. A final decision made on the basis of the analysis contained in the Consultation Document would, simply put, be contrary to the evidence, commercial reality, and common sense.

11.37 Further, the CAA's assessment must now take into account M.A.G's recently completed acquisition of Stansted. This is absent from the assessment contained in the Consultation Document, despite the fact that enhanced competition for cargo operators is to be expected.

11.38 We look forward to working with the CAA in the coming months to enable the CAA to come to a fully informed and legally robust final decision on these issues.

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141 Consultation Document, Summary, paragraph 17, and paragraph 7.28.

PART III

Test B – Competition Law

12 **Misapplication of Test B**

12.1 For the reasons given in Part II above, our position is that Stansted does not have substantial market power. As a result, Test A has not been met, and it is therefore not necessary to consider whether Test B is met.

12.2 However:

(a) The approach taken to Test B in relation to Stansted represents a misdirection as to the requirements and purpose of Test B and, moreover, a misapplication of that test;

(b) competition law, as defined by section 6(8) of the CA Act, demonstrably provides "sufficient protection" against the risk that Stansted may engage in conduct that amounts to abuse of any substantial market power it may be considered to hold; and

(c) as a result, even if Test A is met, Test B is not met and therefore the overall market power test set out at section 6(1) of the CA Act would not be met.

12.3 This Part of the Interim Response demonstrates the following:

(a) The approach taken in the Consultation Document represents a misdirection as to the legitimate purpose of, and the question required to be answered under, Test B. The purpose of Test B is to determine whether additional regulation is necessary, not to allow an assessment of what is the most convenient route for the CAA, or the preferable regulatory position. In line with the CAA's commitment to better regulation principles[142], regulation can only be imposed where it is necessary and proportionate so to do. Test B goes directly to the question of necessity.

(b) The approach to Test B set out in the Consultation Document is undermined by two overarching, but connected, flaws. The first is that the logic of the Consultation Document's approach to what are relevant considerations under Test B is such that it would always be met if Test A is met, thus rendering Test B redundant. The second is that, as a result, the Consultation Document introduces a series of irrelevant considerations into the analysis on this point.

(c) Even if Test A is met, competition law demonstrably provides "sufficient protection" against any risk that we might engage in abusive conduct, not least given that our main customers are well resourced and well informed and have a track record of launching complaints (and possibly damages claims) in response to any abusive conduct.

(d) The concerns expressed in the Consultation Document in relation to Stansted's future conduct are highly speculative and do not reflect the available evidence, and therefore cannot be relied on.

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[142] Initial Views, paragraph 1.4.

The requirements and purpose of Test B

12.4 The market power test, and therefore the threshold for imposing additional regulatory burdens on airport operators who meet Test A, is only met where "*competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of … substantial market power*".[143]

12.5 The purpose of Test B is clear. Additional regulation should not be imposed on an airport operator with substantial market power under Test A where competition law sufficiently addresses any concerns that the airport operator might engage in abusive conduct.

12.6 The approach adopted in the Consultation Document - i.e., that the issues to be addressed are "*what mechanism will better address the risks that flow from the CAA's findings under Test A*"[144] or whether additional regulation would "*prove to be incrementally beneficial*"[145] - therefore represents a fundamental misdirection as to the purpose of Test B.[146]

12.7 This flaw is reflected in the focus of the Consultation Document on:

(a) whether it would more convenient or easier to apply competition law or impose *ex ante* regulation (see, for example, paragraphs 8.93, 8.41 *et seq*, and 8.49); and

(b) the comparative assessment of the merits and demerits of competition law as compared with *ex ante* regulation (see, for example, paragraphs 8.21-8.30 and 8.48).

<u>The interpretation of Test B renders it redundant and introduces irrelevant considerations</u>

12.8 By failing to conduct the necessary Stansted-specific assessment, and by focusing on a series of considerations relating to competition law and the wider industry more generally (i.e., factors that would apply in all cases, not just in relation to Stansted), the approach taken to Test B in the Consultation Document means that Test B would always be met. This approach would render Test B redundant as a component of the overall test for market power, which would frustrate Parliament's intention.

12.9 The analysis of Test B contained in the Consultation Document is therefore subject to two overarching, albeit connected, flaws:

(a) as stated above, the approach to Test B is to consider a number of general factors that render Test B redundant as a component of the overall market power test, and in doing so frustrates the will of Parliament; and

(b) the approach introduces a series of irrelevant considerations.

12.10 These flaws are most clearly manifested in the failure to conduct an operator-specific assessment. Test B requires an assessment of whether "*competition law does not provide sufficient protection against the risk that <u>the relevant operator</u> may engage in conduct that amounts to an abuse of … substantial market power*" (emphasis added). Any assessment in this regard must be specific to the relevant operator in question. It is necessary to identify the exceptional features of a particular case that render competition law insufficient in that particular

143 Initial Proposals, paragraph 2.4.
144 Consultation Document, paragraph 8.8.
145 Consultation Document, paragraph 8.56.
146 The CAA similarly misdirects itself on this issue in its Initial Proposals – Executive Summary, paragraph 7.

case. However, the reasoning contained in the Consultation Document on this issue does not identify any such exceptional features.

12.11 Key examples of this misdirection are set out below:

(a) "*[A] situation of emerging SMP may not satisfy the test of dominance at the time an assessment under the CA98, Article 102 of the TFEU is carried out*".[147]

A "*situation of emerging SMP*" is not a part of the "*risk*" referred to in Test B. Although Test A can be met where an operator "*is likely to acquire*" substantial market power, it is clear that Test B concerns the risk of an operator abusing substantial market power – i.e., abusing the substantial market power it either already holds, or (in the case of substantial market power it "*is likely to acquire*") as and when it acquires that substantial market power.

As a result:

(i) The fact that "*[p]otential or emerging dominance will not be sufficient to base a finding of infringement*" under CA98 is not a relevant consideration in this context. Regarding this as a relevant factor is irrational and represents a misdirection as to the nature of Test B.

(ii) The fact that market conditions may change to give rise to or strengthen a position of market power (including in the way suggested at paragraphs 8.57 to 8.61 as a result of capacity changes) is irrelevant.

(b) "*The concept of abuse of substantial market power would… seem in principle to have a potentially wider scope than abuse as defined in section 18(2) of CA98*".[148]

This is not a reasonable basis on which to conclude that competition law would not provide "sufficient protection":

(i) The Consultation Document does not explain in what ways the concept of abuse of substantial market power – as it would be applied to Stansted or more generally – is considered to be broader than the concept of abuse under CA98.

(ii) In any event, this is not a sound basis for concluding that competition law would not provide "sufficient protection". If correct, that would mean that Test B would always be met if Test A were met. That was clearly not Parliament's intention.

(iii) The position set out in the Consultation Document ignores the broad scope of the concept of abuse under competition law. Although the Consultation Document focuses on sections 18(2)(a) to (d) of CA98, that is only an illustrative list. The concept of abuse under competition law is much broader than that illustrative list – see in particular the long-accepted broad definition of the concept of abuse given by the Court of Justice in *Hoffman-La Roche v Commission*.[149]

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147 Consultation Document, paragraph 8.26 – see also paragraph 8.66.

148 Consultation Document, paragraph 8.7.

149 Case 85/76 *Hoffman-La Roche v Commission* [1979] ECR 461, paragraph 91 – "*The concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods*

(c) "*[I]t is possible that the abusive conduct will not fit neatly into the formal tests developed by competition law*".[150]

This is not a reasonable basis for the provisional conclusion that Test B is met. All competition law cases are fact specific, and it is often necessary for competition authorities to revert to first principles to establish whether competition law has been infringed. That is true of all industries. In any event:

(i) The reasoning in this regard would apply to all cases where there has been a finding of substantial market power. As a result, if this reasoning is followed to its logical conclusion, Test B would always be met where Test A has been met.

(ii) The fact that there may not, in all cases, be precedent which can be neatly applied is irrelevant. As highlighted above, the concept of abuse under CA98 is broad. The fact that it might be necessary to apply general principles rather than point to precedent that "neatly" deals with a case is not a relevant consideration.

(d) "*[I]ntervention after the event will not compensate the competitors or customers of a dominant operator for the loss/prevention of competitive advantage or may not offer remedies that are well suited to problems that have arisen in the market.*"[151]

"*[T]he CAA would have to consider whether an investigation… would produce a solution [that] was sufficiently comprehensive and also that it would be a swift enough process to ensure irreparable harm to competition in the market did not occur.*"[152]

Again, the reasoning in this regard would apply to all cases where there has been a finding of substantial market power under Test A, thus rendering Test B redundant.

In any event:

(i) The reasoning on the issue of remedies is flawed, particularly to the extent that it suggests that remedies imposed following a CA98 investigation or a market investigation "*would not necessarily lead to an across the board remedy aimed at the sector as a whole*".[153] That is not a relevant consideration – the test is whether competition law provides "sufficient protection" with regard to the risk that a specific operator will engage in abusive conduct, not whether competition law can provide a market-wide remedy.[154]

(ii) The position appears to be that competition law investigations do not provide sufficiently swift outcomes. Again, that is not a relevant consideration, not least because the speed and efficiency of such investigations would rest with the CAA.

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different from those which condition normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition".

150 Consultation Document, paragraph 8.26.

151 Consultation Document, paragraph 8.26.

152 Consultation Document, paragraph 8.39.

153 Consultation Document, paragraph 8.26. See also paragraphs 8.68 and 8.69.

154 In any event, particularly in the case of a company with a dominant position or significant market power, it is possible that remedies imposed following a market investigation could have a market-wide impact – the CAA appears to have taken an unduly narrow view of the remedies that can be imposed under Schedule 8 of the Enterprise Act 2002.

Furthermore, to the extent that such deficiencies exist, they apply to all cases and sectors.

(iii) The approach here ignores:

(1) the wide scope for directions to be imposed following an infringement finding, or remedies following a market investigation; and

(2) the possibility of imposing interim measures under CA98 in relation to dominant undertakings. These powers have been significantly enhanced by the Enterprise and Regulatory Reform Act 2013, the relevant provisions of which are due to come into force in 2014.

Competition law provides "sufficient protection"

12.12 As the Consultation Document explains "*[t]he two main concerns of competition law as it applies to the conduct of dominant parties (the focus of Test B) are exclusionary and exploitative abuses*".[155]

12.13 However, in addressing the application of competition law to airport operators in the context of exclusionary and exploitative abuses, the Consultation Document adopts an approach which: (i) overemphasises the difficulties of bringing such cases, and understates the existing precedent, case law and guidance (in relation to specific issues and applicable general principles); and (ii) ignores the effectiveness of the risk of complaints and damages claims launched by our main (sophisticated and well-resourced) customers as a deterrent to engaging in abusive conduct.

Exclusionary conduct

12.14 The Consultation Document makes the important concession that "*[w]ith regards to exclusionary behaviours… the case law suggests that they could be tackled adequately by competition law alone*".[156] That finding should, of itself, answer the question of whether competition law would protect against the risk that we may engage in exclusionary conduct that amounts to abuse of any market power it may be considered to hold.

12.15 However, the position adopted in the Consultation Document is that, despite the adequacy of the law to deal with such conduct, the steps that the CAA would have to take to conclude an investigation means that competition law would not provide "sufficient protection".[157] As stated above:

(a) Such a position would apply in all cases where Test A is met, rendering Test B redundant.

(b) The fact that the CAA would have to conduct an investigation under Part 1 of CA98 is not a legitimate consideration when assessing whether competition law would provide "sufficient protection" against an operator engaging in conduct that amounts to an abuse of substantial market power. It is an entirely circular argument, starting and ending with concerns about how effectively the law can be applied, rather than an assessment of the sufficiency of the law itself.

155 Consultation Document, paragraph 8.32.
156 Consultation Document, paragraph 8.39.
157 Consultation Document, paragraph 8.39.

Exploitative conduct

12.16 The position expressed in the Consultation Document in relation to exploitative conduct is that competition law does not provide "sufficient protection" on the basis that:

> "*[T]he evidential threshold for a finding of infringement based on excessive pricing limits the ability of competition law to discipline this behaviour.*"[158]
>
> "*The assessment of quality abuses is likely to be more difficult.*"[159]
>
> "*[T]here are issues with regards exploitative abuses resulting from the burden of proof necessary and the application of a legal test with poorly defined benchmarks of economic value and an assessment of what is considered to be unfair.*"[160]

12.17 In short, the position appears to be that competition law would not provide "sufficient protection" because the CAA would have to prove that Stansted had abused a dominant position, and that would not necessarily be straightforward on the basis of current case law. That is an irrelevant consideration:

(a) Whether the CAA would find it easy or difficult to bring such cases is not relevant to an assessment of whether competition law, of itself, provides "sufficient protection" against the risk that we may engage in exploitative conduct.

(b) Again, even if the difficulties of bringing excessive pricing cases are accepted, these concerns would apply in all cases where Test A is met, thus rendering Test B redundant.

(c) The difficulty of bringing exploitative abuse cases is overstated:

(i) As the Consultation Document acknowledges, there have been a number of infringement decisions relating to excessive prices. Although these cases are dismissed on the spurious basis that they are fact specific (as all such cases are), they demonstrate that such cases are possible and provide a useful basis for any assessment to be conducted by the CAA.

(ii) It is notable that the Consultation Document does not refer to the most recent UK case in which a dominant undertaking was found to have abused its dominant position by offering excessive prices[161], nor does it refer to cases where investigations into alleged exploitative conduct have concluded that there has not been an abuse of a dominant position.[162]

(d) Specialist regulators, such as the CAA, are particularly well placed to make assessments on the matters, and meet the challenges, identified in the Consultation Document at (for example) paragraphs 8.43 to 8.48 and 8.50 to 8.52.

(e) Our customers, and in particular Ryanair and easyJet, are sophisticated and well-resourced companies who would be expected to use competition law proactively, including by

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158 Consultation Document, paragraph 8.49.

159 Consultation Document, paragraph 8.52.

160 Consultation Document, paragraph 8.53.

161 Case No 1046/2/4/04 [2008] *Albion Water v Water Services Regulation Authority*, CAT 31.

162 See, for example, investigations into BSkyB's supply of wholesale pay-TV services (Decision CA98/20/2002, 30 January 2003) and the supply of statutory services by Companies House (Case CP/1139-01, 25 October 2002).

launching complaints and/or damages claims.[163] We would fully expect vociferous and effective complaints in the event that our customers perceived that Stansted engaged in abusive behaviour.

12.18 Although the Consultation Document appears implicitly to accept that competition law provides "sufficient protection" against exploitative conduct when it states that "*these aspects of competition law [are not] a barrier to deregulation*"[164], it goes on to state that "*where an airport operator is deemed to have substantial market power, the application of some form of regulation may prove to be incrementally beneficial*".[165] However, for the reasons given above, whether *ex ante* regulation is "*incrementally beneficial*" is not a relevant consideration under Test B, and amounts to answering the wrong question.

The concerns about Stansted's future conduct are speculative and unfounded

12.19 The Consultation Document states that "*[o]n balance the CAA is minded to consider that there is a risk of potential exploitative behaviour over the short to medium term resulting from STAL's market power… it is likely that the provision of some form of regulation under the CA Act would provide a more effective safeguard against the risk that [Stansted] would abuse a position of substantial market power than competition law*".[166] This analysis is fundamentally flawed.

12.20 The justifications given for these views are largely based on the factors highlighted and addressed above, and are therefore not repeated here. However, one further justification is given in support of these views. The concern, as expressed, is that "*the risk of STAL being in a position to engage in exploitative behaviour is high*"[167], and that "*there is a risk of potential exploitative behaviour over the short to medium term*".[168] The Consultation Document accepts that there are no concerns about the service quality at Stansted.[169] The purported evidence for the risk of "*potential exploitative behaviour*" therefore appears to be that "*[t]he analysis from Test A suggest that STAL <u>may</u> currently be pricing at a supra competitive level*" (emphasis added).[170]

12.21 Even if that finding could be substantiated (which it cannot), that is not a sufficient basis for a conclusion that we will, absent regulation, engage in exploitative conduct for the following reasons:

(a) The fact that we might be in a position to engage in exploitative behaviour is irrelevant to an assessment of whether Test B is met – regarding this as a relevant factor is tantamount to conflating Tests A and B.

(b) For the reasons given in Part II above, there is no basis for concluding that Stansted is pricing at a supra competitive level.

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163 See, for example, the various complaints brought by Ryanair to the European Commission, and the Ryanair's current claim for damages against ExxonMobil in relation to alleged fuel overcharges.

164 Consultation Document, paragraph 8.56.

165 Consultation Document, paragraph 8.56.

166 Consultation Document, paragraph 8.71.

167 Consultation Document, paragraph 8.65.

168 Consultation Document, paragraph 8.71.

169 See, in particular, Initial Proposals, Executive Summary, paragraph 19: "*the airlines tended to view STAL's service quality as being of a satisfactory standard: there was a need to ensure that it did not deteriorate, but most airlines did not wish to pay for major improvements that they believed that their passengers would not value*".

170 Consultation Document, paragraph 8.55.

(c) In fact, the Consultation Document does not conclude that we are pricing at a supra competitive level, only that we may be. Such a tentative (and unfounded) conclusion is not a sound basis for concluding that there is a risk that we will engage in exploitative behaviour in the future.

(d) Even if our pricing were currently at a supra competitive level (which it is not), given the change of ownership of Stansted, previous pricing policies cannot be taken as a reliable guide for future conduct. This is a relevant consideration that the Consultation Document does not take into account.

(e) These provisional conclusions are highly speculative, and are not grounded in sound evidence.

(f) No evidence is offered as to why it is considered that we will start charging excessive prices in the future. Indeed, it is our intention to offer substantial discounts to all airlines to drive growth.

(g) As stated above, our customers, and in particular Ryanair and easyJet, are sophisticated and well-resourced companies who would be expected to use competition law proactively, including by launching complaints and/or damages claims, in the event that they customers perceived that we engaged in abusive behaviour.

Conclusion to Test B

12.22 For the reasons given above, Test B has not been properly understood and applied to the evidence. The material on which that provisional conclusion relies does not (and cannot) justify a finding that it is met. As a result, even if Test A is met, as Test B is not met the overall market power test set out at section 6(1) of the CA Act would not be met.

PART IV

Test C – Benefits of Regulation

13 **Misapplication of Test C**

13.1 Our position is that Stansted does not have substantial market power, and as a result Test A is not met. Furthermore, our position is that Test B is not met either. On this basis, it is not be necessary to consider whether Test C is met.

13.2 However, in provisionally concluding that Test C is met in relation to Stansted, the Consultation Document fails to have proper regard to relevant factors, in particular the emerging proposals for a licence and representations thereon. Although the CAA has published its Initial Proposals, those proposals are still subject to consultation, and indeed key elements of the terms of any licence (including any price control conditions) have not been published.[171]

13.3 In proceeding on the basis that the licence terms will be "proportionate", thus eliminating the need to take the specific characteristics of the likely terms into account, the approach to Test C set out in the Consultation Document is irrational and frustrates the statutory purpose of section 6 CA Act.

The requirements and purpose of Test C

13.4 The market power test, and therefore the threshold for imposing additional regulatory burdens on airport operators, is only met where "*for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects*".[172]

13.5 The purpose of Test C is to prevent licence conditions from being imposed on an operator where that licence is likely to do more harm than good for users. An assessment as to whether a licence condition is likely to do more harm than good requires an assessment of the direct and indirect effects of the likely licence conditions. Such an assessment cannot be carried out without a consideration of what the likely terms of the licence are.

13.6 Given in particular the wide range of potential regulatory outcomes of a licence-based regime, Test C can only properly be applied by reference to the likely type of regulation under such a licence. When conducting the balancing exercise required under Test C, it is not open to the CAA simply to assume that the licence terms would be proportionate. To do so is to prejudge the answer to Test C. Moreover, it is necessary to balance the pros and cons (both direct and indirect) by reference to the specific relevant operator and thus how the likely licence terms are likely to be applied to that particular operator.

13.7 Notwithstanding the approach taken in the Consultation Document, it would be irrational now to disregard developing thinking and representations on a possible licence. We welcome, therefore, the CAA's more recent acceptance that it is a relevant consideration and one on which we will rightly wish to make representations in due course.[173]

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171 See Initial Proposals, Executive Summary, paragraph 56 – "*Price Control Conditions. These conditions will give legal effect to the CAA's final decisions on this issue. They have not been set out in the draft licence at this stage.*"

172 Section 6(5) CA Act.

173 Letter from John Templeton to Stansted, 19 March 2013.

The assessment of Test C

13.8 The assessment of Test C in the Consultation Document constitutes a general description of the generic costs and benefits of economic regulation. It is not analysed in a way that is specific to airports, and certainly not in a way that is specific to the circumstances at Stansted. In particular, the statement in the Consultation Document that it is not necessary to consider the likely terms of any licence in order to apply Test C because it is only required to be satisfied that there is in theory some form of licence that would achieve greater benefits than costs (see paragraph 9.12) is misconceived and irrational. Furthermore, such an approach precludes us, and other stakeholders, from properly responding to this aspect of the Consultation Document, because we cannot know what the benefits and costs of a licence will be without knowledge of the likely terms of that licence.

13.9 Moreover, the approach set out in the Consultation Document, which is based on the assumption that the licence will be proportionate, rather than considering the question based on the form of licence that may be granted, amounts to a frustration of the statutory purpose of Test C.

13.10 The Initial Proposals contain a draft licence to apply from 1 April 2014. However, that draft licence does not contain details of the price control conditions that will apply, pending the CAA's final decision on that issue. It is crucial that the CAA has regard to, and allows Stansted to make representations on the impact of, the entirety of the proposed licence – including any price control provisions and the likely chilling effect of the threat of further price control provisions in the future – in order to determine whether the proposed licence conditions are "likely" (as per the statute) to provide benefits that outweigh the costs in the particular case. We expect to make further representations on this issue, which will need to be taken into account by the CAA in reaching a decision on Test C.

13.11 Further, insofar as the CAA has sought to balance costs and benefits to <u>users</u> – that is passengers and cargo owners – it is not clear that the Consultation Document does genuinely focus on, or establish the link through to, the impact of the proposed licence conditions on users. For example, paragraphs 9.95 *et seq* of the Consultation Document are concerned with costs to the CAA, not users – such considerations are not relevant to the question that Test C poses.

Conclusion to Test C

13.12 For the reasons given above, the CAA must take into account the draft licence conditions and representations thereon, and must set out the detailed reasons to support any conclusion that in this particular case the benefits of licensing outweigh the adverse effects for <u>users</u>. Moreover, it follows that, should the CAA's licence proposals change, it will need to consider and consult on, the impact of any such changes on the assessment of Test C.

CONCLUSIONS

14 **None of the three statutory tests is met**

14.1 The test for market power under section 6 CA Act requires each of three individual tests to be met.

14.2 To conclude that Stansted does not have market power within the meaning of section 6 CA Act, it is only necessary for the CAA to conclude that one of the three tests has not been met. In our view, the Consultation Document does not demonstrate that any of the three tests is met in this case, and therefore there is no basis for the CAA to reach a final decision that Stansted has market power.

14.3 This Interim Response demonstrates that:

(a) Test A is not met:

(i) As the Consultation Document accepts, the evidence does not support a finding that Stansted currently holds substantial market power in relation to the alleged "Stansted short-haul market".

(ii) The provisional conclusion that Stansted is likely to acquire substantial market power in relation to the alleged "Stansted short-haul market" is not supported by the evidence or economic analysis. In particular, the prospective analysis contained in the Consultation Document – which is based on the bleakest possible interpretation of market developments – is insufficient to sustain such a finding.

(iii) The provisional conclusion that Stansted currently holds substantial market power in relation to the alleged "Stansted cargo market" is not supported by the evidence, and is unsupportable as the market definition adopted in the Consultation Document does not reflect how the cargo market operates in reality.

(b) Test B is not met. Not only does the Consultation Document adopt an erroneous approach to Test B which renders it redundant, competition law would demonstrably provide "sufficient protection" against our engaging in abusive conduct.

(c) Test C is not shown to be met. Again, the Consultation Document adopts an approach to Test C which frustrates the statutory purpose of Test C, in particular by assuming that any licence conditions would be "proportionate". An analysis of whether Test C is met cannot be conducted without taking into account the likely terms of any proposed licence.

14.4 The provisional conclusions contained in the Consultation Document are unsound, and cannot provide the basis for a final decision by the CAA that Stansted has market power.

14.5 Indeed, our view is that the CAA is not in a position to conclude that Stansted has market power on the basis of the evidence presented in the Consultation Document. Such a conclusion would be irrational and contrary to the evidence, previous practice, and the applicable economic and legal frameworks.

14.6 We accept that the CAA must reach a robust final decision. It is in our interests that the CAA does so, and we therefore offer our assistance in assisting the CAA in achieving that aim. In doing so, we outline below the key steps that the CAA must – as a minimum - take before it is able to reach a rational and legally robust final decision:

(a) In relation to Test A, the CAA must in particular:

(i) Reassess its analysis of the competitive constraints from European airports and UK airports, including by addressing the issue of marginal switching and by obtaining and considering pre-existing internal documents from airlines relating to their decisions to switch capacity between airports, and the relevant background route yield data.

(ii) Reassess its analysis of current spare capacity and future planned capacity at London airports, and consider the range of potential outcomes in terms of traffic levels and distribution between London airports (obtaining further evidence where necessary).

(iii) Reassess its analysis of Stansted's multi-sided platform.

(iv) Reassess its analysis of Ryanair's buyer power at Stansted.

(v) Reassess the competitive position of Stansted now that all of London's major airports are under separate ownership, and in particular consider how new ownership is likely to drive Stansted's conduct and position.

(vi) Reassess the relative costs and benefits of an approach where the CAA continues to monitor future market development relating to Stansted, rather than concluding that the airport is likely to acquire market power in the future.

(vii) Consult as appropriate on issues arising from that reassessment, including obtaining and providing to consultees the information required in order for them intelligently to respond.

(b) In the event that the CAA concludes that Test A is met, in relation to Test B the CAA must conduct a full assessment of whether further regulation is necessary, and whether competition law provides "sufficient protection", as opposed to an assessment of what is considered to be the preferable route, which renders Test B redundant.

(c) In the event that the CAA concludes that both of Test A and Test B are met, in relation to Test C the CAA must conduct a full assessment of whether the benefits to users of any proposed licence conditions outweigh their adverse effects by reference to the full proposed licence conditions, and representations thereon, including as to the chilling effect of prospective regulation.

14.7 M.A.G's acquisition of Stansted represents a new start for the airport, as well as passengers and airlines. Under new ownership, Stansted is competing hard to win new business. Instead of imposing regulation, there is a clear opportunity for the CAA to stand back and allow the airport's new management to compete freely, and thereby promote competition in the interests of passengers.