



## **Preparing for a more competitive airports sector**

### **Guidance on the assessment of airport market power: Response to consultation on draft guidelines**

**April 2011**

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## 1. Background and context

- 1.1 Effective competition between airports, airlines and other service providers, with consumers being suitably empowered to engage, is the best way to promote consumer interests. However, there are aspects of the UK aviation market where the pressures of competition are not sufficient to protect the interests of consumers and, in these cases, outcomes can be improved by the application of targeted, proportionate regulation.
- 1.2 As competition develops, spurred by changes in airport ownership, the CAA's economic regulation of airports will need to adapt and may be expected to be focused increasingly on a small number of suppliers with particularly strong market positions. One of the key challenges for the CAA will be to identify when it is appropriate to apply detailed economic regulation to airports and how best to apply regulation when it is necessary, so as to support the development of increased competition.
- 1.3 Against this background, the CAA launched two projects in November 2009, under the banner of 'Preparing for a more competitive airports sector'. The first project aims to explain how the CAA will approach the assessment of the degree of competition faced by airports. The second project is intended to support improvement in the way in which the CAA regulates airports by identifying alternative possible methods of regulation that may be better suited to an airport market where competition may play an increasingly important role in protecting consumers.
- 1.4 These two projects have now finished. The CAA recently published a document taking stock of the progress of the project considering alternative forms of regulation. Going forward, this project will be merged with the CAA's work to prepare the next quinquennial review (Q6) for the currently designated airports.<sup>1</sup>
- 1.5 Following consultation on the draft guidelines (published in early February 2011), the CAA is now publishing, alongside this document, the final guidelines for the assessment of competition in the airport sector. This document summarises stakeholders' responses to the consultation and the areas in which the CAA amended its draft guidelines.

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<sup>1</sup> CAA, Identifying alternative forms of regulation for airports – Stock take and way forward, March 2011, available at <http://www.caa.co.uk/docs/5/ergdocs/AltRegulationWayForward.pdf>.

## 2. The need for and purpose of market power assessment guidelines

- 2.1 The CAA has a number of functions that might require it to establish the degree of market power held by, and the degree of competitive pressure on, airports. In particular, the CAA might need to undertake a market power assessment as part of the analysis involved in:
- considering whether an airport should be designated or de-designated for economic regulation;
  - tailoring regulation to the circumstances of each airport that is subject to price and service regulation; and
  - investigations into cases of potential anti-competitive conduct.
- 2.2 In each of these cases, understanding the competitive position of the airport(s) in question is likely to be an important aspect of the CAA's overall assessment. Whilst the principles and techniques applied to understand competition are likely to be similar – reflecting the somewhat technical nature of this form of economic analysis – it is important to recognise that the CAA's decisions will not only be guided by a market power assessment.
- 2.3 Instead, the CAA will combine this assessment with evidence and analysis of a broader set of considerations, reflecting the CAA's statutory duties. For example, the assessment of the need for detailed economic regulation would be informed by the analysis of market power but would also consider the costs and the benefits to consumers of applying that regulation. It is also worth noting that, in each of the above cases, stakeholders would be provided with opportunities to engage on the substance of each investigation on its own merits, including on the evidence used in any market power assessments.
- 2.4 The practice of undertaking market power assessments is not restricted to airport markets. Rather, these assessments are commonly used as part of investigations under competition law and by other economic regulators to determine whether to apply detailed regulation of businesses. In particular, EU and UK competition law require market power assessments to establish dominance as part of investigations of potential abuses of dominance under Article 102 of the TFEU<sup>2</sup> or Chapter 2 of the Competition Act 1998, and the telecommunications sector regulators are required under EC law<sup>3</sup> to assess whether undertakings hold substantial market power (SMP) as a pre-requisite for ex ante regulation.
- 2.5 The EC and the OFT have well-established guidelines on the assessment of market power. As these guidelines are applicable across all sectors, the CAA has sought consistency between its draft guidelines for airports and the OFT's and EC's guidelines. The drafting of airport sector-specific guidelines is intended to draw out issues that are likely to be of particular importance in

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<sup>2</sup> Treaty for the Functioning of the European Union 2008.

<sup>3</sup> The Communications Act 2003 implements the EC's telecommunications directives issued in 2002.

the airport sector and to provide some guidance on how the CAA expects to approach these issues.

### **Subject matter of market power assessments**

- 2.6 Market power assessments seek to understand the degree of competitive pressure faced by a company (an airport) and the likely behaviours this could drive. The greater the competitive pressure the stronger are the incentives on the airport to keep prices at a reasonable level, uphold service quality and deliver appropriate investment. Conversely, the weaker this pressure, the more likely it is that the airport is able to act in ways that might harm airport users, including by increasing prices, scaling back investment or allowing service quality to deteriorate, in order to increase profits above reasonable levels. Low levels of competitive pressure can create situations in which an airport can enjoy a degree of 'market power'.
- 2.7 Assessing the degree of market power involves the evaluation of two main issues. First, the degree to which airport users can reduce their use of the airport if they do not consider the price-service offering to be reasonable. This ability of airport users to go elsewhere, or to switch (some or all of) their business away from the airport, is likely to depend on a number of factors, which a competition assessment seeks to explore in a structured manner. Second, the impact that the switching of users might have on the behaviour of the airport, and whether it would be sufficient to discipline that airport's pricing, service quality, and investment decisions.
- 2.8 The competition assessment guidelines explain the kinds of factors that help to address these two issues. However, an individual assessment will need to reflect the particular circumstances of the airport in question, and the purpose of that assessment. Consequently, the approach set out in the guidelines might not be appropriate in some specific circumstances. In such cases, the CAA would expect to set out its reasons for departing from these guidelines.

### **3. Process leading to the competition assessment guidelines**

- 3.1 The CAA has sought to involve stakeholders in the development of its thinking from an early stage. This engagement has been structured around a number of Stakeholder Working Group meetings, which have provided a forum for discussion and the identification of issues that need to be addressed by the guidelines. This discussion has been supported by a number of CAA papers and, importantly, presentations and written submissions from a number of stakeholders. We have also held a number of bilateral meetings with stakeholders, either at their request or where the CAA wanted to explore issues that were not covered in the working group meetings, in order to ensure a wide variety of views were gained.
- 3.2 The CAA would like to thank all those that have participated throughout the project for their contributions.
- 3.3 In September 2010 the CAA published an issues paper ('the September Issues paper') that discussed its approach to drafting the competition assessment guidelines and identified what it saw as the most pertinent issues affecting the assessment of airport market power. Stakeholders provided comments on this paper in two further Stakeholder Working Groups, and some stakeholders also provided written comments.<sup>4</sup>
- 3.4 In addition to the September issues paper, the CAA published two working papers discussing some of the empirical approaches that can be used, as part of a competition assessment, to analyse geographic aspects of competition and understand what can be inferred from evidence about the behaviour and performance of airports. Stakeholders have been invited to comment on these papers.<sup>5</sup>
- 3.5 In February 2011 the CAA published a draft of the guidelines for final consultation. In addition to comments discussed at a subsequent stakeholder meeting, the CAA also received a number of written responses that are summarised in this document. The CAA also discussed the guidelines, on the working level, with the OFT and the Competition Commission.
- 3.6 The following chapter is structured in two parts:
- The first section summarises the consultation responses received from stakeholders; and
  - The second section sets out the CAA's views and outlines areas in which substantive changes have been made to the guidelines since their publication as draft guidelines in February 2011.

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<sup>4</sup> The CAA's September Issues paper and the written comments by stakeholders are available on the CAA website: <http://www.caa.co.uk/default.aspx?catid=5&pagetype=90&pageid=586>.

<sup>5</sup> The CAA's working papers empirical methods for geographic market definition and assessing behaviour, performance and profitability are available on the CAA website: <http://www.caa.co.uk/default.aspx?catid=5&pagetype=90&pageid=586>.

## 4. Consultation responses and CAA's views

### Consultation responses

- 4.1 The CAA received a number of written responses from airport and airline stakeholders. These, in addition to comments made at the stakeholder meeting in February 2011 and discussions with the Competition Commission and the OFT, were considered as part of the finalisation of the competition assessment guidelines.
- 4.2 This section summarises the main themes of stakeholders' written responses, and the next section sets out the CAA's views on these and, where appropriate, the consequent changes made to the competition guidelines. The written responses and minutes of the stakeholder meeting on 24 February 2011 can be found in full on the CAA's website.<sup>6</sup>
- 4.3 The responses revealed different levels of support for the guidelines overall. In addition, the written comments contained a number of criticisms and suggestions. The majority of these could be clustered into the following themes:
- Many stakeholders criticised the lack of precision of the guidelines. They argued that to provide additional certainty to market participants the CAA needed to provide more detail about how it would conduct its analysis and how it would interpret different types of evidence.
  - Some stakeholders were concerned that the guidelines were somewhat biased in places towards a specific interpretation of evidence that was unjustified.
  - It was noted that the guidelines were meant to support different regulatory functions, namely the decision about ex ante regulation of airports and investigations of anti-competitive airport behaviour. However, some responses argued that the impact of these differing findings on the competition assessments was not spelled out sufficiently clearly. It was also left unclear if and how the guidelines might need to be revised in the light of the prospective new legislative framework.
  - A number of points were made on the substance of the guidelines, in particular on the four main issues (competitive price level, multi-sided markets, capacity constraints and airline buyer power and switching) that had previously been subject to extensive discussions during the stakeholder meetings and in the covering paper accompanying the draft guidelines published in February 2011. Many of these comments reiterated arguments that had already been raised previously and were fully considered for the draft guidelines published in February 2011.
  - Where comments were made on the substance of the guidelines, and which had not been discussed previously, these typically took the form

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<sup>6</sup> CAA website: <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=68>.

of suggestions for specific areas of the guidelines that would benefit from further specification and clarification.

- Some stakeholders raised issues regarding the CAA's wider work programmes and functions, in particular regarding the way in which the CAA would decide on the need for future ex ante regulation and its general approach to economic regulation.

### **CAA views**

- 4.4 This section outlines the CAA's views on the general themes that arose in the written stakeholder responses and the conclusions it reached on their basis. A list of changes to the draft guidelines is then provided in Annex A, which also picks up a number of comments on the detail of the guidelines.

#### *The need for more precision and predictability*

- 4.5 The CAA considers that there was general agreement on the purpose of the guidelines, namely: to provide additional certainty regarding the CAA's future approach to the determination of the degree of market power held by individual airports. Indeed, one of the reasons for the CAA to embark on this project was to provide clarity on the conceptual approach it would take to future competition assessments, in advance of the assessments themselves.
- 4.6 In drafting the guidelines, the CAA has adopted, as much as possible, the approach and style of established market power assessment guidelines published by the OFT and the Competition Commission. The CAA has also sought to develop guidance that is consistent with the relevant general competition case law.
- 4.7 When producing the guidelines, the CAA has sought to identify areas where the characteristics of airport markets are such that additional guidance can be given that would be generally applicable to the assessment of market power at any UK airport. In doing so, the CAA has sought to avoid making statements about how it would approach the assessment of any particular airport or to undertake analysis that would form part of such an assessment. The CAA notes that principles-based guidelines are widely used and accepted by the EU and UK competition authorities. This is particularly true for areas that require an assessment of effects, rather than of specific forms of behaviour that are explicitly prohibited under law (for example specific forms of collusion).
- 4.8 The CAA carefully considered whether there were any areas in which more specificity would add any genuine value, without the risk of pre-empting the outcome of any individual competition assessment. It is the nature of competition assessments that any individual piece of evidence can only be interpreted properly in the context of the specific circumstances. It therefore appeared that to provide any further detail, for example in the form of worked examples, risked providing a misleading impression that there was certainty about the way the CAA would interpret evidence in any one set of circumstances.

- 4.9 The CAA did not regard it as appropriate for guidelines to be overly specific as to the way in which it would carry out individual pieces of the analysis or how it would perform certain calculations, on the basis that this could differ for different airports. For example, one stakeholder suggested the guidelines should specify whether it would calculate market shares on the basis of air transport movements, passengers, revenues or other metrics. However, the CAA considers that it is not possible to specify such detail independently of the actual assessments as each of the approaches might be appropriate in different circumstances.
- 4.10 In order to provide some additional information about the methods and the data that might be employed for a competition assessment, the CAA has published a range of other material throughout the project, including two working papers on empirical methods for the areas of geographic market definition and the assessment of airport behaviour and performance, the September 2010 and February 2011 publications and presentation material used for the stakeholder meetings.

*The need to avoid pre-judging the outcomes*

- 4.11 The CAA has made a clear commitment to an open and transparent dialogue with stakeholders throughout the preparation of the guidelines. Furthermore, the CAA agrees with stakeholders that the guidelines should not pre-judge the outcomes of any competition assessment, or express a pre-disposition towards a particular result or interpretation of evidence. Rather, guidelines should focus on explaining how the conceptual framework relates to airport markets, including guidance on areas that appear likely to be particularly important to the overall assessment. The CAA reviewed the guidelines carefully and made some amendments to provide additional clarity. For example, the section on capacity constraints was amended to provide a clearer explanation of the possible effects of non-transitory capacity constraints caused by external barriers to entry on competition.

*The different purposes for which these guidelines will be used*

- 4.12 The purpose of the guidelines is to inform the analysis of whether a specific airport possesses substantial market power (SMP). This question is relevant in a number of different contexts, including in the context of determining whether to regulate and when establishing the form of airport regulation, and in the context of investigating whether an airport has engaged in anti-competitive behaviour.
- 4.13 While the subject matter is principally the same (establishing the degree of market power), depending on the context, the scope and time horizon of an assessment can differ. Most importantly, as noted in the draft guidelines, an assessment supporting the consideration of future regulation needs to be based on a forward-looking assessment ('Will the airport enjoy SMP in future?'), whereas an investigation of current or past behaviour needs to be conducted with a focus on the current and/or historical situation ('Did the airport enjoy SMP at the time of the alleged anti-competitive behaviour?').

- 4.14 The CAA agrees with the stakeholders that argued that the specific purpose for a competition assessment might not only shape the time horizon, but it might also shape the scope of the assessment itself. For example, while the consideration of future regulation might require an understanding of the airport's position as a whole, an investigation of a complaint about the provision of a specific service (for example surface access) might require a much narrower focus. The CAA has amended the guidelines to incorporate this point and to clarify the other potential differences between assessments.
- 4.15 In respect of the resilience of the guidelines to future changes in legislation, the CAA has produced these guidelines on the basis that any legislative requirement to assess market power would be modelled on the assessment of market power that supports investigations under Article 102 of TFEU/Chapter 2 of the Competition Act 1998. If future legislation required a significant deviation from this assumption, the CAA would expect to review the applicability of the guidelines, in consultation with stakeholders.

*Comments and suggestions on the substance of the guidelines*

- 4.16 Stakeholders addressed a number of issues regarding the substance of the guidelines. Although not limited to these areas, many of the comments were focused on the four issues that had been extensively discussed with stakeholders throughout the project, namely:
- the competitive price level;
  - multi-sided markets;
  - capacity constraints; and
  - airline buyer power.
- 4.17 A large number of these comments reiterated and / or reinforced comments that have been raised previously and that were considered for the preparation of the draft guidelines published in February. In each case, the CAA reviewed its previous argumentation and material set out in the draft guidelines. Based on this review and previous discussions with stakeholders, its academic consultants, the CC and the OFT, the CAA has amended the drafting of the guidelines to add further clarification. This was done, for example, for the sections regarding the CAA's proposed approach to assessing capacity constraints. A summary of these changes are set out in Annex A.
- 4.18 A small number of comments raised new issues. In particular, stakeholders suggested clarifying the meaning and purpose of the diagrams in the guidelines' annex. Consequently, the CAA has added further references and explanations to the guidelines, clarifying the diagrams' status and purpose: that it is an illustration of the issues that the CAA might consider when assessing airport users' possibilities to switch away from the airport and the associated switching costs that affect the likelihood of airport users acting on any of these switching possibilities.

*Comments regarding the wider context in which the competition guidelines will be applied*

- 4.19 Some stakeholders raised issues regarding the CAA's wider work programmes and functions, in particular regarding the way in which the CAA would decide on the need for future ex ante regulation and its general approach to economic regulation. These questions are beyond the scope of this project, which has focused on how the technical analysis of market power in airport markets would be carried out. However, they are at the core of the CAA's future work regarding the economic regulation of the three designated airports. The CAA has recently announced the one-year extension of the current Heathrow and Gatwick price controls.<sup>7</sup> In its decision statement on the extension, the CAA said that it would use some of 2011 to facilitate with stakeholders a strategic-level discussion on the objectives for Q6, including how future regulation could be best designed to further the interests of consumers and take into account the evolving competitive dynamics at the designated airports. The next step in this process is the publication in July 2011 of a "Setting the scene for Q6" consultation document, which will be informed by two stakeholder roundtables in May and June 2011.
- 4.20 In respect of the designation criteria, the analysis of competition is one part of the overall assessment of whether an airport should be subject to detailed price and service regulation. Indeed, the market position of an airport is crucial to the first of the three designation criteria. However, the remaining two criteria refer to a much broader set of considerations, relating to the incremental benefits of applying detailed economic regulation. These considerations fall outside of the scope of competition guidelines.

**Summary**

- 4.21 In addition to stakeholders' comments, the CAA also sought advice on its guidelines from its economic consultants<sup>8</sup> and, on a working level, from economists at the CC and the OFT. All of these comments helped shape the final guidelines and the CAA would like to thank everyone involved for their contributions.
- 4.22 The Annex provides an overview of the significant changes that have been made to the draft guidelines.

<sup>7</sup> CAA *Extending the current price regulation at Heathrow and Gatwick airports – The CAA's decision* March 2011 <http://www.caa.co.uk/docs/5/ergdocs/Q5extensiondecision.pdf>

<sup>8</sup> Prof. Stephen Davies, David Starkie, Dr Mike Walker and Prof. George Yarrow.

## Annex A. Significant changes made to the draft guidelines

Chapter	Paragraph (reference to final guidelines)	Change made
Foreword		new
1.	1.1-2	new
	1.4	footnotes 1 and 3 added
	1.6	amended
	1.9-10	moved up from Chapter 2
	1.11	amended
	1.12	new
	1.13	moved up from Chapter 2
2.	2.1	amended
	2.3	new
	2.4	amended
	2.5-6	moved up from end of Chapter 2
	2.14-16	new
	2.19	new
3.	3.1-5	amended/ new
	3.6	new
	3.7	moved up from beginning of product market section

Chapter	Paragraph (reference to final guidelines)	Change made
3.	3.9	amended
	3.10	amended
	3.17-18	amended
	3.28	new
	3.36-37	amended
	3.43	amended
	3.54	footnote 44 amended
	3.61	amended
	3.69	new
4.	4.3	amended
	4.5	amended
	4.7	amended
	4.8	amended
5.	5.6	new
	5.9	amended
	5.12	amended
6.	6.4	amended
Annex A.	A.1-3	new
	Figures 1-2	amended