APPENDIX I

Evidence and analysis on Test B

Introduction

I1 As outlined in chapter 1, section 3 of the Civil Aviation Act 2012 (CA Act) prohibits the operator of a dominant area at a dominant airport from requiring payment of charges without a licence. The CA Act only permits economic regulation of an airport operator and the granting of a licence by the CAA if all three components of the market power test set out in section 6 of the CA Act are met.

I2 This appendix sets out the CAA's evidence and analysis relating to Test B for the relevant market for Gatwick Airport Limited (GAL). In particular, it considers:

- The legal framework.
- The consultation process, including the CAA's Consultation on Gatwick market power assessment (the Consultation), stakeholders views' and the CAA's analysis.
- The application of Test B to GAL.

Legal framework

The statutory test

I3 In its assessment of the market power test, having established that an airport operator has, or is likely to acquire, substantial market power (SMP) in a relevant market, the CAA is required under Test B to consider whether competition law provides sufficient protection against the risk of abuse of that SMP.[1]

I4 Although Test B is a separate test, it cannot be divorced from the wider regulatory context: i.e. that the CAA has already determined that the relevant operator has, or is likely to acquire, SMP in a relevant market. Under Test B, the CAA must consider the existence and extent of the risk of the relevant operator engaging in an abuse of that position in the

[1] Section 6(4) of the CA Act.

relevant market and how best to prevent it. Test B, is also a precursor to Test C: i.e. it is only if ex post intervention via competition law is inadequate that the CAA should go on to weigh up the relative costs and benefits of ex ante regulation via a licence.

I5 The assessment of Test B must be conducted in accordance with the CAA's general duty in section 1 of the CA Act, that is '*in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services'.*[2] Importantly, the CAA has to assess the adequacy of competition law from the perspective of '*users of air transport services*', which are defined in section 69(1) of the CA Act as passengers carried by the air transport service or a person who has a right in property carried by the service.

I6 Accordingly, when assessing the merits of competition law, the CAA has to further the interests of passengers and cargo owners, and not the interests of commercial passenger airlines or cargo airlines or other intermediary service providers, such as groundhandling providers, car parking or retail concessionaires.

I7 In doing so, the CAA must, inter alia, seek, where appropriate, to '*promote competition in the provision of airport operation services*'[3] as well as have regard to various matters set out in section 1(3) of the CA Act, including the need to secure that all reasonable demands for airport operation services are met.

I8 The CAA must also have regard to the regulatory principles in section 1(4) of the CA Act, namely that its regulatory activities should be transparent, accountable, proportionate and consistent and targeted only at cases where action is needed. In addition, it must also comply with its statutory duty set out in section 73(2A) of the Regulatory Enforcement and Sanctions Act 2008 to avoid the imposition of unnecessary regulatory burdens.

The concept of abuse

I9 Section 6(8) of the CA Act clarifies that conduct may, in particular, amount to an abuse of SMP if it is conduct that is described in the Chapter II prohibition in section 18 of the Competition Act 1998 (CA98). Section 18(2)(a) to (d) of CA98 contains an illustrative list of exploitative and/or exclusionary behaviour, which includes unfair or excessive pricing, unfair trading conditions, market limitation or production limitation,

2 Section 1(1) of the CA Act.

3 Section 1(2) of the CA Act.

discrimination and making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts.[4]

I10 In competition law, a dominant company has a special responsibility not to allow its conduct to impair undistorted competition in the relevant market.[5] It is not the position of dominance or SMP itself that is prohibited but the undertaking using that position to prevent or distort the effective competition in the market.

I11 The European Court of Justice has defined the term abuse in the following way:

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 different from those which condition normal competition in products or services on basis of the transaction 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.[6]

I12 The essential objective of the Chapter II prohibition and its European counterpart (Article 102 of the Treaty on the Functioning of the European Union (TFEU)) is '*the protection of competition on the market as a means of enhancing consumer welfare and ensuring an efficient allocation of resources… This means that it is competition, and not competitors as such, that is to be protected*.'[7]

I13 The CAA regards this objective as consistent with its general duty under section 1 of the CA Act to further users' interests in the provision of airport operation services and, where appropriate, to promote competition.

4 This reflects the position established in European case law that the categories of abuse set out in Article 102 are not exhaustive: see Case 6/72 Continental Can v Commission [1973] ECR 215.

5 Case 322/81 *Michelin v Commission* [1983] ECR 3461, paragraph 57.

6 Case 85/76 *Hoffmann-La Roche* [1979] ECR 461.

7 DG COMP Discussion Paper on the application of Article 82 EC to exclusionary abuses, paragraph 54.

Competition law

I14 Test B focuses solely on the effectiveness of competition law as an alternative to a licence.[8] These provisions include not just the CAA's concurrent competition law enforcement powers under sections 60 to 63 of the CA Act but also the ability of interested third parties to bring private actions before the courts to enforce directly Articles 101 and 102 and/or the CA98 prohibitions.

I15 A wider form of remedy is available in the UK under the CAA's market investigation reference (MIR) powers[9] than is available under Articles 101 and 102 TFEU or the CA98. The Competition Commission (CC) can, at present, and the Competition & Markets Authority (CMA) when it is established will be able to, impose behavioural and structural remedies that are similar to those provided for under the CA Act. However, MIRs can be made when there are features of markets that restrict, distort or prevent competition. It may be difficult to use MIRs to address individual conduct such as excessive pricing.[10]

I16 Generally, the Chapter II prohibition and/or Article 102 TFEU would be used to address an abuse of dominance and the remainder of this appendix concentrates on those provisions as a sufficiently effective alternative to licence regulation.

I17 Other sectoral regulations are applicable in the absence of a licence, which may protect against some forms of abuse but do not form part of 'competition law' as defined in Test B.[11] In any event, the CAA does not consider that those regulations prevent or substantially diminish the risks of abuse of SMP which are identified below. The CAA will give appropriate consideration to their role in the regulatory framework when it weighs the costs and benefits and proportionality of economic regulation via a licence as part of Test C.

8 Competition law is defined in section 6(9) of the CA Act to include Articles 101 and 102 TFEU, Part 1 of the CA98 as well as Part 4 of the Enterprise Act 2002 (market investigations).

9 Part 4 of the Enterprise Act 2002.

10 The Office of Fair Trading (OFT), for example, takes the view that MIRs are appropriate when it has reasonable grounds to suspect that there are market features, which prevent, restrict or distort competition, but not to establish a breach of CA98 prohibitions. Where abuse of dominance is an issue, the OFT would not see MIRs as appropriate, paragraph 2.4, OFT 511.

11 Examples include the Groundhandling Directive (GHD) implemented in the UK as the Airports (Groundhandling) Regulations 1997 and the Airport Charges Directive (ACD) (implemented as the Airport Charges Regulations 2011).

Ex ante versus ex post regulation

I18 Viewed in context, Test B directs the CAA to weigh the comparative merits of ex post regulation (through competition law) as a sufficiently effective alternative to ex ante regulation via a licence.

I19 The CAA's ex ante sector-specific regulatory powers typically pursue different, albeit overlapping, policy objectives to the strict economic considerations that apply under competition law. In particular, the CAA's general duty of furthering passengers' and cargo owners' interests, where appropriate in a way that will promote competition and to have regard to the various regulatory principles set out in section 1(3) of the CA Act would allow it to address a wider set of objectives and employ additional remedies than it could under its European and UK competition law powers. The flexibility of a regulatory licence also supports this. Both sets of powers are ultimately directed at protecting the interests of end users.

I20 Ex ante regulation of the type imposed through a licence has a different focus from that of ex post competition law. For instance:

- Ex ante powers can be utilised to reduce the level of market power in a market and thereby encourage effective competition to become established.[12] Ex ante regulation seeks, where possible, to promote the development of effective competition in the relevant market by fostering market entry and creating incentives for innovation and efficiency. It also may seek to replicate the outcomes that are expected to be seen within an effectively competitive market, for example, by regulating prices. In this way, it can attempt to minimise the scope for market conditions to develop which are conducive to abusive conduct.
- Ex post regulation is designed to protect the degree of competition that already exists within a market (which may not be perfect or effective). It does this (inter alia) through explicit prohibitions set out in the CA98 and Articles 101/102 TFEU, which penalise the actual or potentially abusive exercise of market power. Action under competition law may take time to reach a conclusion post breach and the remedial powers are more limited.

I21 Figure I.1 below summarises the different features of ex post competition law and ex ante regulation.

[12] For example, where in a market not yet operating in a state of effective competition, there is a risk of abusive conduct, regulation ex ante via a licence can deliver detailed remedies for the benefit of all market participants over an appropriate time period.

Figure I.1: Features of ex post versus ex ante regulation

	Ex post	Ex ante
Perspective	Backwards-looking – i.e. relies on historical evidence of abuse that has occurred in an otherwise commercially competitive market.	Forwards-looking (insofar as it prescribes or controls types of market behaviour regardless of particular circumstances, based on public policy priorities or market failures that are found to exist in the market and need to be remedied).
Market definition	A relatively narrow view of product markets driven primarily by demand side substitutability is normally adopted.	Markets are likely to be defined in broader terms than under ex post competition law. Supply side substitution is equally as important as demand side substitution in determination of the relevant market. In the context of airports supply side substitution is unlikely to be viable.
Focus	On redress for past actions and prohibiting future actions of a similar nature.	Addressing market failures arising from a certain industry structure or history.
Nature of remedies	Results in remedies that are narrow in scope, essentially declaratory in nature and neutral in terms of broader implications for industry of the remedies sought in a specific piece of competition litigation.	Remedies generally are very specific in nature but general in scope affecting the majority of customers. Remedies are generally cost based assuming an efficient operator, they are defined in focus by the legislative context. With regards to airports this is in line with the CAA's section 1 duties.
Enforcement	Through the Courts, the European Commission (EC), the OFT, or other relevant designated national competition authority (in the case of airports the CAA).	Generally enforced through independent sector-specific regulators (who are most likely to be able to address complex technical detail and the economic disciplines which characterise a specific industry). In the case of airports, the CAA has this role.

The Consultation process

The Consultation

I22 In the Consultation, the CAA was minded to conclude that competition law alone would not be sufficient to prevent the risk of GAL abusing its market power in the two relevant markets identified. This was based on the following considerations.[13]

- The CAA found that GAL has SMP in two separate markets.

[13] The Consultation, pages 208 to 233.

- The provision of airport operation services to low cost carriers (LCCs) and charter airlines from Gatwick.
- The provision of airport operation services to full service carriers (FSCs) and associated feeder traffic at Gatwick.

- The CAA considered that the risk of detriment to users of air transport services from any abuse of GAL's market power was most likely in the following respects.
  - Excessive prices (where price increases by GAL are passed straight through to the consumer in the form of increased fares) are likely to have a direct impact on consumers' ability to travel. Although the amounts involved are likely to be limited over the passenger group as a whole, these are likely to lead to significant sums overall. Passengers will either 'take the hit' of the higher prices or decide not to fly at all.
  - Where the prices are not directly passed through, this will have a direct impact on the profitability of the airline sector. This is likely to have an effect on the ability of airlines to innovate their product offer, and is also likely to reduce the viability of the routes offered. This would be likely to, ultimately, affect air transport users as a reduction in choice of both airlines and the direct destinations available from the airport.
  - Likewise, the airport operator's ability to charge excessive prices may lead to a reduction in the quality or range of the services that the air transport users receive directly at the airport.
- There were limitations on competition law's ability to address this type of risk of abuse.
  - There were relatively limited precedents for applying competition law to exploitative abuses, such as excessive pricing, and the outcome was hard to predict. The CAA considered that, given this uncertainty, cases in this area could carry greater risks of failure compared to more common exclusionary abuses such as predatory pricing and margin squeeze.
  - Private actions, especially by passengers, are likely to be challenging and complex given the lack of a direct contractual relationship with the airport operator. The incentives for passengers to bring claims were low given the likely small amount of damage suffered by an individual passenger.

- The remedies available to the regulator via its power to impose and modify conditions in a licence are clearer, more comprehensive and forward-looking in terms of scope than those available under competition law.

Stakeholders' views

I23 GAL considered that the CAA had erred in its approach to applying Test B and in particular had failed to assess the likely risk appropriately by failing to take account of the commitments offered by GAL.[14]

I24 In GAL's view, the commitments offered in relation to pricing and service levels eradicated the risk identified by the CAA of excessive pricing or degraded service quality. [15] It also considered that the CAA had erred in stating that an abuse of SMP could take in a wider range of behaviour than that defined by competition law. [16]

I25 GAL also considered that the complaints brought against it about the level of airport charges showed that airlines are willing to challenge airport operators. [17]

I26 In addition, GAL considered that the CAA had only identified generic failings in relation to competition law and was, in any event, being overly pessimistic about the difficulty of establishing excessive pricing or exploitative reduction in service levels given the CAA's sectoral expertise. GAL cited a number of cases where excess pricing had been tackled. [18]

I27 Virgin Atlantic Airways (VAA) agreed with the CAA's conclusion reached under Test B that competition law alone would not be sufficient to prevent the risk of the airport operator abusing its market power in the relevant markets.

I28 VAA considered that ex post competition law would not provide a satisfactory or timely remedy. In particular, VAA highlighted the retrospective nature of this form of remedy, and the relative limited available competition law precedent for exploitative abuses which would

14 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Q5-050-LGW60, 26 July 2013, paragraph 4.3, first bullet.

15 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Q5-050-LGW60, 26 July 2013, paragraph 4.3, first bullet.

16 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Q5-050-LGW60, 26 July 2013, paragraph 4.3, second bullet.

17 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Q5-050-LGW60, 26 July 2013, paragraph 4.3, third bullet.

18 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Q5-050-LGW60, 26 July 2013, paragraph 4.3, fourth and fifth bullet.

result in a long, drawn out process and be an inefficient means to address the problem.

I29 VAA also considered that ex ante regulation has a number of advantages that outweigh competition law and that some form of licence-based regulation should be applicable at the airport. It disagreed with the view the CAA outlined in the Consultation, that airlines might not necessarily be deterred by complexity or expense in pursuing legal challenges. VAA considered that such challenges were expensive and time-consuming and should be seen as a last resort where other remedies have failed – or do not exist in the first place.

I30 The Gatwick Airport Consultative Committee (GACC)[19] agreed with the CAA's view that it would be difficult to successfully discipline airport operator behaviour using competition law in circumstances of vertical abuse where the airport operator does not have a direct interest in the downstream market. It also considered that relying on competition law, as an ex post measure, would not be adequate when there are known market impediments. Relying on competition law is better suited to protecting markets that are already competitive.

I31 The GACC also considered that there was a high risk of abuse of market power by GAL in the form of excessive prices and lower service levels in the absence of regulation. It noted, for example, the CAA's need to assess the adequacy of competition law, for Test B, from the perspective of 'users of air transport services' that the GACC observed that it was extremely unlikely that individual users of air transport services, or collections of users, would have the resources to mount any such challenge, but would instead rely on airlines to resolve problems on their behalf.

I32 However, the GACC's view was that the complexity, risk, cost and distraction of management time, along with the difficulty and uncertain outcome of private damages action (and associated risk of an adverse cost award), would act as a very significant deterrent, particularly for smaller airlines, and would be seen as a last resort. This would probably mean that only major abuses would be challenged, allowing the airport operator to accumulate the benefits of many smaller abuses. That would carry a risk of potential detriment which would have a significant direct impact on passengers/users that could persist for some time.

I33 The GACC also referred to GAL's stated intention to increase prices above the CAA's assessment of a 'fair price' as evidence that there was a

[19] BA and easyJet refer the CAA to the GACC response for their comments on test B.

high likelihood that GAL would attempt to increase prices or to reduce outputs/service quality in the absence of regulation.

I34 The GACC's view was therefore that competition law would be unlikely to provide a sufficient deterrent to prevent abuse and would not provide an efficient or effective remedy if there was any abuse.

CAA views

The concept of abuse

I35 GAL considers that the CAA has erred in concluding that an abuse of SMP could take in a wider range of behaviour than that defined by competition law.

I36 The CAA has based its interpretation of 'abuse' on the wording of Section 6(8) of the CA Act. This sets out that under Test B conduct may, *in particular,* (emphasis added) amount to an abuse of SMP if it is conduct that is described the Chapter II prohibition in section 18 of CA98. As explained above, section 18(2)(a) to (d) of CA98 contains an illustrative list of exploitative and/or exclusionary behaviour. Section 6(8) does not therefore rule out that conduct can be an abuse of SMP even if it is not listed in section 18 of CA98. This reflects the position established in European case law.

Abuses that have most relevance to airport operators

I37 To assess whether competition law would adequately protect users, it is necessary to consider what types of abuse are most likely in the sector and how effectively they are addressed by competition law.

I38 There have been a number of cases taken at both a domestic and European level against airport operators.[20] This indicates that an airport operator is an undertaking for the purposes of competition law and they can be found to be dominant and abusive without any special dispensation.

I39 Case law also illustrates that competition law has been successfully applied in what could broadly be considered as vertical exclusion cases, where the airport operator is active in the upstream market for airport operation services but also has a presence in the downstream market for air transport or other services. The defining feature of these cases is that they all involved the airport operator leveraging its market power to the

[20] Commission decision 95/364/EC, Commission decision 1999/199/EC, Commission decision 1999/198/EC, Commission decision 98/513/EC; T-128/98, C-82/01 Commission decision 98/190/EC and Purple Parking & Anor v Heathrow Airport Limited [2011] EWHC 987 (Ch).

advantage of either its own subsidiary in a downstream market or a closely aligned party.[21]

I40 As it outlined in the Consultation, the CAA considers that for exclusionary behaviour there are likely to be sufficient precedents available from other industries including those that are similarly regulated (such as telecoms or utilities) which could be relied on as relevant authorities in challenging this type of behaviour by airport operators under the CA98 or Article 101/102 TFEU.[22]

I41 However, it is in relation to exploitative abuses that the CAA considers that there is the greatest likelihood of abuse occurring.[23] Where airport operators have SMP, the most obvious outlet for that market power is to bring it to bear on their customers; a type of abuse that would affect users to the extent that it was passed on. For excessive pricing and exploitative service abuses, there is insufficient case law to provide sufficient legal certainty for successfully completing an investigation or private action alleging such abuses.

Potential for public and private enforcement of competition law to protect the interests of users of air transport services against the risk of abuse

I42 GAL contends that the CAA's concerns around the sufficiency of competition law are generic and overly pessimistic. The CAA considers that it is reasonable to take account of an area of weakness in competition law but it should always be applied to the particular area of risk identified in relation to the particular operator.

I43 As explained above, the CAA considers that the principal area of risk in terms of where GAL's SMP might be exercised, absent regulation, is in the area of pricing such as excessive pass through of future construction costs or by reducing the quality of services provided to users of the airport. Accordingly, the CAA assesses whether recourse to competition law (in the form of a complaint to the CAA or a claim before the courts) would be capable of disciplining GAL's pricing to prevent exploitative abuse. The CAA considers the prospect of action by airlines as well as by users themselves.

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21 The early European cases are typified by a strong single market imperative. These cases in the main consist of a state owned airport supporting stated owned airlines.

22 See chapter 11 of the Consultation, available at: http://www.caa.co.uk/docs/33/CAP%201052%20Consultation%20on%20Gatwick%20market%20power%20assessment%20(p).pdf

23 For certain exploitative abuses, for example, discriminatory pricing, the principles are well-established and can more easily be applied to situations involving airports: see, for example, Case C-82/01 P Aeroports de Paris v Commission [2003] ECR 9297.

Administrative action before the CAA

I44 It is open to any person affected to lodge a complaint with the CAA about anti-competitive conduct in relation to the provision of airport operation services. The CAA was granted concurrent powers with the Competition and Merger Authority (CMA) to take enforcement action under CA98.[24] This would require some commitment of resources to providing evidence to persuade the CAA to open a CA98 investigation.

I45 CA98 also offers the possibility of the CAA imposing interim measures to prevent serious, irreparable harm damage being caused while the investigation is being pursued. This power has to date been rarely exercised. Changes to CA98, brought in by the Enterprise and Regulatory Reform Act 2013, aim to make recourse to interim measures easier for competition authorities in future but these new rules are as yet untested.

I46 Despite the economic complexities with proving excessive prices, there have been some infringement decisions by competition authorities with regards to excessive pricing.[25] This highlights that competition law enforcement based on excessive pricing can be the appropriate way to address some types of commercial behaviour.

I47 However, the CAA considers that the recognised difficulty (detailed above) in applying the test in practice mean that cases in this area carry greater risks of failure compared to other forms of abuse.

I48 Given this uncertainty, the CAA cannot reasonably conclude that the threat of fines and/or directions alone will provide sufficient deterrence to prevent operators from engaging in conduct which amounts to excessive pricing.

I49 Once an infringement decision is taken, this may serve to deter future reoccurrence of the conduct in question both by the airport in question and in the market more widely. It is open to the CAA to impose financial penalties and such directions as it considers appropriate to bring the infringing conduct to an end. Although the CAA can order an operator to desist from such conduct in future, there is no guarantee that the conduct will stop as soon as an investigation has been started or that interim relief will be granted. Consequently, there may be a time lag until the conduct ceases at the end of the investigation, during which the abuse will have taken place and user detriment will have been suffered.

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[24] Section 62 of the CA Act.

[25] E.g. Case 2001/893/EC; Napp Pharmaceuticals Holdings Limited and subsidiaries – OFT CA98/2/2001 decision upheld at appeal CAT/1001/1/1/01, and more recently case brought by the Italian Competition Authority against Roman and Milan airports.

I50 Nevertheless, the shortcomings in terms of deterrence of enforcement under the CA98 are that investigations are essentially backward looking and aimed at examining and punishing a specific course of conduct by one airport over a fixed period of time. Moreover, the CAA cannot award any remedies directly to complainants who would have to look to bring a damages claim separately to recover any loss suffered.

Private litigation

I51 An additional deterrent is to be found in the potential for infringement follow on or stand alone damages actions by those affected by the infringing conduct.[26]

I52 Stand alone damages actions[27] are relatively infrequent. The difficult of bringing such actions has been acknowledged by the EC in its proposal for reform of damages actions in the field of competition law:[28]

While the right to full compensation is guaranteed by the Treaty itself and is part of the acquis communautaire, the practical exercise of this right is often rendered difficult or almost impossible because of the applicable rules and procedures. Despite some recent signs of improvement in a few Member States, to date most victims of infringements of the EU competition rules in practice do not obtain compensation for the harm suffered.

I53 Injunctive relief from the courts is also relatively rare and is subject to proof of urgency and the balance of convenience, which is in favour of providing compensation as primary remedy. The test aims to preserve the status quo in the absence of compelling evidence why damages are not an adequate remedy.

I54 This shortfall in effective enforcement of competition law identified by the EC is, in the CAA's view, a reflection of the risks in bringing private actions in this area, including:

- Cases before the EU and UK courts can take many years without any guarantee of success.[29]

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26 Section 47A of CA98.

27 In standalone actions the defendants are obliged to establish liability. In follow on actions, liability will already have been established by a competition authority.

28 Proposal for a Directive on certain rules governing actions for damages under national law for infringements of the competition law provisions of the Member States and of the European Union: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0404:FIN:EN:PDF

29 Cf Crehan v Inntrepeneur Pub Company [2006] UKHL 38 which took 10 years and was overturned in the House of Lords.

- Injunctions relief from the courts is relatively rare and is subject to proof of urgency and the balance of convenience, which is favour of providing compensation as a primary remedy. The test aims to preserve the status quo in the absence of compelling evidence why damages are not an adequate remedy.
- Calculating damages is difficult, requiring the use of complex economic models and accounting techniques and there is currently uncertainty as to the extent to which damages may be reduced by reference to the 'pass through' principle.
- The loser pays principle in the UK courts means that claimants can be exposed to a large commercial risk.

I55 While the CAA is aware of the reforms to private enforcement, which are being consulted upon at both domestic and EU level, there is nothing on the statute book at present and it may take several years before any EU Directive is implemented.

I56 In the present context, a private litigant would in principle face the same difficulties in seeking to prove a case of excessive pricing as the CAA, but would also lack the CAA's investigative powers in order to seek to make good its case. Obtaining such internal documents or confidential information through the disclosure process is likely to be time-consuming and expensive. These evidential difficulties are likely to diminish the deterrent effect of this element of competition law.

Enforcement in passengers' interest

I57 In determining the effectiveness of competition law, the CAA considers the prospect of enforcement action being brought by airlines as well as by end users themselves.

Airlines

I58 Airlines as the direct purchasers of airport operations services will have a strong interest in protecting their interests. However, where the abuse is exploitative in nature, there may be lower incentives on airlines to resort to complaints or legal proceedings where they are able to pass on an increase in airport charges to passengers instead. As the interests of airlines and passengers are not necessarily aligned, it cannot be assumed that airlines will bring claims on behalf of users as many factors are likely to be involved in the decision to commence complex litigation around the appropriate prices for services and airlines may not necessarily with to jeopardise their commercial relationship with the dominant (or potentially dominant) airport operator.

I59 The CAA acknowledges however that some commercial airlines may be sufficiently well resourced and motivated to assume the litigation risks although it also notes submissions from some airlines that they consider there can be barriers to doing so.[30]

Air transport service users

I60 The level of individual damage is likely to be low for an individual user who is therefore less likely to bring an individual claim. Users of air transport services cannot separately identify how much they have been charged for airport services and so may not detect an abuse.

I61 Users are also not always aware of the existence of an infringement or of the extent of the losses they suffered due to this infringement.[31] Additionally, even if users are aware of the abuse, the costs, delays and burdens involved in taking such actions, are likely to be significant compared to the value of their individual claim.

I62 Standalone claims by consumers, in the absence of a decision by a competent competition authority, are rare and are unlikely to provide a source of strong deterrence for an airport operator like GAL. As explained above, air transport users will not have access to confidential cost information, access to relevant confidential files, and wider market data on which to establish a claim of abuse.[32]

I63 Similarly, the threat of damages actions is unlikely to have a strong deterrent effect. Air transport users are indirect purchasers of airport services; they have no direct contract with the airport operator and therefore no contractual claim.

I64 In these circumstances, establishing a causal link between an increase in the charges by the airport operator and an increase in tariff faced by air transport users and the consequent loss to the user would be complex. As acknowledged by the EC in its proposal for a Directive in this area, proving and quantifying harm is generally very fact-intensive and costly, as it may require the application of complex economic models. While the EC is issuing guidance on this[33] for national courts, this is likely to remain a challenging area for end users particularly given the considerable

30 See, for example, Virgin Atlantic Airways response to Gatwick Consultation.

31 EC DG COMP MEMO/08/216 dated: 3 April 2008.

32 EC (2005) Green Paper - Damages Actions for Breach of Anti-Trust Rules {SEC}92005] 1732} COM/2005/0672 final.

33 Communication from the Commission on quantifying harm in actions for damages based on breaches of Article 101 or 102 of the TFEU, C(2013) 3440.

difficulties in establishing whether a price is exploitative and how the consequent harm to the end user should be quantified.

I65 There is also the prospect of class claims or group representative action. Class actions have not proved easy or effective in the UK as a remedy for breaches of competition law. For example, Which? (currently the only body empowered to bring class actions in this field) dedicated 20 per cent of its legal resource to a class action against sports retailer JJB Sports and incurred significant legal costs. Its view at the time was that it was not likely that it would undertake such a case again.[34] While the Government has proposed reforms to the private enforcement of competition law which aim to facilitate collective redress, it is not clear when the proposed reforms will be in place and whether the reforms, if enacted, will be effective. The CAA therefore has significant concerns as to whether, in practice, standalone competition law claims will adequately protect passengers.

I66 In summary, the CAA considers that addressing abuses of market power through private actions would be challenging and complex. This is a result not only of the complexity of evidence required in establishing excessive pricing, but also practical challenges resulting from collective action and the low level of damage to any individual user.

Effectiveness of regulation and competition law in addressing abuses

I67 For price-based abuses, there have been a number of cases taken forward, such that there is a degree of clarity relating to the terms of the test to be applied. In United Brands[35], the lead case, the Court of Justice recognised that *'charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied would be such an abuse'*.

I68 The court proposed a two part test; it should be shown that i) the price cost margin is excessive and ii) the price imposed is either unfair in itself, or when compared to competing products. This test has formed the framework in the assessment of excessive pricing in the cases that have followed. However, the decision did not provide bounds above which prices would be deemed excessive. In addition, case law does not offer a

[34] Speech by Deborah Prince, Head of Legal Affairs, Which? at The Lawyer's antitrust litigation conference in 25 to 26 November 2008.

[35] United Brand v the Commission, Case 27/76. The finding of abuse was not upheld on appeal for lack of evidence establishing excessive pricing against the legal test the court had articulated.

simple rule against which any price above an appropriate measure of cost may be deemed unfair.[36]

I69 The United Brands case also highlights the key issue of determining the appropriate price against which to measure whether there is excessive pricing above that level. There are a number of issues that affect the accurate measurement of the appropriate price:[37]

- As the Competition Appeal Tribunal (CAT) observed in its judgment on excessive pricing in Albion Water: '*Despite the various cases in this area, no consensus has emerged as to what, if any, is the most appropriate method of measuring cost in excessive pricing cases*.'[38]
- Firms normally record their costs in a format designed for financial presentation rather than economic evaluation. When assessing prices from an economic perspective, the CAA is concerned with the marginal costs of production, which is not needed for standard accounting purposes. Therefore, cost data may need to undergo some form of transformation.
- Where a firm supplies a number of products over a number of areas, such as an airport operator, there is an issue of cost allocation and cost recovery. There is no correct methodology for the allocation of common and sunk costs within a business. Based on two differing sets of clear and objective criteria, the costs of a firm may look significantly different. For example, airport costs derived from the perspective of passenger use may look different from those derived from the perspective of airline use but both may be based on a rational allocation.
- Few products are charged on a basic unit cost. Costs are often dependent on volume or have multiple components. This is especially an issue at airports given the bundle of goods that are purchased by airlines. The nature of costs at an airport is such that there is a high fixed cost of provision therefore on a unit basis costs can decrease at a significant rate as volume rises.

I70 A further challenge is that competition law investigations into conduct necessarily focus on a point in time or at least a fixed period. Making a robust assessment of cost information in this context can be difficult as it may not always be possible to gain robust information on past events.

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36 Albion Water Limited v Water Services Regulation Authority [2008] CAT 31, paragraph 212.

37 Lyons B (2007), The Paradox of the Exclusions of Exploitative Abuses, in: Swedish Competition Authority (ed), The Pros and Cons of High Prices, pages 65 to 87.

38 Albion Water Limited v Water Services Regulation Authority [2008] CAT 31, paragraph 88.

I71 In such a context, a sectoral regulator operating a licence-based regime is more likely to be effective in obtaining the information required to detect an abuse. A sectoral regulator would have regular access to information and accounts that would allow it to assess the efficient level of an airport operator's costs more effectively than a competition authority might when considering them on a case by case basis whereby an abusive course of conduct must be established over a defined infringement period.

I72 Competition law also offers a process that can only act to protect against abusive conduct by imposing remedies after the event. Where a market is making a transition from a state in which there were recognised barriers to effective competition to a fully competitive state, the ability of competition law enforcement to tackle the risk of abusive conduct as it emerges is uncertain. This reason on its own means that, competition law is not sufficient to prevent the risk of GAL engaging in abusive conduct.

I73 The adequacy of ex post competition law to deal with future anti-competitive behaviour has been discussed in the context of ex ante control of mergers. The argument is sometimes advanced that the incentives to adopt anti-competitive conduct post-merger are reduced, or even eliminated, by Article 102 TFEU and mergers should therefore be approved. The European Courts have accepted the relevance of Article 102 to merger analysis, but have also accepted that ex post competition law may not be a sufficient deterrent in all cases. This may be the case, for example, if it would take considerable time and resources to detect, investigate and prove abusive behaviour. Interim relief may not be available or appropriate. In the meantime the behaviour of the merged firm could result in serious harm to the competitive process and harm to consumers.

I74 In *Gencor v Commission,* the General Court held that '*while the elimination of the risk of future abuses may be a legitimate concern of any competent competition authority, the main objective in [merger control] is to ensure that the restructuring of undertakings does not result in the creation of positions of economic power which may significantly impede effective competition*.' [39]

I75 Competition law (as defined) applies only once a 'restriction of competition', 'abuse of a dominant position' and/or 'adverse effect on competition' has been established. There are uncertainties and difficulties where the likely focus is excessive pricing and an emerging course of conduct of this type may cause damage to consumers before it can be

[39] Case T-102/96 Gencor v Commission [1999] ECR II-753, paragraph 106.

effectively deterred by an investigation under Chapter II of the CA98 or Article 102 TFEU.

I76 Commentators have noted the difficulty faced by competition authorities in pursuing enforcement action in respect of alleged excessive pricing. For example, Whish notes:

...there are formidable difficulties in telling whether a price is really exploitative, by what standards can this be assessed?[40]

I77 Cases have also often foundered on the difficulty of obtaining sufficient evidence to apply the relevant legal test as another key element that was raised in the United Brands case is that of total economic value. This can take in such matters as brand appeal based on attributes such as the reputation of the airport as a hub or as a holiday, business or LCC airport. Similarly, an airport being situated by a major city provides additional value in terms of access for the airlines' target market. These components add up to the economic value of the service rather than the basic accounting value of the immediate costs of provision. Finding a credible value for these can prove difficult in practice.[41]

I78 Another issue for the consideration of excessive pricing is the role of high prices in the competitive process. High prices can be part of the mechanism of a well functioning market where they encourage entry by equally (or more) efficient competitors and are eventually competed down to the competitive level. A core question is whether it is likely that, given the particular market dynamics, the high prices are likely to drive entry. Therefore an assessment of price over an appropriate time period rather than a simple consideration of the spot price is important.

I79 Furthermore, prices play a role in rewarding investment and innovation, either of which can be damaged if the dominant firm considers it cannot gain the appropriate compensation. The market setting therefore plays an important and variable role in the assessment of excessive pricing. This can mean looking beyond whether a price represents covering costs plus a reasonable rate of return, and taking proper account of the wider market context.[42]

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40 Whish and Bailey, Competition Law, 7th Ed, pages 718 to 719.

41 See Scandlines Sverige AB v Port of Helsingborg Commission Decision of 23 July 2004 [2006] 4 CMLR 1224, paragraphs 241 to 242.

42 AtTheRaces v British Horseracing Board [2007] EWCA Civ 38, [2007] UKCLR 309. In the original hearing at the High Court excessive pricing was upheld, however it was quashed in the Court of Appeal.

I80 Finally, an issue that has been cited with respect to excessive pricing is the reluctance by competition authorities to prescribe clear upper limits for market prices. This stems, in part, from the lack of specialised knowledge of specific industries and in part due to a reluctance to set what would effectively be a form of price control. This has traditionally been viewed as a rather different activity from competition enforcement.[43]

I81 Given that the CAA has concurrent powers as well as responsibilities as the sector regulator, it does not see this as weighing heavily in assessing the merits of competition law in the context of Test B. The CAA assumes that where appropriate, the CAA would be able to regulate prices if such a remedy was required as part of a regulatory decision made under competition law.

I82 There have been some infringement decisions with regards to excessive pricing.[44] This highlights that competition law enforcement based on excessive pricing can be the appropriate way to address some types of commercial behaviour.

I83 However, the CAA considers that the recognised difficulty (detailed above) in applying the test in practice means that cases in this area carry greater risks of failure compared to more common abuses such as predatory pricing and margin squeeze. Given this uncertainty, the CAA cannot reasonably conclude that the threat of fines and/or directions is sufficient to offset the risks of conduct which amount to excessive pricing.

I84 The CAA is also unaware of any competition law cases that have sought to correct an abuse where a dominant undertaking has exploited its SMP by supplying services of inferior quality compared to those that might be expected in a competitive market.

I85 The CAA considers that complex evidential issues may arise in the establishment under competition law of an exploitative service quality abuse. It is the CAA's consideration therefore that an abuse based on service quality is likely to be challenging to tackle through competition law, given the subjective nature of service quality. The CAA therefore considers that if GAL were not subject to a regulatory licence, there would be scope for it to abuse its SMP in ways that are detrimental to users and against which competition law would not offer effective protection.

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43 OCED (2011), Excessive Prices, Background paper for Working Party No.2 on Competition and Regulation, available at: http://ssrn.com/abstract-1946779

44 E.g. Case 2001/893/EC; Napp Pharmaceuticals Holdings Limited and subsidiaries – OFT CA98/2/2001 decision upheld at appeal CAT/1001/1/1/01, and more recently case brought by the Italian Competition Authority against Rome and Milan airports.

Lessons from other industries

I86 The CAA has seen evidence which seeks to draw lessons from other regulated and deregulated industries around the world.[45] The Australian airports have, for example, been subject to ex ante regulation suggesting that this was deemed desirable even given the existence of a comparable set of ex post rules prohibiting anti-competitive conduct.

I87 It is also of note that at a European level, the EC has opted to put in place market opening legal frameworks in relation to both ports and airports driven by their importance in establishing a single market in Europe and for trade purposes.[46] This is despite the existence of a well established competition enforcement regime at European level suggesting that these sectors had characteristics which required an additional degree of market regulation. The EC has opted to put in places safeguards against discriminatory behaviour by airport operators without any requirement that the airport operators in question have a specific degree of market power.

Summary

I88 The remedies offered by competition law have therefore been supplemented with mechanisms to ensure markets open up to competition. This suggests that where airports are transitioning into full competitive conditions, ex post controls may not always be sufficient. The structural remedies mandated by the CC in relation to BAA were only successfully completed with the sale of Stansted in 2013. This is therefore a market in transition with the full effects of the separation of ownership yet to be ascertained not least because of the continuing capacity constraints. In particular the CC said:

Even under separate ownership, moreover, as a result of capacity constraints, competition in the short term may focus on particular types of traffic, for example in off-peak periods, and therefore be unlikely to be sufficiently effective to substitute for regulation. Separate ownership would also give rise to competition to invest in new capacity; but there would be a period of time before there could be confidence that

45 Sectoral examples of market power, regulation and deregulation and implication for Gatwick Airport: A report to GAL, London Economics, Q5-050-LGW50, November 2012 submitted March 2013.

46 Council Directive 2009/12/EC of the European Parliament and of the Council of 11 March 2009 on airport charges; Council Directive 96/67/EC of 15 October 1996 on access to the groundhandling market at Community airports; Council Regulation (EEC) No 4055/86 of 22 December 1986 applying the principle of freedom to provide services to maritime transport between Member States and between Member States and third countries; Council Regulation (EEC) No 4056/86: Application of the competition rules in maritime transport; Council Regulation (EEC) No 4057/86: Unfair pricing in maritime transport.

competition between separately-owned airports was sufficiently effective to substitute for regulation.[47]

I89 The precedents from the EC would suggest that, in such circumstances, purely ex post controls may not be sufficient initially to provide the necessary protection to end users from anti-competitive conduct. Competition law can offer retrospective punishment but with limited scope to offer recompense to affected end consumers. Where a successful transition to competition does emerge over time, the CA Act makes provision to ensure that the CAA can, of its own motion or on request, revisit an earlier determination with respect to one or more of the three component tests under section 6.

I90 This is particularly important as the planning system for airports creates a level of uncertainty within the market. This is especially the case in the south east of England where the Government currently has a moratorium for expansion at the three largest airports. This affects both the likelihood and the timeframe for any expansion by an individual airport in the south east of England. The effects on Heathrow which currently operates at or very close to full capacity at all times are particularly acute. The Airports Commission is currently exploring potential solutions to airport capacity issues but will not produce final proposals until 2015. It is therefore highly unlikely that any new capacity at airports in the south east of England will be available before 2025 at the earliest.

I91 The CAA currently views this as an important factor. It also takes into account that airport operators have a safeguard against ongoing regulation where there is a material change in circumstances, whereby they can ask the CAA to review their position by asking for a fresh market power determination under the CA Act.

Application of Test B to GAL

Degree of competition and extent of GAL's market power

I92 As set out in its assessment of the application of Test A above, the CAA has found that there is evidence to suggest that GAL has SMP based on its view on a range of indicators including market shares, efficiency, pricing, and engagement and commercial negotiations. This SMP will continue going forward, not least due to improving economic conditions and tightening capacity across the London airports over the Q6 period.[48.]

[47] CC, 2009 Report, paragraph 6.87.

[48] See Conclusions on Test A in chapter 5.

I93 Airlines have, in the CAA's view, limited scope to discipline GAL by the threat of moving their business. This is because of the combined effect of a number of factors including significant costs to switching, lack of credible supply alternatives and lack of countervailing buyer power.[49]

I94 In addition, with the Airports Commission reporting its final proposals in 2015, it is highly unlikely that any new capacity at airports in the south east of England will be available before 2025 at the earliest.

I95 A number of factors underpin this conclusion, particularly the CAA's conclusion that there is evidence that GAL, in general, does not entering into timely or effective engagement and negotiations with airlines at Gatwick with respect to charges.[50] For example, the CAA has found that:

- There appears to be limited scope for short-haul airlines to negotiate any discounts to aeronautical charges and the scope for charters to effectively negotiate with GAL on other issues appears limited, other than to the extent that the prospect of regulation underpins such negotiations.
- GAL is often slow to release information, the information that is released is often limited and that meaningful engagement is often absent.
- The experience from the previous control periods of GAL pricing at, or close to, the regulatory cap for several years. If that price cap was removed, it is likely that GAL would increase charges further. Although the CAA considers current prices to be within the range of prices that could reasonably reflect the competitive price, any substantial increases would risk prices rising above the competitive level.

I96 For the reasons set out in appendices E and F, the CAA considers that the competitive constraints on GAL from airlines and passengers switching would be insufficient to lead to a loss of business that would exceed the critical loss level and that therefore GAL would be able to increase its charges by 10 per cent or more from the competitive level.

I97 The CAA considers that the principal area of risk in terms of GAL's SMP is in the area of pricing and service quality. GAL has been the subject of three challenges around unfair pricing under sectoral legislation and this suggests that, particularly for airlines with a smaller share of GAL's traffic

[49] See appendix E, which sets out the CAA's finding on this aspect in more detail.

[50] As set out in Annex G the CAA considers that the bilateral agreements that GAL has recently sought to negotiate with airlines has been motivated by the regulatory settlement and the CAA does not consider that it is clear that absent regulation negotiations would have taken place.

(and their customers), there is a degree of dissatisfaction with the way GAL sets charges and the relationship that they have to underlying costs. Ryanair has twice successfully brought complaints under the Groundhandling Regulations in respect of the structure of charges for check-in facilities.[51]

I98 In their submissions on the CAA's proposals for the form of regulation should the CAA conclude that GAL requires a regulatory licence, airlines have raised a number of concerns around pricing. For example, airlines consider they are at risk of being burdened with excessive pass through of costs should a second runway at Gatwick become a reality.[52] Airlines have also expressed concerns that GAL may seek to increase charges by re-categorising core services as premium services.[53]

I99 The CAA has set out in its findings on Test A why it considers that in the absence of regulation GAL's prices are likely to be raised significantly above current regulated levels which are broadly consistent with the prices that would arise under competitive conditions.[54]

Consequent detriment to end-users

I100 Given these conclusions, the CAA's concern is that, in the absence of ex ante regulatory controls, GAL may have the incentive to raise prices beyond the level that would apply in an effectively competitive market. The evidence from its airline customers[55] is that their concerns are focused on pricing of the kind identified in the United Brands case, with the airport operator setting charges that bear limited resemblance to the economic value of the service.

I101 Excessive pricing could affect end consumers adversely. This may be through higher prices in the form of increases to ticket prices passed on by airlines. Although individually the amounts involved are likely to be limited over the passenger group as a whole these are likely to lead to significant sums. Passengers will either suffer detriment from high prices or decide not to fly at all. User detriment may also be manifested through a reduction of route choice or timing if airlines feel constrained to

51 http://www.caa.co.uk/default.aspx?catid=5&pagetype=90&pageid=12191
http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15082

52 Letter from the CEOs of British Airways, VAA and easyJet to the CAA, 15 October 2013.

53 Letter from VAA to the CAA, 21 October 2013; Letter from GACC to the CAA, 22 October 2013.

54 See appendix G.

55 Responses from airlines to the Consultation suggested that there was a clear indication that GAL would increase prices if regulation was removed (as they considered it has SMP). See for example, easyJet response to CAA consultation on Gatwick airport market power, page 1.

withdraw routes or scale back frequencies either because they become unprofitable or as an attempt to discipline the airport operator.

I102 Likewise, the ability to charge excessive prices by an airport operator can lead to a reduction in the services that the air transport users (or a sub-set of them) receive directly at the airport. Currently, service quality is regulated and the CAA has seen evidence that suggests that passengers are, in general, satisfied with the service they receive from GAL.[56] It is unclear whether GAL's current service levels are attributable to regulation rather than competitive pressure.

I103 Higher charges may also affect the ability of airlines to innovate and introduce new business models to deliver a more effective service for passengers. The CAA has, as noted above, received complaints from Ryanair, an existing user of Gatwick that it has been presented with charging structures which require it to pay for facilities in a way that does not fairly reflect the relatively limited use by its customers of those facilities.[57]

I104 Given the lack of effective competitive constraints on GAL and the potential difficulties associated with public and private enforcement, the CAA considers that, on balance, competition law will not provide sufficient protection against the risk that GAL may engage in conduct which amounts to an abuse of its SMP.

I105 In the absence of ex ante controls via a licence, GAL's customers and more critically its end users would have to mount a challenge by bringing a complaint to the CAA or resorting to private litigation on the allegation the prices had become excessive or service quality had been unreasonable reduced to the extent that GAL was infringing competition law. As explained above, this can be a lengthy and uncertain process and can only be brought to bear once abusive conduct and its negative effects have already taken hold in the market.

I106 Overall, for all of the above reasons, the CAA considers that competition law does not provide sufficient protection against the risk that GAL may engage in conduct that amounts to an abuse of the SMP found to exist under Test A.

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56 See discussion of service quality in appendix G.

57 See, for example: http://www.caa.co.uk/default.aspx?catid=5&pagetype=90&pageid=12191; and http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15082

Effect of GAL's commitments

I107 GAL has provided voluntary commitments that it has stated it would implement regardless of the existence of licence regulation. These commitments provide protections on price, service quality, consultation and operational and financial resilience. Further detail of these commitments and the CAA's assessment of the commitments are set out in Test C.

I108 GAL has submitted that its voluntary commitments should be taken into account in Test B as commitments address the risks of abuse identified by the CAA.

No statutory scheme for commitments

I109 The CA Act does not contain any statutory scheme for the CAA to accept commitments in lieu of licence regulation. The courts are generally reluctant to read in implied powers to do so where the statute does not confer them expressly.[58] This contrasts with statutes in other sectors which make express provision for regulators to accept voluntary commitments in lieu of regulatory intervention.[59] The absence of any express power for the CAA to accept commitments in lieu of a licence may also be contrasted with other provisions of the CA Act which provide for the CAA to accept undertakings.[60]

I110 If the CAA were required to take the commitments into account in assessing Test B, it would in effect be required to consider whether, in a case such as GAL's, 'competition law plus the commitments' is sufficient to prevent an abuse of its SMP. Yet, the purpose of Test B is to assess whether competition law is sufficient to prevent an abuse of SMP by the relevant operator and not to assess the merits of an alternative enforcement mechanism which purports to address the risk of abuse of the SMP found to exist under Test A. That is the remit of Test C.

I111 As the commitments regime has not been set up by statute, this also means that there are no procedural rights for third parties such as a right

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58 *Office of Communications & Anor v Floe Telecom Ltd* [2006] EWCA Civ 768.

59 See, for example, the power to accept commitments in lieu of competition law enforcement in sections 31A-31E of CA98; the power to accept undertakings at various stages of the merger control process in sections 71(2), 73, 80(2), 82 of the Enterprise Act 2002 and the power to accept undertakings in market investigations under sections 154, 157 and 159 of the Enterprise Act 2002.

60 Sections 60 and 62 of the CA Act explicitly provide for the CAA to accept undertakings relating to the supply of airport operation services in lieu, respectively, of a market investigation reference pursuant to section 154 of the Enterprise Act 2002 and during the course of an ongoing investigation pursuant to section 31A(1) of CA98.

to be notified of a proposal to accept commitments and no market testing process. Similarly there is no right of appeal or enforcement process designed to address breaches of any commitments.

The commitments as mitigation of the risk of abuse

I112 Nevertheless, for completeness the CAA has considered whether the assessment of the sufficiency of competition law to protect against the risk of abuse of SMP by GAL is altered if the commitments are taken into account in terms of the degree of that risk. The CAA disagrees with GAL's view that the commitments eradicate that risk.

I113 SMP is the ability to act independently of competitors or customers. The assessment of whether a business has SMP includes its ability to profitably sustain prices above the competitive level or restrict output, quality, investment or innovation below competitive levels. The CAA considers that, notwithstanding the commitments, there is the potential for substantial user detriment and a risk of abuse of SMP. The CAA notes that the concept of abuse under section 6(8) of the CA Act is not confined to an abuse of dominance under section 18 of CA98.[61]

I114 The potential for GAL to weaken any aspects of its offer below that which would represent the competitive level would represent a risk of abuse and user detriment which the CA Act aims to prevent. That includes reducing the current and future range, availability, continuity, cost and quality of its services to users. OFT guidance states that where market power is exercised with the effect that quality, service or innovation is reduced, customers can be thought of as paying higher prices for a given level of quality, service or innovation, thus deriving poorer value for money than competition would deliver.[62]

I115 The CAA has also considered the impact of bilateral contracts that GAL has agreed with airlines in Test B. The CAA understands from GAL that the terms of bilateral contracts have been agreed or are in late stage negotiations with airlines carrying 56% of GAL's passengers, Norwegian, Thomson, Emirates, [✂],[✂].[63]

I116 As set out in Test C, the CAA considers that these bilateral contracts are a function of the commitments regime as they are conditional upon the

61 Section 6(8) of the CA Act makes it clear that conduct may, in particular, be an abuse when it falls within section18(2)(a) to (d) of CA98 which leaves open the possibility of conduct amounting to abuse for the purposes of the CA Act even though it would not amount to an infringement of the Chapter II prohibition.

62 OFT, Assessment of Market Power, oft 415.

63 [✂].

adoption of the CAA's final proposals for licence-backed commitments, and will fall away if the CAA's final proposals are not implemented. In addition GAL has considerable scope to vary the discount provided in these bilateral contracts through varying the underlying structure of charges. For these reasons, the CAA does not consider that the bilateral contracts provide additional protection over and above the commitments. The following assessment therefore focuses on the protection provided by the commitments rather than the bilateral contracts.

GAL's conduct

I117 The offer of voluntary commitments by GAL has to be viewed in the wider context of GAL having SMP and having priced to the cap since the start of Q4. In addition, despite GAL's lowering of the commitments' prices in response to the CAA's revised view of the fair price, GAL has continually made representations that the current and proposed regulated prices are below the competitive level. It advocates that the competitive price should be close to the much higher marketing clearing price. The CAA's view is that, notwithstanding the commitments, GAL would still have the ability to act in a way that is unconstrained by competition or customer pressure.

I118 It should further be noted that the commitments are a function of the regulatory process, with GAL progressively reducing the price of the commitments in response to representations made by the CAA and airlines in an attempt to avoid regulatory intervention. The first commitments price was RPI+4 per cent per year (whether this would have been offered in the absence of the regulatory process is debateable). If this price was used as the basis for comparison the difference in the commitments price and the fair price could be as much as 47 per cent by the end of the commitments period.

I119 The CAA's view is that GAL's pricing history in Q5 and the context in which the commitments were agreed indicates that, they are a response to the prospect of being regulated by a licence and once that prospect is removed, there is a high risk that GAL would exercise its SMP even within the commitments framework it has indicated it would adopt.

The effect of commitments on scope for abuse

I120 The CAA considers that if GAL were not subject to a licence there would be scope for GAL to abuse its SMP in ways that are detrimental to users and against which competition law would not offer effective protection and that this risk would not be removed by the existence of the commitments. In reaching this conclusion the CAA has had particular regard to the following factors:

i) There are significant differences between the terms of the commitments and the equivalent licence protections e.g. on price, service quality and investment that would allow GAL to exercise its SMP to the detriment of users. In addition the commitments do not include other terms, which would be included in a licence, for example to strengthen financial resilience.

ii) There is uncertainty over the extent to which the commitments can be enforced outside of a licence.

I121 The CAA considers these factors in more detail below.

Prices

I122 The commitments cover GAL's pricing but, without a licence, GAL's pricing is not constrained by reference to the fair price, and could be subject to change.

I123 The CAA does not consider that it can assume that GAL's offer of commitments will protect against the risk of a pricing abuse of SMP. As explained above[64], there is a difference between the price offered in the commitments (RPI +0 per cent) and the fair price proposed by the CAA (RPI-1.6 per cent).[65] That equates to an average difference of around £21 million per year over 7 years. After 7 years (the end of the commitments period) the difference between these two pricing paths equates to prices being around 12 per cent higher under commitments.[66] The CAA also notes that GAL has scope to profile prices through the commitments period (subject to certain criteria) which provides GAL with further flexibility to alter prices.

I124 The CAA's fair price is based on a capital expenditure (capex) assumption of around £160 million per year. The commitments however only include a minimum requirement for £100 million per year. If capex remains at that minimum level, the difference between the fair price and the commitments price would increase to 3.6 per cent per year and prices under the commitments could be 26 per cent higher after 7 years. These calculations are based on the CAA's five-year RAB- based calculation. If

64 See further the Gatwick Q6 notice of the proposed licence and Appendix J of this document which discusses Test C.

65 For the reasons set out in Test C and in the Gatwick Q6 notice of the proposed licence, the CAA considers that the fair price is consistent with the price that would result from a company operating in a fully functioning competitive market. The fair price builds in an allowance to enable GAL to recover its efficiently incurred costs and to make a reasonable profit, whilst at the same time ensuring that GAL can finance its provision of airport operation services.

66 This assumes a constant reduction in charges of RPI-1.6% per year over seven years. The revenue impacts do not take account of any traffic impacts from a change in charges.

a seven-year RAB calculation was considered, consistent with the duration offered in the commitments, these price differences after 7 years would increase to 15 per cent (excluding the adjustment for capex) and 29 per cent (including the adjustment for capex) respectively. It is important to note that these differences may underplay the true difference in prices as the commitments allows GAL to flex both the profile of the price path over the commitments period (as long as the average is consistent with the commitments price cap) and to flex the capital plan across the years of the commitment period.

I125 Furthermore, this is the cap on the average or blended price under the commitments. The commitment on published prices is higher at RPI+1 per cent per year. Consequently, prices for some airlines and their passengers could increase by considerably more than the average.

I126 The commitments also include a cost pass through for the costs of a second runway. The development costs of a second runway are significant, which GAL has estimated at between £5 and £9 billion. This compares to the current regulatory asset base of GAL of around £2.4 billion (31 March 2013). While the commitments require GAL to follow CAA policy on the recovery of second runway costs, there is nothing in the commitments that require GAL to ensure that the expenditure is efficient. Given the scale of the expenditure this could lead to significant costs to airlines and their passengers.

I127 The CAA regulates prices at airports to reflect what would happen in a fully functioning market, without capacity constraints. The market clearing price at Heathrow and Gatwick is likely to be above the competitive price as it is influenced by runway capacity constraints which artificially creates excess demand. Any increase of prices to the market clearing price is therefore unlikely to bring forward new runway capacity, as this is exogenous and is a function of Government policy (for example the Government has ruled out of new runways at Heathrow, Gatwick and Stansted for the duration of the current Parliament) and so would increase profits to the airport operator, with no discernible benefits to users. This is the approach used by the CAA and the CC to regulate airport charges at both Heathrow and Gatwick and is used in other regulatory sectors. The CAA considers that these circumstances make the application of competition law against excessive prices particularly difficult.

I128 For the above reasons, the CAA therefore considers that, even with the commitments in place, there is a risk of GAL engaging in conduct which would amount to an abuse of SMP. The limited effectiveness of competition law against excessive pricing is considered above in the CAA's examination of the potential for public and private enforcement of

competition law to protect the interests of users of air transport services against the risk of abuse.

I129 Irrespective of this pricing issue, there are further reasons why the CAA considers that Test B is met for the reasons set out below.

Service quality

I130 As set out in Test C the commitments place limits on service quality with a similar service quality regime that was in place under the Q5 regulatory process. There are however some important differences in the regime and how it would operate, compared to a licence-backed regime, which could result in lower service quality for consumers.

I131 The service quality regime in the commitments provides rebates to airlines if service quality performance falls below certain preset standards. These rebates are based on a maximum amount at risk of 7 per cent of airport charges spread across a variety of service quality measures. The aim of this rebate and the assessment of performance are to incentivise the airport operator to maintain levels of service. The level of the rebate is not intended to reflect the detriment imposed on airlines or their passengers from the service quality failure.

I132 Indeed, passengers' willingness to pay to avoid poor service quality can be many times the rebate paid. For example, GAL's research indicates that passengers are willing to pay for pier service of £1.51 per passenger. Quality of pier service is important to airlines and their passengers as it allows passengers to board flights directly from the terminal rather than using coaching facilities. However, the proposed monthly rebate under the commitments for not achieving the required pier service quality standard is 0.02 per cent of monthly airport charges at that terminal. This could amount to around £10,000, which when compared to passengers' willingness to pay, is equivalent to the value placed on pier service by less than 7,000 people, or around 0.5 per cent of monthly terminal passengers. If the pier service metric is not met, many more passengers than this are likely to be adversely affected.[67]

I133 While the commitments regime provides GAL with financial incentives to improve service quality, it is possible for GAL to comply with the commitments and reduce service quality. This concern is particularly acute for repeated service quality failures. The rebates in the service quality regime are set to zero if there are repeated service quality failures for an individual metric over six months in a financial year. While GAL has committed to prepare, consult and implement an improvement plan for

[67] For Q5 the pier service standard was set at 95 per cent of passengers receiving pier service.

failures for more than six months, there is no assurance that such an improvement plan would be effective. In addition the overall quantum of rebates is capped at 7 per cent of airport charges. Consequently it is at least theoretically possible for GAL to fail every single metric in the service quality regime for the entire year and pay a maximum rebate of around £21 million (based on airport charges of £300 million). This could be far outweighed by the financial benefit to GAL from not having to achieve the required standards. In addition, airlines' and passengers' interests may not always align on service quality and airlines cannot always be relied on to enforce in passengers' interests.

I134 Furthermore, while GAL has agreed the level of the airport performance standards in the service quality regime with the airlines, it has not yet agreed the standards on pier service. Pier service levels are particularly contentious with airlines, with GAL suggesting that standards would fall unless there is significant capital expenditure on Pier 6 south (the CAA has estimated the cost would be around £150 million in the next control period). There is nothing in the commitments that requires GAL to undertake this project (although it is included in the CAA's fair price calculations). Consequently, there is a risk that GAL would avoid this expenditure and impose a lower level of pier service than required by passengers (or assumed in the fair price calculations).

I135 Any exercise of SMP by GAL through a reduction in its service quality standards would act against passengers' interests and there is a risk it could amount to abuse. Ex post competition law is unlikely to provide sufficient protection against these types of abuse because of the difficulty of establishing ex post, to a legal standard, that the quality of service has fallen below levels that would be seen in a well functioning market. The CAA is aware that no cases have been successfully prosecuted on a service quality abuse, the exact legal test required to measure such abuses ex post is therefore undefined. Even if it were possible to bring such cases under competition law, considerable detriment would be incurred by users until sufficiently strong and convincing evidence of an abuse of SMP became available. The CAA has a duty to further the interests of passengers using Gatwick now and in the future regarding, among other things, the quality of service of airport operation services. It must apply Test B consistently with this objective. The difficulties of using competition law to address service quality issues arising out of SMP are therefore a matter that must be carefully considered in applying Test B.

I136 The limited effectiveness of competition law against reductions of service quality was considered in Paragraphs I84 and I85.

Investment and the impact on future service quality and capacity

I137 Under the commitments, as there is a cap on the price charged per passenger, GAL will have an incentive to maximise passenger throughput. However, as mentioned above, the commitments only include a requirement to undertake a minimum capex of £100 million per year on average through the commitments period. The commitments also require GAL to consult with stakeholders over the capital plan and major projects. However there is no commitment on the outputs from the investment plan beyond any legal or statutory requirements. While there will be some financial incentive on GAL to undertake capex to meet the standards set out in the service quality regime, these financial incentives are unlikely to be sufficient to incentivise GAL to undertake significant capex in these areas as the cost of paying the financial penalties for missing service quality targets is likely to be less than the financial costs of any capex scheme.

I138 In addition many of the capex schemes that GAL set out in its business plan (which the CAA has taken into account in its fair price calculation) would provide early bag storage facilities, new departure lounge, children's and outside zones. Neither of these outputs were included in the service quality regime. This is one of the reasons why the CAA introduced capex triggers in previous control periods which required GAL to meet certain output requirements from capital schemes before the expenditure could be included in the price charged. Consequently, for an airport operator with SMP, the commitments provide little surety that the service quality paid for by airlines and their passengers would be delivered. Under section 1 of the CA Act the CAA has to carry out its functions so as to further the interests of Gatwick's passengers. One of the matters to which it must have regard is the need to promote economy and efficiency on the part of any licence holder in its provision of airport operation services and to secure that all reasonable demands for airport operation services are met. The CAA has therefore to ensure that a risk of the kind outlined above is properly addressed by regulation if necessary.

In summary, the existence of commitments still leaves scope for abuse of SMP. The CAA has set out in paragraphs I42 to I85 above its reasoning for concluding that competition law will not be sufficient to protect against the risk of the abuse of the SMP that GAL holds.

Enforcement

I139 For the commitments to protect against the risk of abuse then the commitments need to be enforceable.

I140 The commitments would form part of the Conditions of Use (CoU), to which all airlines using Gatwick's facilities have to submit as a condition of receiving the aeronautical services. Airlines do not have the scope to individually negotiate these conditions. The CAA considers that the commitments within the CoU are, in principle, capable to amounting to a contract, however there are risks around enforceability when parties to the contract change, for example if there is a change of ownership of GAL The CAA considers at least some smaller airlines would be deterred from enforcing any legal rights that they may otherwise have although they would have the option of bringing a complaint that there has been an infringement of competition law to the CAA. The risk of abusive conduct would not have been eradicated by the existence of voluntary commitments which are not enforceable directly by users or by the CAA on their behalf. The CAA therefore considers that competition law would be insufficient in such circumstances to protect against the risk of abuse.

I141 In contrast to the licence, neither the commitments nor the CoU contain any direct enforceable rights for passengers and owners of cargo, who are not privy to the arrangements between GAL and the airlines even though they ultimately pay for the services provided. If the event of a breach of the commitments which occurred in a way that amounted to an abuse of GAL's SMP, and the interests of users were likely to be harmed, action under the commitments to discipline this would fall to the airlines. The protection of the interests of users would therefore depend on the interests of airlines and users being aligned. This may not always be the case, in particular in times of disruption and for arriving passengers.[68]

I142 Neither the commitments nor the CoU would be enforceable by the CAA, which is not a party to the either arrangement. The commitments also operate outside the CA Act. Consequently there is no statutory enforcement regime or penalties or compensatory redress for any breach.

Wider scope of licence regulation

I143 Licence regulation would allow the CAA to intervene on a wider range of areas and impose more effective remedies than under competition law, for example in terms of operational and financial resilience. It would not be possible to protect users by these measures if the CAA were to rely only on competition law.

[68] CAA, May 2012, Review of price regulation at Heathrow, Gatwick and Stansted airports: Q6 Policy Update, paragraph 3.24. http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf

Conclusion on the effects of GAL's commitments

I144 Based on the reasons set out above, the CAA concludes that competition law does not provide sufficient protection against the risk of GAL engaging in conduct that amounts to an abuse of its SMP, even taking account of the commitments. The CAA has concerns over the enforceability of the commitments. In addition under the commitments GAL could engage in different types of abusive conduct against which competition law does not provide sufficient protection, for example in terms of higher prices, lower service quality, and the types of conduct where the CAA considers its duties under section 1 of the CA Act require that it have particular regard to the potential negative effects on users of air transport services.

Final decision

I145 In light of the above, the CAA has concluded that competition law alone will not be sufficient to prevent the risk of GAL abusing its market power in the relevant market. The reasons for this view are:

- In the CAA's view, the lack of constraints on GAL and the prospect of further pressure on capacity in the market it serves mean that it will have the ability to raise prices or reduce service quality and the incentives to do so. Its customer airlines have contended that this is a risk.
- Competition law, whether under the CA98 or the Enterprise Act 2002, is not well adapted to preventing conduct which amounts to abuse of SMP in the form of excessive pricing or unsatisfactory service quality. This is principally because competition law only applies after the event and may not readily be able to prevent conduct occurring in future or to stop consumer detriment in the interim. The case law reveals the difficulty of establishing infringing conduct and there are considerable practical and legal challenges for end users of air transport services affected by this kind of abuse in bringing challenges or seeking damages based on competition law.
- It is only recently that extensive structural remedies separated GAL from joint ownership with Heathrow and Stansted. Government policy and planning issues mean that the structural constraints on capacity will remain a feature for the coming control period. The CAA's view is that competition in the relevant market remains impaired by the existence of SMP on GAL's part. Competition law cannot, for the reasons give above, readily offer a remedy that supports the opening up of the market and construct remedies that are detailed, timely and can be flexed over time.

I146 The CAA therefore finds that Test B is met in relation to GAL as the relevant operator of the airport area as competition law will not provide sufficient protection against the risk of GAL engaging in conduct that amounts to an abuse of its SMP.