

# CAA comments on the CC's competition working paper *Non-confidential version\**

## 1. Introduction

- 1.1 This paper sets out the CAA's main comments on the CC's competition working paper, published as part of the quinquennial review of Stansted Airport. This response should be read alongside the material previously submitted to the CC and the comments made by the CAA to CC members and staff.
- 1.2 The CAA has significant concerns with the CC's approach in its competition paper and, in particular, the use of an atypical analytical approach, an overly theoretical benchmark against which to measure airport performance, and the dismissal of key pieces of evidence without good reason. Combined, the paper's shortcomings question whether it is a sufficiently robust basis upon which to base conclusions on Stansted's market power or on the impact that RAB-based regulation would have on other UK airports.

### Overall analytical approach

- 1.3 More specifically, the CAA observes that the CC's approach is inappropriate for the analysis of airport competition as it:
- **does not present a structured competition analysis**, not least because it does not set out – or consistently apply – a geographic or product market definition, contrary to standard practice and OFT and CC guidelines;
  - **adopts a textbook model of perfect competition** to analyse Stansted's performance, unsurprisingly leading to the conclusion that it does not operate as predicted by this theoretical model;
  - **ignores or dismisses key sources of constraint on Stansted**, including no mention of the potential for interactions with Heathrow and Gatwick nor of the important role that the price caps on these airports play in explaining the overall competitive dynamic;
  - **treats market power as a binary concept**, failing to recognise that there is a balance of evidence – some of which points towards, some of which against, the existence of significant competitive constraints – dismissing individual pieces of evidence unless they *individually* provide definitive conclusions;
  - **fails to assess the cumulative impact of all the competitive constraints**, instead dismissing individual constraints unless they are individually capable of disciplining Stansted; and
  - **confuses the ability sufficiently to constrain with the existence of competitive interactions**, when it assumes that if Stansted is not sufficiently

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\* Confidential material has been excised and marked with a '§<' symbol.

constrained by Luton then Luton will not be affected by Stansted, despite the possibility of an asymmetric interaction between the airports (as recognised by the CC elsewhere in its paper).

### **Evidential shortcomings**

1.4 The CAA also highlights a number of significant evidential shortcomings, in the CC's paper including that it:

- **uses average as a proxy for marginal willingness-to-pay**, which inevitably introduces a systematic bias into the evidence base, which is concerning in light of the weight placed on this piece of evidence;
- **dismisses the role of pan-European competition**, despite evidence being provided to the CC from airports and the CAA, and airlines' own public statements that they operate (and optimise their networks) across a European market;
- **dismisses the existence of competitive interactions between UK airports** – including between Stansted and Luton and between Luton and regional airports – on the basis of a flawed argument of assumed 'back fill' and despite there being a significant body of evidence – notably from airport operators – suggesting that this is relevant; and
- **places considerable weight on selective extracts of BAA documents**, without placing equivalent weight on other material contained in the same documents that contradict the CC's views.

1.5 The CAA recognises that there are differences between the statutory frameworks that apply to the Market Investigation of BAA Ltd and the quinquennial review of Stansted, and that the appropriate competition analysis should differ in a number of important respects between these inquiries. However, the CAA does not currently understand how it is possible to reconcile the CC's stated view of how Stansted operates within its market (and the lack of competitive interaction between it and its closest – and most proximate – competitor) and the CC's Emerging Thinking that there is potential for more competition between Stansted and more distant BAA airports.

1.6 In light of the serious concerns that the CAA has identified, it has commissioned an external, expert review of the CC's paper. It has not proved possible to submit this to the CC by its deadline, but this paper should be completed by 8 August.

1.7 The remainder of this paper is organised in the following sections:

- The CC's approach to competition analysis;
- Application of the competition analysis to the price control;
- Errors of fact and argument;

- Use of LRAIC as a benchmark of long-run average competitive prices;
- CC's estimate of replacement cost; and
- Comments on the evidence cited by the CC.

## **2. The CC's approach to competition analysis**

2.1 The CAA sets out a number of concerns with the CC's approach to competition analysis, including:

- the lack of a structure market definition;
- approach to the market power assessment; and
- the CC's assessment of the evidence.

These are discussed below.

### **Lack of a structured market definition**

2.2 The CC's paper adopts an atypical approach to analysing competition, in that it fails to consider the relevant geographic and product markets, before going on to assess issues relating to the market power assessment.

2.3 Indeed, the OFT guidelines on market definition explain that the step of defining the relevant market is normally an important part of competition analysis:

“Market definition is not an end in itself but a key step in identifying the competitive constraints acting on a supplier of a given product or service. Market definition provides a framework for competition analysis... Market definition is usually the first step in the assessment of market power.”<sup>1</sup>

2.4 This is mirrored in the Competition Commission's own guidelines on Market Investigations:

“The Commission's approach to market investigation references will normally be framed in terms of two related issues. The first concerns the identification of the relevant market (or markets) for the goods or services concerned (hereafter referred to as products)... The second concerns the Commission's assessment of competition in the market ...”

2.5 Whilst the CAA endorses the OFT's statement that “market definition is not an end in itself” and that the important issue is to collate and assess the evidence on the sources of constraints on an undertaking, the lack of a structured analysis limits the degree to which the CC's overall argument can be assessed. In particular, the overall presentation of evidence is difficult to assess in the round, as individual elements are not brought together in a coherent manner to address the issues of market definition and market power.

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<sup>1</sup> “Market definition guideline”, OFT, December 2004

- 2.6 The lack of structured analysis of the relevant geographic market is illustrated by the lack of any discussion of the interactions between Stansted and the other BAA London airports. Instead the paper limits its analysis – apparently by assumption – to the consideration of non-BAA airports. Imposing such a prior assumption to the analysis of the geographic market is clearly not appropriate as it will result in an incomplete analysis that cannot be guaranteed to result in an appropriate conclusion.
- 2.7 The CAA also notes that a product market definition is not proposed by the CC.

## Approach to the market power assessment

### *Adoption of an atypical approach*

- 2.8 The CC does not appear to have adopted the standard approach to the assessment of market power. The OFT explain that:

“Market power can be thought of as the ability profitably to sustain prices above competitive levels or restrict output or quality below competitive levels.”<sup>2</sup>

- 2.9 The OFT also state that:

“When assessing whether and to what extent market power exists, it is helpful to consider the strength of any **competitive constraints**, i.e. market factors that prevent an undertaking from profitably sustaining prices above competitive levels.”<sup>3</sup> [original emphasis]

- 2.10 This approach does not distinguish between the sources of individual competitive constraints. It also highlights the importance of considering the “strength of **any** competitive constraints” (emphasis added).

- 2.11 In contrast, the CC appears to adopt a different analytical approach, and instead identifies which:

“... non-BAA airport[s] ... could be considered an effective substitute by airlines and passengers”<sup>4</sup>

- 2.12 It is worth considering the different aspects of this approach. First, the CC appears to restrict its analysis to non-BAA airports by assumption. This is particularly problematic in the current context as the other BAA London airports are both significant potential substitutes to Stansted – which, in the CAA’s view, are in the same geographic market – and, importantly, are subject to binding price controls.

- 2.13 In fact, the CC’s paper fails to discuss the impact of the other BAA London airports on its analysis. This is an unusual omission, in light of the need to consider the “strength of any competitive constraints”. Furthermore, in light of the need to consider the incentives faced by Stansted, the CAA considers that any reasonable

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<sup>2</sup> “Assessment of market power”, OFT, December 2004

<sup>3</sup> *ibid*, OFT, December 2004

<sup>4</sup> “Assessment of competition at Stansted Airport”, CC, July 2008

analysis of the market power held by Stansted would need to assess the impact of both BAA's ownership of other airports and the impact of the binding price controls imposed at Heathrow and Gatwick.

2.14 Indeed, the OFT states that:

“Economic regulation is a further relevant factor [to the assessment of competitive constraints] when assessing market power in industry sectors where, for example, prices and/or service levels are subject to controls by the government or an industry sector regulator.”

and

“In some sectors the economic behaviour of undertakings (such as the prices they set or the level of services they provide) is regulated by the government or an industry sector regulator, and an assessment of market power may need to take that into account.”<sup>5</sup>

2.15 In short, the CC has failed to analyse one of the major sources of constraint on Stansted's conduct. Whilst, the price controlled airports of Heathrow and Gatwick cannot be viewed as operating 'as if' they were wholly independent competitors, it is equally inappropriate to ignore the potential for these airports to constrain Stansted, as the price caps on these airports affect the incentives faced by BAA at Stansted. The price caps on Heathrow and Gatwick prevent BAA from coordinating price rises across the airports and dull the incentive to do so, as gains experienced at Heathrow and Gatwick are 'clawed back' by the price control mechanisms at these airports. As a consequence, the price caps at Heathrow and Gatwick are a relevant source of 'competitive' constraint on Stansted.<sup>6</sup>

2.16 Second, the CC's proposed test seems to be that constraints on conduct are only relevant if they are "...considered an effective substitute by airlines and passengers...". This appears to impose an inappropriate precondition on the type of competitive constraints that the CC considers to be relevant (and contrasts with the OFT's reference to "any competitive constraints").

2.17 The CAA has already argued that competitive constraints can take a number of different forms for airports, including:

- switching by airlines of existing services away from an airport;
- switching by airlines of their growth plans away from an airport; and
- switching by passengers away from using an airport (be it to another airport or in the form of an overall reduction in travel demand).

2.18 Clearly, if the forms of relevant switching are restricted to those that involve airlines and passengers (together) this will systematically under-state the sources of

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<sup>5</sup> *ibid*, OFT, December 2004

<sup>6</sup> Technically, it may be problematic to describe these incentive effects as "competitive constraints", as they arise from the operation of regulation. However, what is clear is that they are relevant to the question of whether Stansted has the ability and incentive profitably to sustain prices above the competitive level.

competitive constraint and tend to restrict artificially the geographic market to neighbouring airports.

2.19 Indeed, this approach might explain why the CC places reliance on the analysis undertaken by Frontier, when this analysis did not consider whether airlines and/or passengers would switch away from Stansted and instead considered the price reduction that would be necessary for East Midlands Airport to attract the same route and all of the same passengers to use the airport instead of Stansted. This highly restrictive analysis is clearly not relevant, as it models an unrealistic (and clearly not marginal) form of switching that involves Stansted passengers from, say, Kent travelling up to East Midlands.

2.20 The CC then goes on to restrict its assessment of competitive constraints further by adopting a definition of “effective substitutes” as follows:

“If Luton were an effective constraint on Stansted, we might expect to have seen enough switching to Luton to make the recent price increase at Stansted unprofitable.”<sup>7</sup>

2.21 Taken at face value, this appears to imply that the CC’s test for determining the competitive constraints faced by Stansted first imposes a restriction of assessing only non-BAA airports and then imposes a further restriction of only considering those non-BAA airports that alone are capable of disciplining Stansted’s pricing. This contrasts with the OFT’s suggested approach and leads to a systematic bias in the assessment against smaller sources of competitive constraint that, whilst individually weak, are cumulatively significant. As discussed later in this paper, this is particularly problematic as evidence suggests that regional UK airports could collectively impose a discipline that is similar in magnitude to that of Luton.

#### *Failure to consider the strength of market power*

2.22 The CC does not present a coherent explanation of the degree of market power that Stansted might currently or prospectively enjoy. Instead, the CC concludes both that “Stansted is likely to develop market power”<sup>8</sup> and that “it has significant market power”<sup>9</sup>.

2.23 Stansted clearly has some degree of market power – as no business will measure up to the perfect competition model. The important issue is, therefore, the degree of market power. The OFT recognises this in its market power guidelines:

“Market power and buyer power are not absolute, but are matters of degree; the degree of power will depend on the circumstances of each case.”<sup>10</sup>

2.24 Instead, the CC adopts a seemingly binary approach to its analysis, whereby if Stansted does not compare well to the model of (arguably perfect) competition constructed by the CC then it must have significant market power. As most – if not

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<sup>7</sup> Paragraph 21, CC, July 2008

<sup>8</sup> Paragraph 2, CC, July 2008

<sup>9</sup> Paragraph 7, CC, July 2008

<sup>10</sup> “Assessment of market power”, OFT, December 2004

all – companies will fail the first test, if this approach were to be adopted more generally it would inevitably lead to the conclusion that most companies have significant market power (and that many might even be considered to be dominant).

*Inconsistent treatment of the competitive price level*

2.25 As the CC will be aware, the appropriate test for market power is whether an undertaking can profitably sustain prices above the competitive price level.

2.26 However, the CC does not apply this test consistently through its paper. In particular, the CC fails to consider whether any increase in price reflects:

- an increase above the competitive price level;
- an increase in the competitive price level; or
- an increase towards competitive price level.

2.27 In the context of analysing airports, it is important to be very clear about these three different explanations for any price rise – as well as to distinguish between a short-term price movement and a price change that is *sustained*<sup>11</sup>. For example, the capital intensity of airports, and the sunk nature of investments, means that prices will vary from the long-run average competitive price level. As capacity becomes scarcer the competitive price level will tend to rise.

2.28 Further, the existence of long-term contracts means that prevailing prices can be held below the competitive price level and, upon expiry, move back towards that level.

2.29 However, the CC fails to appreciate these differences when assessing the profitability of past price rises and instead appears to place considerable weight on the observation that the following changes in Stansted's pricing have been profitable:

- the decision not to extend a series of long-term contracts with airlines, struck at prices that were significantly lower than the level of published charges;
- the 8.7 per cent increase in published charges in 2007; and
- the 6 per cent increase in published charges in 2008.

2.30 Indeed, when assessing the profitability of these pricing decisions the CC states that:

“If Luton were an effective constraint on Stansted, we would expect to see switching in response to a significant price increase on a level so as to make the increase in price

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<sup>11</sup> This is particularly relevant in the current context, where Stansted's pricing decisions take the form of the announcement of published charges and then the negotiation and/or offering of discounts (which can happen at a later date).

unprofitable. In fact, this does not appear to have been the case, which suggests that at least in the recent past, Stansted has held a position of market power.”

2.31 If we set aside for one moment whether it is appropriate to restrict the analysis to switching to Luton alone, it still appears that the CC has assumed that any increase in price should be unprofitable in a competitive market. This general theme in the CC’s analysis is particularly concerning in light of the historical level of charges at and profitability of Stansted. Indeed, it is only very recently that Stansted has achieved returns that are similar to its regulated cost of capital, the implication of the CC’s analysis is that Stansted would not be permitted to recover efficiently incurred investment costs and that any discounts offered to airlines raise the prospect that increases in prices above these discounted levels are deemed to be evidence of abuse.

2.32 The CAA also notes that the approach adopted contrasts with the CC’s own statements on how it will approach profitability analysis, including the CC’s recognition that:

“More generally, a competitive market is likely to generate significant variations in profit levels between firms as supply and demand conditions change, but with an overall tendency towards levels commensurate with the cost of capital of the firms involved. At points in time, the profits of some firms may exceed what might be termed the ‘normal’ level. Reasons for this could include, for instance, cyclical factors, transitory price or other initiatives, the fact that some firms may be more efficient than others and, the fact that some firms may be earning profits gained as a result of past innovation. However, in nearly all cases competition should result in pressure on profit levels towards the cost of capital in the medium to long run.”<sup>12</sup>

2.33 The CC also notes that this analysis would normally be undertaken on the basis of “depreciated replacement cost of assets, unless there are specific reasons why this is inappropriate” and notes that “such profits could be significantly different from profits reported in statutory accounts which are usually on a historic cost (or modified historic cost) basis.”<sup>13</sup>

#### *Failure to assess the balance of evidence*

2.34 , The CC identified a number of different sources of potential competitive constraints. However, the CC adopts an approach to compiling its evidence whereby individual pieces of evidence are assessed and then dismissed as not being relevant if they are not sufficient on their own to constrain Stansted.

2.35 To illustrate this approach, consider the discussion of the CAA’s survey data (paragraphs 41 to 47 of the CC’s paper). This correctly states that

“the CAA attributed significance to the proportion of respondents giving non-London airports as a first or second choice—22 per cent and 19 per cent respectively for Stansted.”

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<sup>12</sup> ‘Market Investigation References’, CC, June 2003

<sup>13</sup> *ibid*, CC, June 2003

2.36 The CC then identifies some limitations to this type of analysis before concluding that:

“For this reason, we do not agree with the CAA that there is a significant competitive constraint on Stansted from non-London airports.”

2.37 However, the CAA did not suggest that the survey evidence was sufficient to conclude that there “is a significant competitive constraint from non-London airports”. Rather, the CAA argued that this piece of evidence provided some supportive evidence that there was current and potential competition from regional airports.<sup>14</sup>

2.38 However, the CC goes on to summarise this evidence by stating that it “...showed little, if any, evidence of a competitive constraint being imposed on Stansted from non-BAA airports outside London.” It is difficult to understand how this evidence – albeit evidence that is not definitive or without some shortcomings – can reasonably be viewed as showing “little, **if any**” [emphasis added] evidence of competitive constraints. The fact that around 40 per cent of passengers indicated some preference for a non-BAA airport outside London suggests that this summary is both unreasonable and untenable, not least given the growth in recent years of regional airports relative to those in London.

2.39 Indeed, this example provides a useful illustration of the overall construction of the CC’s argument<sup>15</sup>: dismissing individual pieces of evidence in their entirety whenever they are not individually sufficient to indicate that Stansted faces competitive constraints. Such an approach inevitably leads to overly definitive conclusions on individual aspects of the analysis which, when all of these individual conclusions are assimilated, will tend to lead to into an overly definitive conclusion that is out of line with the overall balance of the evidence, whereas a balanced assessment of each individual aspect would lead to a more balanced and appropriate overall conclusion. The CAA also notes that the CC’s current approach stands in stark contrast with the reality that market power is always a matter of degree rather than absolutes<sup>16</sup>.

2.40 The CAA suggests, therefore, that the CC re-evaluate the evidence base to consider the overall balance of the available evidence.

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<sup>14</sup> The CAA’s overall conclusion in respect of this survey evidence was: “This analysis suggests that there is considerable scope for current and future interactions between the London airports and between the London airports and those located outside of the London area. Indeed, there was a significant preference expressed for regional airports; airports that are continuing to expand the range of services that they offer. This suggests that there is scope for interactions between the London-area airports and regional airports to grow in future.” (‘Supporting Paper II’, CAA, December 2006)

<sup>15</sup> This is not the only example of the CC’s method of constructing its argument. For example, despite the existence of different views on the extent to which Luton competes with non-London airports (including the views expressed by the airport operator) the CC concludes that “it **cannot be argued** that regional airports constrain Luton’s pricing” [emphasis added]. Again, such a conclusion is unreasonably definitive about an issue that is clearly a matter of degree, rather than absolutes.

<sup>16</sup> As discussed in paragraph 2.23 of this paper (including the citation of the OFT’s guidelines).

## The CC's assessment of the evidence

2.41 The CC's overall conclusion appears to rest on three particular premises:

- “the only non BAA airport that could be considered an effective substitute for Stansted by airlines and passengers is Luton”;
- “the current price at Stansted is unlikely to be below the price that would be expected to result in a well-functioning market largely because there is no evidence of excess demand and the price level is significantly higher than our estimates of marginal cost”; and
- “...prices are currently below the maximum allowed under the cap because of strategic considerations rather than competitive constraint.”

The CAA discusses each of these in turn below.

*“the only non BAA airport that could be considered an effective substitute for Stansted by airlines and passengers is Luton”*

2.42 As discussed in paragraphs 2.8 to 2.21, the CC's approach appears to adopt an atypical approach to the analysis of Stansted's market position, by assessing whether there is a non-BAA airport that is an effective substitute for both passengers and airlines. This approach contrasts with the OFT's recommendations that such analysis should consider the strength of “any” constraints on conduct.

2.43 Taken at face value, this approach appears to suggest that the CC has adopted a geographic market definition that encompasses an area that is no wider than the area from which Stansted and, perhaps<sup>17</sup>, Luton attract their passengers.

2.44 This implicit finding on the geographic market appears to conflict with the other evidence presented by the CC<sup>18</sup>, evidence previously published by the CAA, and the market definition adopted by the CC in its Market Investigation of BAA<sup>19</sup>.

2.45 Indeed, the CC reproduces isochrone analysis that the CAA published in 2006. It is somewhat surprising that the CC gives this analytical approach such cursory treatment in the paper, particularly as this evidence provides a useful way of assessing the potential for competition between airports in a way that is independent of the current distribution of an airport's passengers and given that similar analysis has formed an important part of the evidence base used by the CC in other inquiries – notably the Groceries market investigation – where issues of geographic market definition are of particular importance.

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<sup>17</sup> The lack of a structured market definition makes it difficult to establish whether the CC views the relevant market as extending to include the area over which Luton Airport attracts its passengers.

<sup>18</sup> For example, the CC refers to interactions between Stansted, Heathrow and Gatwick in its LRAIC paper and in its Emerging Thinking published as part of the Market Investigation of BAA Ltd.

<sup>19</sup> There are, of course, good reasons why these market definitions might differ – not least the fact that the Stansted quinquennial review analysis should maintain an assumption of binding price controls on Heathrow and Gatwick airports – but there should be a coherent explanation of why the CC's approach does differ.

2.46 Indeed, the CC appears to dismiss the relevance of the isochrone evidence (which normally forms part of a geographic market definition exercise) with the following argument:

“It is our view that regional airports do not provide an effective constraint on Stansted. They do not offer a comparable range of destinations and frequency of services to Stansted, which, in the short term, limits the ability of passengers coming from overlapping catchment areas to switch to regional airports in response to price changes. In the longer term, in principle airlines could switch their services to regional airports. However, since the number of passengers in the overlapping catchment areas is relatively small, it seems unlikely that an airline could expect to obtain significant passenger density at any one individual regional airport in order to switch a route. Furthermore there are a large number of passengers in the London area who are more than a 2-hour drive-time from any regional airport. If Ryanair were to move from Stansted to East Midlands in response to a substantial price increase, it is very likely that another airline would enter Stansted to fill the gap (‘back-fill’) because these passengers without a choice would continue to want to travel.”

2.47 The CC presents a number of arguments here. First, that regional airports “do not offer a comparable range of destinations and frequency of services to Stansted”. In doing so, the CC appears to adopt a product market definition that implies that passengers place value on frequency and the range of destinations, and that there is little ability of passengers to switch between different destinations. However, the CC draws this conclusion without presenting supporting evidence for the degree to which this is a relevant consideration.

2.48 Whilst this product market definition might be appropriate for business passengers, the available evidence suggests that many leisure passengers compare across groups of destinations – such as city breaks, ski and beach holidays – when planning trips.<sup>20</sup> As discussed above, the CC’s paper lacks clarity due to the absence of a structured discussion of the product and geographic market.

2.49 The CC also ignores the evidence that the CAA provided to the CC that demonstrates that significant ‘passenger overlaps’ can be achieved through a relatively small ‘route overlap’, due to the relative concentration of passengers on the most popular routes. For example, the CAA presented analysis that showed that in 2005 East Midlands Airport offered 23 of the 50 largest routes at Stansted. On these 23 routes alone, this translates to a ‘passenger overlap’ of 37 per cent of Stansted’s *total* passengers (i.e. on all routes)<sup>21</sup>. In short, a regional airport does not need to attract the same range or frequency of services as Stansted for it to represent a potentially significant constraint on the airport’s conduct.

2.50 Indeed, the CC’s approach appears to differ somewhat from the arguments presented in the CC’s Market Investigation Emerging Thinking. In this paper the CC uses the interaction between East Midlands and Birmingham airports as an

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<sup>20</sup> See, for example: ‘Demand for Outbound Leisure Air Travel and its Key Drivers’, CAA, December 2005; ‘No-Frills Carriers: Revolution or Evolution?’, CAA, November 2006; and ‘Supporting Paper II’, CAA, December 2006 (in particular Figure 3-12).

<sup>21</sup> This evidence also demonstrated that 55 per cent of Stansted’s passenger base was exposed to a non-BAA airport on these ‘top 50’ routes alone.

example of effective competition between neighbouring airports. However, East Midlands currently offers only 21 of the 41 routes that are available at Birmingham, and in 2000 offered only 11 of the 38 routes. This suggests that the CC's current approach would question the strength of current competition between these two airports, and certainly the degree of competition that existed in 2000. More generally, this example highlights the risk of adopting a static approach to the analysis of airports markets, as this will inevitably lead to a systematic under-assessment of the potential for competition and the strength of competitive interactions.

- 2.51 The CC's argument also places reliance on the fact that "the number of passengers in the overlapping catchment areas is relatively small". Whilst inevitably this is an issue of judgement, the CC's own analysis of catchment areas – on its preferred methodology – shows that in excess of 90 per cent of Stansted's passengers originate from the catchment area of another airport and that 12 per cent originate from the catchment area of a non-BAA airport.
- 2.52 It is also, perhaps, rather unusual to question the relevance of isochrone analysis on the basis of current catchment analysis, when these two techniques are normally treated as part of the same overall analytical approach. Isochrone analysis can usefully complement the analysis of current catchment areas, and benefits from the fact that it allows the potential for current catchment areas to change. Briefly, current catchment analysis can establish benchmarks of how far consumers are willing to travel, that can then be assessed in terms of isochrone overlaps.<sup>22</sup> In this respect, the CC's focus on current catchment areas risks introducing a bias in the evidence base, as it will unduly focus on the current overlaps without considering how, for example, airports might compete with Stansted and extend their current catchments into what is currently measured as 'Stansted's catchment area'. In light of Stansted's large current catchment, and tendency to attract passengers from further afield than other airports, this is a significant shortcoming of the CC's analysis.
- 2.53 Finally, the CC argues that "if Ryanair were to move from Stansted to East Midlands in response to a substantial price increase, it is very likely that another airline would enter Stansted to fill the gap ('back-fill') because these passengers without a choice would continue to want to travel". As discussed later in this paper, this argument fails to appreciate that a change in relative prices across airports would not be expected to result in 'back-fill'<sup>23</sup>. The CC also appears, again, implicitly to adopt a very narrow product market definition, assume that there is little potential for passengers to switch between different destinations and that passenger price elasticity is very low. The CAA considers each of these aspects of the CC's argument elsewhere in this paper.

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<sup>22</sup> The CAA set this out in more detail in its response to the CC's working papers published as part of the Market Investigation into BAA Ltd.

<sup>23</sup> See paragraphs 4.19 to 4.23 of this paper.

*“the current price at Stansted is unlikely to be below the price that would be expected to result in a well-functioning market largely because there is no evidence of excess demand and the price level is significantly higher than our estimates of marginal cost”*

- 2.54 The CC’s argument here appears to apply an implicit benchmark that an undertaking should set prices equal to marginal cost and, therefore, price according to the textbook models of perfect competition. In light of the substantial fixed and sunk costs involved in airport investment and operation such a benchmark is clearly not appropriate.
- 2.55 Furthermore, this argument – together with the lack of any distinctions between different degrees of market power – appears to set up a test whereby if Stansted does not compare well to the perfectly competitive ideal then it must have a very high degree of market power.
- 2.56 The CC’s pricing analysis will be discussed in more detail later in this paper. However it is informative to note at this stage that it is difficult to identify any undertakings in the real economy that set prices just to cover marginal cost. Even local grocery stores – which one would assume to be operating in a highly competitive sector – would not survive on, and cannot charge, prices equal to short-run marginal cost. This is because even these businesses face fixed and sunk costs.
- 2.57 The analysis of excess demand is also problematic. The CC’s ‘binary’ approach to assessing excess demand – perhaps resulting from its implicit adoption of a model of perfect competition – implies that there must be excess demand if the short-run price is below the short-run competitive price level. This, of course, ignores the reality that markets do not operate according to this static, perfect equilibrium analysis. Long-term contracts can, for example, mean that prevailing prices are significantly out of line with the short-run competitive price. In addition, adjustments to changes in supply and/or demand conditions take time, and there cannot be an expectation that price, demand and supply are perfectly in balance in all periods.
- 2.58 Further, the model adopted by the CC appears to rule out the possibility that airports and airlines negotiate over prices and that there is a range of prices that could be described as *reasonably* reflecting the short-run competitive price level, rather than there being a *single* price point, from which any divergence could be taken to be evidence of (substantial) market power, or abuse.
- 2.59 Finally, the CC argues that the short-run marginal cost (and thus the competitive price level) is likely to be between £3 and £5. However, the CC also states that willingness to pay is above this level, which the CAA understands to be approximately £[3<]. Setting aside for the moment the problems associated with relying on average values to assess incentives at the margin<sup>24</sup>, taken at face value if willingness-to-pay is above the current price level at the margin, this would

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<sup>24</sup> This is discussed further in paragraphs 4.1 to 4.8 of this paper.

appear to suggest that there is excess demand.<sup>25</sup> The fact that this prediction of excess demand does not match the observed balance between demand for slots and their availability (there is at least one slot available at peak) calls into question the CC's model of price determination and/or the evidence assembled, as it fails to reconcile with current market outcomes.

2.60 It is, of course, possible that willingness-to-pay at the margin is actually relatively low (and significantly lower than the CC's current analysis suggests). The CAA notes that this alternative explanation of the current market dynamic would question the CC's conclusion that Stansted is able to sustain prices above the current – or indeed, the competitive – price level. Further, if willingness-to-pay at the margin is somewhat above the current price level this would appear to suggest that the airport could increase its charges without having an impact on outcomes for consumers (i.e. passengers).

*“...prices are currently below the maximum allowed under the cap because of strategic considerations rather than competitive constraint.”*

2.61 The CC presents BAA's reasons for not increasing charges as being “strategic” in nature, but does not define what is meant by this term. Given the weight placed on this piece of evidence – and its centrality to the conclusions drawn – it is important to be precise about what is meant by ‘strategic reasons’ and whether these are supportive of the view of some competitive constraints or of very few.

2.62 Having reviewed the confidential evidence cited by the CC, the CAA does not consider that the CC presents a balanced picture of BAA's decision-making process when setting its charges, for a number of reasons.

2.63 [redacted]<sup>26</sup>

2.64 [redacted]

2.65 On balance, therefore, the majority of the reasons cited by BAA not to raise charges relate to competition, buyer power and the constraints of contract and competition law – in short, normal commercial considerations. Overall, therefore, this document appears to support the view that BAA faces constraints when setting its prices.

2.66 Further, whilst the CC places considerable weight on the [redacted] reason cited by BAA it fails to place equal – or indeed any significant – weight on the other [redacted] reasons. This apparent inconsistency in the evaluation of evidence does not seem appropriate, particularly as the CC concludes elsewhere that, for example, Stansted does not face significant constraints from countervailing (airline) buyer power when the BAA documentation indicates that there is a significant element of buyer power. [redacted]

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<sup>25</sup> This follows from the observation that the demand curve is the relationship between price and quantity demanded – i.e. of willingness to pay – and that with a downward-sloping demand curve this implies that at a price below willingness-to-pay there will be excess demand

<sup>26</sup> [redacted]

2.67 The CAA has also reviewed the presentation referred to by the CC. Again, it is notable that the CC does not place weight on the following comments made by BAA:

“Stansted stimulated the growth to its current level by offering consistently attractive discounts below the regulated allowable yield. This encouraged the rapid growth of low cost carriers.”

and

“The growth of away based European carriers has been challenging for a number of factors including competition from other airports, particularly Luton, and Stansted’s pricing strategy.”<sup>27</sup>

2.68 Overall, therefore, the BAA documentation appears to reveal that Stansted’s pricing is set against a background of a range of constraints: competition-related, buyer-power, regulatory, legal, etc. This contrasts somewhat with the considerations that an undertaking with a very high degree of market power would consider. The existence of supplier-customer negotiations and internal debate about pricing seems to suggest that pricing at Stansted is subject to more external constraint than pricing at Heathrow or Gatwick.

### **3. Application of the competition analysis to the price control**

3.1 The CC assesses the impact of the application of a building-block price cap on competing airports in its competition paper, presenting its conclusion as follows:

“Our review of this evidence concludes that the only non-BAA airport that could be considered an effective substitute for Stansted by airlines and their passengers is Luton. This tells us two things. First, that, as competitive constraints on Stansted are weak, any price cap is likely to be binding. Secondly, the only non-BAA airport that might be affected by any distortions to Stansted’s pricing is Luton.”<sup>28</sup>

#### *Failure to recognise the potential for asymmetric relationships*

3.2 The CC’s argument at this point in the paper ignores the potential for asymmetric relationship between Stansted and Luton airports<sup>29</sup>. Due to the potential for asymmetric relationships, it simply cannot be inferred from the observation that Luton is the only “non-BAA airport that could be considered an effective substitute for Stansted” that “the only non-BAA airport that might be affected by any distortions to Stansted’s pricing is Luton”.

3.3 To illustrate, consider the CC’s Groceries market analysis, where ‘one-stop shops’ were considered to constrain local convenience stores, but that local convenience stores were not considered to sufficiently constrain ‘one-stop shops’ (and were thus not included within the relevant product market for the analysis of ‘one-stop shops’).

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<sup>27</sup> BAA/Q5/777

<sup>28</sup> Paragraph 3, *ibid*, CC, July 2008

<sup>29</sup> Although such a possibility is raised by the CC in paragraph 73 of its paper

*Lack of any evidence presented on the level of the price cap*

- 3.4 The CC's analysis of the impact of a building-block price cap assesses the relationship between the prospective price cap and the prospective competitive price level and concludes that:

“We therefore think it unlikely that a RAB-based price cap would hold prices below the competitive level during the Q5 period.”

- 3.5 However, the CC does not present any analysis of the potential RAB-based price cap when reaching this conclusion. This is a significant omission as under certain scenarios<sup>30</sup> the projected price cap could show a reduction in real terms. It is difficult to see how the CC could reach its conclusion in this regard, particularly when its theoretical model of price determination in airports markets implies that the competitive price level should be rising (in real terms) as demand grows. The application of a building-block price cap could easily result in a profile of falling real prices when competitive prices would be rising.

*Lack of any clear illustration of how the competitive price might change over time*

- 3.6 The CC also does not present in its paper the quantitative analysis of how the competitive price level might move over time, but instead relies on an assertion that – under its model of price determination – the competitive price level will be below the price cap. The numbers used to illustrate the CC's argument are redacted from the version shared with the CAA, making it particularly difficult for the CAA to offer fully informed comments.

*Apparent inconsistencies with the arguments made elsewhere*

- 3.7 The CC argues in its competition paper that Luton Airport will not be affected by the application of a building-block price cap at Stansted. The CC also appears to adopt a geographic market definition that extends only to include Stansted and Luton.

- 3.8 However, the CC argues in its LRAIC paper that:

“We consider a LRAIC approach at Stansted may also distort investment incentives on the grounds that Heathrow and Gatwick operate under a different price control methodology. Under this scenario BAA may be encouraged to increase investment above efficient level at those airports operating under a RAB-based approach in order to increase the price cap at these airports, instead of conducting efficient investment programs at Stansted.”<sup>31</sup>

- 3.9 This statement appears to contemplate that Stansted affects the operation and profitability of Heathrow and Gatwick airports<sup>32</sup> and that the building-block price cap can lead to distorted incentives. The geographic market definition implied by this

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<sup>30</sup> And in particular were AICC not to be included in the allowed revenues.

<sup>31</sup> 'Assessment of LRAIC-based price cap within the Q5 Stansted inquiry', CC, July 2008

<sup>32</sup> Alternatively, the CC could be arguing that there is a fixed supply of capital for investment, but this is unclear from the paper.

statement appears to contradict that adopted by the CC in the competition paper, albeit that the CC does not state what it considers the relevant market to be.

- 3.10 More generally, the CAA does not understand how there can be sufficiently low interactions between Stansted and Luton to remove the distorting impact of a RAB-based price control on Luton (as is argued in the CC's competition paper) whilst there also being sufficiently high interactions between Stansted, Heathrow and Gatwick to imply that the three airports should be regulated in the same manner (as is argued in the CC's LRAIC paper). The CC's view of interactions between Stansted, Heathrow and Gatwick also highlights the importance of the CC's failure to discuss Heathrow and Gatwick (and the role of the price caps) in its competition paper.
- 3.11 The CAA also recognises that there are differences between the statutory frameworks that apply to the Market Investigation of BAA Ltd and the quinquennial review of Stansted, and that the appropriate competition analysis should differ in a number of important respects between these inquiries. However, the CAA does not currently understand how it is possible to reconcile the CC's stated view of how Stansted operates within its market (and the lack of competitive interaction between it and its closest – and most proximate – competitor) and the CC's Emerging Thinking that there is potential for more competition between Stansted and more distant BAA airports.
- 3.12 In reconciling the analysis between the two separate inquiries, it will be important for the CC to answer two separate, albeit related, questions<sup>33</sup>:
- Is the strength of competitive constraint posed by Luton<sup>34</sup> sufficient to discipline BAA Ltd such that it removes the need for regulation and/or removes the case for separate ownership of its airports?
  - Is the strength of competitive constraint posed by Luton<sup>34</sup> sufficient to discipline Stansted (owned by BAA, but with Heathrow and Gatwick subject to price control regulation) such that a strict RAB-based price control should not be applied to the airport?
- 3.13 The CAA considers that the answer to the first of these is likely to be 'no' (certainly in respect of the need to apply regulation to Heathrow and Gatwick, given the current common ownership of airports). There are, however, good reasons to suspect that the answer to the second is 'yes'. Further, it is worth stressing that it is perfectly reasonable for the answers to these questions to be different.

#### *Failure to consider incentive effects*

- 3.14 The CAA notes that the CC's explanation of the impact of a building-block price cap on airport and airline competition is incomplete. The CC does not consider the

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<sup>33</sup> These questions are posited to illustrate the concept and should not be viewed as a strictly accurate interpretation of the relevant statutory frameworks.

<sup>34</sup> The competition analysis is, of course, not solely about Luton airport, and should consider any (and all) other forms of competitive constraint.

impact of the mechanistic link between investment and the price cap on the incentives faced by both the airport operator and airlines.

#### *Failure to distinguish between the degrees of market power*

- 3.15 As discussed earlier in this paper, the CC fails to clearly distinguish between the different degrees of market power. In the context of price control design this is particularly problematic.
- 3.16 In particular, the CC treats market power and ‘significant market power’ interchangeably and appears to imply that as soon as an undertaking has significant market power then it will abuse its dominance and should be subject to a building-block price cap.
- 3.17 Such an approach implies that any dominant undertaking should be price controlled, suggesting that as soon as dominance is acquired it will be abused and that this requires price control regulation. This interpretation would significantly lower the threshold at which cost-based price cap regulation – a particularly intrusive form of regulatory intervention – would be applied. Indeed, the DfT’s designation criteria, and analysis of the case for designating Stansted, recognise that price cap regulation results in direct and indirect costs. Further, both the Secretary of State’s decision and the peer review contemplated modifications to the price control approach to reduce these distortions, including through the use of ‘safeguard’ caps.

#### **4. Errors of fact and argument**

- 4.1 The CAA considers that the CC’s paper makes significant errors of fact and/or argument in a number of places.

##### **Use of average as a proxy for marginal in the willingness-to-pay analysis**

- 4.2 The CC argues that:

“Where capacity is fully utilized, willingness to pay of the marginal user becomes the appropriate measure of competitive price.”

- 4.3 However, the evidence that is then assembled by the CC relates to average profitability and average willingness-to-pay. In a market where the product is differentiated in a range of ways (not least due to airlines serving different destination airports and times of day) it is possible – and, indeed, likely – that average values will not provide a reasonable proxy for marginal values. In this respect it is notable that all of the evidence presented by the CC relates to the analysis of average willingness-to-pay. Indeed, the summary of Ryanair’s statement also suggests that the airline was referring to average, and not marginal, willingness-to-pay.
- 4.4 This focus on average willingness-to-pay is particularly problematic when the following is considered:

- [§<]
- Recent market evidence – with both Ryanair and easyJet reducing capacity at Stansted – suggests that the willingness-to-pay in respect of marginal services is currently below the level of current airport charges.
- Airlines operate a range of mature and new routes, cancelling routes that turn out not to be profitable. This implies a degree of variation in profitability.

4.5 More generally, the CC notes that:

“As [the average profitability at Gatwick] is higher than average profitability at Stansted, it suggests that the cost of acquiring a slot at Gatwick must be higher than suggested by the slot trade data. It is therefore unlikely an operator at Stansted would currently be able to acquire sufficient slots at Gatwick to switch their operations in response to a relative price change.”

- 4.6 The CC observes that the measured profitability at Gatwick is higher than at Stansted and that this could indicate that the cost of slots is higher than the CC's previous estimate (as noted by the CC). However, it also could indicate that the comparison of average (rather than marginal) profitability is inappropriate or that charges at Gatwick are held below the short-run competitive price level by the price cap. The CC's argument assumes, of course, that there is a form of competitive interaction between the two airports, an issue the paper does not consider (alongside the impact of binding price caps).
- 4.7 The CAA also notes that the CC's final, concluding, sentence above draws an inference (that an airline would not be able to switch to Gatwick) based solely on the CC's own assumption that the cost of acquiring slots at Gatwick must be higher than it has estimated. The logic applied here appears to be circular.
- 4.8 More generally, the CC's comparison of Stansted and Gatwick appears likely to suffer from a significant source of systematic bias. Ryanair operates a broad range of destinations at Stansted but only a limited number at Gatwick. This means that the CC's comparison of Stansted to Gatwick results in it comparing the profitability of the three Gatwick routes (Dublin, Cork and Shannon) that Ryanair operates at Gatwick to the very large number of routes operated to/from Stansted. It would be surprising if the profitability on these three routes at Gatwick were similar to that across Ryanair's more diverse portfolio of routes at Stansted, including a number of less popular (i.e. 'thin') routes.
- 4.9 Further, the CC's analysis of willingness to pay imposes a prior assumption either that Stansted is a monopoly (paragraph 148: "If Ryanair has no viable alternative") or that the geographic market is limited to including Gatwick and Luton alone (paragraph 149). This introduces a methodological problem that the CC introduces an assumed market definition in order to establish the willingness-to-pay that is then used to assess evidence on market definition and market power. This appears to imply that the CC has assumed a large part of its own conclusion.

## Dismissing the impact of pan-European competition

4.10 Referring to the potential for other European airports to act as a competitive constraint on Stansted, the CC states that it is:

“... not convinced that this is currently a significant constraint on Stansted’s prices. An increase in charges at Stansted does affect the relative profitability of routes, but it is difficult to see, if a particular route was profitable prior to the Stansted charge increase, why it was not already being served. Given relatively strong competition between low-cost carriers, we would expect to see entry occurring at unconstrained airports until rents are competed away. As no passengers would switch from the Stansted route to the European route, there would be no increase in demand on the European route following a price increase at Stansted. It is difficult to see then why airlines would switch to this route, unless they had previously been constrained in the number of planes they could deploy.”

4.11 The CC’s argument seems to ignore the link between Stansted charges, opportunity costs and the likelihood of expanding operations at other airports. An increase in Stansted charges would reduce airline yields on the affected services. As a result, the opportunity cost of the next best alternative use of the aircraft (be it in the UK or beyond) would fall, making previously unprofitable services profitable. It should also be noted that the act of shifting capacity in response to changing relative prices would affect supply in the market into which the capacity was added. This would have the effect of increasing demand<sup>35</sup>.

4.12 This view is also simply not tenable given the observed operation of the European aviation market.<sup>36</sup> This market operates with real constraints and actual imperfections. Airlines cannot increase the size of their fleets without facing additional costs – it does, after all, take a considerable time to build additional aircraft – and face limits on the speed with which their management teams can identify and exploit profitable opportunities.

4.13 Further, this view of the market does not compare well to the statements made by airlines to their investors of how they expand their businesses. . For example, Ryanair recently announced reductions in its use of Dublin, Glasgow, Rome, Warsaw, Leeds Bradford and Stansted. easyJet has announced reductions in its use of Stansted and Dortmund. Both of these airlines have also stated that they plan to continue to grow. The presumption here must be that there has effectively been switching of airline capacity away from a number of airports – including Stansted – and towards other airports.

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<sup>35</sup> In conventional supply-demand analysis, the rightward shift in supply reduces prices and increases demand.

<sup>36</sup> The CC’s view also ignores the potential for demand and supply factors to change across the European market, in a way that makes previously unprofitable opportunities profitable. In a world with imperfections and some switching costs, there will be opportunities out there. As a result, when relative airport charges change, the relative profitability of various alternatives will change, prompting a response from airlines.

4.14 Finally, the CC also states that:

“Analysing the strength of this potential constraint is difficult because airlines have not told us that they would switch in this way and we cannot look at passenger behaviour in this context.”

4.15 However, it is not clear whether this conclusion is arrived at because the airlines were not asked the appropriate question or gave an answer which, in the context of this inquiry, is in their commercial interests. Indeed, as written, the CC’s paper appears to place weight on the absence of a statement by airlines, rather than any positive statement that they do not operate in this way.

4.16 Either way, the conclusion is not tenable because it ignores a raft of evidence:

- evidence presented to the CC by the CAA in writing and at hearings, and in two reports on regional air services<sup>37</sup> which reflected discussions with a wide range of airports and airlines;
- evidence from airports about the pan-European dimension of competition they face;
- public statements by airlines themselves including:
  - easyJet’s 2008 interim results statement that: “Performance management of the network and improving the quality of the schedule continue to be the key drivers of easyJet’s success with new routes added including the southern European GB Airways destinations and domestic routes in France and Italy. In addition, easyJet has culled 11 underperforming routes.”;
  - Slide 26 (and the supporting commentary) of easyJet’s Interim Results presentation highlights the pan-European nature of its network optimisation<sup>38</sup>; and
  - Ryanair’s Director of Scheduled Revenue, Sean Coyle recently stated that “Edinburgh Airport has competed successfully against airports across Europe for Ryanair’s 27th base.”

4.17 It is clear that the development of the low cost point to point model in the context of the Single European Aviation Area has generated competition between airports across Europe for both based aircraft and inward [journeys]. Understanding this as part of a set of cumulative competitive constraints on UK airports is important background to the Stansted inquiry but would also be expected to form part of a broader understanding of the market relevant to the BAA market inquiry. It is therefore surprising that this feature of the market is so readily dismissed on the basis of such limited – and partial – evidence.

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<sup>37</sup> See, for example, the CAA’s regional airport studies published as CAP754 (Chapter 7, page 83, para 5) and CAP775 (Chapter 6, page 7, para 6.13).

<sup>38</sup> [http://www.easyjet.co.uk/common/img/interim\\_results\\_2008\\_easyJet.pdf](http://www.easyjet.co.uk/common/img/interim_results_2008_easyJet.pdf)

4.18 Indeed, this form of competitive constraint is widely recognised, as illustrated by the following extract from a recent article in the Financial Times:

“While [Ryanair] is reducing its flying programme at some airports for part of the coming winter season to reduce lossmaking operations - chiefly at London Stansted and Dublin, its main European bases - it is increasing its overall capacity in the winter by 8-9 per cent following an expansion of 18-19 per cent during the current summer months.”<sup>39</sup>

### **Assuming “back-fill” of any services switched away from Stansted**

4.19 The CC argues that:

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

4.20 This argument appears to be premised on a failure to understand the impact of a price increase at Stansted. If prices rose at Stansted this would alter *relative* prices at Stansted and other airports. If it were not profitable for Ryanair to operate its service at Stansted at these *relative* prices then it would, presumably, also not be profitable for another operator to offer this route.

4.21 This argument would not, of course, hold if Ryanair were not the most efficient operator of the service in question, and a more efficient operator existed. However, in such circumstances, the question remains as to why this operator had not already opened the service at Stansted<sup>40</sup> and used its cost advantage to compete away Ryanair on this route.

4.22 Finally, it is perhaps worth noting that Ryanair is widely reported to have the lowest unit costs of any European short-haul airline, questioning whether such a ‘more efficient’ operator actually exists.

4.23 Overall, therefore, the CC’s assumption that back-fill will happen appears flawed and, as a result, the conclusion that “it cannot be argued” that regional airports compete (to some degree) with Luton is not supported by the analysis.<sup>41</sup>

### **Treating Luton’s investment as unaffected by market pricing**

4.24 In respect of capacity availability at Stansted, the CC states that:

“One factor that could limit the ability of Luton to impose an effective constraint on Stansted in the future is a lack of spare capacity. Luton Airport is particularly constrained

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<sup>39</sup> ‘Ryanair expands presence in Italy’, Financial Times, 1 August 2008

<sup>40</sup> This is particularly possible in light of the CC’s view that there is existing spare capacity at Stansted.

<sup>41</sup> It is, perhaps, worth noting that the CAA does not consider that the CC’s statement on the competition faced by Luton is supported by market evidence, the overlapping catchments (including isochrones) between Luton and other airports, and the statements made by Luton Airport.

with respect to stand capacity... We understand from the hearing with Luton Airport that whilst one additional stand may become available in the short term, this would not significantly increase its ability to compete for peak traffic. Any further additions to stand capacity would have to be accompanied by significant investment in terminal and taxiway infrastructure and [redacted]."

4.25 The CC has adopted a very static view of the interaction between Luton and Stansted airports, focusing on the nature of Luton's current plans. However, the important issue is the degree to which Luton's plans might change in response to a change in market circumstances. Put simply, if prices and demand for capacity at Luton increased, would the airport be able to respond? The history of Luton changing its plans in response to the changing commercial environment provides some supportive evidence of the airports ability and willingness to do so. Investment at Luton is part of the market dynamic - it should not be assumed to be determined outside the market.

4.26 Indeed, the CC confirms that Luton is contemplating ways in which it might expand capacity, when it states that:

"Although Luton Airport is currently investigating ways of increasing its capacity, there is uncertainty surrounding these plans. As a result, it is our working assumption that no significant developments are likely to occur in the short term and, therefore, existing capacity constraints are likely to continue."

4.27 However, the CC appears to use the lack of certainty about these plans to make an assumption that the airport will not expand and, implicitly, cannot respond to changing circumstances. Such an approach does not appear reasonable.

4.28 Indeed, the CC goes further in suggesting that prices at Stansted are not important to Luton's investment plans, when it states that:

"The factor most immediately constraining Luton's ability to undertake large-scale investment projects is not the level of charges at Stansted but [redacted]."

4.29 Of course, simply because the level of charges at Stansted is not the most important factor this is not sufficient to conclude that it is not an important or significant factor. It is this latter consideration that is important for the assessment of competition and of the potential for Stansted to affect investment at Luton.

4.30 Indeed, Luton Airport explained the relationship between pricing at Stansted and its investment decisions in its response to the CAA's January consultation document. The arguments presented by Luton do not appear to support the overall conclusion reached by the CC in respect of the lack of (some degree of) competitive constraint or of impacts from Stansted on Luton's investment:

"Given the degree of overlap for passengers and routes between STN and LTN, these low prices have had, and continue to have, an impact on LTN prices. Although LLAOL does not seek to argue that this is the only or even the determining factor in its investment decisions,

the price it is able to charge in its competitive environment does have a significant bearing on return on investment calculations."

- 4.31 Finally, it is perhaps worth noting that the other arguments presented by the CC implicitly adopt a different product market definition than that implicitly adopted elsewhere. In particular, the CC states that:

"As a consequence, it is not possible for airlines to park additional aircraft at Luton overnight, which means that Luton cannot compete with Stansted for 'based' aircraft. This will limit the extent to which Luton can compete with Stansted for existing or new business, as the majority of carriers at both airports operate a business model relying on access to an early-morning departure slot to make their entire networks profitable."

- 4.32 This appears to adopt a product market definition of "the supply of capacity to based aircraft". Whilst the product market is not analysed in the CC's paper, the CAA notes that it should not be assumed that there is a simple relationship between aircraft serving peak periods and based aircraft. For example, some based aircraft will be serving very early morning periods (not typically associated with "peak" demand), whilst some non-based aircraft will serve peak periods (for example, inbound operators to Luton, such as Wizz Air).

### **Dismissing evidence proposed by the CAA using arguments that apply equally to the CC's own evidence**

- 4.33 The CC states that:

"The CAA presented additional evidence showing that easyJet offered its prospective passengers a range of alternatives that extended beyond London airports, reproduced in Table 6. This does not tell us how many passengers are likely to be marginal."

- 4.34 The CAA agrees that the evidence from easyJet's website does not indicate how many passengers are likely to be marginal. However, this observation applies to all of the evidence in the "airline views" section. It is, perhaps, odd that some of the evidence (i.e. that presented by the CAA) is apparently dismissed when the CC appears to place weight on the stated views of airlines, when all of the evidence suffers from the same shortcoming.

- 4.35 Indeed, the CAA would expect more weight to be placed on evidence collected directly from the market (in this case, from easyJet's interactions with its prospective passengers) than stated views.

## **5. Use of LRAIC as a benchmark of long-run average competitive prices**

- 5.1 The CC makes reference to the potential for measures of forward-looking cost - notably long-run average incremental cost (LRAIC) - to provide a benchmark against which current prices should be compared. In particular, the CC notes that:

"[it discusses] the theoretical aspects of LRAIC in more detail in a separate working paper. That paper makes it clear we do not disagree that LRAIC could in principle be used to

approximate the average competitive price over the lifetime of the assets over which it is computed. However, we also point out in that paper that LRAIC is not the only methodology for approximating the long-run competitive price: both the replacement cost and RAB approaches attempt to estimate the competitive price in different ways, and there is considerable uncertainty attached to the LRAIC estimates."

- 5.2 The CC correctly notes that the RAB could also be a method for estimating the competitive price. However, the supporting paper on LRAIC has an important caveat, namely that the RAB-based price cap must be calculated for:

"...a de novo airport entrant, [in which case] both the LRAIC and RAB approaches would be expected to result in the same net present value, if correctly applied."

- 5.3 It is, therefore, clear that the current RAB-based price cap, based on the current RAB, does not provide an estimate of the competitive price level, as it does not meet the conditions set out in the CC's LRAIC paper. The CC acknowledges this in the footnote of the LRAIC paper, when it states that:

"However, in reality at Stansted the two approaches would not result in the same net present value, partly due to historic application of the RAB, including cross-subsidies from Gatwick and Heathrow."

- 5.4 5.4 The CC also appears to misunderstand the role of LRAIC in assessing prices, when it argues that:

"In the case at hand we see problems with using a forward-looking measure of costs that includes the cost of investing in a new runway. This is because we are interested in the evolution of the competitive price over the next quinquennium, during which time our analysis of capacity and traffic forecasts suggests significant expansions to capacity will not be necessary. If, as it appears, the costs of large expansions will be significantly higher in the future than they have been in the past, it is likely there will be a discontinuity in the long-run average price level at the date investment in a new runway becomes economic."

- 5.5 The CAA considers that in a growing market, prices are likely to be constrained, over the longer-term, by the incremental cost of the next capacity expansion and/or new entry. However, the CC appears to consider that airport pricing would exhibit a "discontinuity" and jump from historical marginal costs or historical willingness-to-pay to long-run incremental cost of the new assets "at the date investment in a new runway becomes economic".

- 5.6 This appears to run counter to economic theory of 'real options value', that implies that prices in well-functioning markets would rise above the average cost of new investment in the period preceding that investment. The CC does not set out the mechanism by which prices exhibit this discontinuity.

## **6. CC's estimate of replacement cost**

6.1 The CC presents an estimate of the replacement cost of Stansted, but appears to place no weight on this estimate. However, the CC's own Market Investigation guidelines state that:

"The Commission will normally consider returns on the depreciated replacement cost of assets, unless there are specific reasons why this is inappropriate. Such profits could be significantly different from profits reported in statutory accounts which are usually on a historic cost (or modified historic cost) basis."

6.2 This appears to suggest that forward-looking measures of cost, and in particular replacement cost, should be used as the benchmark of competitive pricing. The CC state that "previous high-level analysis suggests a replacement cost in the region of £6.50..." This, taken together with the observation that short-run prices are expected to vary around replacement cost, calls into question the CC's conclusion that the current level of pricing is above the competitive level. Whilst the basis of the CC's calculation is unclear, this figure of £6.50 compares to the current charges (excluding any discounts agreed and excluding ANS charges) of £5.881.

## **7. Comments on the evidence cited by the CC**

7.1 This section presents some comments on the remaining evidence presented by the CC in its paper. In light of the time available to comment, the CAA has not sought to offer views on all aspects of the CC's paper.

7.2 The CAA notes that it provided extensive comments to the CC on issues raised in the CC's competition paper, including in its responses to the CC's working papers published as part of the Market Investigation into BAA.

### **Demand-side substitutes & catchment analysis**

7.3 The CC places considerable reliance on one approach to calculating current catchment areas. In its response to the CC's working papers on the Market Investigation into BAA, the CAA made a number of recommendations, including that:

- the CC adopt a number of approaches to estimating current catchment areas;
- a clear distinction should be drawn between current and potential catchment areas, as reliance on the former will tend systematically to understate competition; and
- the CC use isochrone analysis (applied by the CC in other inquiries) to supplement the analysis of the relevant geographic market.

7.4 This is particularly important as the methodology chosen by the CC, and the data that are used, will lead to a systematic bias towards under-stating competitive interactions, as it:

- will result in smaller airports having small, or even no, measured catchment areas; and
  - relies on data that is only collected at larger airports, leading to the exclusion of certain airports (as they did not participate in the CAA's passenger survey).
- 7.5 As noted above, the CC does not propose a product market definition or discuss the implications of the indirect relationship between passengers and the airport for the assessment of the relevant market (in light of the constraints that this places on effective price discrimination).
- 7.6 However, the CC appears to dismiss the potential for regional airports to provide a relevant competitive constraint on the basis that they are not in the relevant product market. In doing so, the CC appears to adopt a product market akin to "supply of sufficient capacity to support a network of routes and a certain degree of frequency". The recent history of the UK regional airport market suggests that smaller airports can compete with larger airports (to a greater or lesser degree, depending upon the circumstances) suggesting that the CC's implied product market definition would exclude an important source of potential competitive constraint, as underlined by recent history.
- 7.7 It is clearly important to understand the reasons for excluding regional (and other) airports from the CC's analysis in light of the fact that cumulatively these airports appear to offer a competitive constraint similar in magnitude to Luton, based on:
- the CC's catchment analysis (Table 2) which shows regional airports with a greater overlap than Luton (10 versus 9 per cent);
  - the CAA's survey evidence (which indicates that 40 per cent of Stansted passenger have some preference for a non-London airport;
  - BAA's survey evidence which shows that 13 per cent of BAA's passengers expressed a second choice of Luton whilst 12 per cent gave a regional airport.
- 7.8 As noted above, the CC appears to suggest that the CAA used survey evidence to conclude that Stansted faces competitive constraints, when the CAA, in fact, simply used this data as one part of the overall evidence base.

### **Airline competitor analysis and airline views**

- 7.9 The CAA notes that the evidence and views presented in this section do not make clear whether references are being made to the switching of all operations, or just switching at the margin. The latter is the relevant issue for competition analysis.
- 7.10 In this respect, the CAA would urge the CC to review the recent market evidence, which includes statements that easyJet and Ryanair intend to significantly scale-back their operations at Stansted, whilst also growing their overall networks across

Europe. This, and other evidence provided by the CAA, is discussed earlier in this paper.

### **Wider competitive constraints**

7.11 As noted above, the CAA does not consider that the available evidence supports the CC's views on the lack of any competitive constraints from the operation of the wider European aviation market.

### **DfT designation decision**

7.12 The CC appears to place weight on the material published by the DfT in its review of the designation status of Stansted Airport. The CAA noted in its reference document<sup>42</sup> to the CC that there are shortcomings with the analysis that the DfT undertook, particularly in respect of the assessment of future market power<sup>43</sup>.

### **Comparison of prices at Stansted and Luton**

7.13 The CC presents price information in Figure 4 and comments that "...overall there does not appear to be a strong correlation between the two series." However, what appears more relevant is that Stansted expansion has had a significant impact on charges set by Luton. This, in itself, suggests that a RAB-based price control should take account of the impacts of any distortions to investment at Stansted, as these distortions will also affect Luton.

7.14 The CAA agrees that this does not, of itself, establish that Luton would affect charges at Stansted. There are a number of ways of assessing this issue further. For example, relevant evidence would include whether airfares are correlated between the two airports and the degree to which services at one airport affect the profitability of services at the other airport. In this respect, the CAA presented analysis and provided a summary of analysis undertaken by NERA for BAA. This evidence, which took a range of different approaches, supported the conclusion that airfares at the two airports were related.

### **Capacity at Luton**

7.15 The CAA has provided comments on this section earlier in this paper.

### **Profitability of past price increases**

7.16 In this section the CC treat the expiry of long-term discount contracts as if they are an increase in the price level above the competitive price and then go on to argue that the limited response of airlines to the expiry of contracts demonstrates a lack of airline response and low elasticity of demand.

7.17 However, the expiry of these contracts was known to all parties, signalled in the agreements and well publicised by Stansted. As such, the contract expiry did not

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<sup>42</sup> See chapter 6 of the reference document.

<sup>43</sup> See paragraphs 6.43 to 6.47 of this document.

represent a change in expected prices or any new information. This means that the response to the contract expiry would be expected to have been incorporated into existing plans, leading, for example, to a scaling-back of growth prior to the contract expiry. In short, much of the price response would have been prior to, and in expectation of, the contract expiry.

7.18 The CAA does not, therefore, consider that it is appropriate to place much weight on the elasticities calculated using the increase in prices paid upon expiry and the changing airline plans post expiry. This will tend to systematically under-state the response to such a change in price.

7.19 However, it should also be noted that the appropriate elasticity is that which applies to a sustained increase in price above the competitive level, rather than an increase in prices towards the competitive level or increase in the competitive price level (as discussed earlier in this paper).

7.20 Overall, therefore, the CAA does not consider that it is appropriate to use the expiry of long-term contract prices to support the statement:

“This reduction in seat capacity still represents a highly inelastic response to an average net price increase of almost 80 per cent.”

7.21 In fact, the CAA notes that the year-on-year increase in published charges was around six per cent (as calculated by the CC in paragraph 80). If this is used to calculate an implied elasticity it gives a very different picture of market dynamics. Using the CC’s estimate of the reduction in seat capacity of 8 to 15 per cent this gives an estimated elasticity of between -1.3 and -2.5 – i.e. highly elastic (particularly when viewed against the relevant critical loss factors). However, the CC adopts the conclusion that demand “showed an inelastic response” when there is an alternative calculation and interpretation that would result in a very different conclusion.

### **7.15 Profitability of future price increases**

7.22 In paragraph 95 the CC incorrectly states that:

“The CAA does not appear to place any weight on its critical loss calculation and concluded that an operator of Stansted might require control of airports located outside the London area to find an increase in price profitable.”

7.23 The CAA’s argument was actually as follows:

“These results suggest that passenger responsiveness, *on its own*, would be insufficient to act as a sufficient constraint on airport pricing. However, these calculations assume that there is no response from other passengers (e.g. those travelling for business purposes) and that the airline offering remains unchanged<sup>44</sup>.”

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<sup>44</sup> In fact, the analysis assumes that airlines pass the full increase in cost through to passengers. As noted above, it is likely that airlines will pass a proportion of the cost increase through to passengers and, as

This last point is particularly important and is discussed in more detail below, in the context of the likely responsiveness of airlines."<sup>45</sup> *[original emphasis]*

7.24 The CAA also argued that:

“Combined with the above survey results, this suggests that, in order to raise prices profitably, the airport operator might require control of airports that are located outside of the London area, **at least so long as Heathrow and Gatwick are subject to binding price controls.**”<sup>46</sup> *[emphasis added]*

7.25 The highlighted section of this statement is important to understand the argument that the CAA is making here (but is not reproduced in the CC’s paper), as the financial incentives of the hypothetical monopolist (and of BAA in practice) would be affected by the existence of binding price controls at Heathrow and Gatwick. As noted earlier in this paper, the CC does not discuss these airports or the impact of their price cap regulation.

7.26 In addition, the CAA notes that the summary of its analysis presented in paragraph 96 related to a comparison of the impact of an increase in charges at Stansted on Ryanair and easyJet’s group profit (as this was the only publicly available measure of profitability). It, therefore, systematically understated – probably by quite a margin – the impact of changes in Stansted charges on the profitability of Stansted services, as noted by the CAA at the time.

7.27 Finally, the CAA notes that reports of recent market events have highlighted the sensitivity of passengers to price changes. For example, consider the following summary of the views of financial analysts:

“One analyst, speaking on condition of anonymity, said Ryanair’s fares announcement indicated that the business is more vulnerable than it thought to a downturn in discretionary spending. “One wonders if they are finding that they have less pricing power than they thought. The airports and passengers on Ryanair routes might be more marginal and price sensitive” said the analyst.

Another Ryanair stockwatcher said the airline’s predominantly leisure traffic customer base left it badly exposed to an economic downturn. Andrew Fitchie, analyst at Collins Stewart, said: “Ryanair is directly in the path of the current economic storm. Its demand is made up of leisure traffic much of which is highly discretionary short break holidays.”<sup>47</sup>

### **Comparison of traffic and fares at Stansted and Gatwick**

7.28 The analysis presented in this section relies upon a comparison of profitability between Stansted and Gatwick for services to Dublin. The relevant figures are excised, so the CAA’s comments are restricted to the observation that the chosen

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discussed below, might be expected to consider whether existing services or their growth plans could be relocated to other airports.

<sup>45</sup> Paragraph 3.95, ‘Supporting Paper II’, CAA, December 2006

<sup>46</sup> Paragraph 3.100, ‘Supporting Paper II’, CAA, December 2006

<sup>47</sup> The Guardian, 29 July 2008

service is atypical – as it is the largest destination served out of Stansted – and cannot be assumed to be equivalent to a marginal service.

- 7.29 As it is marginal services (and marginal passengers) that determine the strength of competitive constraints, this evidence appears to be of limited relevance.

### **Frontier analysis**

- 7.30 The CC states that:

“Frontier came up with a number of interesting conclusions including that moving a service from Stansted to East Midlands would lead to a very large loss in passengers and that fare elasticities were typically of a similar order of magnitude to distance elasticities, which were high.”

- 7.31 As the CC will be aware – and notes in its following paragraph – there are significant limitations to the Frontier analysis.

- 7.32 The CAA notes that the analysis relied upon by Frontier to reach its conclusion in respect of East Midlands was highly unrealistic, as it assessed whether it would be profitable to move a service and attract all of the same passengers (including, for example, those travelling to Stansted from Kent) whilst not attracting any additional passengers (such as any travelling south to East Midlands from Sheffield). As a result, it is difficult to place any significant weight on this particular conclusion.

- 7.33 In light of these analytical problems, and the fact that Frontier reports that price elasticities are high (i.e. elastic), the CAA questions why the CC appears to place weight on the analysis, when it states that:

“Despite these limitations, we note that the results of this analysis are consistent with other evidence we have seen on competition at Stansted **and therefore support our finding.**”  
[*emphasis added*]

### **Countervailing buyer power**

- 7.34 The CAA’s comments on this section are set out earlier in this paper. However, the CAA notes that the CC cites a range of evidence that indicates bargaining (such as the existence of “very generous” offers) but then appears to conclude that buyer power is not a significant competitive constraint.

### **BAA's current pricing behaviour**

- 7.35 The CAA has provided its comments on this section earlier in this paper.

### **Competitive price at Stansted**

- 7.36 The CAA has provided its comments on this section earlier in this paper.

### **Estimating short-run marginal cost**

- 7.37 The CAA has provided comments on this section earlier in this paper.
- 7.38 However, the CAA also notes that, in light of the data presented in Figure 10, OLS estimation of the short-run marginal cost (SRMC) appears likely to understate the actual SRMC, as there appears to be a structural break in the data above 15 mppa.
- 7.39 Further, much of this analysis relies upon observed changes in historical cost and changes in passenger numbers. However, over much of this period the airports have been operating with relatively low levels of scarcity. As such, historical data will tend systematically to under-state the SRMC that currently prevails at these airports.
- 7.40 It is also relevant to note that the analysis of constraints focuses on runway (i.e. slot) capacity, whereas in practice airports will tend to face a range of constraints across their many processes. It is also likely that airports consider the opportunity cost (and option value) of capacity as soon as there is a prospect of scarcity, and price that capacity accordingly.

### **Estimating willingness-to-pay**

- 7.41 The CAA has provided its comments on this section earlier in this paper.