

APPENDIX J

Evidence and analysis for Test C

Introduction

- J1 This appendix sets out the assessment of Test C of the market power test (MPT) for the passenger market at Stansted airport (Stansted) for the next quinquennium. The present regulatory arrangements cover the financial years 2009/10 to 2013/14 and are known as the fifth quinquennium (Q5). The arrangements to apply beyond this date are commonly known as the sixth quinquennium (Q6) although the length of the regulatory period can be more or less than five years.
- J2 In January 2013, the Stansted market power assessment, Developing our 'minded to' position (the minded to Consultation) identified separate markets for cargo and passengers at Stansted.¹ Passenger flights account for 92.4 per cent, and cargo flights account for 7.6 per cent of flights at Stansted.² The minded to Consultation considered that there were separate markets for airport operation services to low cost carriers (LCCs) and Charters, and to full service carriers (FSCs) and associated feeder traffic. However, the CAA has concluded that there is a unified product market for airport operations services to passenger airlines (LCCs, Charters and FSCs).³

¹ The minded to Consultation identified two passenger markets: one for services to Full Service Carriers (FSCs) and associated feeder airlines; and one for services to Low Cost Carriers (LCC) and Charter airlines. For the purpose of this document the passenger market refers to the LCC and Charter market. [3<].

² CAA Airport Statistics.

³ Chapter 4 and Appendix D - Stansted Determination Statement of Reasons January 2014

- J3 In the minded to Consultation, the CAA's provisional view was that Test A was passed for the passenger and the cargo markets. As a consequence, Test C was assessed for both markets together.
- J4 However, the market developments that took place between January and September 2013 meant the passenger and cargo markets may have different outcomes for Test A and should therefore be assessed separately. These developments included:
- With the approval of the Competition Commission (CC), Manchester Airports Group plc (MAG) acquired Stansted Airport Limited (STAL) in February 2013.
 - MAG had reached long term bilateral agreements with some of its passenger airlines including easyJet and Ryanair for their use of Stansted.
- J5 In the consultation on the relevant market developments that was published in October 2013 (the additional Consultation)⁴, Test C was considered separately for each market.
- J6 The structure of the rest of this appendix is:
- The legal framework for the assessment of Test C.
 - A summary of consultations and responses.
 - The CAA's decision on Test C for STAL's passenger market.

Assessment framework

- J7 Test C of the market power test requires '*that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.*'
- J8 The relevant operator is '*the person who is the operator of the airport area at the time the test is applied.*'
- J9 Users of air transport services are defined in the CA Act as passengers, or those with a right in cargo and includes future users of such services.

⁴ Stansted Market Power Assessment: consultation on relevant market developments, available at: <http://www.caa.co.uk/application.aspx?catid=33&pagetype=65&appid=11&mode=detail&id=5807>.

- J10 Test C forms part of the market power test that must be satisfied before the CAA may impose a licence, and identify appropriate licence conditions, pursuant to sections 15 to 18 of the CA Act. Test C requires the CAA to assess whether the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects. Test C does not expressly require the CAA to apply this test by reference to a specific set of regulatory licence conditions. Such a requirement would reverse the logical structure of the CA Act, and would require the determination of individual licence conditions before the decision on whether to impose a licence is made.
- J11 The assessment of Test C must be conducted in accordance with the CAA's general duty in section 1 of the CA Act: in a manner which it considers will further the interests of users of air transport services (passengers and cargo owners) regarding the range, availability, continuity, cost and quality of airport operation services. The CAA must also carry out its functions in a manner which it considers will promote competition in the provision of airport operation services.
- J12 The CAA must also have regard to various matters set out in section 1(3) of the CA Act. These include:
- The need to secure that all reasonable demands for airport operation services are met.
 - The regulatory principles in section 1(4) of the CA Act, namely that its regulatory activities should be transparent, accountable, proportionate and consistent and targeted only at cases where action is needed.
- J13 As part of the assessment the CAA must consider the extent to which any likely net benefits are transposed into end users benefits. Under section 1 (5) of the CA Act, if the CAA considers that there is a conflict between the interests of different classes of user or between the interests of users in different matters its duty is to carry out the functions in a manner which it considers will further such of those interests it thinks best.

- J14 When balancing the needs of passengers' interests the CAA is conscious of the need to protect against the risk of abuse of substantial market power (SMP). Consequently, where an airport operator has SMP over all passengers, albeit the requirements of different groups of passengers differ, the CAA will focus regulation where the risk of abuse of market power and potential detriment to passengers is greatest. The CAA recognises that this is likely to benefit some passengers more than others, although the CAA considers this can be minimised by focusing the protection on the cost of a minimum bundle of common services. This approach allows passengers that have higher service quality requirements to purchase additional quality, rather than impose higher costs and quality on all passengers. The CAA considers where an airport operator has SMP over all passengers, and there are trade-offs between different groups, the CAA should seek the outcome that provides the greatest overall benefit.
- J15 The CA Act also sets out the provisions for granting a licence and what a licence may contain. A licence may include such conditions as the CAA considers necessary or expedient in relation to the risks of abuse of market power and any other conditions the CAA considers necessary or expedient having regard to the CAA's duties.
- J16 Although Test C is a separate test, it cannot be divorced from the wider regulatory context: i.e. Tests A and B. Under Test A, the CAA needs to determine whether the relevant operator has SMP in the relevant market. Under Test B, the CAA needs to determine whether ex post regulation of that SMP via competition law is inadequate.
- J17 If the CAA has determined that the relevant operator has SMP and that ex post regulation via competition law is insufficient in terms of preventing the operator engaging in abuse of that position of SMP, then it needs to assess, under Test C, whether benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.

- J18 The assessment of benefits of economic regulation via a licence includes an assessment of the impact on price, efficiency, service quality, and investment, and other potential benefits of licence regulation:
- **Prices** - Licence regulation may be a good way to limit excessive prices through price caps or price monitoring. Price caps can limit excessive prices by placing a limit on the level of prices during a control period.
 - **Efficiency** - Licence regulation can be an effective way of promoting operating and capital expenditure efficiency.
 - **Service quality** - Licence regulation can address service quality through greater regulatory scrutiny.
 - **Investment incentives** - Licence regulation can provide incentives to invest, for example by ensuring investment can be recouped.
 - **Operational resilience** - A licence can be used to compel or incentivise the airport operator to adopt certain behaviours regarding the needs of the end users. One example of this is requiring the airport operator to ensure operational resilience, especially in times of disruption.
- J19 The assessment of adverse effects includes considering the direct costs and other adverse effects of economic regulation via a licence. Direct costs are incurred in the time and expenditure of management and regulation staff at the CAA, the regulated airport and their airlines. There will also be the cost of management and regulation staff at the airport and airlines as well as the direct costs of compliance with regulatory measures such as the introduction of automated security queue measurement.
- J20 The potential adverse effects from licence regulation encompass:
- Crowding out of a more commercial approach such as commercial innovation, investment and development that would encourage commercial growth in aeronautical and non-aeronautical revenues.

- Management distraction, which can distort incentives by distracting management to focus on maximising the value from a regulatory settlement rather than to focus on improved efficiency or service quality.
- Distortions to incentives, such as investment incentives that encourage too much or too little investment, distortions in the trade-off between operating expenditure (opex) and capital expenditure (capex) efficiency, distortions of the service quality requirements and associated financial incentives so that they do not match passengers' priorities or there is a focus only or primarily on attributes that can be easily measured.

J21 The assessment of the benefits of introducing licence regulation includes assessing the application of the sectoral regulatory powers that are already in place. These sectoral regulatory powers include:

J22 **Competition law powers** - Under section 62 of the CA Act, the CAA has concurrent powers with the Competition and Markets Authority (CMA)⁵ to undertake investigations into whether STAL is breaching a prohibition under the Competition Act 1998 or under European competition law. Under Section 60 of the CA Act, the CAA has concurrent powers with the CMA to make market investigation references to the CC under the Enterprise Act with respect to the provision of airport operation services.

J23 **Airport Charges Regulations** - Stansted remains subject to the Airport Charges Regulations (ACR).⁶ The ACR came into effect in November 2011 and transposed into UK law Directive 2009/12/EC of the European Parliament and of the Council of 11th March 2009 on airport charges. The ACR provide airlines with a number of protections. There are no explicit duties directed towards passengers or owners of cargo. The CAA may commence an investigation under the ACR for an apparent breach of its requirements.

⁵ The CMA takes over the duties of the CC and the Office of Fair Trading (OFT) from 1 April 2014.

⁶ The airport charges directive can be found at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:070:0011:0016:EN:PDF>.

The airport charges regulations can be found at:

http://www.legislation.gov.uk/uksi/2011/2491/pdfs/ukxi_20112491_en.pdf.

- J24 **Airports Groundhandling Regulations** - The Airports Groundhandling Regulations (AGR) transpose the European groundhandling directive into UK law.⁷ Groundhandling covers a multitude of activities including check-in, handling baggage, cargo and mail, re-fuelling aircraft, and transporting passengers and crew to aircraft. Under the AGR, airport operators with more than 2 million annual passengers cannot restrict the numbers of self handling airlines or third-party groundhandlers that operate at the airport without a determination from the CAA. There are currently no restrictions on the number of handlers in the UK. Where handlers use aircraft facilities, such as check-in desks, baggage belts and fuel hydrant systems, the airport operator must set its charges according to relevant, objective, transparent and non-discriminatory criteria. The CAA can investigate alleged breaches of the AGR.
- J25 **Monitoring** - The CAA has a duty under section 64 of the CA Act, so far as it appears practicable to do so, to keep under review the provision of airport operation services and to collect information about those services.
- J26 Section 50 of the CA Act allows the CAA to require the provision of information or documentation that it reasonably requires for the purpose of carrying out its regulatory functions under the CA Act.
- J27 The CAA also has to have regard to the regulatory principles in section 1(4) of the CA Act, which taken together with Test C, ensure that the CAA carries out a proportionality exercise and thereby satisfies itself that ex ante regulation via a licence is only imposed where it is suitable, necessary and proportionate.

⁷ Airport Groundhandling Regulations - The airport groundhandling directive can be found at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1996:272:0036:0045:EN:PDF>
[Directive 96/67/EC Groundhandling.](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1996:272:0036:0045:EN:PDF)

The airport groundhandling regulations can be found at:
[http://www.legislation.gov.uk/ukSI/1997/2389/made.](http://www.legislation.gov.uk/ukSI/1997/2389/made)

Summary of consultations and responses

Minded to Consultation

- J28 The minded to Consultation, considered that the MPT as set out in the CA Act was met in relation to Stansted.⁸ The CAA was minded to conclude in relation to the Stansted passenger market for LCCs and Charters, that STAL held a degree of market power which *might* currently be substantial, and *was likely* to become substantial over the period 2014-2019.
- J29 The CAA appreciated that the evidence did not all point in one direction and a judgement was therefore needed on the balance of the evidence it had reviewed up to that point. The CAA also acknowledged that there were some uncertainties and that in the future its analysis could change over the longer term. For example, the change of ownership of Stansted could establish different behaviours and relationships between the airport operator and the airlines. The outlook for the economy was uncertain and future government policy in relation to new capacity in the south east of England could change. Moreover, the airlines operate in a market that is characterised by change and hence the business models operating at Stansted could change, as could passenger preferences.
- J30 In regard to Test C, the minded to position considered the incremental benefits and costs of regulation by way of a licence which seeks, via appropriate conditions, to mitigate the risk of the abuse of SMP.
- J31 In general, the abuse of SMP can arise in many areas. For the purposes of Test C, the minded to assessment focused on the areas most commonly addressed by economic regulation in assessing the likely impact of such regulation at STAL:
- **Price.** As STAL was pricing at its regulatory cap, and there was evidence to suggest this was above the competitive level, there was a reasonable expectation that if the price cap were removed then charges would rise.

⁸ Paragraph 9.7 - Stansted minded to Market Power Assessment January 2013
<http://www.caa.co.uk/default.aspx?catid=1350&pagetype=90&pageid=14395>.

- **Efficiency.** While the impact of regulation on efficiency is difficult to judge, the CAA had not seen evidence to suggest that competition had significantly driven improved efficiency, and it appeared unlikely that the removal of licence regulation would lead to an improvement in efficiency in and of itself.
- **Service quality.** STAL's improved service quality performance appeared to coincide with greater regulatory scrutiny since the start of the Q5 review and the introduction of the Service Quality Rebate (SQR) scheme in quarter 2 of 2009. While it could not be said for certain that this improved service quality performance reflected the impact of regulation, the CAA had not seen evidence to suggest that competition itself has driven the improved performance.
- **Investment.** While licence based regulation can distort investment incentives, the current regulatory framework did not appear to have resulted in too much investment in the current quinquennium.

J32 The CAA⁹ considered whether users may benefit from other licence requirements that may be necessary to fulfil the CAA's duties under Section 1 of the CA Act, for example on operational resilience.¹⁰

J33 The adverse effects of licence regulation were considered¹¹ in terms of:

- The direct costs to the CAA, regulated companies and their users for example in manpower and expenditure.
- The indirect costs/effects such as: management distraction, distortions to incentives, crowding out of a more commercial approach, distortions to competition more widely, and other potential adverse effects such as those on consumers.

J34 Where relevant, adverse effects were discussed with potential benefits (for example in terms of investment incentives).

⁹ Paragraph 9.8 - Stansted minded to Market Power Assessment January 2013.

¹⁰ Section 18 of the CA Act.

¹¹ Paragraph 9.9 - Stansted minded to Market Power Assessment January 2013.

- J35 The assessment also took into account the incremental benefits and adverse effects of licence regulation over and above other forms of regulation that currently exist, most notably the ACR and AGR.
- J36 That consultation assessed Test C together for the passenger and cargo markets because the CAA was minded to conclude that Test A was met for the passenger market and the cargo market. The CAA was minded to conclude that Test C was met¹² and that some form of licence regulation should apply to STAL. The CAA considered that with the level of market power provisionally identified in relation to STAL, the ACR or AGR¹³ would not necessarily provide sufficient protection for users.

Summary of responses to the minded to Consultation

- J37 There were seven responses¹⁴ to the minded to Consultation, six of which were relevant to the STAL passenger airline market:
- easyJet;
 - GAL;
 - MAG (two submissions);
 - Ryanair; and
 - London Southend Airport Company Limited (Southend).
- J38 Southend stated that the assessment should be based on a forwarding looking assessment of market power and economic regulation should be a matter of last resort.
- J39 Ryanair supported the CAA's minded to assessment of Test C.
- J40 MAG (who made two submissions) disagreed with the CAA's minded to assessment of Test C. MAG's response included a paper from Starkie and Yarrow.

¹² Paragraph 30 - Stansted minded to Market Power Assessment January 2013.

¹³ Paragraph 9.22 - Stansted minded to Market Power Assessment January 2013.

¹⁴ <http://www.caa.co.uk/default.aspx?catid=1350&pagetype=90&pageid=14395>.

- J41 GAL disagreed with aspects of the CAA's minded to assessment, in particular that the CAA is being inconsistent with its own and others' precedents (without justifying these departures), that the CAA has made errors in its analysis and that the CAA fails to make balanced assessments of factual evidence and others' views.
- J42 easyJet supported the minded to assessment of Test C.

Additional consultation

- J43 The additional Consultation noted that the market developments since the publication of the minded to Consultation provided new evidence on STAL's behaviour.
- J44 Over 90 per cent of the existing passenger traffic at STAL are now covered by long-term bilateral agreements with easyJet and Ryanair. The agreements:
- cover all of Q6¹⁵;
 - have prices that are within the range of what the CAA considers to be a competitive level;
 - have terms designed to encourage growth in passenger numbers and to increase non-aeronautical commercial revenues; and
 - have been publicly welcomed by easyJet and Ryanair.
- J45 The provisional view in the additional Consultation was that Test A (whether STAL has SMP) for the Stansted passenger market would not be met because the bilateral agreements with Ryanair and easyJet could imply that there is a sufficient level of buyer power to constrain STAL's behaviour.
- J46 The provisional view for the passenger market was that the benefits of regulation by means of a licence would not outweigh the adverse effects, and that Test C could not be passed.

¹⁵ The present regulatory arrangements cover the financial years 2009/10 to 2013/14 and are known as the fifth quinquennium (Q5). The arrangements to apply beyond this date are commonly known as the sixth quinquennium (Q6) although the length of the regulatory period can be more or less than five years.

Summary of responses to the additional Consultation

- J47 The CAA received seven responses to the additional Consultation, five of which were relevant to the STAL passenger airline market:
- London First;
 - GAL;
 - MAG;
 - Ryanair; and
 - Stansted Airport Consultative Committee (SACC).
- J48 The Stansted Airport Consultative Committee's (SACC) response was on behalf of all the airlines at STAL except for easyJet. The SACC stated that the deals reached between MAG and the airlines were contingent on ongoing regulation and separate ownership.
- J49 easyJet, although it did not formally respond to the consultation, informed the CAA that its view was that STAL does not have SMP over easyJet and as a result does not require economic regulation.
- J50 Ryanair stated that the CAA should with proceed with its initial proposals to regulate STAL.
- J51 MAG stated that the benefits of regulation would be negligible because regulation would have little or no positive effect on MAG's pro-competitive approach to operating STAL; yet the adverse effects of regulation remain high.
- J52 London First considered that the burden of proof required to impose a licence on STAL had not been met and that the CAA should confirm as soon as is practicable that STAL would not be subject to a licence.
- J53 Gatwick Airport Limited (GAL) considered that the Test C is not likely to be met for STAL.

Final decision

- J54 The conclusion on Test C for the relevant passenger market for STAL is that the benefits of regulation by means of a licence are unlikely to outweigh the adverse effects because STAL does not have, nor is it likely to acquire SMP in the relevant passenger market at Stansted. Consequently, there is no need to protect passengers against the risk of abuse of SMP by means of a regulatory licence.
- J55 In performing its duties under section 1 (4) of the CA Act, the CAA must have regard to, amongst other things, the following two regulatory principles:
- (a) Regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent.
 - (b) Regulatory activities should be targeted only at cases in which action is needed.
- J56 Imposing a licence in the absence of SMP would, in the CAA's view, impose an unnecessary and disproportionate regulatory burden on the airport operator.
- J57 Therefore, as the CAA has concluded under Test A that STAL does not have, nor is likely to have SMP, there is no risk of abuse of such market power and no basis for imposing a licence under the CA Act for the next quinquennium.

Sectoral regulation and subsequent MPDs

- J58 Regardless of whether the CAA makes a market power determination (MPD) that STAL does or does not pass the MPT for the passenger market at this current time:
- The CAA has sectoral regulatory powers (as outlined in the assessment framework) that still apply and which the CAA will consider using in appropriate circumstances.
 - The CAA recognises that circumstances may change in the future. Such change may necessitate a fresh look at the question of whether the three elements of the MPT are met in relation to STAL.

- J59 Under section 7 of the CA Act:
- The CAA may make an MPD whenever it considers it appropriate to do so.
 - If there has been a material change in circumstances since the CAA last made an MPD, then STAL or another person whose interests are likely to be materially affected may request that the CAA makes a new MPD, and the CAA must make an MPD.
- J60 The results of any subsequent MPD could lead the CAA to consider the need for economic regulation for STAL.
- J61 In considering whether a further MPD should be undertaken, the CAA is likely to consider whether there has been any material change in circumstance since the previous MPD. STAL or an affected party can make a request to the CAA at any time if they consider that there has been such a material change.