

APPENDIX F

Evidence and analysis on indicators of market power

Introduction

- F1 In the absence of regulation, an airport operator holding a position of significant market power (SMP) may behave, to an appreciable extent, independently of its competitors and its customers, enabling it to:
- raise prices;
 - maintain levels of inefficiency;
 - compromise service quality; and
 - achieve supernormal profits.
- F2 The CAA recognises that the assessment of whether an airport operator has (or has not) SMP in the relevant market requires the analysis and examination of structure of the relevant market as well as the conduct and performance of the relevant market players.
- F3 To analyse the relevant market (see appendix D), the CAA has, in addition to considering competitive constraints, considered the following indicators of market power:
- market shares;
 - efficiency;
 - pricing behaviour;
 - engagement with airlines and commercial negotiations;
 - quality of service; and
 - profitability.
- F4 In considering these indicators of market power the CAA has examined:
- The historical and current status of these indicators as well as their likely evolution.

- What these indicators suggest individually as well as their cumulative and combined effect.
- F5 In interpreting the evidence on Heathrow Airport Limited's (HAL) behaviour and/or performance in the relevant market, the CAA recognises that HAL is subject to economic regulation and that its behaviour is therefore likely to be influenced (or even driven by) regulatory requirements.
- F6 The CAA's analysis on these indicators of market power, together with its analysis on competitive constraints (appendix E), have helped inform the CAA's final view on whether or not HAL has, or is likely to have, SMP in the relevant market.

The Consultation

- F7 In the Consultation on Heathrow market power assessment, CAP 1051 (the Consultation), the CAA considered that as a whole, the analysis of the indicators of market power suggested that:
- HAL is the single airport operator operating in the market comprising the provision of aeronautical services to full service carriers (FSCs) and associated feeder traffic at Heathrow, with a 100 per cent market share.
 - HAL enjoys SMP in the relevant market (particularly when efficiency, pricing behaviour, engagement and commercial negotiations are considered).
 - HAL will continue to hold a position of SMP in the relevant market due to improving economic conditions, tightening capacity across the London airports and excess demand at Heathrow.
- F8 In coming to this view, the CAA noted:
- While HAL's market share of 100 per cent in the relevant market supports a presumption of dominance, market shares are not always a conclusive indicator of the level of market power of airport operators.
 - Several independent studies identified areas where operating expenditure (opex) and capital expenditure (capex) inefficiency was present at Heathrow.
 - HAL prices to the regulatory price cap and, since 2008, its average revenue per passenger has been maintained at levels much higher than that achieved by comparable airport operators;

- Evidence on HAL's price negotiations suggests that HAL does not engage in genuine negotiations and that it targets the airlines it wishes to operate at Heathrow.
- The financial performance of, and the service quality outcomes of, HAL were unlikely to provide strong evidence about its market power as these were likely to be driven by the economic and service quality regulation that HAL is subject to.

F9 The CAA received three responses to the Consultation from:

- HAL;
- London Airline Consultative Committee (LACC) & Heathrow Airline Operators Committee (AOC); and
- Virgin Atlantic Airways (VAA).¹

F10 In summary, the issues raised by stakeholders in response to the Consultation were:

- HAL considered that the CAA's analysis on the indicators added little to the overall analysis of SMP.²
- VAA and the LACC & AOC did not respond specifically to the CAA's analysis on market indicators but both:
 - Agreed *'with the CAA's assessment that HAL continues to hold significant market power.'*^{3,4}
 - Noted that Heathrow is the UK's only hub airport and that as such it is a unique, essential facility⁵ and that it leverages its SMP when engaging with its customers.⁶

¹ Non-confidential versions on these responses are available on the CAA's website: <http://www.caa.co.uk/default.aspx?catid=1350&pagetype=90&pageid=14785>.

² HAL, Response to CAA's Market Power Assessment, July 2013, p. 26.

³ LACC & AOC Response to CAA's Market Power Assessment of Heathrow Airport Limited, July 2013, p. 1.

⁴ VAA, Response to CAA Consultation on Heathrow Market Power Assessment, July 2013, p. 1.

⁵ LACC & AOC Response to CAA's Market Power Assessment of Heathrow Airport Limited, July 2013, p. 1 and VAA, Response to CAA Consultation on Heathrow Market Power Assessment, July 2013, p. 1.

⁶ LACC & AOC, Response to CAA's Market Power Assessment of Heathrow Airport Limited, July 2013, p. 3.

- Suggested that *'Heathrow airport has become increasingly expansive and out of line with comparable hub airports and therefore been able to use its market power to sustain prices above an efficient level'*.⁷
- Noted that following the publication of the Economic Regulation at Heathrow from April 2014: Initial Proposals (the Initial Proposals)⁸ that HAL responded by unilaterally disengaging from the Q6 review and reducing its proposed capital plan for Q6.⁹

CAA analysis

- F11 In light of the representations from stakeholders as part of the Consultation, the CAA has re-evaluated its assessment of the indicators of market power for HAL and considers that, when considered as a whole, they suggest that HAL has SMP in the relevant market.
- F12 The analysis of the indicators of market power also suggest that, going forward, HAL's position of SMP is likely to be strengthened due to improving economic conditions combined with tightening of capacity across the London airports.
- F13 The CAA received many responses to the Heathrow: Market Power Assessment, the CAA's Initial Views – February 2012 (the Initial Views) and the Consultation. It has carefully read and considered all the points made in each response. This final decision contains summaries of, and answers to, the key points raised.

Market shares

- F14 Evidence on market shares is commonly used in competition assessments as the starting point of market analysis providing information about the structure and concentration levels of the relevant market.
- F15 However, for airport markets, the analysis of market shares provides only an initial indication about the potential for market power in the relevant

⁷ LACC & AOC Response to CAA's Market Power Assessment of Heathrow Airport Limited, July 2013, p. 1 and VAA, Response to CAA Consultation on Heathrow Market Power Assessment, July 2013, p. 1.

⁸ The Initial Proposals are available on the CAA's website:
<http://www.caa.co.uk/application.aspx?catid=33&pagetype=65&appid=11&mode=detail&id=5521>.

⁹ LACC & AOC Response to CAA's Market Power Assessment of Heathrow Airport Limited, July 2013, p. 1 and VAA, Response to CAA Consultation on Heathrow Market Power Assessment, July 2013, p. 1.

market, which is not sufficient on its own to establish whether SMP actually exists.

F16 According to established European case law:

- A firm with a market share of less than 25 per cent is unlikely to have an SMP position in the relevant market.¹⁰
- A firm with a market share of over 40 per cent generally raises SMP concerns in the administrative practice of the European Commission (EC).
- Large market shares (over 50 per cent) are in themselves, other than in exceptional circumstances, evidence of SMP.¹¹

F17 The above is also consistent with the Office of Fair Trading's (OFT) view¹² that:

The European Court has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50 per cent. The OFT considers it unlikely that an undertaking will be individually dominant if its share of the relevant market is below 40 per cent, although dominance could be established below that figure if other relevant factors (such as the weak position of competitors in that market and high entry barriers) provided strong evidence of dominance.

F18 According to EU competition law¹³, an undertaking with a large market share may be presumed to have an SMP position if its market share has remained stable over time.¹⁴ However, as noted above, high and stable

¹⁰ Recital 15 of Council Regulation (EEC) No. 404/89 on the control of concentrations between undertakings, OJ 1989 L395-1 states that: '*Whereas concentrations which, by reason of the limited market share of the undertakings concerned, are not liable to impede effective competition may be presumed to be compatible with the common market; whereas, without prejudice to Articles 81 and 82 of the Treaty, an indication to this effect exists, in particular, where the market share of the undertakings concerned does not exceed 25% either in the common market or in a substantial part of it.*

¹¹ Case C-62/86, AKZO Chemie BV v. Commission, [1991] ECR I-3359. A market share in excess of 50 per cent is said to create a rebuttable presumption of SMP.

¹² OFT, Assessment of market power guideline (OFT 415), paragraph 2.12.

¹³ Case 85/76 Hoffman-La-Roche v Commission [1979] ECR 461, paragraph 41.

See also, by analogy, Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services, (2002/C 165/03), paragraph 75.

¹⁴ This is consistent with the OFT's view that 'in general, market power is more likely to exist if an undertaking (or group of undertakings) has a persistently high market share. Source: OFT,

market shares do not always indicate that a firm has SMP. Where high and stable market shares are present they will need to be interpreted differently depending on the particular commercial and regulatory history by which the market shares came about (including other features of the market, such as competitive constraints from outside the market, barriers to entry and countervailing buyer power).

Consultation view

- F19 In the Consultation, the CAA outlined that:
- HAL operated in one market consisting of the provision of aeronautical services to FSCs and associated feeder traffic at Heathrow.
 - HAL has 100 per cent of the market irrespective of whether it is measured by passenger numbers or Air Transport Movements (ATMs).
- F20 As a result, the CAA outlined that HAL's market share supported a rebuttable presumption of dominance. However, as market shares are not always a conclusive indicator of the level of market power for airport operators the CAA outlined that it had undertaken further analysis of the other indicators of market power to determine if HAL has or is likely to acquire SMP.

Stakeholders' views

- F21 HAL, in response to the Consultation, indicated that:
- The CAA's analysis of the indicators of market power added little to its overall analysis of SMP.
 - The CAA seeks to identify a number of indicators that may be relevant to its assessment but acknowledges that several of these indicators are of limited relevance to HAL.¹⁵
- F22 HAL also noted that: *'the CC and the CAA agree that these may be of limited use in determining market power where the geographic market definition is difficult to determine precisely'*.¹⁶

CAA views and conclusion on market shares

- F23 The CAA has undertaken further analysis on the definition of the relevant market for HAL and continues to consider that the relevant market for

Assessment of market power guideline (OFT 415), paragraph 4.2.

¹⁵ HAL, Response to CAA's Market Power Assessment, July 2013, p. 26.

¹⁶ HAL, Response to CAA's Market Power Assessment, July 2013, p. 26.

HAL is the provision of aeronautical services to FSCs and associated feeder traffic at Heathrow (see appendix D).

F24 Based on this market definition, the CAA's market share analysis therefore finds that:

- HAL has 100 per cent of the market irrespective of whether it is measured by passenger numbers or ATMs.
- HAL's market share in the relevant market establishes a rebuttable presumption of a position of SMP in the relevant market.

F25 Market shares alone may not, however, be sufficient to establish a position of SMP for an airport operator. The CAA has therefore examined other indicators of market power to determine whether they corroborate or alter the rebuttable presumption of SMP for HAL that has been found from the market share information.

Efficiency

F26 An airport operator enjoying a position of SMP might face insufficient competitive pressure to enhance its operating efficiency by driving operating and capital costs towards competitive levels. However, as HAL is currently subject to price cap regulation, which includes incentives to increase operational and capital efficiencies, there are difficulties in distinguishing the extent to which observed operational efficiencies at Heathrow reflect a response to regulatory requirements or to competitive pressures.

Consultation view

F27 In the Consultation, the CAA outlined that there were a number of areas of inefficiency at Heathrow. In particular, a number of independent consultants had considered HAL's performance and found areas of opex and capex inefficiency.¹⁷ For example:

- The CAA's own benchmarking evidence showed that adjusted opex per passenger at Heathrow has risen significantly faster than the sample average since 2000.
- There is inefficiency in several areas related to wage and pension costs.

¹⁷ For example, that several pieces of opex benchmarking evidence that it examined had been adjusted through various processes to attempt to normalise the indicator. Comparisons between airports are then made using the metric of opex / passenger to adjust for airport size.

- There are a number of capex shortcomings, in particular with respect to:
 - The Terminal 3 Integrated Baggage (T3IB) system project, where on a reasonably conservative basis, a £19.5 million capital inefficiency was incurred.
 - Procurement inefficiencies.

F28 The CAA also outlined that it had seen no evidence that competitive constraints had driven the efficiency initiatives that HAL had pursued.¹⁸

Stakeholders' views

F29 HAL, in response to the Consultation, suggested that the evidence collected on efficiency and how the CAA had interpreted it was flawed. In particular, it considered that the CAA's analysis had failed to consider:

- Whether the comparator airports chosen were suitable, in terms of size location and/or complexity.
- Appropriate comparators for Heathrow's labour costs, and the context of Heathrow's legacy pension arrangements. For example, the IDS study appears to compare Heathrow security guards with retail security jobs.
- Appropriate evidence and substantiation of supposed efficiencies identified.

F30 HAL also considered that the CAA had not assessed increases in opex relative to improved outcomes, for example initiatives that contributed to Airport Service Quality Survey (ASQ) scores reaching their highest levels and security waiting times continuing to improve.¹⁹

F31 The LACC & AOC considered that HAL's SMP was reflected in HAL's record of delivering infrastructure, which it noted was comparable to an infrastructure supplier operating in a competitive environment. As an example, the LACC & AOC highlighted the '*extreme delays and cost overruns*' associated with T3IB system project.²⁰

¹⁸ See the CAA's working paper, 'Empirical methods for assessing behaviour, performance and profitability of airports', which states that an airport operator with SMP may face insufficient competitive pressures to drive up operating efficiency.

¹⁹ HAL, Response to CAA's Market Power Assessment, July 2013, p. 27.

²⁰ LACC & AOC Response to CAA's Market Power Assessment of Heathrow Airport Limited, July 2013, p. 2.

F32 VAA, in its response to the Consultation, did not raise the issue of efficiency.

CAA views

F33 A number of independent consultants were commissioned to examine opex efficiency at Heathrow and these studies used a variety of methodologies and different samples to inform their work. The results from these studies, as well HAL's own analysis, suggest that there is evidence of inefficiency in several areas at Heathrow. In particular:

- Benchmarking evidence²¹ shows that HAL's opex per passenger is very high relative to the sample average, and higher than several comparable operators of large hub airports such as Hong Kong, Atlanta and Amsterdam Schiphol.
- The CAA's benchmarking evidence shows that adjusted opex per passenger at Heathrow has risen significantly faster than the sample average since 2000, suggesting a relative decline in efficiency.

F34 Taken together, these studies suggest that there are a number of areas of opex inefficiency at Heathrow and that this has arisen despite regulatory incentives to improve efficiency. This suggests that HAL faces relatively weak competitive pressures to improve efficiency.

F35 With respect to HAL's concerns on the choice of comparator airports, several alternative benchmarking studies, following different methodologies and using different samples, showed that HAL's opex per passenger appears to be high. More importantly, HAL's own study by Booz & Co concluded that opex per passenger at Heathrow, when adjusted to enable a like-for-like comparison, appears to suggest that HAL is inefficient.

F36 The Booz & Co study highlighted (among other issues) that:

- HAL has one of the highest operating costs per passenger within the benchmarked group of comparator and competitor airports.
- Even adjusting for the inherent costs associated with operating Heathrow, it moved from having the second highest opex per passenger to fourth place (after Munich, Paris Charles de Gaulle and Zurich Airports).

²¹ These studies include: (1) Air Transport Research Society 2011 Airport Benchmarking Report; (2) Leigh Fisher 2011 Airport Benchmarking Report; (3) Booz Allen 2012 European Airport Benchmarking Report commissioned by HAL; and (4) Steer Davies Gleave 2012 Stansted Mid Q Review Report commissioned by the CAA and (5) the CAA's own benchmarking analysis.

- Staff costs are currently much higher than competitors as HAL sources labour from a high cost London borough.
- While utility contracts are now more in line with market rates, utility costs could be further improved (if it was not constrained by a continuing agreement).²²

F37 With respect to HAL's concerns associated with labour costs, the CAA notes that the bottom-up IDS Employment cost benchmarking study found evidence of inefficiency in several areas related to wage and pension costs. This study, which is based on an internationally established methodology, was conducted in consultation with HAL (and on many occasions HAL's comments were taken on board and reflected in the analysis).

F38 Some of the key findings from this benchmarking study were that:

- Wage growth at HAL between 2006 and 2012 was 1.6 per cent above the average across the wider economy.
- There is some evidence of grade drift across staff groups leading to a 'virtual de-population of the lower grades'. For example, there are now three Leading Fire Fighters for every Fire Fighter.
- Based on a three month sample (June to August 2012), the estimated absence rate at HAL was 7.6 days per employee per year. This is higher than the industry average of 6.8 days.
- Overall the study estimated that employee total cash reward at HAL was between 10 per cent and 21 per cent higher than benchmarks.

F39 In addition, this analysis found:

- The defined benefit and defined contribution pension schemes were both significantly higher than its comparators.
- Relatively poor performance on the passenger security lane flow (an issue that HAL accepts requires improvements).
- The potential to increase staff rostering efficiency by as much as 10 per cent.

F40 HAL, through its actions, also appears to verify that staff costs and pension scheme costs are too high and proposed wage reductions²³ of

²² Booz & Co, European Airport Benchmarking Study 2012, p. 6.

²³ Source: HAL [§<].

[§<] per cent in real terms and reducing pension costs²⁴ from 33 per cent of pay to [§<] of pay in the latest Q6 business plan that it submitted to the CAA.

- F41 Airlines have also identified concerns with the level of efficiency seen at Heathrow. For example, [§<] noted that there is scope for HAL to improve its efficiency and has indicated that:

*[HAL] don't see the need to be more aggressive in costing.*²⁵

And:

*It doesn't understand why Heathrow doesn't see the need to curtail its costs in order to derive more revenue and drive demand.*²⁶

- F42 Finally, in relation to HAL's comment that the CAA had not assessed increases in opex relative to improved quality outcomes, the cost efficiency improvements that the CAA has proposed as part of the Q6 process have been calculated on the basis of maintaining and not reducing service and quality standards. As such, the cost efficiency improvements that the CAA has proposed are real efficiency improvements which, if achieved, will enable HAL to deliver the standard of service at improved costs.

Conclusion on efficiency

- F43 The evidence, taken together, suggests that there are areas where efficiency at Heathrow can be improved. In particular, evidence from a number of independent benchmarking studies – studies which were top-down and bottom-up, and were carried out by different consultants following different methodologies and approaches – all point to areas of inefficiency at Heathrow.
- F44 Inefficiency was also identified by HAL's own consultants and was reflected in material submitted to the CAA. In addition, HAL was provided opportunities to comment on the studies being undertaken and amendments (where appropriate) were made to reflect those comments.
- F45 The CAA recognises that there may be areas of disagreement with HAL, but considers that the approaches that have been used to assess efficiency but considers that the approaches that have been used are reasonable.

²⁴ GAD, Review of pension costs for Heathrow Airport, 2013, p. 10.

²⁵ Source: [§<].

²⁶ Source: [§<].

- F46 The CAA has also seen no evidence from HAL, including in response to the Consultation, regarding how competitive constraints have driven the efficiency initiatives that HAL has pursued.
- F47 Based on the above, the CAA considers that the identified inefficiencies at Heathrow are consistent with HAL enjoying a position of SMP in the relevant market. That is, HAL is facing insufficient competitive pressures to enhance its operating efficiency by driving operating and capital costs towards competitive levels.

Pricing behaviour

- F48 The economic concept of market power is reflected in European case law. For example, in *Hoffman la Roche v Commission* [1979] ERC 461, it was outlined that market power:

*relates to a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of the consumers.*²⁷

- F49 This case also highlighted that:

*such a position does not preclude some competition, which it does where there is a monopoly or a quasi-monopoly, but enables the undertaking which profits by it, if not to determine, at least to have an appreciable influence on the conditions under which that competition will develop, and in any case to act largely in disregard of it so long as such conduct does not operate to its detriment.*²⁸

- F50 The EC considers that an undertaking has SMP if ‘it is capable of profitably increasing prices above the competitive level for a significant period of time’ and that the reference to ‘increasing prices’ is used as shorthand for a variety of ways of influencing competition to the advantage of the dominant undertaking, including by decreasing output, innovation, variety or quality of goods or services.²⁹

- F51 By analogy, the EC's SMP Guidelines state that:

However, in an ex-ante environment, market power is essentially measured by reference of the power of the undertaking concerned to

²⁷ Paragraph 38.

²⁸ Paragraph 39.

²⁹ EC Guidance on Article 102 Enforcement Priorities, OJ [2009] C 45/7, paragraph 11.

*raise prices by restricting output without incurring a significant loss of sales or revenues.*³⁰

- F52 Therefore, the assessment of an airport operator's pricing behaviour is an important indicator of market power. In particular, given that an airport operator having SMP will be able to profitably sustain prices above the competitive level over time, it is important to consider prevailing and historical prices in relation to the competitive price level. However, pricing at or even below the competitive level does not necessary indicate the absence of SMP.³¹
- F53 If a competitive price benchmark could be identified with certainty it would allow comparison of historical and prevailing prices with the identified competitive price. This information would, in-turn, help identify if there was market power. However, there are a number of challenges associated with identifying precisely what the competitive price is for HAL and therefore a proxy (or proxies) of the competitive price needs to be used.
- F54 The main approaches to identifying a proxy for the competitive price level are benchmarking and cost modelling replicating the cost and pricing structure of a hypothetically efficient entrant.³²

Consultation view

- F55 As stated in the Consultation, the CAA considered that it was unnecessary to undertake a detailed assessment of the prevailing price at Heathrow. In particular, the CAA:

... has not found it necessary to undertake a detailed assessment of the prevailing price level at Heathrow in order to reach its initial views on the airport [operator]'s market position, for a number of reasons. First, some reliance can be placed on the price cap at Heathrow, which ensures that prices are not significantly above competitive levels, and certainly not at levels reflecting monopoly pricing. Second, the CAA's conclusions for Heathrow, whilst drawing on switching evidence, do not rely on factors that would be affected – to a significant degree – by the prevailing price

³⁰ Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services, (2002/C 165/03), paragraph 73.

³¹ Pricing at or below marginal costs (strategic foreclosure or predatory pricing) is an abuse by dominant firms (firms having SMP).

³² Benchmarking: Under this approach, some kind of average price is calculated from the prices of the substitutes (or comparable products). Cost modelling: This approach entails the construction of a cost model designed to replicate the cost structure of a hypothetical efficient entrant, operating in a competitive environment. The derived prices are assumed to proxy the competitive price level.

level differing from the competitive level. Finally, there is a degree of consistency in the overall evidence about [HAL's] market power that provides a degree of comfort that the conclusions have not been affected by any difference between the prevailing and competitive price levels.³³

F56 As such, the CAA focused its effort on assessing the pricing behaviour of HAL by analysing its historical pricing pattern and by considering the evidence provided by range of sources, including the airlines, other airport operators and from a benchmarking study that the CAA commissioned from Leigh Fisher (LF).

F57 The analysis of the above mentioned evidence suggested that:

- A number of stakeholders considered that Heathrow is relatively expensive, that HAL does not offer any discounts to its prices and that there have been some significant price increases over the last ten years.
- Some stakeholders (airlines) suggested that HAL may be over charging. However, another stakeholder (an airport operator) suggested that HAL may be under charging.
- HAL has historically priced to the cap. To the CAA's knowledge, HAL has not agreed discounts outside published charges. There is also a premium on the value of landing slots at Heathrow (as discussed in chapter D).
- As HAL is pricing to the cap, and slot pairs are traded for considerable sums, there is a reasonable expectation that, if the price cap was removed, HAL would seek to increase prices.

F58 The CAA also highlighted (that in the absence of regulation HAL would seek to raise charges at least by approximately £4 per passenger. In particular, it noted that the comparison of HAL's Q6 initial business plan and the assessment made by the CAA (initial proposals) shows that the CAA's proposed price cap is £4 lower. This equates to prices in a single year being £295 million, which is substantially higher than the direct costs of regulation. In addition, the CAA outlined evidence on HAL's negotiations with its customers, which suggested (given the excess demand at Heathrow), that:

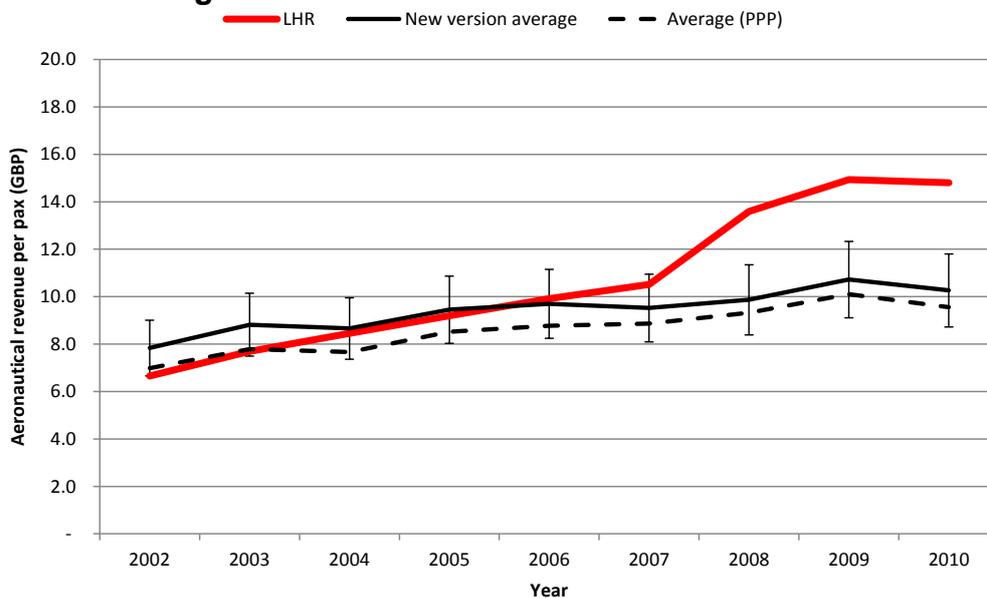
- HAL does not pursue genuine engagement in decision making processes, rather it acts to an appreciable extent unilaterally.

³³ CAA, Initial Views, paragraph 2.25.

- HAL does not enter into commercial negotiations with the airlines and instead it sets the terms that an airline will receive for using the infrastructure at Heathrow with limited scope for negotiation.

- F59 To better inform its understanding of the potential range of prices that might be considered as a proxy for the competitive price, the CAA commissioned LF to benchmark airport charges at Heathrow against suitable comparator airports. LF benchmarked HAL aeronautical and total income per passenger against those from comparator airport operators.³⁴
- F60 LF's analysis shows (see Figure F.1 below) that HAL's aeronautical charges were above those of comparator airport operators. It also shows that this is likely to be the case notwithstanding the margin of error present within the analysis (represented by the error bars around the average from comparator airports).
- F61 LF's analysis also showed that HAL's aeronautical revenue per passenger at Heathrow has, since 2008, been significantly above the average secured by comparable airports and as of 2010, around £5 higher.³⁵

Figure F.1.: Aeronautical revenue per passenger at Heathrow compared to the basket average



Source: Leigh Fisher

Note 1: Comparator airport operator and airports included Charles De Gaulle, Amsterdam Schiphol, Milan Malpensa, Istanbul Ataturk, Frankfurt Main, and Gatwick. Note 2: PPP: Purchasing Parity Power.

³⁴ LF benchmarked HAL aeronautical and total income per passenger against those of the comparators. The CAA stated that given that HAL is regulated and that its incentives to maximise non-aeronautical income may be adversely affected by the form of regulation, the relevant basis of comparison should be aeronautical income per passenger.

³⁵ The analysis also shows that HAL's aeronautical revenue per passenger was roughly in line with the average of comparable airports over the period 2002 to 2007.

Stakeholders' views

F62 In response to the Consultation, HAL noted that:

- The current market clearing price could be higher due to an endogenous capacity reduction by a monopolist or by an exogenous capacity constraint and the CAA has not distinguished between the two. HAL also noted that the CAA had acknowledged that the current capacity constraints have resulted from public policy and that therefore the relevant market clearing price was the one that would arise in a competitive market subject to the exogenous capacity constraint faced by Heathrow.
- In considering the longer run competitive price absent capacity constraints, the CAA had failed to account for the forward-looking cost of adding capacity. HAL proposed to account for this using a cost-based standard such as the forward-looking FAC-CCA model (Full Allocated Cost with Current Cost Accounting) used by Ofcom in the case of Openreach.
- The CAA's observations that HAL has set tariffs at Heathrow close to the cap over the last eight years, and that it does not offer discounts on charges, were not indicative of HAL exercising its market power.³⁶
- Since the price limits have been set to allow it to recover, on average, no more than the cost of capital, any reduction in the price below the limit set by the CAA, whether through setting published charges at a level below those implied by the price limit, or through discounting relative to the standard charges, would simply have led to (further) sub-normal returns and under-recovery relative to the respective settlements.³⁷

F63 HAL also raised a number of concerns regarding the methodology and approach of LF's benchmarking study and therefore its suitability to serve the CAA's intended purpose which was *'to further inform its understanding of the potential range of prices that might be considered competitive.'*³⁸ Specifically, it noted that:³⁹

³⁶ HAL, Response to CAA's Market Power Assessment, July 2013, p. 27.

³⁷ HAL, Response to CAA's Market Power Assessment, July 2013, p. 27.

³⁸ HAL, Response to CAA's Market Power Assessment, July 2013, pp.11 to 13.

³⁹ HAL, Response to CAA's Market Power Assessment, July 2013, pp.11 to 13.

- The CAA's statement implies a narrow range of competitive prices for one type of product/service, where in actuality, a market can often have a range of products/services with differing attributes and thus differing prices that are seen as potential substitutes, and any price benchmarking would need to take sufficient account of such attributes.
- The CAA failed to account for a number of caveats of LF's benchmarking analysis, including:
 - The comparability of the airports included in the benchmarking analysis (particularly given the methodology by which they were chosen).
 - The use of an average benchmark, when LF itself acknowledged that '*the available basket of comparators is polarised into two groups*' of high and low revenue per passenger.
 - Failing to account for service quality, input cost and investment cycles in understanding differences in prices.
- LF had acknowledged that the regulatory context within which HAL operates is not comparable with that of its comparators and in particular that '*it is not possible to make comparisons between Heathrow and airports subject to light-handed regulation as there are none with appropriate revenue data in the comparator basket*', implying it is not a competitive market price benchmark.

F64 Finally, HAL indicated that given the uncertainties involved in determining the competitive price benchmark and the fact that market definition depends upon the competitive price level, that the CAA does not have sufficient grounds to conclude robustly that HAL's SMP analysis would not be overturned if airport charges were different.⁴⁰

F65 VAA and LACC & AOC both considered that HAL has SMP and noted that the benchmarking carried out by the CAA's consultants had been helpful in identifying and benchmarking pricing trends across hub airports. Both also noted that the benchmarking showed that Heathrow has become increasingly expensive and out of line with comparable hub airports and that HAL has used its market power to sustain prices above an efficient level.⁴¹

⁴⁰ HAL, Response to CAA's Market Power Assessment, July 2013, p.13.

⁴¹ VAA, Response to the CAA Consultation on Heathrow Market Power Assessment, p.1 and LACC & AOC, Response to CAA's Market Power Assessment of Heathrow Airport Limited, p.1.

CAA views

- F66 The current regulated prices are designed to be cost-based and prevent HAL from earning supernormal profits and for this reason have also been considered by the CAA as an appropriate basis for undertaking its analysis (see appendix D).
- F67 With respect to HAL's comment about the market clearing price, given excess demand and capacity constraints within the London area, it is likely that the current regulated price is below the market clearing price. However, in the absence of regulation, given the current capacity constraints and that HAL is the only operator in the relevant market (see appendix D) the market clearing price that would result would most likely be far above competitive levels (potentially at levels close to the price that would be set by a dominant operator).⁴²
- F68 With respect to HAL's comment regarding the distinction between an endogenous constraint and an exogenous one, the CAA understands and acknowledges this distinction. However, as stated above, given the excess demand and the capacity constraints in the absence of regulation the market clearing price would be higher than both the current regulated price and the competitive price. This would be the case whether the market clearing price was a result of endogenous or exogenous constraints.
- F69 In relation to HAL's concern that the CAA has not accounted for the forward-looking costs of adding capacity, the CAA has already explained the reasons why it did not build an alternative cost based model:
- Heathrow is a highly differentiated airport and HAL has a market share of 100 per cent of the relevant market, providing comfort about HAL's SMP in this market.⁴³
 - The development of a cost model (be it long run average incremental cost (LRAIC) or other cost standard), on top of the RAB based price requires significant resources and that given the other available evidence (see paragraph F56) such an exercise was not considered necessary;

⁴² The CAA has come to this conclusion by looking at the costs of slots at Heathrow, which due to their high demand (and relative scarcity), are traded at substantial sums.

⁴³ The CAA does, however, recognise that market shares are not always a conclusive indicator of the level of market power of airports.

- The development of a cost model also typically requires significant resources and consultation.⁴⁴

F70 HAL has also suggested, in its response to the Consultation, that the CAA has not taken account of forward looking costs as part of its assessment. As part of this, it highlighted that a FAC-CCA type model may be appropriate.⁴⁵

F71 However, HAL has also indicated, early in the Q6 process, concerns with using non-RAB based regulatory approaches and the associated regulatory burden that this would bring. In particular, HAL noted:

[redacted].⁴⁶

F72 As regulated prices are based on forward looking costs, and given HAL's concerns with minimising regulatory burden (as well as the other reasons cited earlier), the CAA considers that its approach is reasonable.

F73 With respect to HAL's comment on pricing to the cap and that not doing so would lead it to under-recover relative to the respective settlements, HAL has been pricing to the cap for some time. Figure F.2 (below) illustrates the regulated price caps (or maximum airport charge) that were set at Heathrow as well as the revenue yields that HAL has achieved over the period 2003/4 – 2011/12.

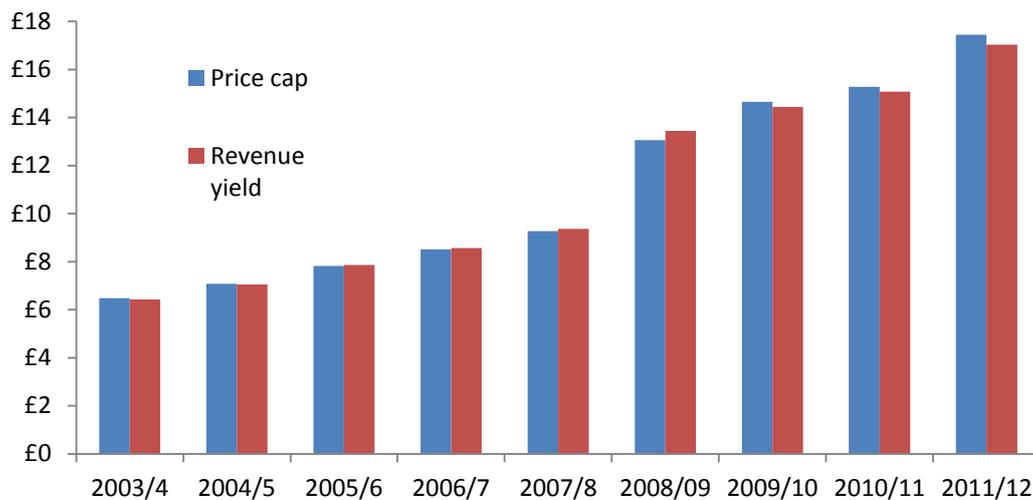
F74 Figure F.2 shows that since at least 2003/4, HAL has set the airport charges for Heathrow at the regulated price cap. Evidence submitted by HAL (and other stakeholders) supports this view – see the discussion on engagement and commercial negotiations in appendix F.

⁴⁴ For example, the development of such cost model requires a transparent consultation process involving a number of choices regarding: the cost standard to be used; the modelling approach (bottom-up vs. top-down); the depreciation methodology (economic depreciation, straight line or other depreciation method); the asset valuation methodology; and the forward-looking projections and related assumptions of the key variables and many other parameters of the model. While LRAIC estimates were produced for Stansted and Gatwick and that it considers that the approach that was used was reasonable, there are a number of concerns associated with using LRAIC for airports – these concerns were outlined in the Consultations for both these airport operators.

⁴⁵ HAL, Response to the CAA market power assessment, July 2013, p. 13.

⁴⁶ HAL [redacted].

Figure F.2: HAL's regulated price cap and revenue yields (£ per passenger – current prices)



Source: CAA analysis of regulatory returns

- F75 As discussed in the Consultation, the CAA considers that in the absence of regulation HAL would seek to raise charges. This view is supported by the comparison of the five year average yield in HAL's Q6 alternative business plan (£23.43 over four years and nine months) with the one in the CAA's Q6 Final Views (£19.74), which indicates that the CAA's proposed price cap is £3.69 lower than HAL's proposal.
- F76 If an airport operator has been consistently, and is continuing to, price up to a cap and that cap is relaxed, this means that a binding constraint will have been removed. This would allow, in theory, an airport operator with SMP, in the absence of effective competitive market forces, to increase its prices above the cap to which it had been subject to. In such a situation, it can be reasonably inferred that de-regulation would likely to lead to a price rise.
- F77 The CAA also notes that, consistent with a view expressed by another airport operator (Gatwick Airport Limited (GAL)), HAL may be able to set lower (cost reflective) price that would allow it to operate more successfully at Heathrow if it increased its overall efficiency.⁴⁷ In particular, GAL has indicated that:

⁴⁷ For more information on efficiency see earlier discussion.

*Competitive companies need to maximise returns on investment also [and that] Competitive companies maximise returns through innovation, better understanding of customers' needs and efficient operations etc.*⁴⁸

- F78 Airport operators are also able to reduce charges through increasing retail revenue due to the single till. Thus, similar to the point above on efficiency, by facilitating increased spending per person, directly or indirectly, HAL may be able to reduce its aeronautical charges.
- F79 With respect to the issues of the willingness (or not) of HAL to offer discounts on charges in the context of relative bargaining power with airlines, the behaviour of an airport operator with respect to engagement with airlines and its commercial negotiations can provide useful insight into how an airport's management views the degree to which it can be constrained by competition (and the degree to which it may be possible to exercise market power).
- F80 An airport operator with SMP can, in any case, choose not to exercise any market power that it may have by, for example, entering into genuine engagement and negotiation with customers. Therefore, pricing at or around the regulated price is not necessarily an indicator of the lack of market power.
- F81 A number of stakeholders have expressed support for the benchmarking analysis that LF undertook. However, conscious of the concerns raised by HAL in responses to the Consultation, the CAA re-engaged LF to consider some of the issues:
- On HAL's concern that it does not consider the LF analysis to be appropriate for the CAA's intended purpose, LF indicated:
 - That its benchmarking is based on actual data and, as such, it is simply a presentation of actual analysis rather than theoretical judgements.
 - Reasonable inferences could be drawn to inform the CAA's work, both on the range of prices in a competitive market and the trajectory of aeronautical revenue over recent years relative to a reasonable basket of comparators.⁴⁹

⁴⁸ Source: GAL [§<].

⁴⁹ LF, Addendum Note, Comparing and Capping charges at Regulated Airports, 9 August 2013, p. 6.

- On HAL's concerns about the comparability of airports included in the sample, that the comparator sample was derived using a framework which was outlined in LF's report. This framework was applied to remove subjectivity from the selection of comparators as far as possible, although LF acknowledges that certain subjective judgements are still needed, e.g. definition of the cut-off value for inclusion of comparators in the sample.⁵⁰
- F82 In addition, LF has followed a data-driven approach⁵¹, which reveals that some of the factors which might, at first glance, be considered relevant are less important in reality. As such, airports that met the requirements for comparison were considered as part of the LF analysis. This approach has therefore resulted in the most appropriate airports being selected by LF to undertake its analysis.
- F83 On HAL's concern that airports subject to light handed regulation were not included in the comparator basket (due to a lack of data) and that this meant that the LF analysis did not produce a competitive price benchmark, the CAA notes that the outputs from the benchmarking exercises are based on the available facts and that the identification of a price range, including a band of uncertainty, addresses some of the specific concerns or inevitably different views on relevant comparators or key variables used in the study.⁵²
- F84 While LF has recognised that ideally it would have used a greater range of reliable data if it was available, that does not in itself undermine the validity of the work undertaken or the conclusions that were drawn.⁵³
- F85 More broadly, LF indicated that the benchmarking exercise itself attempts to identify the relative prices at different comparator airports based on their core attributes rather than explore and explain the many different reasons that may lie behind each of the differences, including differences associated with type of regulatory regime an airport may be subject to.⁵⁴

⁵⁰ LF, Addendum Note, Comparing and Capping charges at Regulated Airports, 9 August 2013, p. 4.

⁵¹ LF, Addendum Note, Comparing and Capping charges at Regulated Airports, 9 August 2013, p. 4.

⁵² LF, Addendum Note, Comparing and Capping charges at Regulated Airports, 9 August 2013, p. 6.

⁵³ LF, Addendum Note, Comparing and Capping charges at Regulated Airports, 9 August 2013, p. 9.

⁵⁴ LF, Addendum Note, Comparing and Capping charges at Regulated Airports, 9 August 2013, p. 9.

F86 Regarding some of the other specific concerns on quality, input costs and investment cycles that HAL raised, LF has responded in the Addendum Note titled *Comparing and Capping charges at Regulated Airports*, which is available on the CAA's website.⁵⁵

Conclusion on pricing behaviour

F87 The CAA considers that the evidence, including evidence from airlines, other airport operators and from the LF benchmarking study, are consistent in suggesting that:

- Heathrow is relatively expensive, that HAL does not offer any discounts to its prices and that there have been some significant price increases over the last 10 years.
- As HAL has historically priced to the cap and slot pairs are traded for considerable sums, it can reasonably be inferred that if the price cap were removed HAL would seek to increase prices.
- HAL's aeronautical charges were significantly above those of comparator airport operators. Specifically, LF's analysis suggests that HAL's aeronautical revenue per passenger has, since 2008, been significantly above the average secured by comparable airport operators and as of 2010, around £5 higher.⁵⁶

F88 The CAA considers that this evidence on pricing behaviour is consistent with HAL, as the only operator in the relevant market, having SMP.

Airline engagement and commercial negotiations

F89 The conduct of an airport operator with respect to airline engagement and commercial negotiations provides useful insights about the degree to which an airport operator can be constrained by demand substitution and competition and therefore the degree of its market power and its ability to exercise it.

⁵⁵ See:

<http://www.caa.co.uk/docs/78/LF%20Response%20to%20Comparator%20Model%20Comments%2012Aug13.pdf>. While this report largely focuses on issues raised by stakeholders other than HAL, the information contained within this document is applicable to Heathrow.

⁵⁶ The analysis also shows that HAL's aeronautical revenue per passenger was roughly in line with the average of comparable airports over the period 2002 to 2007.

Consultation view

F90 In the Consultation, the CAA outlined that it had considered a range of evidence from both HAL and from airlines to further develop its thinking on this issue.⁵⁷ For example, it noted that the material it had considered included:

- Various strategy documents, including papers discussing potential and actual strategies for encouraging growth at the airport.
- Marketing and promotional material, including presentations to airlines considering launching new routes.
- Discussions/teleconferences with a range of airlines, including airlines who are currently at Heathrow.

F91 The CAA also outlined that the evidence suggested that:

- There were concerns with HAL's approach to negotiations, with a number of airlines highlighting the lack of engagement and/or the absence of any negotiation with respect to aeronautical charges.
- The willingness of HAL to hold extra meetings with its key stakeholders on the prices proposed in the Conditions of Use (CoU) notwithstanding evidence that suggested that the scope for material change appeared limited.
- HAL identifies airlines that it considers may be hindering its ability to maximise its capacity by efficiently using its infrastructure (it has also identified possible means to address this, including consolidation of operations at the airport and/or encouragement to leave the airport). [redacted].⁵⁸
- HAL's strategy in dealing with airlines appears to depend on [redacted].
- Growth being delivered through a number of mechanisms but not through [redacted]. In particular, evidence from HAL states that [redacted].⁵⁹

F92 The CAA therefore considered that HAL largely sets the terms that an airline will receive and that the scope for negotiation is limited. The CAA also considered that the high demand for slots at the airport ensured that:

⁵⁷ There are often limitations associated with this type of evidence as records of negotiations are often incomplete, as discussions often occur face to face/on the telephone and recordings and/or minutes are not kept.

⁵⁸ Source: HAL [redacted].

⁵⁹ Source: HAL [redacted].

- Prices charged are at the cap [3<]. As such, HAL has, in effect, adopted a 'take it or leave it' approach.
- There is some scope for [3<], although this seems to comprise a [3<].
- There is such demand for airlines to operate at Heathrow that HAL can be selective as to what airlines it wants to pursue to develop its network [3<].

Stakeholders' views

- F93 HAL considered that the CAA's review of the indicators of market power added little to the SMP analysis and that the airlines' relative bargaining power is understated (an issue the CAA examines in appendix E).
- F94 The LACC & AOC noted (among other issues) that as the UK's only hub airport, Heathrow is a unique and essential facility and a key input for airlines to compete in the downstream air transport services market. It also noted that the behaviour of HAL and its propensity to act independently of its customers evidenced its SMP.
- The LACC & AOC also suggested that HAL's SMP is manifested by HAL's behavioural (see evidence outlined in the earlier discussion on efficiency).

CAA views

- F95 HAL's response to the CAA's analysis on airline engagement and commercial negotiations was limited in scope and provided little new evidence to alter the view in the Consultation. HAL's concerns regarding relative buyer power are addressed in appendix E.
- F96 The two other stakeholders who responded to the Consultation have also suggested that HAL's SMP is manifested by HAL's behaviour, which is evidenced in its approach to the CoU, its unilateral disengagement from the Q6 review process and the delays and cost overruns of the T3IB Project and HAL's actual capex during Q5.
- F97 With respect to the disengagement from the Q6 review process, the CAA notes, consistent with the views expressed by both VAA and LACC & AOC, following the publication of the Initial Proposals, HAL did withdraw from meetings with the airlines on the investment programme for almost one month. In late June 2013, without further consultation with the airlines, HAL then submitted a revised business plan to the CAA based on a £2 billion investment programme. In July 2013, it submitted a brief addendum to its plan, assuming a £3 billion investment programme and a higher WACC.

Conclusion on airline engagement and commercial negotiations

- F98 Based on the evidence outlined above, the CAA maintains the position it outlined in the Consultation. The evidence suggests that:
- HAL does not pursue genuine engagement with its customers and that instead it acts to an appreciable extent unilaterally.
 - HAL does not enter into commercial negotiations with the airlines and instead it largely sets the terms that an airline will receive for using the infrastructure at Heathrow and that the scope for negotiation is limited.
- F99 That said, the CAA recognises that there is some scope for [redacted], although this seems to comprise a [redacted].
- F100 There is also such demand for airlines to operate at Heathrow that HAL can be selective as to what airlines it wants to pursue to develop its network [redacted].

Quality of service

- F101 In a competitive market, airport operators may face significant pressure to maintain or improve their service quality to prevent airlines and passengers from switching to other airports. The analysis of service quality could, therefore, provide evidence about whether an airport operator faces significant competitive pressures.
- F102 In the absence of regulation an airport operator holding a position of SMP, may choose either to raise prices and/or compromise service standards. Heathrow is, however, subject to service quality regulation that was introduced in Q4 under the Service Quality Rebate (SQR) scheme.

Consultation view

- F103 In the Consultation, having considered evidence from a range of sources, the CAA considered that:
- Overall, passengers appeared to be reasonably satisfied with the service quality at Heathrow.
 - Heathrow appears to be at or slightly above the target levels on service quality.⁶⁰

⁶⁰ In coming to this view, the CAA noted that in Q5 the SQR scheme captured five areas of HAL's service quality: (1) passenger satisfaction – with metrics taken from HAL's Quality of Service Monitor (QSM) survey and covering flight information, cleanliness, way-finding, and departure lounge seating availability; (2) security queue times – with metrics based on queue times for central search, transfer search, staff search and control posts; (3) passenger operational

- F104 The CAA also outlined that discussions with HAL and the airlines on their own research indicated a broad consistency with the results outlined above.
- F105 However, the CAA also noted that due to the imposition of service quality targets by economic regulation, it was not possible to reach a clear conclusion of whether Heathrow's observed service quality reflects competitive pressures or a response to the price control incentives provided by the SQR scheme. In addition, the CAA noted that the level of service quality experienced at Heathrow may reflect the level and the efficiency of the capex and opex incurred by HAL.
- F106 The CAA therefore considered that an examination of the relative efficiency of this expenditure would be useful in helping to inform the CAA's view on the market power for HAL.

Stakeholders' views

- F107 HAL, in its response to the Consultation, noted that the CAA does not account for HAL's strong service quality performance as it cannot differentiate whether this is due to competitive pressures or regulatory incentives and as a result it puts little weight on HAL's strong performance.
- F108 HAL also considered that the CAA was selective in its use of evidence, given that pricing and opex are also heavily influenced by regulatory incentives.⁶¹
- F109 In addition, HAL noted that: *'Heathrow's continuing improved performance in service quality cannot be solely explained by regulatory incentives, but we agree that it may be difficult for the CAA to isolate the various incentive effects'*.⁶²
- F110 VAA and the LACC & AOC, in their responses to the Consultation, did not respond specifically to the CAA's analysis of HAL's service quality.

CAA views

- F111 The CAA does not accept HAL's comment that it is making *'selective use of evidence'* and that it treats differently the evidence on efficiency, pricing

elements – with metrics based on the availability of passenger-sensitive equipment (PSE), track transit systems, and arrivals reclaim (baggage carousels); (4) airline operational elements – with metrics covering pier service, stands, jetties, FEGP (Fixed Electrical Ground Power), PCA (Pre-Conditioned Air), and stand entry guidance. Metrics are generally based on the availability of these elements.

⁶¹ HAL, Response to CAA's Market Power Assessment, July 2013, p. 26.

⁶² HAL, Response to CAA's Market Power Assessment, July 2013, p. 34.

and service quality. The approach that it has adopted as part of its assessment of indicators of market power recognises that the assessment of whether or not a regulated airport operator has SMP is complicated by a number of the relevant indicators being influenced or driven by the regulatory regime.

- F112 While the CAA may have set the maximum allowed revenue to be recovered by HAL on the basis of assumptions, including with respect to efficiency, this does not prevent HAL from reducing prices below the cap by enhancing its level of efficiency while maintaining service quality standards. The CAA also notes that cost efficiency improvements that it has proposed as part of the Q6 process have been calculated on the basis of maintaining and not reducing service and quality standards seen at Heathrow.
- F113 HAL also appears to be responding to the regulatory incentives of service quality and that this is a credit to it. However, the service quality seen at Heathrow cannot be interpreted as a sign of competitive pressures faced by HAL. The CAA considers that HAL essentially agrees with this view as it has stated that *'Heathrow's continuing performance in service quality cannot be solely explained by regulatory incentives, but we agree that it may be difficult for the CAA to isolate the various incentive effects'*.
- F114 While HAL has recognised the difficulties in isolating the different drivers of service quality, the CAA notes that HAL, in its response to the Consultation, did not present any arguments or evidence to explain how it differentiates the extent to which the level of service quality seen at Heathrow can be attributed to competitive pressure or to a response to the SQR scheme.

Conclusion on quality of service

- F115 Having considered evidence from a range of sources, including from stakeholders' responses to the Consultation, the CAA maintains the view on the quality of service outlined in the Consultation. That is, the CAA, due to the imposition of service quality targets by economic regulation, has not been able to reach a clear conclusion about the extent to which Heathrow's service quality performance reflects competitive pressures rather than a response to a regulatory incentive.
- F116 The CAA also considers that the level of service quality experienced at Heathrow may reflect the level and the efficiency of the capex and opex incurred by HAL – an issue that was explored earlier in this appendix.

Profitability

F117 In the absence of regulation, an airport operator holding SMP can act to an appreciable extent independently of its competitors and its customers, due to insufficient competitive pressure. As a result, an airport operator may increase prices above the competitive level, compromise service quality and enjoy supernormal profits.

Minded to view

F118 In the Consultation, the CAA stated that HAL is subject to price cap regulation by the CAA and that analysis of its financial performance is unlikely to provide strong evidence about HAL's market position.

Stakeholders' views

F119 In response to the Consultation, HAL noted that the CAA had discounted profitability measures on the basis that HAL is regulated via a price cap, preventing HAL from earning supernormal profits in the longer term.⁶³

F120 VAA and the LACC & AOC, in their responses to the Consultation, did not comment specifically on the CAA's views on HAL's profitability.

CAA views

F121 Regarding HAL's concerns on the use of profitability measures, the CAA notes, as per the Consultation, that:

- HAL is subject to price cap regulation, which is designed to prevent airport operators from earning supernormal returns in the long run. Consequently, the analysis of its financial performance is unlikely to provide strong evidence about its market position, particularly if the airport operator chooses to set their prices at, or near to, the allowed price cap.⁶⁴
- HAL (and other stakeholders) did not express any concerns with the approach that the CAA adopted with respect to profitability in its response to the Initial Views⁶⁵; there are a number of issues associated with profitability – namely efficiency, service quality and pricing – which, if examined, may be more useful in informing an assessment of market power.

⁶³ HAL, Response to CAA's Market Power Assessment, July 2013, p. 26.

⁶⁴ CAA, Initial Views, p. 99.

⁶⁵ HAL did, however, note that individual commercial services may operate in a separate market from, for example, off-site car parking and retail markets, but that this would not significantly affect the assessment of market power in relation to the primary markets (airport charges).

- HAL, in its response, apart from noting the CAA's views, did not present any arguments or evidence against the CAA's view to discount HAL's financial performance as a reliable indicator of its SMP.

F122 The OFT has indicated that it is possible for a firm to be regulated on the basis of an average price or profit and at the same time exercise its SMP by raising prices for individual services above competitive levels:

it is feasible that regulation of the average price or profit level across several markets supplied by an undertaking may still allow for the undertaking profitably to sustain prices above competitive levels in one (or more) of these markets and/or engage in exclusionary behaviour of various kinds.⁶⁶

F123 The CAA has not, however, seen any evidence of such behaviour to date.

Conclusion on profitability

F124 As stated in the Consultation, given that HAL is subject to economic regulation designed to preventing it from earning supernormal profits, the CAA considers that HAL's financial performance is unlikely to be a useful indicator of market power.

Conclusion on the indicators of market power

F125 The CAA considers that examination of indicators of market power can provide insight into the performance and behaviour of an airport operator. The CAA recognises that while individual indicators of market power on their own may not be determinative of market power (and may each suggest slightly different assessments), when considered as a whole, they help to determine whether an airport operator has SMP. However, the CAA's overall assessment of SMP, presented in chapter 5 of the Statement of Reasons, draws on the evidence in this appendix and that in the other appendices.

F126 The CAA has re-evaluated the evidence on the indicators of market power as it relates to HAL and considers that when considered as a whole, the indicators suggest that HAL has SMP in the relevant market and that this SMP will continue going forward, not least due to improving economic conditions and tightening capacity across the London airports.

F127 HAL's market share analysis suggests that HAL has 100 per cent of the market and that this provides a rebuttable presumption of SMP under

Source: HAL, Response to the CAA's consultation on the Initial Competition Assessment, 26 March 2012, Final Draft, p. 10.

⁶⁶ OFT, http://www.of.gov.uk/shared_of/business_leaflets/ca98_guidelines/oft415.pdf, p. 26.

established European practice. This presumption of SMP from the market share analysis is supported by the analysis of a number of other indicators, including HAL's efficiency, pricing behaviour and its approach to airline engagement and commercial negotiations.

F128 With respect to efficiency, there appears to be a number of areas where efficiency at Heathrow can be improved and that evidence from a number of independent benchmarking studies all point to areas of inefficiency at Heathrow. Inefficiency was also identified by HAL's own consultants and was reflected in material submitted to the CAA.

F129 With respect to HAL's pricing behaviour, the evidence suggests that:

- HAL does not offer any discounts to its prices and there have been some significant price increases over the last ten years. In addition, in the absence of regulation, it could be reasonably inferred that prices at Heathrow would rise.
- HAL has historically priced to the cap and it has not agreed discounts outside published charges.
- LF's analysis shows HAL's aeronautical revenue per passenger has, since 2008, been significantly above the average secured by comparable airports – in 2010, around £5 higher.⁶⁷

F130 The evidence on HAL's approach to engagement and commercial negotiations is consistent with HAL having SMP in the relevant market. In particular, the evidence suggests that:

- Genuine engagement with stakeholders is not occurring, including with respect to price, capex and potential airline incentives.
- HAL largely sets the terms that an airline will receive and that the scope for negotiation is limited.
- According to HAL's own strategy, it appears to target specific airlines.

F131 With respect to quality:

- Since HAL is a regulated airport operator that is subject to a quality scheme, the quality outcomes are unlikely to provide particularly strong evidence about whether the airport operator has SMP. However,:
 - Heathrow appears to be at or slightly above the target levels for the measure of service quality.

⁶⁷ The analysis also shows that HAL's aeronautical revenue per passenger was roughly in line with the average of comparable airports over the period 2002 to 2007.

- The level of service quality experienced at Heathrow may reflect the level and the efficiency of the capex and opex delivered by HAL.

F132 HAL's financial performance is also unlikely to provide particularly strong evidence about the level of market power, as HAL is a regulated airport operator.