APPENDIX D

Evidence and analysis on market definition

Introduction

D1 This appendix sets out the CAA's analysis and evidence relating to the definition of the market(s), in which Gatwick Airport Limited (GAL) operates.

- Section 1 sets out the legal and analytical framework under which the CAA has undertaken its analysis.
- Section 2 sets out the conclusion from the Consultation on Gatwick market power assessment (the Consultation). It also sets out the key points raised by stakeholders in response to the Consultation.
- Section 3 sets out the CAA's formal market definition analysis.
- Section 4 sets out the CAA's conclusions on market definition for GAL.

Section 1: Legal and analytical framework

D2 Market definition is a key component of the market power test in sections 6 and 7 of the Civil Aviation Act 2012 (the CA Act) and is relevant for assessing whether GAL, as the operator of Gatwick, has or is likely to have substantial market power (SMP) for the purposes of Test A. The test is applied by reference to the relevant market, i.e. a market for one or more types of airport operation service within the airport area.

D3 In reaching its decision, the CAA has had regard to its own guidance for the assessment of market power of airports (the Guidelines)[1] as well as the applicable Office of Fair Trading (OFT) and European Commission (EC) competition law notices and guidance to which it must have regard under section 6(10) of the CA Act.[2]

[1] The Guidelines can be accessed via the CAA's website at: http://www.caa.co.uk/docs/5/Final%20Competition%20Assessment%20Guidelines%20-%20FINAL.pdf

[2] See the OFT's Competition Law Guideline on Market Definition, dated December 2004 (OFT 403) and the EC's Notice on the definition of relevant market for the purposes of Community

D4 Market definition is a useful tool for identifying, in a systematic way, the competitive constraints which the relevant operator faces in the market and whether those constraints prevent it from operating independently of effective competitive pressure.[3] However, there may be characteristics of the airport sector that make it difficult to define the market precisely. As explained in the Guidelines, a market power assessment should seek to analyse all the competitive constraints faced by an airport operator, regardless of whether they arise from within or outside the relevant market or markets.[4]

D5 The CAA does not regard market definition as an end in itself, but rather as an economic framework within which to analyse the competitive effects of market definition in order to support and inform the CAA's regulatory policy.[5] The exercise of market definition consists, in essence, of identifying the effective alternative sources of supply for the customers of the relevant operator in terms of the products or services supplied and their geographical location.[6]

Hypothetical monopolist test

D6 The Guidelines state that, wherever feasible, the hypothetical monopolist test should be adopted as a useful starting point for defining the relevant market.[7]

D7 The hypothetical monopolist test involves starting with the narrowest possible bundle of products or services and the smallest geographical area (normally those supplied by the operator in question) and assessing marginal customers' switching reactions to a hypothetical monopolist making a small but significant non-transitory increase in price (SSNIP), above the competitive price level (generally considered as being 5 to 10 per cent).

competition law (OJ 97 C 372 p. 3) (EC Market Definition Notice).

3 EC Market Definition Notice, paragraph 2.

4 Guidelines, paragraph 3.5. This is consistent with the approach adopted in the Competition Commission's report on the supply of airport services by BAA in the UK 19 March 2009 (CC's 2009 BAA Report), paragraphs 2.48 to 2.49.

5 Guidelines, paragraphs 1.4, 3.3 and 3.4. See also OFT 403, paragraphs 2.1 and 2.6 and the EC Market Definition Notice, paragraph 2.

6 EC Market Definition Notice, paragraphs 7 to 9 and 13 and Guidelines, paragraphs 3.6 to 3.9.

7 Guidelines, paragraphs 3.10 to 3.12; OFT 403, paragraphs 2.5 to 2.13 and EC Market Definition Notice, paragraphs 15 to 19.

D8 If the price increase is unprofitable due to marginal customers switching away to substitute products/services and areas or new suppliers entering the market and competing away any potential profits, then the test is repeated by widening the set of products/services and geographic area to include the closest substitute until the price increase is profitable. What is then left is the narrowest set of products/services and geographic area over which a hypothetical monopolist could profitably sustain prices 5 to 10 per cent above competitive levels.

D9 Although the SSNIP test is a useful starting point, it requires a significant amount of information about the market, including the supply and demand conditions. The test also:

- Is not 'mechanistic' as it requires judgement to be applied at a number of points in the analysis.
- Is intended to be carried out by reference to the competitive price level, with the result adjusted where the prevailing price levels observed in the market are not reflective of the competitive price.[8]
- Assumes that competitors' pricing strategies are competitive.

D10 In addition, there may be other external considerations that might affect the uniformity and/or the profitability of the price increase.[9]

D11 As a result, and as noted in the Guidelines, it is rarely possible to apply the SSNIP test in a precise manner due to data and evidential restrictions.[10] Therefore, the SSNIP should be considered as a way to frame the market definition process rather than be used as a mechanistic process for producing a market definition.

D12 Given the particular circumstances relating to the historical regulation and common ownership of Heathrow, Gatwick and Stansted, the CAA has been unable to carry out a formal SSNIP test. However, it has gathered a range of evidence, including catchment area analysis, passenger surveys, documentary evidence and the views of airlines and relevant airport operators on substitutability. This has been interpreted, so far as possible, within the hypothetical monopolist framework.

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8 As the OFT observes, the test assumes that the hypothetical monopolist is not subject to economic regulation that might affect its pricing behaviour.

9 OFT 403, paragraph 2.10 to 2.11 and 5.4 to 5.6. See also Guidelines, paragraphs 3.15 to 3.16 and 3.24 to 3.25.

10 Guidelines, paragraph 3.13. See also the CC's 2009 BAA Report, paragraph 2.1.

Product market

D13 As defined in both OFT[11] and EC[12]guidance, a relevant product market comprises all those products and/or services that are regarded as interchangeable or substitutable by the consumer by reason of the products' characteristics, their prices and their intended use.[13]

D14 The CAA has looked at demand side substitutability for each user group individually, while accounting for interactions between the different groups, to determine whether services to each group constitute a distinct product market or whether they form part of a two-sided market with inter-related demand.[14]

Geographic market

D15 The geographic market '*comprises the area in which the undertakings concerned are involved in the supply of products or services and in which the conditions of competition are sufficiently homogeneous*.'[15]

D16 This area can be distinguished from neighbouring areas because the conditions of competition are appreciably different. In addition, it is important to recognise, as airports serve a number of different users, that there may be different relevant geographic markets for different groups of users.[16]

D17 The assessment of competitive constraints for geographic market definition will include an analysis of the ability of airlines to switch away from an airport as well as the potential for passengers to switch between airports, whether independently or by following a particular airline. With respect to this, the EC notice on market definition states:[17]

Firms are subject to three main sources or competitive constraints: demand substitutability, supply substitutability and potential competition. From an economic point of view, for the definition of the relevant market, demand substitution constitutes the most immediate

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11 OFT, Understanding Competition Law: Market Definition, 2004, available at: http://www.oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft403.pdf

12 Commission Notice on the definition of relevant market for the purposes of Community competition law OJ C 372, 9.12.1997, pp. 5 to 13, available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y1209(01):EN:HTML

13 Guidelines, paragraphs 3.7 and 3.27 et seq.

14 Guidelines, paragraphs 3.29 to 3.33.

15 CAA, Guidelines, paragraph 3.8 and EC Market Definition Notice, paragraph 8.

16 CAA, Guidelines, paragraph 3.59.

17 EC Market Definition Notice, paragraph 13.

and effective disciplinary force on the suppliers of a given product, in particular in relation to their pricing decisions. A firm or a group of firms cannot have a significant impact on the prevailing conditions of sale, such as prices, if its customers are in a position to switch easily to available substitute products or to suppliers located elsewhere. Basically, the exercise of market definition consists in identifying the ***effective alternative sources*** *of supply for the customers of the undertakings involved, in terms both of products/services and of geographic location of suppliers (emphasis added).*

Supply side substitution

D18 As noted in the Guidelines[18] (and the OFT Guidelines[19]), supply side substitution is a key part of the market definition analysis. The EC summarises supply side substitution in the following way:

Supply-side substitutability may also be taken into account when [defining markets], in those situations in which its effects are equivalent to those of demand substitution in terms of effectiveness and immediacy. This means that suppliers are able to switch production to the relevant products and market them in the short-term without incurring significant permanent changes in relative prices. When these conditions are met, the additional production that is put on the market will have a disciplinary effect on the behaviour of the companies involved. Such an impact in terms of effectiveness and immediacy is equivalent to the demand substitution effect. [20]

D19 However, supply side substitution in the airports sector is likely to be limited. In particular:

- Although the CAA recognises that airport development may be motivated by competition or prospective competition between airport operators, the CAA considers this to be part of a long-term market dynamic rather than a short to medium term competitive response.
- Both new entry and expansion are unlikely to be sufficiently timely market responses to a SSNIP by an incumbent airport operator due to planning legislation and the time required for the construction of facilities to constrain its ability to raise prices above the competitive level.

18 Guidelines paragraphs 3.27, 3.56 to 3.58.

19 OFT 403 paragraphs 3.12 to 3.18 and 4.5.

20 EC Market Definition Notice, paragraph 20.

D20 The CAA therefore considers that airport markets are likely to be segmented on the supply side based on currently available infrastructure.

Temporal markets

D21 The OFT guidance[21] states that a possible third dimension to market definition is time. The Guidelines state that a time dimension may be appropriate where it is not possible for customers or suppliers to substitute between time periods.

Section 2: The consultation process

The Consultation

D22 In the Consultation, the CAA suggested that airport operators supply a broadly generic product. However, it also considered that there was differentiation in the product market due to difference in the facilities required to service particular segments of the market – low cost carriers (LCCs) and charter airlines (charters), full service carriers (FSCs) and associated feeder traffic.

D23 For LCCs and charters, the CAA saw limited differentiation in their passenger base, which resulted in the need for generic facilities. The CAA also considered that:

- LCCs require the airport operator to provide tight turnaround times for their operations.
- The geographic scope of this market extended just to Gatwick.
- It was unlikely that this market would include Luton or Stansted.

D24 For FSC and associated feeder traffic, the CAA considered that:

- They had a segmented passenger base requiring the provision of certain facilities for their passengers, i.e. first class and business lounges.
- There was a requirement to allow passengers to interline between the feeder flights and the long-haul flights to ensure efficient load factors.

[21] OFT 403, paragraphs 5.1 to 5.3.

- The geographic scope of the market was unclear, as this market may comprise both Gatwick and Heathrow.[22]

D25 The CAA did not define a separate market for cargo at Gatwick, given the lack of freighter operations and the linkages between belly-hold cargo and the full service carrier (FSC) business model.

Stakeholders' views

D26 The CAA received five responses to the Consultation, three of which supported the CAA's position. Responses were received from:[23]

- British Airways (BA);
- easyJet;
- GAL;
- Gatwick Airport Consultative Committee (GACC); and
- Virgin Atlantic Airways (VAA).

D27 GAL, in response to the Consultation, noted that:[24, 25]

- It agreed with the CAA that it was not appropriate to segregate the market based on passenger groups.
- It did not consider that it was appropriate for the airport market to be segregated on the basis of airline business model as there was a generic market for *'aeronautical services to airlines and ground handlers*'.
- It also considered that if segregation on business model were to be maintained that, at the very least, the market should extend to include Stansted, given available infrastructure there.

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22 For example, a number of pieces of evidence suggested, including price elasticity of demand (PED) analysis, that it was a Gatwick-focused market. However, using either definition (i.e. Heathrow in or out of the market), given the severe capacity constraints at Heathrow, HAL was unlikely to pose a significant constraint on GAL's behaviour.

23 Non-confidential versions of these submissions are available on the CAA's website.

24 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013.

25 Further representations were put to the CAA by GAL on market definition in a memo on 7 November 2013 this did not bring forward any new evidence or significant argumentation. See Coombs J, Lisle J, and Shaharudin D; Memorandum: The CAA report's market definition, 6 November 2013.

- The CAA had not taken sufficient account of precedent with respect to the geographic scope of the market and had not sufficiently explained why it had departed from the precedent in this area;
- The CAA had relied too heavily on PED analysis and had not placed sufficient weight on the evidence it had presented in on the constraint arising from passengers detailed in chapter 8 of the Consultation.
- The CAA had misdirected itself in its assessment of the multi-sided nature of the airport and its implications for market definition.[26]

D28 BA and easyJet both supported the CAA's overall position on the market power assessment for GAL but considered that the product market definition should be widened. Both stakeholders considered the distinction between the LCCs and FSCs is increasingly blurring and is somewhat artificial, especially at Gatwick. VAA also contested the point on market segmentation, although it considered its business model fitted clearly into the FSC business model.

D29 GACC did not comment directly on the market definition but supported the CAA's overall findings on the level of market power held by GAL.

D30 While the CAA's analysis on stakeholders' views is outlined in the section below, the CAA responds to the criticism that it has been inconsistent in this section.

D31 With respect to the criticism of the CAA's supposed inconsistency with its previous statements and decision, the CAA does not consider itself bound by its previous views that were given in a different regulatory context. Much of the material that the CAA has produced on the airport market was undertaken a significant time ago and under a different legislative regime. In particular, the de-designation assessment of Stansted in 2007 and comments made by the CAA in its initial considerations of the CC's investigation into BAA airports took place prior to the extensive level of work undertaken by the CC and the discussion of key issues during the course of the appeals that followed. The CAA considers that it would not be rational for it to ignore the CC's findings and approach as part of its assessment of the current market position of GAL.

[26] GAL made additional representation in response to the Charles River Associates report commissioned by the CAA. These representations can be found in GAL Q5-050-LGW68 and are discussed in section 3.1 below.

D32 With the exception of the geographic market definition where the CAA considers the market to be Gatwick. The CAA considers its treatment of the product market and other hubs is consistent with that of CC. The difference in the geographic market arises as a result of the question under investigation where the CAA has to consider the market position of the individual airport operators.

D33 It is also widely accepted that market definition is a flexible tool that may alter depending on the question being asked. For example, the CC's BAA airports investigation considered a particularly wide question on the potential for the development of competition between the three BAA airports and sought to remove structural impediments to the development of potential competition. The CC was not looking into the much narrower question that the CAA must consider under Test A, which is the determination of the particular market in which an individual airport operator has substantial market power in a market for airport operation services provided at the airport in question. The CAA must also do so in a manner which complies with its duties under s.1 of the Act. These direct CAA to focus on the interests of end users of air transport services and to do so, where appropriate, by promoting competition while having regard to a wide range of (potentially) competing factors.

D34 Likewise, with the merger case law, the investigating authority is seeking to determine whether a merger will weaken the current competitive landscape observed within a market. The decision maker in such cases is not considering the more focussed question that falls to the CAA under Test A.

D35 Furthermore, market definition is a time-sensitive and context specific exercise. It is based on an analysis of the structure of the market and competition prevailing at a particular point in time,[27] therefore any assessment may change over time as market circumstances evolve.

D36 In addition, a prior finding of dominance by the EC or a national competition authority or even and national court is not binding and even the EC has to start a fresh analysis of the condition of competition in the course of making subsequent decisions: [28]

in the course of any decision applying Article 86 of the Treaty the Commission must define the relevant market again and market a fresh

[27] Bellamy and Child EU law of Competition, paragraph 10.018.

[28] Case T-125/97 Coca-Cola v Commission [2000] ECR ii-1733, paragraph 82.

analysis of the conditions of competition which will not necessarily be based on the same considerations as those underlying the previous finding of a dominant position.

D37 The CAA's view, therefore, is that while a significant amount of information can be drawn from the investigation on BAA airports, the CC was considering a different question under different legislation. Test A, the test that the CAA must consider, is concerned with individual airport operator's market position.

D38 It also does not follow that the divestment remedy imposed by the CC on BAA is tantamount to there being an immediate and effectively competitive market. In particular, although the potential for competition increased following divestment, this is coming from the position of effectively no competition as the airports were under joint ownership. (Indeed, under the CC investigation the potential for increased competition was assessed from the base of no competition between the airports under joint ownership.)

D39 The CC also expected competition to develop over time:

Even under separate ownership, moreover, as a result of capacity constraints, competition in the short term may focus on particular types of traffic, for example in off-peak periods, and therefore be unlikely to be sufficiently effective to substitute for regulation. Separate ownership would also give rise to competition to invest in new capacity; but there would be a period of time before there could be confidence that competition between separately-owned airports was sufficiently effective to substitute for regulation. Heathrow, however, may retain a strong market position as the main UK hub airport, requiring effective regulation for longer.[29]

D40 In developing its views the CAA does not consider it appropriate to take as its starting presumption a view of the market which has been subject to extensive further evaluation and decision making by the CC and the CAT. In the 2011 working paper the CAA therefore set out a wider range of approaches to encourage similarly wide-ranging responses and allow the CAA to begin the development of a robust evidence base for the decision it had to take under s.7 of the Act. The Initial Views allowed the CAA to communicate its thinking on the limited evidence it had gained by that stage. Since the publication of the Initial Views the CAA has gathered further evidence on which to base its decision. This

[29] CC, 2009 Report, paragraph 6.87.

evidence and how the CAA has used it was outlined in the Consultation and is also outlined in this reasons document

Section 3: CAA analysis

D41 In light of the representations from stakeholders on the Consultation, the CAA has re-evaluated its assessment of the evidence and has altered its position on the relevant market definition for GAL. The CAA now considers that there is a single relevant market in which GAL operates. The market is for the provision of airport operation services to airlines, limited to those services provided at Gatwick. The key points in altering our analysis has been:

- Consistent evidence provided from all respondents on the closeness of competition between the differing airline business models.
- An evaluation of the credibility of the constraint posed by a severely capacity constrained Heathrow.

D42 The full evidence and reasons for the CAA's conclusions are set out in the next section on an issue by issue basis. In defining the relevant market the CAA has used the current, regulated price as the basis for its analysis (see section 3.1 below)

D43 The CAA received many responses to 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.

D44 This section sets out the CAA's analysis of the evidence available to it on market definition for the services provided by GAL. In particular, it considers the following issues:

- Section 3.1 examines, in more detail, the analytical concepts considered by the CAA;
- Section 3.2 outlines the relevant product market definition;
- Section 3.3 outlines the relevant geographic market definition; and
- Section 3.4 outlines the relevant temporal markets definition.

Section 3.1: Analytical concepts

D45 This section considers a number of analytical concepts considered by the CAA and covers:

- The SSNIP test.
- Interdependence of demand from different user groups.
- The role of airline and passenger switching in vertical derived demand analysis.
- Air transport markets.

The SSNIP test

D46 As noted in the Guidelines, it is rarely possible to apply the SSNIP test in a precise manner due to evidence and data limitations. One of the key difficulties associated with using this test is identifying the competitive price level for an airport.

D47 Using a price which is too high as the starting point for a SSNIP analysis risks defining an overly wide market (the Cellophane Fallacy), while using a price which is too low risks defining an overly narrow market (the reverse Cellophane Fallacy).

D48 As discussed in the Consultation, there are several reasons why it may be difficult to identify a competitive price level for an airport.

D49 To deal with the difficulties in identifying an appropriate price level to be used in the SSNIP test for GAL (that is a price level which controls for the risks of Cellophane fallacy and the reverse Cellophane fallacy), the CAA considered:

- the regulated price or RAB-based prices;[30]
- a long-run average incremental costs (LRAIC) based price; and
- a price based on benchmarking of comparable airports.

The regulated (RAB-based) price

D50 The CAA considers that use of the regulated prices are an appropriate starting point for the SSNIP analysis as they are:

[30] RAB is the Regulatory Asset Base. A RAB-based price is derived from the income per passenger that allows for the recovery of efficient opex and capex plus a fair return on the assets as measured by the RAB.

- Cost-based (on the basis of an acceptable cost standard) and are designed to prevent a regulated airport operator from pricing at levels exercising SMP (and potentially making supernormal profit). For example, GAL's RAB-based price cap allows for the recovery of efficient operating expenditure (opex) and capital expenditure (capex) plus a fair return on its RAB. As a result, the use of regulated prices provides the CAA with comfort that they are not the prices that would occur in the extreme cases of monopoly or below cost pricing, which reduces the risk of defining either overly wide (Cellophane Fallacy) or overly narrow (reverse Cellophane Fallacy) markets.

- Are the prices faced by airlines, groundhandlers and passengers. Its use therefore limits the risks associated with gathering evidence around or hypothesising about unknown price levels. The CAA also considers that it would be difficult for the airlines to respond on how they would react to a 5 per cent SSNIP from a price that they do not observe in practice.

- Have been used in several cases of market definition for other regulated sectors, such as telecommunications, across Europe. In particular, the EC has taken the view that regulated prices should be taken as the starting point for conducting a SSNIP test. Specifically, the EC has stated in the context of telecoms:[31]

  In principle, the 'hypothetical monopolist test' is relevant only with regard to products or services, the price of which is freely determined and not subject to regulation. Thus, the working assumption will be that current prevailing prices are set at competitive levels. If, however, a service or product is offered at a regulated, cost-based price, then such price is presumed, in the absence of indications to the contrary, to be set at what would otherwise be a competitive level and should therefore be taken as the starting point for applying the 'hypothetical monopolist test.'

D51 Connected with the first bullet point above, the regulated price at GAL is determined through a cost-based approach and the process that it goes through to determine this is rigorous, consultative and lengthy. Importantly, the CAA's general duty requires it (under section 1 of the CA Act) to carry out its functions in a manner which it considers will further the interests of users of air transport services regarding the

[31] EC, 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, 11-7-2002), paragraph 42.

range, availability, continuity, cost and quality of airport operation services.

The long-run average incremental costs based price

D52 The CAA carefully considered the LRAIC modelling and estimates provided by FTI[32], a consultant engaged by GAL to estimate their LRAIC cost on their behalf. The CAA noted that:

- The LRAIC estimates produced by FTI for GAL were based on information about the cost of expanding Gatwick, which might not represent the next expansion project to occur in a well-functioning market.
- FTI was clear that its approach was designed to make best use of the most accurate information available; namely, the cost information provided by GAL and that the relevant price benchmark might be a (lower) cost of expanding a competing airport.
- The combination of the uncertainty attached to the input assumptions, and the reliance on cost estimates that were based on expansion (only) at Gatwick, meant that it was difficult to place much weight on FTI's estimates.

D53 To address the conflicting views on the merits of using LRAIC, the CAA engaged Europe Economics (EE)[33] to:

- Estimate a LRAIC for Gatwick.
- Identify the advantages and disadvantages of using a LRAIC based approach to inform estimates of the competitive price at Gatwick (and to set price caps).

D54 GAL provided a number of comments on EE's initial LRAIC modelling and as a result EE undertook further work to refine its modelling. Following this, the CAA examined EE's revised analysis and considers that the refinements to its approach are reasonable.

32 FTI Consulting 'LRAIC for Gatwick Airport: Presentation to CAA workshop' 7 December 2011.

33 EE, Advice on the application of long run incremental cost estimates for Gatwick and Stansted, Final Report, 20 December 2012.

D55 As part of the Consultation, the CAA also notes that:

- EE's work concluded that 'in our view, therefore, a full LRAIC-based approach to establishing the costs of Gatwick is not appropriate.'
- Under EE's revised model that the LRAIC estimate for a replacement airport (Increment 3a) increased to £11.05, up from the £10.60 originally stated using a cost of capital assumption of 6.5 per cent.
- If EE's model is updated to reflect the CAA's current view on the cost of capital for GAL (5.65 per cent), the appropriate LRAIC estimate would be £9.99, which is well below the level that GAL has suggested and remains broadly consistent with the findings from the first EE study.

D56 There are a number of issues with LRAIC cost modelling which render LRAIC-based prices as an inappropriate basis for the SSNIP test. In particular, the CAA considers that:

- As LRAIC is a long-term forward-looking measure, there is a risk of over and under recovery in a particular period. This means LRAIC may not be well-suited as a benchmark to indicate whether a particular price is proximate to the 'competitive' price at any given time. Charging a flat LRAIC price over time also raises similar issues as any other 'smoothing' effect, which is that existing passengers may resist being asked to pay for future improvements where they may not benefit.
- A LRAIC approach is data intensive and requires regulatory judgement to define the increment (although this might be less for a replacement cost approach). This can lead to significant uncertainty over future price profiles and it may be possible to generate large price increases or decreases depending on the assumptions used, limiting the protection to users and introducing variability owing to regulatory judgements.
- It has also been argued that it is not an effective proxy for competitive airport prices where investments are very 'lumpy' for example it may not reflect the capacity cycle which, in a competitive market, could produce significant price volatility. Indeed, the Guidelines state that when considering prices it is important to take account of the effects of the capital intensive nature of airports and of the 'lumpiness' of capacity increments.

Benchmarking

D57 An alternative way of try and estimate competitive price levels is to consider evidence on pricing at comparable airports. As airports are relatively differentiated, there are, however, some difficulties in identifying reasonably equivalent comparators. In addition, many airport operators are subject to economic regulation and their pricing is likely to be a reflection of the effectiveness of the regulatory regime under which they operate and may therefore bear little resemblance to prices that would be established under competitive conditions.

D58 To further inform the CAA's understanding on price it commissioned Leigh Fisher (LF)[34] to undertake work on benchmarking airport charges at Heathrow, Gatwick and Stansted, against suitable comparator airports which, where possible, were operating in a competitive market.

D59 The CAA considers that the benchmarks used in this analysis are appropriate and can help inform the discussion of the competitive price at Gatwick. LF's approach was to identify a set of suitable comparators for each airport based on a set of criteria (such as catchment size and traffic mix) which were important in determining similarities across airports. Suitable criteria and comparators were discussed with airline and airport stakeholders.

D60 The CAA has considered GAL's concerns and a revised LF study (which took into account feedback from the CAA and other stakeholders). This revised study has sought to address a number of issues, including the method used to derive weighting criteria for the selection of comparator airports and inconsistencies/errors in input data.

D61 On the basis of LF's revised study, the CAA considers that where there is a reasonable concurrence between the LF benchmarking and the RAB-based regulated charge. This provides further comfort that the regulated prices can be used as a starting point for a SSNIP test.

[34] LF, Updated Final Report, Comparing and Capping Airport Charges at Regulated Airports, for the Civil Aviation Authority, 19 April, 2013.

Conclusion

D62 The CAA is therefore confident that conducting its analysis from current regulated prices is a reasonable approach and should ensure robust analysis. However, the conclusions on market definition would be unlikely to change were the CAA to use an alternative approach to defining the market based on the assessment of the competitive conditions across airports.

Interdependence of demand from different user groups

D63 The Guidelines state that airports can be viewed as platforms in a multi-sided market. In particular, the Guidelines state that, account should be taken of any interactions and interdependencies between the various activities that the airport operator undertakes.

D64 The extent to which conventional (one-sided) market definition methods need amending will depend on the strength of the interrelationships between the various activities and whether these form a genuine platform that brings together consumers and other service providers as different sides of the market.[35]

D65 In deciding whether or not the market definition for GAL should be carried out using conventional methods or as part of a two-sided market, the CAA has adopted a pragmatic approach. That is, the CAA has adopted a conventional approach but has adapted its approach where it considers there are gains to be made in terms of clarity and robustness of analysis.

D66 A multi-sided approach has not been taken previously by competition authorities with respect to airports and there is little guidance on how to approach the issue in this sector.[36] However, in summary, the CAA considers a multi-sided market consists of a firm whose product acts as a platform through which it can actively bring together different customer groups with demand interdependencies to generate revenue. Therefore a true multi-sided market is one where the demand interdependencies are reciprocal. The price charged on one side of the market affects the demand on the other side and vice versa. The CAA refers to this as reciprocal demand effects.

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35 The Guidelines, paragraphs 3.18 to 3.26.

36 Most recently, the CC's 2009 *'BAA airports market investigation: A report on the supply of airport services by BAA in the UK*'. Previous decisions by the EC: 95/364/EC, 1999/199/EC, 1999/198/EC; 98/513/EC; T-128/98; C-82/01 and 98/190/EC.

D67 The key characteristics of a multi-sided market, in the context of airports, was set out in a paper prepared by independent consultants (Starkie & Yarrow (S&Y)) commissioned by the CAA in 2010 (referred to below as the SY criteria):[37]

- The airport is the platform and it can be viewed as having multiple revenue (and associated cost) streams, some of which are highly interrelated.
- Airlines and passengers are the two main groups that use the platform.
- An airport is more attractive to passengers the greater the number of airline services (more routes, greater frequencies, better connections) offered to and from that airport.
- An airport is more attractive to airlines the greater the number of passengers who might use that airport.
- In matching airlines to passengers, the airport operator takes account of the different demand conditions – on the one hand, the airline's demand for access to the airport and its facilities and, on the other, the demand of the passenger for services from the airport.
- If the airport operator is itself the provider of commercial services to passengers (retailing, car parks etc.), or has revenue sharing agreements included in its leases with commercial service providers, then the airport operator has a revenue stream from each of these two groups, and has to consider two sets of prices.

D68 The arguments outlined above fall into three broad categories:

- The existence of reciprocal demand effects between the different customer groups.
- Marketing activities carried out by the airport operator to attract passengers and airlines separately to the airport.
- The existence of a stream of commercial (non-aeronautical) revenue driven by passenger volumes.

[37] David Starkie and George Yarrow 'Market definition in the airports sector', 1 July 2010, available at: http://www.caa.co.uk/docs/5/ergdocs/MarketDefAirports.pdf, p. 13.

D69 In the Consultation,[38] the CAA considered that there were limited reciprocal demand effects present at Gatwick given:[39]

- GAL did not appear to approach passengers and airlines as separate user groups.
- Views expressed by BAA, at the time of the CC's review into the joint ownership of BAA airports, which suggested that airport operators have limited levers with which to affect their passenger base.
- GAL has limited direct commercial relationship with passengers.

D70 The Consultation also recognised[40] that there were complementarities between the airport operator's aeronautical and non-aeronautical revenue streams. As identified by S&Y, by affecting passenger volumes, aeronautical charges may affect the revenues that an airport operator can derive from commercial services. As such, an airport operator may take this into account when setting charges.

D71 However, the CAA was not convinced that pricing of commercial non-aeronautical services affected either passenger demand for air transport services from the airport or airlines' demand for aeronautical services from the airport. In particular:

- There was no indication that complementarities in GAL's revenue streams had been taken into account in its aeronautical pricing decision. It also noted that although GAL has operated on a single till basis, commercial revenues are forecast as an independent part of the price cap.
- GAL was insulated from changes in its passenger base due to minimum guarantees on income from its concession, excepting car parking.
- easyJet's one bag rule suppresses demand for some non-aeronautical services.

D72 Drawing this evidence together, the CAA considered that GAL did not strongly exhibit the characteristics of a multi-sided platform. In particular, it was apparent that the main relationship is of a vertical nature, whereby the airport operator in the upstream market provides a

38 The Consultation, paragraphs 3.20 to 3.27.

39 In the Consultation the CAA considered airline network effects as relevant to its consideration. It no longer considers that this has a material impact on its analysis of this issue.

40 The Consultation, paragraph 3.28.

key input in the form of access to infrastructure and facilities to airlines operating in the downstream air transport markets.

D73 Based on the above, the CAA did not therefore significantly modify the standard approach to its market analysis.

Stakeholders' views

D74 In its response to the Consultation, GAL outlined a number of concerns with the CAA's approach to market definition:[41]

- The CAA had fundamentally misunderstood the theory of multi-sided platform markets and had not properly considered airline network effects.
- The CAA's approach was inconsistent with its critical loss analysis. It noted, for example, that passengers in the FSC and associated feeder market contributed a greater proportion of non-aeronautical revenues than passengers in the LCC market.
- The CAA had treated the multi-sided platform markets and airlines' derived demand for airport services as mutually exclusive, when they should be additive.

D75 GAL also noted that similar objections had been raised by the Manchester Airport Group (MAG) in response to the Stansted Airport Limited (STAL) Consultation.[42]

D76 This issue was not raised by other stakeholders to the Consultation.

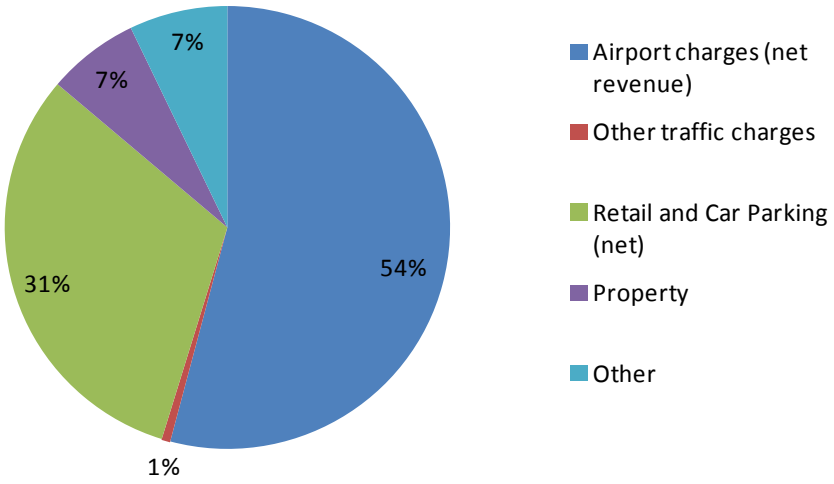
CAA views

D77 The CAA has used the SY criteria to help determine the changes it needs to make to a standard market definition approach. It has also resisted simply excluding the standard approach on the basis that airports are evidently a platform that brings together at least three groups – airlines, concessionaries and passengers – without giving consideration to the possible strength of the interrelationships. Figure D. 1 (below) shows that retail and car parking revenue is around 31 per cent of GAL's total revenue.

41 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraphs 3.81 to 3.84.

42 The CAA has responded to the points raised by MAG in the STAL Market Power Determination.

Figure D.1: Break down of GAL revenue by area (2012/13)



Source: Statutory accounts 2012/13

D78 Aeronautical charges evidently impact on non-aeronautical revenues since higher aeronautical charges reduce demand by airlines, and passengers through higher fares, with fewer passengers there will be fewer shoppers and hence lower non-aeronautical revenues. However, the CAA has not seen evidence of the feedback loop or the network effects in the other direction to which S&Y alludes.

D79 The CAA would have altered its analytical approach where it was clear that there was feedback from the non-aeronautical side of the platform back to the aeronautical side. For example, the CAA has not seen evidence that a rise in non-aeronautical pricing would lead to a decline in passengers (and from that, decline in aeronautical revenues).

D80 In light of this lack of reciprocal demand effects, at least to an extent that is material and would justify the extra complexity of the multi-sided approach, the CAA considers that non-aeronautical revenue can merely be viewed and treated as complementary to the aeronautical revenue.

D81 With respect to the alleged inconsistency between the CAA's vertical approach and its critical loss analysis; and the mutual exclusivity of the multi-sided platform and a derived demand approach, the CAA considers that its critical loss analysis integrates both these points. In particular, the CAA's critical loss analysis recognises the platform nature of airport operators with multiple income streams from both airlines through airport charges and from concessionaires via

commercial revenues. Furthermore, the CAA's analysis recognises the platform nature of airports within its considerations of passenger constraints.

D82 The CAA does not consider that its position on the multi-sided nature of airports is undermined by its stance on the single till regulation of airport operators. The CAA has come to this conclusion based on the following reasons:

- Its approach reflects the aeronautical pricing observed at airports actively competing for airlines' business where, to gain passenger volume, airport operators subsidise aeronautical charges with potential commercial revenues.
- As a multi-product firm, regulation of a limited range of services may allow the operator to collect rents elsewhere from unregulated services. A single till limits the scope for such behaviour as all revenues are considered.
- Single till regulation negates the need for resource intensive cost allocation of services that utilise the same infrastructure.

D83 To ensure the robustness of its consideration on the use of the standard vertical approach to market definition the CAA commissioned Charles River Associates (CRA) review the CAA's position and the response received on this issue as part of the Consultation process. The CRA report sets out: [43]

- There is no single definition of multi-sided market. Under differing definitions practically all markets can be considers to be multi-sided.
- Not all markets that have been identified as multi-sided require an adjustment from the standard approach; the analysis depends on the context of the market.
- Regardless of the structure of the analysis what is important is that it takes into account the possible multi-sided or complementarities present, which CRA conclude that the CAA has done.
- The arguments for single till regulation do not rely on the proposition that airports are two-sided markets.

[43] Charles River Associates, "Two-sided market analysis in the context of the CAA's Airport Market Power Assessments", November 2013, available at: http://www.caa.co.uk/docs/78/two%20sided%20markets.pdf

D84 GAL[44] made additional representation on in relation to the CRA report. In this GAL criticised the CAA for the late publication, the lack of notification that the report had been commissioned, delivered, or published and the unclear interpretation that the CAA is placing on the analysis. GAL considers that the report asserts that airports are not platform markets. GAL sets out in the response its consideration of two sets of demand interdependencies one between airlines and passengers and the other between passengers and retailers.

D85 The CAA's interpretation of the report is set out above, which the CAA does not consider as stark as GAL's interpretation of the report. The CAA notes GAL's consideration of demand interdependencies within GAL's response, however the CAA consider as set out above that the relationship between airlines and passengers is simple demand relationship where as capacity falls so too does the number of passengers flying. Further the CAA notes that GAL, its response, highlights the uncertainty over the relationship between retail presence and passenger demand for air transport services. GAL's discussion of differing airport's retail services fails to appreciate the difference in airlines operating at the airports. For example in GAL's comparison of Luton and Heathrow Terminal 5 the former is focussed on short haul provision by LCC while the later is focussed on long-haul provision for FSC. Likewise GAL note to attract Far East airlines a developed retail offer is required.

D86 For the reasons above, the CAA does not therefore agree with GAL's concern that the CAA has fundamentally misunderstood the theory of multi-sided platforms and/or has underestimated the competitive constraints. The CAA maintains the position it took in the Consultation and considers it is appropriate for it to analyse the markets in which GAL operates within a conventional vertically derived demand framework.

The role of airline and passenger switching in vertical derived demand analysis

D87 Airlines' demand for airport operation services is derived from passengers' demand for air transport services. To assess derived demand for airport operation services, the CAA has considered both the direct and indirect effects on the demand for airport services. The derived demand process is illustrated below:

[44] GAL, Gatwick Airport's comments on the Charles River Associates report to the CAA on two-sided market analysis in the context of the CAA's market power assessments, Q5-050-LGW68, 12 December 2013.

- Following an increase in airport charges an airline makes the initial response to, broadly, either absorb the cost increase or to pass it on to its passengers and/or to switch some services to another airport.
- Should an airline remove some capacity, there will be a direct effect on the volume of passengers travelling through the airport, provided that the removal of this capacity does not trigger entry or expansion by another airline.
- Assuming that the airline maintains the same level of capacity at the airport, and passes the price increase on to its passengers, the passenger becomes indirectly exposed to the airport operator's pricing decision.
- To the extent that a sufficiently close substitute flight is available at another airport, the passenger may decide to switch to that airport in response to the price rise thus affecting the level of derived demand.

D88 As it is primarily the airline that considers whether or not to provide services from a particular airport, the CAA considers that its market definition analysis should start with the evaluation of airlines' views of the substitutability of other airports for Gatwick and, where possible, evidence on airlines' actual switching behaviour. The willingness of passengers to switch airports is still a relevant consideration but is viewed as a consequence of the airlines' initial decision.

D89 Airlines' requirements regarding infrastructure at an airport are also likely to differ according to their business model and the type of services they offer. In turn, the business model adopted and services provided by an airline may dictate the type of aircraft that it uses and whether it requires special airport facilities.[45]

D90 The Guidelines emphasise that the nature and magnitude of airlines' switching costs will depend upon a number of factors and are an important aspect of the overall competition assessment.[46] An airline's ability to switch is not just relevant for the product market definition but also the definition of the relevant geographic market.[47]

D91 The geographic market definition will be affected by the ability and willingness of passengers to switch between airports. In particular:

[45] The Guidelines, paragraph 3.41.

[46] The Guidelines, paragraph 3.42.

[47] The Guidelines, paragraph 3.65.

- The ability of passengers to respond to a price increase imposed by the airport operator is only derived if they are exposed to the price increase after the airline's initial response.
- The ability and willingness of passengers to switch will depend, in part, on the extent to which they regard services at different airports as reasonably close substitutes and the costs they face in switching demand to the next best alternative.[48]
- An important factor will be the availability of suitable alternative flights to the same destination as well as the willingness of passengers to follow an airline to an alternative airport.

D92 The Guidelines highlight the importance of passenger switching for geographic market definition stating:

The CAA considers that passenger switching is likely to be a significant focus of geographic market definition. However, it may also be important to consider the interdependencies with, or feedback effects from, the airport's other user groups.

Whilst geographic market definition might be focused on the potential for passengers to switch between airports, it will also be important to ensure that the ability of airlines to switch away from an airport – potentially to a relatively distant airport – is included within the wider assessment of competitive constraints... Assessing the likelihood that airlines and passengers take these choices, and the impact this would have on the airport in question, is at the core not only of the market definition but also of the assessment of the strength of competitive constraints an airport is facing.[49]

D93 The CAA therefore considers that downstream air transport markets are relevant to market definition for upstream airport operation services. Where marginal passengers are able to substitute in sufficient numbers between airports, this will reduce the switching costs involved for airlines. Where this is not the case, the costs of switching for airlines are likely to be higher due to the additional opportunity cost of no longer serving that particular air transport market from that airport.

D94 In common with other authorities carrying out such analysis,[50] the CAA has sought to understand the propensity of marginal passengers'

48 The Guidelines, paragraph 3.34.

49 The Guidelines, paragraphs 3.60 and 3.61.

50 See, for example, CC's 2009 report into BAA.

likelihood to switch in response to a price rise. It has done this using passenger surveys and catchment area analysis.

D95 However, as part of the analysis of derived demand, the CAA considers that an airline, in making decisions to switch or discontinue a service in response to a price rise at an airport, could be expected to have considered:

- The likely behaviour of their passengers in the downstream market.
- Passengers' willingness to use other airports.

D96 It is therefore reasonable to assume that passengers' propensity to switch in response to a price rise by the airport operator has, to some extent, been internalised in the airline's decision-making process.

D97 Given the above, where airlines' decision-making processes are supported with primary evidence, e.g. an analysis of catchment overlaps developed for airports' and airlines' internal purposes, the CAA has attached weight to that evidence when delineating the boundaries of the geographic market. It has complemented this evidence with evidence taken from interviews with airlines and airport operators.

D98 However, airlines' propensity to switch may not be fully aligned with that of passengers, as they face different switching costs and constraints. In addition, relying solely on existing airlines' views and evidence may provide too static a view of the market. The CAA has therefore complemented airline and airport evidence with findings from its own research and analysis of passenger behaviour.

D99 Analysis in the Initial Views on the cost structure of airlines suggested that, for LCCs, airport charges made up around 30 per cent of their cost base.[51] For FSCs, airport charges accounted for around 10 per cent of their cost base. This suggested that a 5 to 10 per cent increase in airport charges, if passed on fully to passengers, would translate, at most, into a 3 per cent increase in charges to the passenger.

D100 In addition, passengers' choice of airport is part of a wider decision on air transport services, whether they are travelling for business or leisure. The impact of airport pricing on passengers is likely to be significantly lessened as it forms one component of a bundle of

[51] The Initial Views, GAL, Figure 19.

goods.[52] The CAA's view is, therefore, that passenger responses to an airport operator's SSNIP are likely to be muted.

D101 Given GAL's emphasis on the relevance of point-to-point services for market definition, the CAA has considered the downstream air transport markets that operate from Gatwick.[53]

Air transport markets

D102 Merger case law suggests[54] that airline competition takes place on a city pair basis. That is to say, competition takes place between airlines on routes between two cities and their surrounding areas i.e. London to Milan as a city pair forms a different market from London to Rome or London to New York. Therefore a London Luton to Paris Charles De Gaulle flight may compete with a London City to Paris Orly flight as both flights are serving London to Paris. Neither of those flights would, however, compete with a London Heathrow to New York JFK flight. For long-haul services, such as transatlantic routes, indirect routes for which a single ticket is purchased that increase the journey time by no more than 150 minutes may impose a competitive constraint on direct flights.

D103 Assuming that the EC's analysis of the downstream air transport market is correct, the CAA considers that this implies that Gatwick (or indeed any airport) would be a wholesale input for a range of air transport markets that face varying degrees of competition. For example, on the London to Paris route there is the possibility to fly with three different airlines from three different airports[55], plus on the London to Paris route it is possible that rail may provide a suitably close substitute. For London to New York, there is a choice of at least 13 airlines but from only one airport (Heathrow).[56]

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52 In this context a list, by no means exhaustive, that may be purchased includes surface access charges, flights, and hotels.

53 The CAA has not undertaken formal analysis of the retail markets but considers the implications drawn from case law. Furthermore, the CAA does not comment on the market position enjoyed by any airline operating within the downstream air transport markets.

54 See COMP/M.5440 Lufthansa/Austrian Airlines; COMP/M.5335 Lufthansa/SN Airholding; COMP/M.5364 Iberia/Vueling/Clickair; COMP/M.3280 Air France/KLM; COMP/M.3770 Lufthansa/Swiss; COMP/M.5747 Iberia/British Airways; COMP/M.6447 IAG/BMI.

55 Review of available direct return flights with one airline departing London 10 July and returning the same day from taken from skyscanner.com accessed 4 July 2013.

56 Review of available direct return flights with one airline departing London 10 July and returning the 17 July taken from skyscanner.com accessed 4 July 2013.

D104 Case law[57] also suggests that passengers can be segmented between time sensitive and non-time sensitive passengers.

- Time sensitive passengers tend to travel for business purposes, require significant flexibility with their tickets (such as cost-free cancellation and modification of the time of departure, etc.) and tend to pay higher prices for this flexibility.
- Non-time sensitive customers travel predominantly for leisure purposes or to visit friends and relatives, book a long time in advance, do not require flexibility with their booking and are generally more price sensitive.[58]

D105 In BA/AA/IB[59], the EC considered that passengers could be segmented by cabin class, with business and first class services (premium passengers) forming a separate product to economy class services (non-premium passengers).

D106 As for airport substitution, the EC stated:

- In the BA/AA/IB case that, for transatlantic routes, both supply and demand side substitution were insufficient to suggest Heathrow belonged in the same market as the other four London airports.
- In the Iberia/BA case, for routes between London and Barcelona and Madrid, that for non-time sensitive passengers at Heathrow, that Gatwick and London City were substitutable.

D107 In addition for the Iberia/BA case, the EC stated that all five London airports may be substitutable due to surface access links and cheaper airfares than those which are less conveniently located. The inclusion of Stansted and Luton was left open as this did not affect the analysis for the purposes of the case.

D108 For time sensitive passengers it was less clear whether Stansted and Luton should be included.

57 See COMP/M.5440 Lufthansa/Austrian Airlines; COMP/M.5335 Lufthansa/SN Airholding; COMP/M.5364-Iberia/Vueling/Clickair; COMP/M.3280 Air France/KLM; COMP/M.3770 Lufthansa/Swiss; COMP/M.5747 Iberia/British Airways.

58 COMP/M.5747 Iberia/British Airways.

59 COMP/39.596.

- In the IAG/bmi case, it did not conclude on airport substitutability; it carried out its assessment at three levels; at the airport, at three airports and at five airports.[60]
- in the Ryanair/Aer Lingus[61] case, it considered that the five London airports were substitutable for services between Dublin and London.
- The CC, in its recent consideration of Ryanair/Aer Lingus, considered a similar substitutability.[62]

Airline competition

D109 In 2008, a working paper by the CC analysed airline yield data and found some evidence that BAA airports (Heathrow, Gatwick and Stansted) were substitutes for passengers. In that analysis, the CC considered that:

It is not possible to estimate cross-price elasticities [faced by airports] directly: historical joint-ownership has prevented competition between the airports and so we observe only a few instances of switching behaviour by airlines. This means we must look to passenger willingness to substitute between airports in response to relative airfare changes instead to guide our view on incentives for airlines to switch in response to changes in relative airport charges. [63]

D110 To develop the CAA's view on air transport markets and what this may mean for the airport operation services market, it has reviewed data on easyJet route yield. In particular, the CAA has analysed easyJet route revenue and profitability data[64] to better understand the extent to which:

- There is competition between airlines across the London airports
- Passengers substitute between London airports.

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60 COMP/M.6447 IAG/bmi.

61 COMP/M.4439. Ryanair/Aer Lingus III case COMP M.6663 has recently been decided on by the Commission [case documentation not available].

62 CC, Aer Lingus/Ryanair Provisional Findings Report, 3 June 2013.

63 CC, Working paper on analysis of airline yield data, available at: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/working_paper_airline_yield_data.pdf

64 For the analysis, the CAA constructed a panel fixed effects model, matching easyJet route revenue to the CAA aviation statistics data. The CAA regressed easyJet revenue against a number of capacity variables for London airports. See chapter 8 of the Consultation for more detail.

D111 The results from this examination suggests that:

- One extra seat provided at another London airport to the same destination reduces easyJet revenue on a route between Gatwick and the destination by about £[✂]. One extra seat provided at Gatwick by another airline but to the same destination reduces easyJet revenue on that route by about £[✂].
- There is some evidence that Heathrow and Luton seem to be constraining easyJet route revenue at Gatwick,[✂].

D112 While the CAA did not compute elasticities of demand from that analysis, recognising the limitation of this analysis, it concluded that:

- There are signs of airline competition for passenger demand at and across London airports.
- Airline competition between routes at Gatwick seems to be stronger than competition from other London airports.
- [✂].
- Air services from different London airports may place different constraints on easyJet routes but it is difficult to say from where the constraint is bigger.

Conclusions on air transport markets

D113 Based on the case law outlined and supported by the CAA's analysis above, the CAA considers that in its assessment that it should consider that:

- Airlines compete for passengers on a city-pair basis.
- Airports operate as a wholesale input to a number of air transport markets – the airport is either the origin or the destination.
- There is some level of substitutability between all London airports depending on the air transport market in question.
- Non-London airports are not substitutable for London airports at the downstream air transport level therefore by extension would not be at the upstream airport operation services level for passengers.

D114 However, case law on airline competition is based on a 5 to 10 per cent increase from the competitive price in the downstream air transport market. A SSNIP on air transport fares would equate to a 17 to 100 per cent increase in upstream airport operational service

charges.[65] At this level of price increase, substitutability between airports from a passenger perspective could be expected to be greater than that observed when passengers are exposed to a 5 to 10 per cent SSNIP on airport operation services alone.

Section 3.2: Product market

D115 This section defines the product market(s) in which GAL provides services and covers:

- competition with other transport modes;
- service bundle;
- retail, property and car parks; and
- market segmentation, including that associated with;
  - inbound and based carriers;
  - passenger segmentation;
  - cargo; and
  - airline business models.

Competition with other modes of transport

D116 As discussed in the consideration of air transport markets (above), other transport modes may compete with airlines for some services, particularly for services that non-time sensitive passengers may require. That said, only 8 per cent[66] of passengers that fly on services from Gatwick do so on services that may be substitutable with surface journeys i.e., domestic routes and those European destinations served by high speed rail (Paris and Brussels).

D117 The CC, in its BAA airports market investigation, did not consider that there was sufficient scope for surface substitutability at the London airports.[67]

D118 Based on the above, the CAA does not therefore consider it expeditious to the current investigation to consider this issue further.

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65 This calculation assumes that charges levied by the airport account for 10 to 30 per cent of the airlines' cost base.

66 Source: CAA analysis.

67 CC Report 2009, paragraph 2.11.

The markets considered within this document reflect this thinking and are not widened to include surface journey alternatives.

Service bundle

D119 GAL provides a number products and service (which may be interlinked) to airlines, passengers, freight operators and a range of other companies (groundhandlers, retail concessionaires etc) for access to and the use of the infrastructure and facilities at Gatwick.

D120 For the market definition, it is therefore important to identify the focal product or service that is being provided by an airport operator. However, given the nature of an airport the CAA considers that it is more appropriate to analyse the focal product market in terms of a service bundle rather than individual products or services.

D121 The approach is consistent with the approach adopted by the CC in its consideration of market definition for the BAA airports market investigation.[68]

D122 The CA Act provides a logical starting point for defining the service bundle. In particular, section 3 of the CA Act prohibits an operator of a dominant airport area at a dominant airport from requiring the payment of charges in respect of airport operation services unless it has a licence. An airport area will be dominant if the CAA has made and published a Determination that the market power test in section 6 of the CA Act is met in relation to that area.[69]

D123 Section 66 of the CA Act also states that an airport:

means an aerodrome within the meaning of the Civil Aviation Act 1982[70] *together with other land, buildings and structures used for the purposes of—*

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68 Indeed the CC's analysis highlights that where secondary products (i.e. aircraft parking fees and check-in) are constrained by the interaction with a primary product (i.e. landing of aircraft at the airport), it is generally accepted that they should be treated as a single product market. At this point the CAA does not consider that it is analytically necessary to define primary and secondary products, as the CC did. For clarity, the CAA considers them as a whole.

69 Section 5(1) of the CA Act. An airport will be dominant if all or part of its core area is in a dominant area.

70 At section 105 of the Civil Aviation Act 1982 aerodrome means any area of land or water designed, equipped, set apart or commonly used for affording facilities for the landing and departure of aircraft and includes any area or space, whether on the ground, on the roof of a building or elsewhere, which is designed, equipped or set apart for affording facilities for the landing and departure of aircraft capable of descending or climbing vertically. In its narrowest

(a) the landing and taking off of aircraft at the aerodrome,

(b) the manoeuvring, parking or servicing of aircraft between landing and take-off at the aerodrome,

(c) the arrival or departure of persons carried or to be carried as passengers by air transport services operating to or from the aerodrome, together with their baggage,

(d) the arrival or departure of cargo carried or to be carried by such service(s)

(e) the processing of such persons, baggage and cargo between their arrival and departure, and

(f) the arrival or departure of persons who work at the airport.[71]

D124 As such, the definition of airport operation services does not include air transport services, air traffic services or services provided in shops and other retail businesses.[72]

D125 This definition feeds into section 6(1) of the CA Act which sets out the market power test that must be applied to the airport area. In addition, under section 5(3) an airport area is defined as *'an area that consists of or forms part of an airport'.*

D126 The market power test will be met by the airport operator if Tests A to C are met by the relevant operator of the airport area at that time. The relevant operator is the person that has overall responsibility for that area by controlling the type, quality, or price of services provided from that area or the access to and development of that area.[73]

D127 Section 6(3) sets out Test A, i.e. whether the relevant operator has, or is likely to acquire SMP. In particular, section 6(3), read in conjunction with sections 6(6) and 6(7), requires that an SMP assessment must be made by reference to a market for one or more airport operation services which are provided in the airport area or, where appropriate, the 'core area'.[74]

interpretation an aerodrome can be consider as the runway.

71 The definition of airport specifically excludes hotels (except those situated in a passenger terminal that is part of an airport), bus, tram and railway stations.

72 Section 68(4) of the CA Act.

73 Section 9(4) of the CA Act.

74 Section 6(7) of the CA Act provides that, where the airport area includes all or part of the core area, the MPT test will be applied by reference to a market for airport operation services

D128 The core area is defined in section 5(4) as:

(a) the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft at the airport,

(b) the passenger terminals, and

(c) the cargo processing areas.

D129 Based on the above, the CAA considers that the initial focal product is, therefore, likely to consist of one or more of the airport operation services supplied in the core area. However, GAL's primary function is to provide access to the infrastructure of Gatwick for the landing, parking and departure of aircraft and for the processing of passengers and cargo.

D130 The CAA therefore considers that the aeronautical services provided by GAL at Gatwick are likely to consist of at least:

- the use of the runway and taxiways;
- aerodrome Air Traffic Control (ATC)[75];
- aircraft parking;
- the provision of access and infrastructure needed for the provision of airside and landside groundhandling services;[76]
- the provision of facilities for check-in;

provided in the core area.

75 Aircraft landing at Gatwick will only face charges from the airport operator for the aerodrome element of ATC. The approach service is provided by NERL Plc as part of the London terminal manoeuvring area (LTMA) and charged directly to airlines operating in this space. At airports outside of the LTMA, the approach service would be included within this bundle of activities. It should be noted, however, that the CA Act formally excludes ATS as defined in the Transport Act 2000 from airport operation services. The ability to land and manoeuvre aircraft at and around an airport is a key service that airport operators are required to provide as part of its services to airlines. In the UK these services are currently contracted by the airport operator with an air navigation service provider in a liberalised market. It is then up to the airport operator how they recover this cost in a similar manner to any other costs incurred, it is not a 'pass through' cost.

76 Ramp handling services, fuel and oil handling, and aircraft maintenance are groundhandling services as defined in Directive 96/67/EC. Groundhandling services are often provided by the airlines or to the airlines by third parties. However, the groundhandlers pay fees to the airport operator relating to use and access to infrastructure. In these cases the airport charges would still affect the airline through the charges levied on the groundhandlers.

- the provision of facilities for baggage handling;
- security screening;
- the provision of access and facilities for holding passengers between arriving at the airport and departure (Holding passenger facilities);
- facilities for the processing of airline staff arriving and departing the airport[77] (Airline staff processing facilities); and
- the transit of passengers to and from the aircraft (in the case of a passenger airline) (passenger transit facilities)

D131 For ease of reference, the CAA refers to these services as Bundle A.

D132 In addition, for certain airlines, such as those operating as FSCs, the airport operation services will also include:

- access to infrastructure and facilities for the provision of services such as lounges and priority security lanes for premium passengers (premium passenger facilities);
- access to facilities to transfer connecting passengers and their baggage between aircraft without the passenger leaving the airport (Integrated transfer facilities); and
- the provision of access and facilities for the processing of cargo (in the case of an aircraft carrying cargo, either in bellyhold or as a cargo-only flight) (Cargo processing facilities).

D133 For ease of reference, the CAA refers to this bundle as Bundle B.

D134 The CAA considers that Bundles A and B services should be treated as a single product as:

- These services are likely to form the key bundle of services that an airline would require to operate from an airport.
- An airline would be required to bear the costs of all of these services to provide air transport services.[78]

[77] Given the legislative definitions, staff may never arrive at an airport if they do not enter a passenger terminal, pass the forecourt of such a terminal or use a qualifying car park. Nevertheless, the CAA considers that staff access costs would be a consideration as part of an airline's decision to operate from an airport.

[78] Air transport services are defined in the CA Act as a service for the carriage by air of passengers or cargo to or from an airport in the UK.

- In deciding whether to land at an airport, an airline would take account of the total bundle of charges rather than focusing on any one charge in isolation (even though services may be priced individually by the airport operator to reflect different cost drivers).

D135 Although the airport operator may not directly supply each individual service identified above, it has a degree of management control or influence over the services provided, for example, by determining the quality and prices of such services.[79]

Retail, property and car parks

D136 This section briefly outlines the CAA's approach to the retail, property and car park activities that are not included in the service bundle set out above. This includes the services outlined in section 68(3)(b)-(c) of the CA Act:

(b) facilities for car parking, and

(c) facilities for shops and other retail businesses.

D137 In relation to the provision of facilities for retail and car park (RCP), and following the discussion outlined above on the multi-sided nature of airports, the CAA would need to be assured that the services in the airline product market and RCP services are interdependent[80] for them to be in the same market.

D138 Although retail services would not be offered if the airport operator did not provide services to commercial passenger airlines, in principle, an airport could operate without the provision of facilities for retail activities.

D139 Although some passengers may take into account the retail offering and/or prices of products sold at the airport when making a decision on the airline/airport with which they choose to fly, evidence suggests that this varies across different passenger groups, and expectations vary by airport.[81] To phrase it another way, 'all shoppers are fliers, but not all fliers shop'.

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79 Section 9(4) of the CA Act.

80 In this context, the CAA defined interdependent such that an increase (decrease) in the price to one set of customers impacts on the demand from another set of customers and vice versa. It is not enough for the pricing on just one side of the market to impact on the other, interdependence requires reciprocation.

81 *Understanding Airport Passenger Experience*", Independent Social Research on behalf of the

D140 In addition, in practice, the price for retail activities is unlikely to affect passengers' choice of an airline or airport in a significant way. Furthermore, in considering how to respond to an increase in rent and/or change to other terms of their contracts, concessionaires' decisions are likely to be independent from decisions made by airlines in relation to aeronautical services. Likewise, airlines' decision making and profitability is independent of that of RCP concessionaires.

D141 The CAA's view is therefore that in examining the existence and extent of GAL's market power it is more appropriate to define a separate market for the provision of facilities for retail activities and car parks that is distinct from that of the aeronautical product market. This approach is consistent with the approach adopted by the CC with respect to RCP,[82] as well as previous case law.[83]

D142 The CAA does not therefore consider, for the purpose of the document, that it is necessary to define this distinct market.

Market segmentation

D143 This section considers the available evidence on whether it is appropriate to segregate the product market due to differences in demand from GAL's airline customers.

Inbound and based operators

D144 In the Consultation, the CAA considered it was not appropriate to segment the market between inbound and based carriers.[84] In coming to this view, the CAA outlined that:

- The product demanded by based and inbound airlines appears sufficiently similar. This is in terms of the product bundle and requirements of access to the airport.[85]

DfT, March 2009: http://webarchive.nationalarchives.gov.uk/+/http://www.dft.gov.uk/pgr/aviation/airports/reviewregulatioukairports/understandingexperience.pdf; and Consumer Research, Accent for CAA, May 2011: http://www.caa.co.uk/docs/2107/2131ConsumerResearch06122011.pdf

82 CC 2009 report, paragraph 2.41.

83 In Purple Parking v HAL [2011] EWHC 987 (Ch) at paragraphs 109-131, the High Court distinguished the upstream "Facilities Market" (i.e. the provision of access to Heathrow's facilities) from the downstream "Parking Market" (parking services at Heathrow, including off-airport park and ride parking).

84 The Consultation, paragraph 5.38.

85 The Consultation, paragraphs 5.37.

- It appears that the competitive options are similar for those of both operations.[86]

D145 The CAA received no further representations on this issue and therefore concludes that it would be inappropriate to segment the market by whether airlines operate based or inbound from the airport.

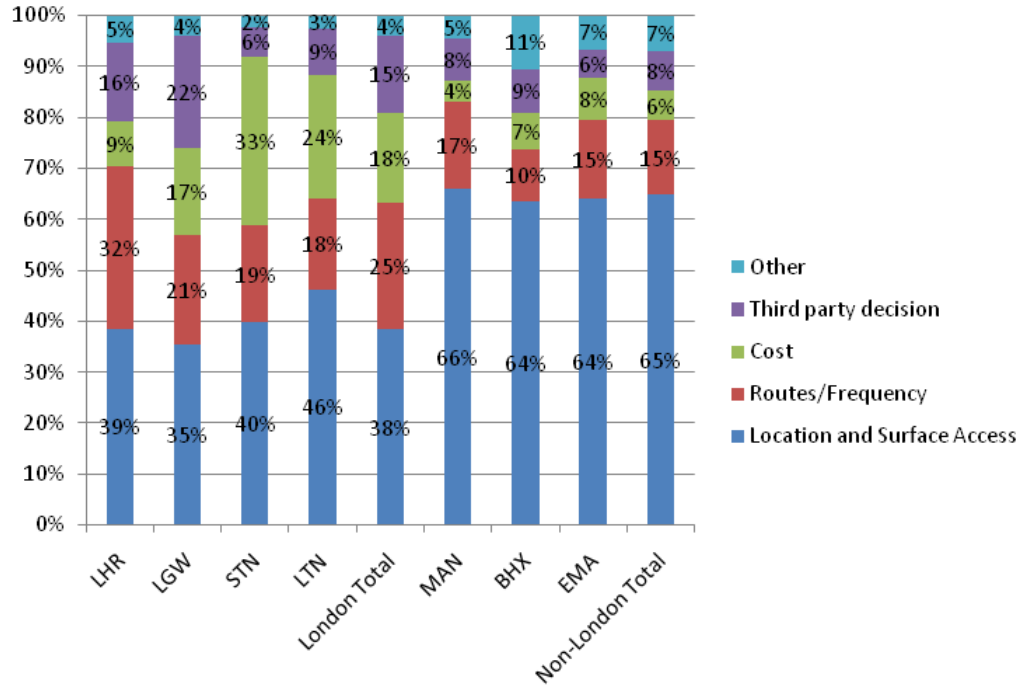
Passenger segmentation

D146 There are a number of ways the product market for airport operation services could be segmented, including:

- surface and transfer passengers; and
- business, leisure and passengers visiting friends and relatives (VFR).

D147 Figure D.2 (below), shows passengers' reasons for their airport choice which could be considered as aspects of the airport product for passengers.

Figure D.2: Reasons for airport choice



Source: CAA Passenger Survey Working paper November 2011

D148 Figure D.2 (above) shows that at Gatwick, location and surface access is the primary driver and that a third party decision (such as by an

[86] The Consultation, paragraph 5.36.

employer or other family member), was the second most cited reason of choice. Routes/frequency was the third most cited reason.

D149 The factors passengers cite as their reasons for airport choice are, in the main, outside of the influence of the airport operator over the short to medium term, for example, location and surface access.

D150 However, to some extent, surface access can be altered, although this can take some time for any modifications to come on stream, or may be part of wider Government initiatives.[87] In addition, although the airport operator does have some influence on cost, through airport charges, these are a small part of the overall fare. Routes/frequency can only be affected indirectly by an airport operator's engagement with airlines.

D151 However, it would not be possible for an airport operator to identify with accuracy differing passenger groups, nor to prevent arbitrage by passengers that would eliminate any possibilities of price discrimination.

D152 In addition, in aggregate, passengers' demand influences the services offered by airlines, which in turn affects the airline's demand for airport operation services. Furthermore, through the purchase of an airfare passengers also self-select and reveal information about their preferences, on which an airport operator may be able to discriminate through charges on airlines.

D153 GAL agrees with the CAA that it is not appropriate to segregate the product market by passenger groups.[88] The CAA received no further commentary in response to the Consultation on this issue.

D154 The CAA does not therefore consider it is appropriate to segregate the product market by passenger groups. However, it does consider passenger switching in more detail with respect to the geographic market, where passengers switching between similar services at differing airports is likely to affect the geographic scope of the market.

87 For example, the development of Crossrail began in 2001 receiving full support from Parliament in 2008. When Crossrail opens in 2018 it is expected to bring four trains an hour to Heathrow. See: http://www.crossrail.co.uk/ (accessed 2 April 2013).

88 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.23.

Cargo

D155 In the Consultation, the CAA considered it was unnecessary to define an independent product market for cargo at Gatwick.[89] The CAA's main consideration in doing this was the overall small size of cargo operations at Gatwick (some 97,567 tonnes in 2012) and the focus of these operations on belly-hold provision. [90]

D156 The CAA received no further representation on its decision to consider a separate cargo market at Gatwick and considers that there is no merit in developing an independent definition for cargo services at Gatwick. Further cargo is unlikely to effect the choice of airlines and users to purchase airport operation services at Gatwick given its size, and as it is not an essential service for airline operation as demonstrated by the operational requirements LCC business model and its prevalence at Gatwick Consequently, it does not consider cargo separately within the analysis presented within this appendix.

D157 The CAA is aware that as the market(s) develop in the future the position of cargo at Gatwick may change.

Airline business model

D158 In the Consultation, the CAA concluded that the market could be segmented by airline business model, with separate markets for LCCs and charters, and for FSCs and associated feeder traffic.[91]

D159 The CAA received a number of responses to the Consultation on this issue, including from BA, easyJet, GAL and MAG (in response to the Stansted consultation). These responses suggested that the CAA had:

- Misinterpreted evidence and placed too much weight on differentiation in services between the two main carrier types.[92]

89 The Consultation, paragraph 5.41.

90 The Consultation, paragraphs 5.40.

91 The Consultation, paragraphs 5.18 to 5.34

92 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, easyJet, easyJet response to CAA consultation on Gatwick airport market power, July 2013, BA, BA Response to CAA consultation on Gatwick market power assessment of May 2013, 26 July 2013, MAG, Civil Aviation Authority Stansted Market Power Assessment; Interim response of MAG to the CAA's 'minded to' document 24 May 2013 .

- Not given sufficient weight to the competition between the differing types of carrier especially on short-haul routes.[93]

D160 Having considered the evidence, including that submitted in response to the Consultation, the CAA now considers that it is unlikely that the identification of separate markets, segmented by airline business model is appropriate. In reaching this conclusion the CAA is mindful that there are still significant operational differences between LCCs and FSCs that affect their substitution opportunities.

D161 In reaching this view, the CAA recognises that the LCC business model has a number of key features, including:

- The need for quick turnaround times and minimal use of airport facilities.
- All customers using the same basic service without differentiation and the airline maximising the usage of its assets through high rotations.
- Uniformity in fleet to drive down asset operation costs.
- No ability to interline in an integrated manner. [94]

D162 The CAA also recognises that the FSC business model has a number of distinct features, including:

- The provision of differentiated services to a differentiated passenger base (premium and non-premium passengers).
- The requirements for a higher specification of airport facility to cater for premium and non-premium passengers separately.
- Integrated transfer for connecting passengers.
- Carrying of bellyhold cargo.
- Greater fleet diversity to cater for both long and short-haul services.

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93 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, easyJet, easyJet response to CAA consultation on Gatwick airport market power, July 2013, BA, BA Response to CAA consultation on Gatwick market power assessment of May 2013, 26 July 2013, MAG, Civil Aviation Authority Stansted Market Power Assessment; Interim response of MAG to the CAA's 'minded to' document 24 May 2013 .

94 It is possible to self connect with LCCs (as with FSCs) by buying an extra ticket. However, this requires no additional airport infrastructure as the passenger arrives at the airport to go through the entire departure process again. This takes place in the same manner as a passenger arriving at the airport by car or train.

D163 Given the above, it appears that for LCCs there is no reliance on additional connecting traffic at the airport or sophisticated transfer baggage systems (a position not shared with their full service counterparts). Given the fleet types employed by the LCCs and the focus on short haul destinations,[95] some may also have lower requirements on airport infrastructure in terms of runway length. The CC made similar observations with respect to LCCs' use of airport infrastructure:

The requirement of such carriers for airport facilities is also significantly different from that of the more traditional carriers; in particular, a need for rapid and reliable turnaround times (of no more than 25 minutes) to allow three or more rotations of aircraft each day; and no requirement for facilities such as airbridges or facilities for transfer passengers or their baggage."[96]

D164 However, the CAA has been presented with further evidence from GAL, BA and easyJet which suggests that this distinction is not as clear as the CAA initially considered.

D165 GAL, for example, has made the following representations on the closeness of the different FSC and LCC business models. In particular, GAL noted that:[97]

- It is unclear in which market a number of operators would fall, such as Norwegian Air Shuttle (Norwegian) and Aer Lingus.
- LCCs are offering more FSC services and FSC operators are offering more LCC style hand luggage only tickets.
- The majority of traffic at Gatwick whether LCC or FSC is point to point.
- There is little differentiation in the infrastructure used by the different airlines at Gatwick, with differences relating to only a small part of the overall infrastructure.

95 Just over half of short-haul services in the UK are provided by LCCs. In 2011, CAA airport statistics show that 54 per cent of passenger flew short-haul with a LCC.

96 CC, BAA Report 2009, paragraph 3.10.

97 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.24 bullet points 5 and 6.

- GAL has launched Gatwick Connect to allow travellers on differing tickets to have a more integrated transfer experience regardless of airline on which they are transferring. Similarly, there are a range of third party lounges available for passengers to purchase access to regardless of carrier or ticket class.

D166 BA similarly noted that with respect to the proposed segmentation by the CAA that:

...[it] is artificial and an unclear and arbitrary basis on which to frame the market power assessment. In fact, the distinction between these airline concepts and what each on might need when it comes to airport services is increasingly blurred.[98]

D167 BA also noted that traditional FSC and LCC fiercely compete to provide services to passengers.[99] It listed 26 short-haul and five long-haul routes from Gatwick in which they are in direct competition with LCCs and charters.

D168 On the convergence of business models, BA stated that LCCs are continually seeking to provide services to more corporate customers. It also highlighted evidence relating to easyJet's moves to provide these services.[100] For example, it highlighted recent easyJet investor presentations that outlined how it was targeting corporate passengers:[101]

- Deployment of flexible fares.
- Connecting to primary airports.
- The development of business-friendly routes.

D169 BA also highlighted evidence from the CAA, including:

- Passenger survey data showing 17 per cent of easyJet's passengers are travelling on business.

98 BA, BA Response to CAA consultation on Gatwick market power assessment of May 2013, 26 July 2013, paragraph 2.1.

99 BA, BA Response to CAA consultation on Gatwick market power assessment of May 2013, 26 July 2013, paragraph 2.2.

100 BA, BA Response to CAA consultation on Gatwick market power assessment of May 2013, 26 July 2013, paragraph 2.4.

101 BA, BA Response to CAA consultation on Gatwick market power assessment of May 2013, 26 July 2013, paragraph 2.4.

- The CAA's considerations in the Moscow scarce capacity decision, which discussed easyJet's ability to service passengers travelling on business.

D170 In addition, BA pointed to developments within its own business model and that of other airlines within the IAG group. In particular, it noted that:

- BA's core cost basis is at LCC levels at Gatwick;[102]
- BA's recent launch of a low priced product targeting LCC passengers, with hand baggage only and no interlining; [103]
- [✂];[104]
- [✂];[105] and
- Vueling, traditionally operated as a LCC operation and is increasingly offering differentiated services such as the 'Vueling Business Pass'. BA also noted that it interlines with Vueling at Barcelona.[106]

D171 BA also presented evidence relating to the facilities used by airlines, including:

- LCCs are increasingly using larger aircraft. For example, it noted easyJet's deployment of A320s within its fleet as well as Norwegian's use of B787s on intra Europe routes. It also outlined the charter airline, Thomson Airways, plans to deploy B787s on long-haul routes from Gatwick, which will provide the airline with greater range than BA can currently achieve from Gatwick.[107]
- The LCC method of operation focuses on speed of turnaround and is likely to require additional and more intensive use of airport infrastructure at the ramp.[108]

102. BA, BA Response to CAA consultation on Gatwick market power assessment of May 2013, 26 July 2013, paragraph 2.5.
103. BA, BA Response to CAA consultation on Gatwick market power assessment of May 2013, 26 July 2013, paragraph 2.5.
104. [✂]
105 [✂]
106 BA, BA Response to CAA consultation on Gatwick market power assessment of May 2013, 26 July 2013, paragraph 2.7.
107 BA, BA Response to CAA consultation on Gatwick market power assessment of May 2013, 26 July 2013, paragraph 2.10.
108 BA, BA Response to CAA consultation on Gatwick market power assessment of May 2013, 26

D172 In its response to the Consultation, easyJet indicated that it did not consider the business model segmentation presented by the CAA was helpful. It noted that the defining difference between airline business models is generally whether they offer a point to point or network product. easyJet also did not consider that there were differences in airlines' requirements for airport infrastructure, providing the example that point to point operators do not require complex baggage systems. Segmentation is therefore possible in theory, but at Gatwick no such differentiation is present.[109]

D173 easyJet also noted that it considers there are airports which provide services to FSCs without the need for passengers connecting. It noted, for example, EL AL operating at Luton.[110]

D174 Given the evidence outlined above, the CAA considers that while there are some differences in the demand from airlines purchasing Bundle A and those purchasing Bundles A + B, it does not consider this is sufficient to delineate different markets in operation at Gatwick.

D175 The CAA therefore considers that the market for airport operation services should not be segmented by airline business model. It therefore considers that the product market should be defined, on the demand side as a generic market comprising of airport operation services to all airlines. More specifically those services may contain at least the services outlined in Bundle A and for some airlines in addition at least those services outlined in Bundle B.

Supply side substitution

D176 As well as considering demand side substitution, the CAA needs to consider issues relating to the supply of services by airports. Supply side substitutability is the ability of an alternative airport operator to enter the market at short notice and provide services in competition with the current provider(s) without incurring substantial sunk costs.[111]

D177 In addition to (or as an alternative to) new entry, an existing airport operator could expand or develop its current offering to compete with GAL. If alternative operators could effectively provide additional capacity in the short term (i.e. less than one year), the CAA considers

July 2013, paragraph 2.8.

109 easyJet, easyJet response to CAA consultation on Gatwick airport market power, July 2013.

110 easyJet, easyJet response to CAA consultation on Gatwick airport market power, July 2013.

111 The Guidelines, paragraphs 3.56 to 3.58; see also OFT 403, paragraphs 3.12 to 3.18 and EC Market Definition Notice, paragraphs 20 to 23. The CAA refers here to sunk costs specifically as costs incurred in entering the market that are not recoverable on market exit.

that this would be reasonably likely to discipline GAL's pricing behaviour.

D178 There are a number of ways in which supply side substitution could occur, including:

- Conversion of a military airfield to civilian use.
- Investment in infrastructure at a current general aviation airport to allow the use of commercial passenger flights.
- A commercial airport improving its current infrastructure to accommodate larger aircraft.

D179 However, the amount of investment needed in any of these scenarios (and any other) will depend on a number of factors as there are many constraints on the type and volume of traffic that an airport can handle.

D180 Investment in a runway extension (or other airport infrastructure) can also be a complex and resource intensive exercise. While the precise costs and practicalities of any such development are likely to depend on the location of an airport and the technical nature of the project, some of the challenges associated with such a project include would probably include:

- Significant capital and resource cost for the airport operator.
- Local and possible national planning restrictions.[112]
- Potentially physical restrictions that are site specific.

D181 The CAA also considers that:

- It is likely that substantial investment costs involved in supply side substitution for Gatwick would be of a level that would rule it out as a short-term response to direct airport competition.
- Due to planning restrictions and other constraints, entry or expansion is not likely to occur within a reasonable time period.
- It would not be rational for it to consider that airlines may alter their fleets as a response to airport charges. The CAA also considers that this is especially true for LCCs, where fleet uniformity is one of their key cost-reduction strategies.

[112] For example, there is currently a Government moratorium on airport expansion at Heathrow, Gatwick and Stansted.

D182 The CAA's analysis suggests that airport operators can provide services for a range of aircraft sizes. It is not necessary for an airport operator to be able to provide services to every aircraft type to be able to compete but to be able to provide services over a sufficient range of aircraft types.

Conclusion on product market definition

D183 Based on the evidence outlined above, the CAA does not consider it is appropriate to segregate the product market by reference to based and inbound carriers; cargo operations; or passenger groups.

D184 The CAA is also no longer convinced that the relevant market should be segmented according to airline business model. In the Consultation, the CAA relied on a significant body of evidence suggesting that there are different demand conditions for airlines based on their business models. However, the evidence presented as a result of the Consultation strongly suggests that, although differences exist, there is no clear demarcation line between LCC and FSC business models, especially with respect to demand for specific facilities at Gatwick. GAL and its major airlines appear to agree on this point.

- BA, a FSC, has submitted substantial evidence suggesting that at Gatwick its operations are akin in operational terms to those of a LCC. Likewise, evidence from easyJet and BA suggests that they are targeting an increasingly similar client base at Gatwick.
- easyJet suggests that segmentation by point to point and networked operations is an enduring segmentation. While the CAA recognises that this may be the case, in light of the evidence it is unclear how this would affect the market definition analysis at Gatwick as the point to point or networked operation is highly specific to an individual airline and the particular airport context.[113]
- It is also unclear that a long-haul vs. short-haul segregation would be appropriate, given the difficulties associated with drawing a line between the two types of air transport service.[114] This is especially the case where the CAA sees long-haul capable aircraft being used for intra Europe, typically short-haul, flying.

[113] For example, BA operates a hub operation at Heathrow but not at Gatwick. Similarly, Emirates operates a spoke operation at Gatwick fulfilling O&D demand into Dubai where it operates a hub.

[114] In general, for this document, the CAA considers broadly a 5 hour flight time as being the definition between short and long haul services. However, the CAA does not consider that this is

D185 The CAA does not consider that it would be rational for an airline to alter its business model at an individual airport in response to a 5 to 10 per cent price rise by an individual airport. Intuitively, the CAA considers that the costs of doing so are likely to be prohibitive. Given the statements by BA regarding its cost base at Gatwick and route overlap with easyJet at Gatwick, it is, however, credible that there could be sufficient marginal passengers at Gatwick such that an attempt by the airport operator to impose a SSNIP on a particular airline business model may prove unprofitable, given the ability of the passenger to arbitrage and switch to another airline (even if operating under a different airline business model).

D186 However, equally it could be possible for a SSNIP to be imposed on airport charges to short-haul operators without sufficient passenger switching to long-haul flights to render the SSNIP unprofitable as the air transport services, by their nature, would not be substitutable. However, as noted above, it is not clear where a dividing line between short and long-haul might be drawn.

D187 For the purposes of the Determination, the CAA does not, therefore, consider it necessary to provide a definitive segregation of the product market, especially given the lack of firm evidence of substitution on either side. As a result, the CAA concludes that the relevant product market that GAL operates in is likely to consist of at least the following airport operation services to all passenger airlines:

- the use of the runway and taxiways;
- ATC;
- aircraft parking;
- the provision of access and infrastructure needed for the provision of other airside and landside groundhandling services;[115]
- the provision of facilities for check-in;
- baggage handling;
- security screening;
- Holding passenger facilities;

a sufficient basis to segregate the market.

[115] Groundhandling covers aircraft maintenance services. The CAA notes that it has also made a operator determination that GAL is not the control of this area of the airport. It is possible for there to be multiple suppliers of services within a market, and within the services bundle.

- Airline staff processing facilities;
- passenger transit facilities
- Premium passenger facilities; and
- Integrated transfer facilities.

D188 In defining a wider market the CAA recognises that there are likely to be a number of market segments where groups of airlines have different substitution possibilities. The CAA has considered these differences, where appropriate, in its geographic market definition and its overall assessment of market power for GAL.

Section 3.3: Geographic market definition

The Consultation

D189 In the Consultation, the CAA considered that there were two geographic markets in which GAL operated – one market for each of the product markets that it had defined:

- LCC and charter market, which extended to Gatwick and was unlikely to include Luton or Stansted; and
- FSC and associated feeder traffic market which included services provided at Gatwick and Heathrow.[116]

Stakeholders' views

D190 GAL expressed concern with the CAA's geographic market definition for a number of reasons. In particular, it noted that:[117]

- The CAA had failed to take full account of the evidence available in the Consultation which pointed towards there being a wider London and south east England market.
- The CAA placed too great a reliance on PED analysis, which is inherently weak and may be flawed as the regulated price may not be at the competitive level.

[116] The key consideration is the strength of the competitive constraint from Heathrow rather than whether it is, or not included in the relevant market.

[117] GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraphs 3.27 to 3.37.

- The CAA focused too much on direct passenger switching in response to a price change and ignored the impact on the profitability of airlines' marginal routes.
- The CAA's markets were not consistent with precedent set by the CC and the Competition Appeal Tribunal (CAT).
- The CAA's markets were narrower than its Initial Views yet appear based on the same evidence.
- Evidence presented by MAG suggested that the LCC and charter market could be wider than the south east of England.
- The FSC market should at the very least also include Stansted, which has suitable facilities.

D191 GAL also criticised the CAA for looking at competitive constraints individually rather than in aggregate and for focusing on airline substitution opportunities first, with only a limited assessment of passenger substitution.

D192 Other stakeholders did not comment on the scope of the CAA's proposed geographic markets.

CAA's views and conclusion

D193 Since the release of the Consultation the CAA has considered the product markets in which GAL operates and has changed its view. The CAA now considers that the evidence, including that submitted by stakeholders, suggests that its analysis should be undertaken based on a unified product market definition (see earlier discussion). This has implications for the CAA's consideration of the geographic market.

D194 This section considers the evidence for the geographic market definition of the service provided by GAL and covers:

- European markets.
- Airport operators' views.
- Airline evidence.
- Passenger switching.

D195 For the reasons explained above (paragraphs ##), the CAA maintains its position that it is appropriate to look first, at airline switching and subsequently at passenger switching as part of its conventional derived demand analysis.

European markets

D196 In the Initial Views, the CAA suggested that airports may operate in a European market.[118] This view was based on submissions to the CAA on airlines' ability to move aircraft, with limited focus on passengers' ability to switch. The ability of aircraft to switch was in-turn based on the flexibility of the LCC business model and the number of European bases that they operate out of. The CAA considered that, at that time, this lowered the switching costs faced by these airlines. Additionally, the Initial Views considered that inbound carriers could easily switch between London arrival airports, given limited sunk costs.

D197 Responses to the Consultation suggest that airports compete in a pan-European market, based on the flexibility of the LCC business model and that airport operators compete to some degree with European airports.[119] However, the CAA has been provided with limited direct evidence that this is the case.

D198 Airport operators also do not appear to monitor prices charged at European airports. The CAA considers that:

- This suggests that airport operators do not consider how their price/service offer compares with European airports.
- It is rational to expect that an airport operator would monitor prices at those airports run by operators that it considers to be its competitors.
- This lack of monitoring is in contrast to the position that airport operators have taken with respect to other UK airports. For example, GAL, LLOAL and STAL appear to monitor the prices of airports within the UK.

D199 In its response to the Consultation, MAG suggested that the CAA's reasoning on price monitoring of possible competing airports was flawed, that airline airport deals are confidential and it would therefore be of little benefit to monitor tariff charges. The CAA does not consider this to be the case and has reviewed the tariff price and growth incentive schemes of a number of European airports.[120]

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118 The Initial Views, paragraph 2.178.

119 Source: Birmingham Airport ([✂]); GAL,[✂];[✂]; Manchester Airport [✂]; MAG, Civil Aviation Authority Stansted Market Power Assessment; Interim response of MAG to the CAA's 'minded to' document 24 May 2013 ; STAL [✂]; HAL, Response to CAA's Market Power Assessment, CAA/Q6/80, 26 July 2013.

120 The CAA considered the airport charges and any incentive schemes offered by the top five

D200 As noted above, the CAA's statements on European markets gave limited consideration to air transport markets, where passengers make their decision on which London airport to use, which, in turn is a result of their decision to fly to or from London. The evidence to date shows generally that airlines flying from airports in the south east of England operate primarily to serve the outbound demand generated by the local catchment area and/or the inbound demand of those that wish to travel to London and the South East. Case law also indicates that competition in air transport markets is based on city pair routes. As shown in the airline evidence below, airlines do not consider that UK regional airports compete with Gatwick. Therefore, by extension, operating flights from an airport in Europe would not serve the local catchment area either.

D201 The CAA considers that passenger demand for air transport services is fixed to a particular location, so a London airport is needed to serve passenger demand to and from London. This line of reason appears to be non-contentious and was the view of the CC:

...if Ryanair has a customer who wants to fly from the UK to Spain, the customer will not think that an airport in Italy is a close and effective substitute for Stansted from which to fly. It seems to us that airlines care about access to particular locations precisely because the passengers who will choose to fly from a UK airport will not be the same as those who are based close to, for example, an Italian one.[121]

D202 Given the fixity of the passenger demand to London, further consideration is needed of how switching capacity across their network fits with an airline's business model. However, this is clearly set against a backdrop of airlines withdrawing from the provision of services in those particular downstream air transport service markets.

D203 In its response to the Consultation, GAL noted the evidence and the argument put forward by MAG in support of a wider geographic market definition.[122, 123] MAG suggests that airlines would, in response to an

airports in terms of seats offered in summer 2012 by both easyJet and Ryanair. The CAA was able to view the charges of Berlin Schönefeld, Charleroi, Dublin, Frankfurt-Hahn, Geneve, Milano Malpensa, Paris Charles de Gaulle, Paris Orly, Pisa, and Amsterdam Schiphol. Many of the airports also published growth incentive schemes. Source: Airport websites accessed: 14 August 2013.

121 CC's 2011 report, paragraph 181.

122 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.38 to 3.40.

123 HAL also put forwards arguments about competition with European airports. However these

increase in airport charges, reallocate aircraft within the airline's own network. This ability to move aircraft from a less profitable route to a more profitable route (as a result of the charging increase) causes airport charge increases to be self defeating.[124] That is to say that from the current routes served where one becomes less profitable the next best alternative route will be served in its place.

D204 To support this, MAG present evidence of volume changes in summer season weekly departures for both Ryanair and easyJet from 2006 to 2013 which it considered to be '*clear and unequivocal evidence of a competitive constraint being exercised on Stansted from airports across Europe (and, indeed, across the UK).'* The CAA has recreated this analysis in Figures D.4 and D.5 below.

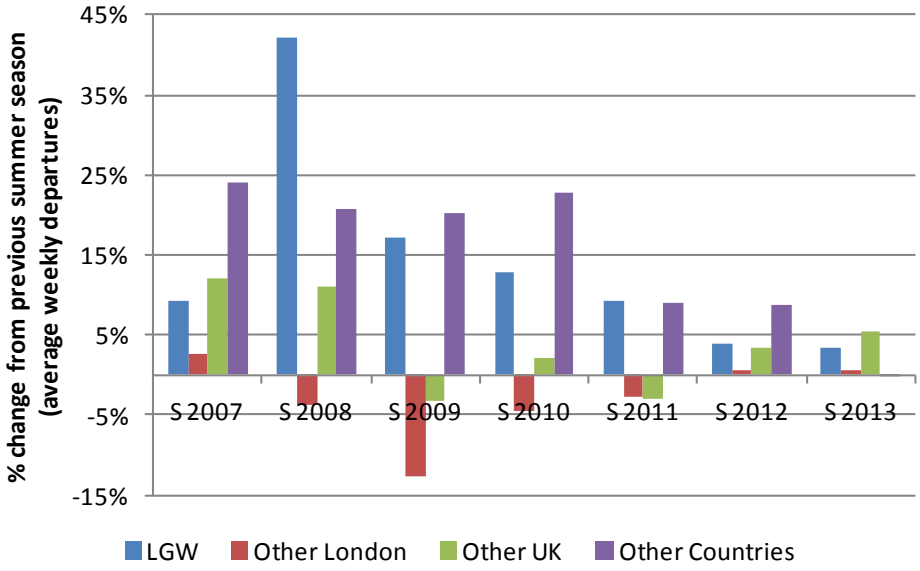
Figure D.4: Growth in Ryanair and easyJet weekly departures by Geographic area

Source: CAA analysis of OAG scheduling data

arguments related specifically to competition between hub airports for connecting traffic. The CAA considered that these arguments are of limited relevance to assessing the market position of GAL given the limited switching and the lack of an airline operating Gatwick as a hub operation.

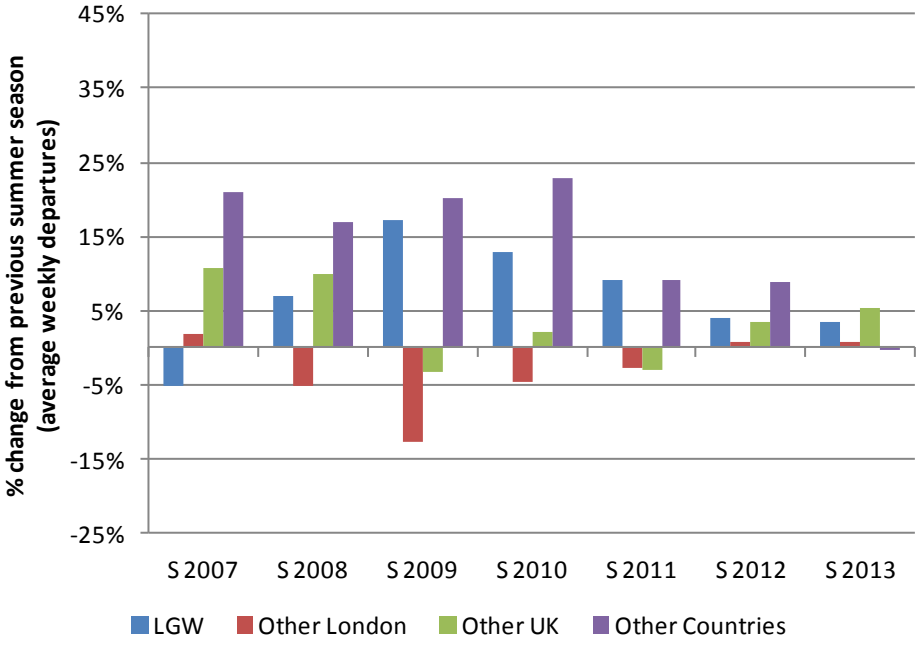
124 MAG, Civil Aviation Authority Stansted Market Power Assessment; Interim response of MAG to the CAA's 'minded to' document 24 May 2013 (Appendix A).

Figure D.5: Proportional growth in Ryanair and easyJet weekly departures by Geographic area



Source: CAA analysis of OAG scheduling data

Figure D.6 Proportional growth in Ryanair and easyJet weekly departures by Geographic area adjusted for GB Airways merger



Source: CAA analysis of OAG scheduling data

D205 Figure D.6 adjusts the data to take account of easyJet takeover of GB airways, as although new to the easyJet network, the routes would have already been in operation at Gatwick. As can be seen from the figures above, this significantly reduces the increase in departures from Gatwick from 2007 to 2008.

D206 These figures also show that for GAL, Ryanair and easyJet have between them added additional departures from Gatwick since summer 2007. Departures have also been added across the UK and more widely in Europe whereas 'other London airports' saw a decline in departures.

D207 The CAA does not consider that the figures show that GAL faces a strong competitive constraint from European airports. The CAA notes that this data highlights the European scope of the LCC networks and their ability to procure and deploy aircraft across that network. In particular:

- The data is insufficient to show switching to or from Gatwick as it does not tackle flows. It does however show growth in services at Gatwick and other non-London airports. It also shows a decline in services from other London airports.
- The data does not take account of the possible demand side conditions in downstream air transport markets. The low and negative changes in weekly departures at other London airports from S2008 to S2012 could be explained by the performance of the UK economy against countries served by the rest of the LCC's networks. The CAA is aware that traffic fell across the London airports as a result of the financial crisis and recession; Stansted saw a considerable fall in demand and has not yet recovered previous traffic levels.
- It is not clear whether the growth seen in Europe could have rationally been supported by developing operations from Gatwick instead. Neither does the analysis consider the impact that this would have had on the airlines' position against its rivals in other markets.

D208 MAG's argument also assumes that airlines are limited in their ability to procure aircraft and open bases, such that a route would only be opened, and aircraft diverted, if it were more profitable than current options. Profitable routes would close so that aircraft may service more profitable routes, which may be indicative of a wider airports

market. In the absence of airline assets being fixed it would be expected that all profitable routes would currently be served.

D209 The CAA does not consider that airlines are, in general, constrained in their choice of airport by either the number of aircraft or bases that they can operate, as MAG has suggested. The CAA considers that airlines are able to procure aircrafts through purchasing from manufacturers,[125] or from other airlines and/or engaging in leasing agreements. This being the case, the CAA also considers that the decision to open up new bases or deploy aircraft on particular routes would be driven by individual route or base profitability. The CAA notes that a route has to be profitable (not more profitable than an existing route) to be operated; if a route is unprofitable it would close.

D210 MAG also presented a range of statements from Ryanair and easyJet on the flexible nature of their business models and their European approach.[126] The CAA considers that these statements are consistent with those from a company that operates a pan-European business and has a presence in a number of different markets.

D211 If airlines did close profitable routes as suggested in paragraph D212 (above), the CAA would expect that route yields would converge, as an airline seeks to rapidly maximise its portfolio return. However, in reviewing easyJet's route yield[127] it is clear that easyJet maintains routes on a continuum of differing returns, including some with negative returns.[128] In an investor presentation easyJet noted the role that low performing routes play:[129]

- Supporting corporate strategy and providing a wider product range.
- Competitive battles.

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125 Airbus forecasts that from 2012-2031 that it will supply 5,700 aircraft to European airlines. It estimates that 40 per cent of deliveries over this period will be for replacement with the remainder for growth. See: Airbus, Global market forecast; navigating the future 2012 to 2031, pp. 40 to 41, available at: http://www.airbus.com/company/market/forecast/ accessed 4 March 2013.

126 MAG, Civil Aviation Authority Stansted Market Power Assessment; Interim response of MAG to the CAA's 'minded to' document 24 May 2013 , paragraphs 4.23 to 4.29.

127 easyJet Investor presentation, May 2013, 31 January 2012 and Analyst and Investor presentation, 15 November 2013.

128 The CAA notes that it has only observed average yields. Its expectation is that marginal yields are likely to be lower as additional capacity would, all else being equal, be expected to reduce prices.

129 easyJet Investor presentation 31 January 2012, easyJet half year results analyst and investor presentation 9 May 2012.

- Retaining strategic slots or achieving volume deals at high performing airports.
- Completing a high performance line of flying.[130]

D212 This implies that there is likely to be a certain 'stickiness' of routes at airports. Routes that would otherwise appear marginal may be retained for strategic reasons and individually unprofitable routes may be maintained where they are acting to the benefit of the network or other flights i.e. by maintaining high asset utilisation.

D213 The CAA recognises that network yield optimisation of LCCs involves a degree of switching assets between differing markets across Europe. This ability to yield manage across a range of markets is likely to provide some degree of constraint on airport operator pricing. However, when moving capacity from Gatwick to a European airport, more so than to a neighbouring UK airport, the airline will be giving up on its competitive position at Gatwick and the customers it serves. The CAA considers that this is not so much switching as market exit, which is a valid response to a SSNIP.

D214 For all the reasons above the CAA does not therefore consider that the market should be widened to include European airports.

Airport operators' views

D215 GAL's response to the Consultation supports the position it has taken in its previous representations to the CAA.[131] GAL considers that it competes with a number of airports within the UK especially those in the south east of England, namely Heathrow, Luton, Stansted and London City, and considers that the market could be broader than outlined in the Consultation.[132] GAL argues that its view is consistent with geographic market definitions previously used by other authorities, including the CC,[133] previous CAA considerations, the OFT, the Department for Transport and the EC.[134]

130 Line of flying refers to the utilisation of the aircraft assets.

131 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013 paragraphs 3.27 to 3.49.

132 Source: GAL, [✂].

133 GAL, Airport Competition: Competing to Grow and become London's airport of choice, November 2011, Ref: Q5-050-LGW05, pages 21-24.

134 Source: GAL, [✂].

D216 On this basis, GAL submitted that Gatwick's passenger market share is no more than 25 per cent of the south east England market. It also noted that dominance is very rarely found by competition authorities at market shares below 30 per cent and, therefore, considers it is incumbent on the CAA to provide exceptional and compelling reasons in support of any finding that GAL has SMP.[135]

D217 GAL's statements about competition with other airports are not underpinned by a structured market analysis and the extent to which marginal customers will move in response to a SSNIP. In addition, GAL's evidence focuses on the ability of passengers to switch, not on the key relationship between airlines and the airport. The CAA considers passenger switching and its implications for market definition below.

D218 GAL has submitted evidence with regards to airline switching (discussed in the instances of switching section below). It has also made references to development of airlines.[136] The CAA does not expect fleet or carrier mix to remain constant. For example, the CAA is aware of GAL's efforts to incentivise the use of larger aircraft at the airport; which was the key issue in a recent S.41 complaint.[137]

D219 In 2012, LLAOL stated that it considered it competed with GAL for airlines rather than for passengers. LLAOL considered its size limits its ability to compete for passengers. Furthermore, LLAOL noted that:

- the demographics of the Gatwick catchment area are identical to those of Luton but there was a perception that Gatwick's catchment area was better and delivered higher yields; and
- it is possible that the higher yields at Gatwick are (at least in part); a result of the strength of airline brands at the airport and in particular the legacy airlines.[138]

D220 HAL presented regression analysis which suggests that it faces different demand conditions to GAL and therefore their respective

135 Source: GAL, [✂].

136 Source: GAL, [✂].

137 CAA (2013), Investigation under Section 41 of the Airports Act 1986 of the structure of airport charges levied by Gatwick Airport Limited - CAA decision; APD 13 url: http://www.caa.co.uk/docs/5/S41GatwickFlybeDecision.pdf

138 Source: LLAOL.

airports are not substitutes.[139] HAL has also submitted evidence that compared Heathrow to Gatwick, including:[140]

- 99 per cent of air transport services from Heathrow are delivered by FSCs compared to 36 per cent at Gatwick;
- the average fare at Heathrow is three times higher; and
- the yield at Heathrow is 30 per cent higher.

D221 MAG has also indicated that it considers Stansted competes with Gatwick and other airports across Europe.[141] Previous responses from STAL suggest that it is actively seeking to attract airlines from Luton and Gatwick as well as other UK and European airports, and that it has lost airlines to Gatwick.[142]

Airline views

D222 This section considers the views of airlines and observed switching. The section is split into substitutability by airport.

D223 In late November 2013[143] the CAA was formally made aware that GAL had entered into commercial negotiations with airlines under the proposed regulatory commitments framework. A full discussion of these is provided in appendix G in summary the CAA considers that:

- The negotiations are a result of the incentives on GAL resulting from the proposed regulatory framework.
- They are conditional upon the regulatory outcome in that they indicate that absent the CAA's acceptance of the regulatory commitments and the price in them, the agreements do not apply.

D224 The CAA consulted the affected airlines on whether these negotiations changes their evidence submitted as part of this assessment. The airlines that responded did not consider that it was the case and further that the discussion had been entered as a result of the proposed regulatory framework.

139 HAL, Response to the CAA's consultation on the Initial Competition Assessment, March 2012.

140 Source: HAL, [✂].

141 MAG, Civil Aviation Authority Stansted Market Power Assessment; Interim response of MAG to the CAA's 'minded to' document 24 May 2013, paragraph 3.9(a) and 3.9(b).

142 Source: Stansted, [✂].

143 GAL, email to Iain Osborne from Kyran Hanks, 21 November 2013 at 17:12.

D225 The CAA also notes that these negotiations which include requirements for both growth and the maintenance of current traffic come at a time when a number of airlines common Gatwick and Stansted have formally signed deals for growth with STAL. The CAA considers that this suggest the airports are being developed as complements.

D226 The CAA does not consider that the bilateral negotiations affect its market definition analysis.

Substitutability between Gatwick and Heathrow

D227 The CAA has consistently considered that there is a level of substitutability between Gatwick and Heathrow.[144] Furthermore, it has considered that it is likely that Heathrow provides an asymmetric restraint to Gatwick i.e. Heathrow constrains Gatwick but not vice versa.

D228 The limited substitutability between Gatwick and Heathrow is supported by the response from VAA to the Initial Views, where it noted that:

whilst [the CAA analysis] suggests that Gatwick appears to compete with Heathrow for long-haul leisure destinations, this competition will in reality be limited by available capacity at Heathrow which acts as a barrier for entry.[145]

D229 In further submissions, in response to questions on the substitutability of Heathrow for Gatwick, VAA has also noted that:

It is Virgin Atlantic's experience that Gatwick fails to act as a suitable substitute for Heathrow, but to a large extent Heathrow may be a competitor to Gatwick. Particularly amongst business passengers, Heathrow acts as an appropriate substitute for Gatwick due to its demographic profile, greater access, convenience, timesaving and route availability. For leisure passengers there is evidence that a degree of competition exists between the airports, however this should not be exaggerated.

... it is Virgin Atlantic's belief that if we were able to move all services that we currently operate from Gatwick to Heathrow virtually all current passenger traffic would transfer with these services

...If Virgin Atlantic were able to move services from Gatwick to Heathrow, the services would retain current levels of transfer traffic.

144 The Initial Views, paragraph 2.190 and The Consultation, paragraph 5.246.

145 Source: VAA, [✂].

Indeed, Virgin Atlantic would expect that the number of transfer passengers of any services moved to Heathrow would increase, due to its greater transfer potential. This further exemplifies the ability of Heathrow to act as a commercially appropriate substitute for Gatwick. When Virgin Atlantic has previously switched services from Gatwick to Heathrow, it experienced a positive effect on yields

Capacity constraints are a key limitation on substitution. Virgin Atlantic would want to move more of its services to Heathrow, but has been unable to do so because of a lack of runway slots.[146]

D230 VAA has also supplied the CAA with quantitative analysis which suggests that [✂].[147] This evidence supports the CAA's view that Heathrow provides an asymmetric constraint to Gatwick.

D231 In addition, VAA has noted that it operates effectively separate fleets for its Gatwick services than those from Heathrow.[148] The leisure fleet from Gatwick uses aircraft with around 14 Upper Class seats. However, the Heathrow fleet consists of aircraft with between 33 and 45 Upper Class seats providing a greater premium offering.[149]

D232 Air Malta flies from Heathrow, Gatwick and Manchester to Malta with a mainly leisure product and is an unaligned airline. Originally, Air Malta operated exclusively from Heathrow. However, due to limited availability of slots, which meant that it could not grow, it commenced operations from Gatwick.

D233 Air Malta has indicated that if there was a significant expansion of capacity at Heathrow, it would develop its operations there. However, it also noted that, at this stage it wasn't sure whether this would be at the expense of Gatwick (i.e. removing its frequency from Gatwick altogether).[150]

D234 Air Malta also indicated that the main difference between Heathrow and Gatwick is the level of connectivity: [151]

- The level of connectivity at Gatwick is much more limited than at Heathrow (i.e. far fewer transatlantic flights).

146 Source: VAA, [✂].

147 Source: VAA, [✂].

148 VAA uses the same fleet for its flights from Manchester and Glasgow.

149 Source: VAA, [✂].

150 Source: Air Malta, [✂].

151 Source: Air Malta, [✂].

- If it uses Heathrow, it not only can connect to the UK, but internationally as well (to important markets in the US, Canada, Australia, Japan etc).
- Its passengers prefer Heathrow.

D235 When questioned by the CAA on its possible reaction to a 5 to 10 per cent price increase at Gatwick, Air Malta noted:[152]

- [✂].

D236 BA considers that there are significant switching costs in their operation, which would mean that the movement of marginal traffic between airports may be unfeasible.[153] For example, BA has indicated:

It is clearly not viable to move our LHR operation, for a number of reasons, including the lack of sufficient hub capacity in the London market area. Similarly, our Gatwick operation has [✂] short haul aircraft and [✂] long haul aircraft. We do not believe that there is an airport suitable for our services and passengers with the capacity to absorb this size of operation in the London market area. [154]

D237 BA has also noted the different ways in which its operations are organised at Gatwick noting that BA's Gatwick operation is now also run as a separate business unit. BA considers that its Gatwick operation is not scheduled as a hub (i.e. flights are not timed to provide feed to each other), but is operated on a point-to-point basis which focuses on serving Gatwick's surface catchment passenger demand. BA's Heathrow operation is however operated as a hub. As a result connecting traffic (approximately [✂]) is not as significant as at Heathrow – but it does make an important contribution to the overall profitability.[155]

D238 Furthermore, BA considers that the market is limited by its client base and has indicated:

Although British Airways regards the London area as a single market, our premium customers are not equally distributed across the south east.

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152 [✂]

153 The CAA interprets this to mean the switching of marginal routes to airports at which BA does not currently operate.

154 Source: BA, [✂].

155 Source: BA, [✂].

Our analysis of [✂].

Our analysis also shows that the further away from the three London Airports that BA serves these premium passengers are, then the [✂]. *.... We see London area as a single market BUT [...] the areas extending to [✂] have the greatest number of high value customers, this implies that were we to consider moving traffic away from LGW or LHR then we would have to rebase to one of the airports in the South or East of the South East or risk losing premium traffic. Or alternatively we could only move our non-premium traffic, which again would risk incurring heavy fixed costs for [✂].*

In any event, the location of LHR and LGW and our established premium customers with their propensity to travel, severely limits our ability to move traffic from LHR and LGW. [156]

D239 Cathay Pacific, which does not currently fly into Gatwick but operates daily services from Heathrow to Hong Kong, has indicated that:

Although LGW has recently improved, LHR remains the preferred airport for passengers flying out of London. LHR is well-connected into the centre of London. It first started flying to London in the 1980s into LGW, but its passengers made it clear that they prefer LHR and CP switched when they got the opportunity.[157]

D240 Delta, an American carrier operating between Heathrow and a number of cities in the USA, has recently stopped its services from Gatwick and moved them to Heathrow. When questioned about this move it stated that:

Many corporate companies are in the central London area and LHR is better placed to serve these pax due to the good transport links (such as the Heathrow Express), hotels and other facilities etc. LHR is the preferred London airport; it is where business passengers are. LGW is a great airport with great facilities and good links with the Gatwick Express, but LHR is closer and perceived to be the London airport.[158]

D241 Furthermore, Delta noted that:

There is a long history of competition evaluation between LHR and LGW in ascertaining whether they are substitutable, and this has found that they are not. The overwhelming conclusion is that business

156 Source: BA, [✂].

157 Source: Cathay Pacific, [✂].

158 Source: Delta, [✂].

travellers prefer LHR which is why it is prepared to absorb large leasing costs in order to operate from there. Furthermore, as it has a relatively small footprint, it would be quite awkward to operate from two airports.[159]

D242 Emirates, which is based in Dubai and operates three daily flights from Gatwick and five daily flights from Heathrow, has indicated that:[160]

- *Heathrow and Gatwick appeal to separate markets but to the extent that they are substitutes, this appears to be one-way.*
- *There is a geographic and market distinction between Gatwick and Heathrow in that they both serve different catchments and markets.*
- *Gatwick has built a reputation as a "leisure-based airport" for charter airlines. And that while this perception is deep rooted, it is slowly changing under Gatwick's new ownership.*
- *There is a huge catchment overlap between the Gatwick and Heathrow (i.e. areas such as Guildford), but Gatwick serves a separate market: serving the south coast is its "winning card" as this is where Emirates consider that the core population resides.*
- *Heathrow has significant inbound carrier traffic feed and is business-focused. Heathrow has higher yields due to the better concentration of business passengers and better connectivity to the USA, Canada and Europe. On the other hand Gatwick is a UK originating airport for Emirates (with 65-70% of passengers connecting onwards at Dubai) and is leisure-focused.*[161]

D243 Flybe has made representations to the CAA suggesting that Gatwick constitutes a market in itself.[162] The evidence suggests that Flybe faces substantial barriers to switching arising from the sunk costs of its investments in establishing a network of services at Gatwick. Flybe also mentioned that it faces substantial barriers to entry at Heathrow and that slot constraints at Heathrow would prevent the airline from:

159 Source: Delta, [✂].

160 Source: Emirates, [✂].

161 Source: Emirates, [✂].

162 Source: Flybe, Complaint to the Civil Aviation Authority under section 41 Airports Act 1986 paragraph 3.9, March 2011.

being able to construct a weekly timetable for its regional services which would be timed consistently day by day and operate at times which fitted the relevant markets and were operationally achievable.[163]

D244 Lufthansa, which operates from both Gatwick and Heathrow, has indicated that it considers each airport to be a market within itself for the airport's own core catchment. It also noted that its motivation for commencing a service from Gatwick was to service Gatwick's catchment more directly, providing feeder and point to point traffic into Frankfurt.[164] However, it also noted that it would not move away from Heathrow due to the considerable switching costs involved and the presence of the Star Alliance at Heathrow.

D245 Monarch, which operates scheduled and charter services from Gatwick, has indicated that it does not regard Heathrow as an alternative option to Gatwick due to higher charges and lack of slot availability at Heathrow. It also noted that its leisure business does not fit with the mix at Heathrow and that Gatwick has a reputation as a holiday destination airport. In addition, it noted that Gatwick has a very big pull for tour operators with a wider choice of charter operators as it acts as a consolidated charter and package holiday airport.[165]

D246 The CAA considers that the evidence on the substitutability between Gatwick and Heathrow shows that each airport possesses a strong and different brand and that this is reflected in the demand for and use by the airlines and impacts on the substitutability of the airports. The CAA notes that Gatwick is considered by airlines as being leisure focused and point to point whereas Heathrow is considered the business airport and is operated as a hub. For example, the evidence from BA suggests that its premium customer base is present mostly in the areas close to Heathrow. Similarly, VAA operates a fleet with different specifications to serve Gatwick demand compared to those that it uses at Heathrow.

D247 Based on the evidence outlined above, the CAA considers some that airlines would switch from Gatwick to Heathrow if there was sufficient capacity there because it may be financially beneficial for them to do so. However, given the differences in airport brand and usage, it also considers that the evidence does not appear to suggest that airlines would consider moving from Heathrow to Gatwick at this time. The

163 Source: Flybe, [✂].

164 Source: Lufthansa, [✂].

165 Source: Monarch, [✂].

evidence also suggests that Heathrow is a superior or preferred product to Gatwick for some carriers.

Airline switching from Gatwick to Heathrow

D248 This section considers actual switching observed between Gatwick and Heathrow. The dates of switching that has occurred is outlined below:

- October 2009, BA closed a number of services from Gatwick and switched some further services back to Heathrow.
- May 2011, Qatar Airways pulls out of Gatwick for Heathrow.
- April 2012, Delta pulls out of Gatwick for Heathrow.[166]
- March 2013 US Airways switching Charlotte service from Gatwick to Heathrow.
- BA has switched a number of routes between Gatwick and Heathrow between 2010 and 2012. These switches have not altered the disposition of BA's aircraft.

D249 Where possible, the CAA has sought to ascertain the motivations behind the observed switching behaviour – it has, however, only been able to do this with respect to Delta and BA.

D250 Delta recently switched its operations from Gatwick to Heathrow. The reasons for this move were detailed earlier, however,. in summary, Delta's switch appears to have been to secure passenger demand. Importantly, this move was did not occur due to changes in relative price or quality. Indeed, Delta has commented on the good quality of Gatwick's facilities:

Gatwick is a great airport with great facilities and good links with the Gatwick Express, but Heathrow is closer and perceived to be the London airport.[167]

D251 BA has provided the CAA with information relating to changes within its routes at Gatwick and Heathrow between 2010 and 2012. There have been six routes moved. In the business cases supporting the decision to undertake these swaps, the switching of routes from Gatwick to Heathrow appear to be where BA has evaluated a network benefit; the route contributes additional connecting passengers. The switching of routes from Heathrow to Gatwick appear to be where BA has evaluated

166 Source: GAL, [✂].

167 Source: Delta, [✂].

that the route better fits a leisure point-to-point travel without a requirement for connecting passengers.[168] In all the route switches observed, no assets have been moved and all switches out have been backfilled[169].

D252 This evidence shows switching from Gatwick to Heathrow. The only observed switching in the opposite direction has been by BA as part of its network optimisation, which is consistent with the existence of asymmetric constraints between Gatwick and Heathrow and the development of different demand characteristics at each airport. In other words, although Heathrow may be a substitute for Gatwick, Gatwick appears to impose little pricing constraint on Heathrow. The observed switching evidence is supportive of the evidence presented by airlines in their written responses.

Substitutability with Stansted and other regional airports

D253 As noted in the product market definition section (above), Stansted has the requisite infrastructure for the provision of services to FSCs as well as LCCs and, in theory, could be a potential competitor to Gatwick.

D254 However, the CAA has been provided with evidence that suggests that Stansted is not regarded as a viable substitute due to its weaker catchment area and lower connecting passenger feed, (especially as Stansted's current customers (which are predominantly LCCs) are more interested in serving point-to-point passengers rather than in providing interlining services).

D255 The relative unattractiveness of Stansted is occurring despite significant efforts made by STAL to attract FSC traffic (efforts that appear to have increased since MAG's purchase of STAL). In one particular case, STAL's efforts were unsuccessful for the following reasons: [170]

- The Stansted catchment was not considered to support the level of traffic needed given the type of routes operated.
- Insufficient opportunities for interlining at Stansted.
- Significant switching costs due to previous investment at Gatwick.

168 Source: BA response to S50 request, 6 August 2013.

169 Where routes are backfilled there is limited impact on the airport as passenger numbers are maintained.

170 Source: [✂].

D256 BA has similarly indicated that it would not consider Stansted as a substitute for Gatwick as:

- Stansted has no feed, a less convenient location for BA's existing Gatwick passengers and no current BA presence.
- Stansted is 72 miles from Gatwick and passengers want to travel from their local airport and are only willing to travel further if it is cheaper.
- BA cannot switch its base at Gatwick because of its sunk investments in infrastructure, crew base, community ties and loyal passenger base.[171]

D257 easyJet, the largest airline operating from Gatwick, has also submitted evidence to the CAA that deals with issues associated with substitutability. Strategy papers from easyJet suggest that they view London as a series of discrete catchments with limited overlap. Indeed some evidence suggests that it focuses on a relatively small catchment area of up to [✂] minutes, with airports having unique [✂] minute catchments.[172]

D258 When questioned by the CAA on whether Luton and Stansted are perceived as possible alternatives to Gatwick, easyJet noted:[173]

- *It views them as separate markets as each has their own demand and catchment areas.*
- *There is some overlap in these catchment areas and in choice, but this does not impact upon easyJet's core business.*
- *There is marginal competition between airlines at other London airports. For example, someone living in Guildford has the choice to go to Gatwick or Heathrow and easyJet will compete with BA for those passengers.*

D259 The CAA has also seen evidence from easyJet which shows a clearly differentiated strategy for the North London airports and Gatwick. These support its representations[174] where it stated that:

171 Source: BA, [✂].

172 Source: easyJet, [✂].

173 Source: easyJet, [✂].

174 Source: easyJet, [✂].

The market is characterised by a [✂] where continued growth in [✂]. Growth in [✂] due to a wide range of external and internal factors such as competition, market share as well as airport infrastructure issues.[175]

D260 In June 2013, it was announced that STAL and easyJet had signed a growth deal that could see easyJet's traffic at Stansted double.[176] This deal would see easyJet growing by three million passengers at Stansted over the five year term of the deal. easyJet also recently purchased 25 slot pairs at Gatwick from Flybe for £20 million[177], which would see easyJet grow by two million passengers a year at Gatwick.[178] This shows a significant commitment from the airline to grow its operations at both of these airports. This is consistent with the easyJet evidence that Gatwick and Stansted serve separate markets.

D261 Emirates, which operate services from Dubai to the UK out of Gatwick, Birmingham, Glasgow, Heathrow, Manchester and Newcastle,[179] noted that its regional operations were not substitutable with those in London as its operations in London were vital given its magnetic appeal to passengers from around the world. It also noted that it does not regard Stansted as a viable alternative at present due to its difficult poor transport links, small catchment (even though some of it overlaps with Heathrow and Gatwick) and geographical location.[180]

D262 Flybe indicated that it does not consider that Luton, Stansted or London City are effective substitutes for Gatwick, as it needs to cater for:

- a local market which can provide a core of regular passengers;
- passengers' whose origin or destination is central London; and
- those who are travelling onwards from a regional point.[181]

D263 In addition, Flybe noted that all three airports are situated to the north and east of London. As a result, Flybe considered that the airports

175 Source: easyJet, [✂].

176 See: http://www.stanstedairport.com/about-us/media-centre/press-releases/easyjet-sign-long_term-deal-to-double-traffic-at-stansted (accessed 18 October 2013).

177 See http://www.flybe.com/corporate/media/news/1305/23.htm

178 This estimate is based on Flybe carrying 1.1 million passengers into Gatwick in 2012 and CAA estimate of easyJet being able to derive a further 1 million passengers in developing those slots. See CAA Gatwick final proposals, paragraph 3.25.

179 Route Map, Emirates.com (accessed 13 February 2013).

180 Source: Emirates [✂]. Emirates have since noted that it expects the new owners of Stansted to improve transport links to the airport.

181 Source: Flybe, [✂].

enjoy a much smaller local natural market (subject to greater competition from rail and car) than Gatwick, which attracts strong flows of traffic with origins and destinations to the south of the airport. Furthermore, Flybe considered that interlining opportunities are virtually non-existent at Luton and Stansted.[182]

D264 Flybe also indicated that London City is a different type of airport from Gatwick and, as well as being geographically distant from Gatwick, it would not provide the benefits to users which Gatwick historically provided.[183] In later discussions with the CAA, Flybe expanded on this point and stated that operating from London City did not provide access to south London and the South coast; or opportunities for connecting business and leisure traffic.[184]

D265 The CAA questioned Flybe over the possible use of Southampton[185] as a substitute for Gatwick. In response, Flybe noted that it considers Southampton as a complementary operation to Gatwick; as most of the routes it flies from Gatwick are also flown from Southampton. A recent study conducted by Flybe also suggests that it would be unable to service their Gatwick routes from Southampton.[186]

D266 Monarch gave evidence that, although it has operated from Stansted in previous years, it does not regard it to be a viable alternative to Gatwick because of its location. Similarly, it does not regard Luton as a substitute because of its short runway.[187]

D267 Ryanair has stated that:

Ignoring capacity constraints in any consideration of airport substitutability only leads to incorrect conclusions. In the case of London airports, LHR, LGW, LTN and LCY are substitutable but are fully utilised (or fully utilised in peak periods in the case of LTN), and where planning and policy constraints prevent the addition of new airport capacity at these airports, airport substitutability cannot be assessed in ignorance of these facts.

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182 Flybe, Complaint to the Civil Aviation Authority under section 41 Airports Act 1986, March 2011.

183 Flybe, Complaint to the Civil Aviation Authority under section 41 Airports Act 1986, March 2011.

184 Source: Flybe, [✂].

185 Southampton airport is a similar travel distance from Gatwick as Luton and Stansted airports. It is also a significant base for Flybe.

186 Source: Flybe, [✂].

187 Source: Monarch, [✂].

...The European Commission has ruled that LHR, LGW, LTN and LCY are substitutable but capacity constraints mean that Ryanair cannot move there.[188]

D268 Ryanair's statements show that it considers there is to some extent a generic London airport product. However, Ryanair highlights that the opportunities for substitutability between London airports are constrained to a high degree by an absence of spare capacity and congestion. Ryanair goes on to consider that:

To the extent that there exists a very limited room for growth at the London airports that are suitable for Ryanair's operations, these airports are only partially substitutable for STN. The reason for this limited substitutability is the fact that each of these three airports [Stansted, Luton, and Gatwick] serves a distinct catchment area (with only a limited overlap), with customer bases of different levels of affluence and propensity to travel by air, as well as the fact that each of these three airports has a different appeal for inbound traffic to London.[189]

D269 Ryanair also doubts whether passengers originating from Stansted's catchment area to the north of London consider Gatwick as a suitable substitute for Stansted.[190]

D270 The evidence that the CAA has considered in relation to the development of easyJet's Southend operation also shows that easyJet was not concerned over impacts that the development may have on its operations at Gatwick.[191]

D271 Thomson Airways, part of TUI Travel PLC, considers that Gatwick is a must have airport for charter operators and is an important airport for UK business. Gatwick has a London area catchment, and in spite of the north/south barrier where passengers south of the Thames do not typically travel north to fly from Luton or Stansted, Gatwick has a pull even in the north of London. Another factor in the attractiveness of Gatwick is that it is situated in an affluent part of the UK, and also proximate to a capital city, which means there is a considerable feed of inbound passengers from other airlines to the area.[192]

188 Source: Ryanair, [✂].

189 Source: Ryanair, [✂].

190 Source: Ryanair, [✂].

191 Source: easyJet, [✂].

192 Source: Thomson Airlines, [✂].

D272 Thomas Cook, which has its own airline as part of its overall holiday business, shared similar views to Thomson. Thomas Cook explained that Gatwick is important for charters. It has a large catchment area, its customers are comfortable with the airport, there is a familiarity in their customer base as to the routes it offers, and Gatwick holds a good brand. Thomas Cook noted that it is possible to fly from Stansted but the catchment is small and local. It also does not have a reputation for being a holiday departure point and considered that Stansted is a LCC airport. Further, it does not consider it could sustain a single aircraft at Luton despite the fact it is considered a holiday airport.[193]

D273 Wizz, an inbound LCC, had considered other London airports when deciding to open operations at Luton. Of the airports it considered, it considered Heathrow was the least accessible due to high costs and the scarcity of suitable slots. That is consistent with the CAA's view that Heathrow, even if a potential asymmetric constraint, is not an effective substitute in practice do to capacity constraints and other barriers to entry. By contrast, Gatwick, Luton and Stansted were a much better strategic fit for Wizz's business model.[194]

D274 Wizz illustrated to the CAA the decision-making process it undertakes when considering switching between airports key considerations were:

- The extent of catchment overlap between the airports
- The impact of growing a route at the new airport on the airline's existing services at its current airport and the impact of growing an existing service at that airport, e.g. how many passengers would follow a service moving from one airport to another, and how much of the passenger base would need to be rebuilt if the service was moved.
- The impact at their current airport of switching some services to a new airport. For example, if Wizz switched a route/part of its network to a new airport, another airline may enter at the current airport on the route(s) previously served by Wizz.

193 Source: Thomas Cook, [✂].

194 Source: Wizz, [✂].

- Additionally considering their downstream competition with beginning operations at an airport where the same route(s) were already operated by a competitor with significant capacity results in increased competition on these routes at that airport. This could drive down fare levels and profitability of each airline's operations on the relevant routes.

D275 Wizz also considered that:

- Luton and Stansted catchments overlap and both airports predominantly have LCCs and are in competition with each other. Their catchment overlap covers approximately 60 to 70 per cent of Wizz's passenger base.
- Heathrow's catchment overlaps with that of Luton but it is highly capacity constrained and serves a different airline segment (namely long haul).
- Gatwick has lower degrees of overlap with the rest of the London airports than Luton and Stansted, due to its location in the south of London. Its catchment overlaps with approximately 30 to 40 per cent of Wizz's Luton catchment.[195]

D276 The evidence presented by airlines on the substitutability for Stansted and other regional airports suggests that there is limited substitutability between Gatwick and these airports. These considerations appear to be built around Gatwick's location, the wealth of its catchment, yield, surface access links, alliance operations and Gatwick's strong brand for leisure services. A number of airlines have commented on a north south divide in that passengers currently using Gatwick would not switch to using the airports north of London. Evidence from Wizz does however suggest that Luton and Stansted may be substitutable for Gatwick.

D277 As well as the easyJet deal, the CAA is aware that STAL has been successful in securing growth deals with a number of other airlines.[196] Some of those airlines are common to both Gatwick and Stansted. The CAA regards this as evidence that airlines are developing Gatwick and Stansted as complementary operations not substitutes.

195 Source: Wizz, [✂].

196 STAL, Response to 28 June 2013 S.50 request, Hogan Lovells letter to John Templeton 30 July 2013, and STAL, Tim Hawkin's letter to John Templeton 20 September 2013.

Switches between Gatwick and Stansted

D278 This section considers actual switching observed between Gatwick and Stansted. The dates of switching that has occurred is outlined below:

Stansted to Gatwick

- Mid 2009, Norwegian moved its entire operation from Stansted to Gatwick.
- February 2011, Air Berlin moved two of its five Stansted routes to Gatwick.
- October 2011, Air Asia X switched from Stansted to Gatwick. The service was cancelled in April 2012.

Gatwick to Stansted

- April 2013, Air Moldova switched its limited twice weekly service from London to Chișinău from Gatwick to Stansted.[197]

D279 Where possible, the CAA has sought to ascertain the motives behind the observed switching behaviour. Norwegian indicated that it moved from Stansted to Gatwick due to:

- Gatwick's good connectivity and transport links to London; and
- its improved ability to attract business passengers from Gatwick, compared to Stansted, which is more leisure orientated and associated with LCCs.

D280 Norwegian also indicated that it did not consider Luton as an alternative as it is unknown in Scandinavia and the facilities at London City were not compatible with its aircraft. It also considered that the limited ability for it to grow at Heathrow due to slot constraints and the excessive costs of entry made Heathrow unsuitable for its operations.[198]

D281 Since moving to GAL Norwegian operation has increased and in October 2013 it announced that it would be operating long-haul routes from Gatwick.[199] Additionally GAL has recently announced the signing

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197 Reported in the press and on STAL's website, the CAA has not been able to discuss the motivations for this move with the airline, see: http://www.stanstedairport.com/about-us/media-centre/press-releases/new-airline-for-new-stansted-owners (accessed 29 April 2013).

198 Source: Norwegian, [✂].

199 See: http://media.norwegian.com/en/#/pressreleases/norwegian-launches-new-routes-from-london-gatwick-to-new-york-los-angeles-and-fort-lauderdale-918430

of a bilateral agreement under the proposed regulatory commitments framework with Norwegian.[200]

D282 Air Berlin switched traffic in recent years from Stansted to Gatwick. Airport charges were given as a secondary concern in its switching decision; its primary consideration was the level of passenger demand available at the airports, noting that Gatwick and Stansted have different catchment areas. It was also influenced by the fact that Gatwick is a base for its One World alliance partners.[201] Air Berlin has since closed some routes from Gatwick.

D283 In October 2011, Air Asia X[202], which flew limited services between Kuala Lumpur and London, switched its services from Stansted to Gatwick. It noted that it did not initially start operating into Gatwick due to restrictions placed on them by the Malaysian Government. The move was based on the following reasons:

- Gatwick is closer to a greater proportion of the London catchment.
- Most of Air Asia X's passengers self connect and Gatwick has more low cost flights to more destinations than Stansted.
- Surface access provision to Gatwick is cheaper than to Stansted.
- Gatwick had a [✂].

D284 Air Asia X also noted that [✂].

D285 The majority of these switches are all moves in the same direction, that is, from Stansted to Gatwick. Only the most recent move by Air Moldova has been from Gatwick to Stansted. The CAA considers that this suggests that, particularly for the time before MAG took control of Stansted, Gatwick has faced little competition from airports north of London. This finding is supported by input from the airlines concerned, which emphasised that the moves were not price-related.

D286 This suggests, similar to the situation with respect to Heathrow, Gatwick may be perceived as a superior or preferred product to Stansted. However, this is not conclusive given the limited degree of switching observed.

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200 See: http://www.mediacentre.gatwickairport.com/News/Norwegian-and-London-Gatwick-sign-landmark-long-term-commercial-partnership-87a.aspx

201 Source: Air Berlin, [✂].

202 Source: Air Asia X, [✂].

D287 STAL has, however, been successful in attracting Aegean Air for the 2013 summer season[203] and it has been reported that Air Blue will commence operations at Stansted in 2014.[204] Although both of these operations are small, and it is unclear whether these airlines had considered developing operations at Gatwick ahead of Stansted, it does demonstrate the ability of STAL to provide the required services to these types of airline.

Switches from Gatwick to regional airports

D288 This section considers actual switching observed between Gatwick and regional airports. The dates of switching that has occurred is outlined below:

- November 2011, SAS ceased operations from Gatwick, to provide services at Manchester.[205]

D289 The CAA has not discussed this switching with SAS but considers that this move constitutes a switch out of the market. Although a move out of a market is a valid response to a price rise, and may discipline the airport operator's pricing, the CAA does not consider this evidence is sufficient to widen the market to include regional airports, such as Manchester.

New services or closures at Gatwick

D290 This section considers new services opening and route closures at Gatwick. The dates of these openings and closings are outlined below:

- October 2011, Lufthansa opened operations from Gatwick.
- December 2011, Turkish Airlines opened operations from Gatwick.
- December 2011, Vietnam Airlines opened operations from Gatwick.

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203 See: http://en.aegeanair.com/all-about-us/press-office/press-releases/press-release/?prid=429 (accessed 25 October 2013).

204 See: http://www.travelweekly.co.uk/Articles/2013/10/15/45635/stansted+boss+sets+out+vision+for+two+runways.html (accessed 25 October 2013).

205 SAS ceased its Gatwick-Bergen service from November 2011, in January 2012 SAS launched Manchester-Bergen. It has been reported that this new route is effectively a replacement for the Gatwick service. See http://www.breakingtravelnews.com/news/article/sas-to-move-bergen-flight-from-london-to-manchester/ (accessed 6 March 2013).

- March 2012, Hong Kong Airlines opened operations from Gatwick. However the route was cancelled in September 2012.[206]
- April 2012, Air Nigeria opened operations from Gatwick the service was cancelled in September 2012.
- April 2012, Korean Air opened operations from Gatwick. Korean cancelled its winter 2012 flying programme. It was originally GAL's understanding that this was to resume in summer 2013, however GAL, following the launch of a BA route from Heathrow to Incheon, considered that this was uncertain. GAL does however now understand that the Korean route is likely to return in summer 2013.[207]
- May 2012, Air China opened operations from Gatwick.
- March 2013, Vueling to open operations from Gatwick.[208]
- Winter 2013 Air China has cancelled its Gatwick – Beijing route. [209] The CAA has been made aware that this route is due to reopen in summer 2014
- March 2014 Flybe will have terminated all its services currently operated from Gatwick.
- May 2014 Garuda to launch London Jakarta route following delays to the scheduled 2013 launch.[210]
- May 2014 Adria Airways will be resuming operations into Gatwick with two weekly flights from Ljubljana.[211]

206 Hong Kong Airlines' departure from Gatwick was reported within the media as being due to weak overall economic outlook in Europe and the company refocusing on its regional business. See: http://www.travelweekly.co.uk/Articles/Details/41319

207 Source: GAL, [✂].

208 Vueling, press release, October 2012, available at: http://www.vueling.com/en/we-are-vueling/press-room/press-releases/corporate/vueling-network-to-expand-to-100-destinations-from-barcelona-el-prat-airport-in-2013/, (accessed 26 February 2013).

209 See: http://www.routesonline.com/news/29/breaking-news/216529/air-china-cancels-london-gatwick-service-in-w13/ (Accessed 21 October 2013).

210 See: http://www.routesonline.com/news/29/breaking-news/211989/garuda-indonesia-delays-london-launch-to-may-2014/ (Accessed 21 October 2013).

211 See: http://www.routesonline.com/news/29/breaking-news/222087/adria-airways-resumes-london-gatwick-from-may-2014/ (Accessed 21 October 2013).

- July 2014 Norwegian commences weekly services from Gatwick to New York, LA and Fort Lauderdale.[212]

D291 The examples provided by GAL in the list above do not denote switching but rather represent new entry by airlines (and in some cases exit without switching to another neighbouring airport).

D292 Although these new services may indicate that airlines are willing to serve the London area from Gatwick, the CAA has not been able to examine the choices made. New airlines choosing to serve Gatwick rather than Heathrow may be influenced by capacity constraints at Heathrow. For example, HAL has told the CAA that Vietnam Airlines wanted to fly from Heathrow in preference to Gatwick, and HAL was interested in developing the South East Asia catchment, but was unable to offer them any slots.[213]

D293 As noted earlier, Lufthansa opened a service at Gatwick in 2011. This occurred to serve the Gatwick catchment which it perceives as being a complement to its services at Heathrow. However, for the 2012 winter season, Lufthansa removed its Gatwick service due to a lack of demand rather than the level of airport charges.

D294 Similarly, the choice of using Gatwick for new routes, over other airports, such as Luton or Stansted, may be due to airlines not regarding these alternative airports as adequate substitutes, regardless of price.

D295 In response to the Consultation, the CAA received no additional information from GAL or the airlines on the development of new routes at Gatwick and how these should be interpreted. Neither did stakeholders comment on whether new entrant airlines had been gained in preference to other airports.

D296 Since the consultation Norwegian announced its addition of services to New York and other US destinations in the summer of 2014. The service has been launched with particularly low prices and as such the CAA expect that this may have some impact on operators flying Heathrow to New York in the downstream air transport services market for flight from London to New York. However this will represent only a small increase, less than a 2 per cent, in total capacity provided on that route, which will limit its impact. It has been reported that the

[212] See: http://media.norwegian.com/en/#/pressreleases/norwegian-launches-new-routes-from-london-gatwick-to-new-york-los-angeles-and-fort-lauderdale-918430

[213] Source: HAL, [✂].

Norwegian's long haul service would make up less than 1 per cent of total UK-US capacity.[214]

Summary of airline evidence

D297 The evidence from airlines suggests that Heathrow is, in theory, a substitute for Gatwick, with Heathrow being viewed as their preferred airport of operation. However, there are limitations to its effectiveness as a substitute due to capacity constraints and other entry barriers. The evidence on the substitutability of the north London airports is less clear; however, there is likely to be limited substitutability, for airports such as Luton and Stansted due to a preference for operations from Gatwick. This stems from its perceived advantages in terms of location, yield, catchment area, leisure reputation tour operator and alliance links and surface access links.

D298 The CAA is aware of a number of deals signed by STAL and its airlines since MAG took ownership in early 2013. However, it does not consider that this alters the evidence previously provided by the airlines. As they appear to be developing the airports as complements rather than as substitutes.

D299 The CAA considers that switching evidence is supportive of a preferential hierarchy amongst London airports. Switching appears to be from the north London airports to Gatwick and from Gatwick to Heathrow (with only one reported move in the opposite direction). This suggests that airlines (and passengers) have a strong preference for Gatwick as a superior proposition.

Passenger switching

D300 This section considers what the analysis of passengers implies about the relevant market. As noted above, the CAA considers that airlines (to some degree), internalise the passenger preferences and broad demand. In particular, this section reviews the evidence available on passengers' choice of airport to assess whether independent passenger analysis supports airlines' evidence on the geographical market. To do this, the CAA has considered:

- catchment analysis;
- passenger preference; and

[214] See: http://www.anna.aero/2013/10/24/norwegians-london-gatwick-north-atlantic-routes-less-than-1pc-uk-us-capacity/

- PED.

D301 GAL has criticised the CAA's use of passenger switching evidence for the purpose of geographic market definition. GAL considers that the CAA had not taken account of evidence supporting a wider market definition for London and the South East of England.[215] GAL considered that the CAA has also not given sufficient consideration to inbound passengers, focusing purely on outbound passengers.[216]

D302 GAL has also criticised the CAA for what it considers to be an over reliance on PED analysis. In particular, GAL considers that:[217]

- PED analysis requires prices to be at the competitive level (which GAL contests).
- The CC and the CAT rejected BAA's argument that Stansted and Heathrow were in separate markets based on PED of passengers.
- The analysis focuses only on the direct impact on passengers. The analysis ignores the impact of passenger switching on airlines' most marginal routes.
- The analysis ignores non-price elements.
- The evidence is inherently weak, even the CAA provides a criticism of the PED analysis that it uses.

D303 The CAA considers that it is appropriate to take account of passengers' preferences in determining the geographical scope of the market. Elsewhere, GAL criticises the CAA for not giving enough weight to passengers and only doing so as part of a derived demand analysis.

D304 Furthermore, contrary to GAL's claims, the CAA has looked at the position of both incoming and outbound passengers. Although catchment analysis by definition focuses on the domestic catchment, that is just one source of evidence on consumer choices. In addition, the CAA's surveys were addressed to both UK residents and visitors to

215 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.31.

216 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.34.

217 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.32.

the UK[218] and its evidence from airlines considered both inbound and outbound flights.

D305 In response to GAL's concerns with the elasticity analysis, PED analysis is highly relevant to the market definition analysis as it targets most precisely the marginal passenger. The CAA also considers that it is using an appropriate proxy for the competitive price level.

D306 The CAA has not relied on any individual estimate of the PED at Gatwick. Rather, it has considered a wide range of estimates. In assessing these estimates, the CAA has considered both the strengths and weaknesses of each PED estimated. In light of this assessment, the CAA has considered a range in which the actual PED may sit rather than a point estimate.

D307 The CAA recognises the decisions made by the CC and the CAT and notes that the CAA's consideration of market definition is not based solely around the PED estimates available.

D308 The CAA details in appendix F the assumptions that it has considered in the PED analysis not least that of 100 per cent pass through of the price increase by the airline to the passenger. The PED therefore implies that it would be profitable for the airlines to serve the new pattern of demand. Furthermore, it is not possible with accuracy to comment on the impact of passenger switching on marginal routes without making assumptions as to the distribution of marginal passengers across the routes and airlines available.

Catchment areas

D309 This section considers the analysis of airport catchment areas and draws from the CAA's catchment working paper published in 2011.[219]

D310 The CAA notes that catchment analysis can provide useful evidence regarding an airport's passenger base. In particular, it is a way of estimating the geographic area from which a large proportion of an airport's outbound passengers originate. The size of catchment areas and overlaps between catchment areas of neighbouring airports can

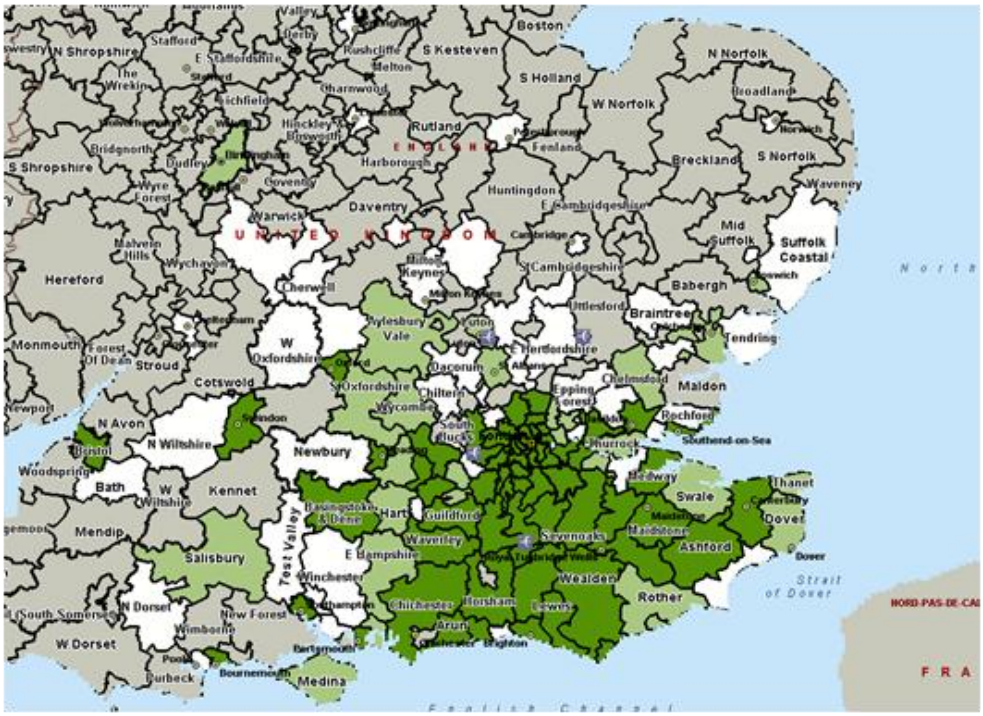
[218] The surveys are conducted as a random sample of passengers in the departure lounge of the airport. The survey captures passengers that are leaving the UK on either business or leisure and those that are leaving the UK after visiting. Therefore the survey covers both outbound and inbound passengers.

[219] Source: CAA (2011), Catchment area analysis - working paper, available at: http://www.caa.co.uk/docs/5/Catchment%20area%20analysis%20working%20paper%20-%20FINAL.pdf

also provide useful evidence of the potential competition between various airports.

D311 Catchment analysis does not, however, take account of passengers' price sensitivities as it only considers their location and the travel times that they may face. It may therefore overestimate the competitive constraint arising from passengers' willingness to switch.

Figure D.7: Gatwick historical usage catchment area



Note: shading shows cumulative proportion of passengers flying from Gatwick when districts are ranked by passengers numbers; Dark green – the first 70 per cent of passengers, Light green – the first 80 per cent, White – the first 90 per cent.

Source: CAA Catchment area analysis working paper October 2011

D312 Figure D.7 (above), shows that very few passengers flying from Gatwick originate from East Anglia, or the north east of London. The CAA considers that this indicates that:

- Passengers may be reluctant to travel to or from the other side of London, or that Stansted or Luton may be poor substitutes for Gatwick in many cases.
- Gatwick draws passengers from some distant urban centres such as Bristol and Southampton this may reflect the populations of these districts' propensity to fly and their relatively fast transport links to the airport.

Figure D.8: Gatwick historical catchment area overlap

Overlaps	Districts	Proportion of passengers at Gatwick
LGW	23	13%
LGW/LHR	21	18%
LGW/STN	4	2%
LGW/LHR/STN	7	6%
LGW/LHR/LTN	8	6%
LGW/LHR/STN/LTN	28	34%
Total LGW catchment	91	78%
Out of catchment		22%
Total		100%

Source: CAA Catchment area analysis working paper October 2011.

Note: Districts refer to UK planning districts; they are ranked by reference to the amount of passengers that flew from or to the airport and originated from or visited the district. An upper limit of 80% of the airports passengers was taken.

D313 Figure D.8 (above), shows how the historical catchment of Gatwick translates into overlaps with other airports. In particular, it shows that Gatwick serves 23 districts, representing 13 per cent of its traffic, where less that 20 per cent of passengers use an alternative London airport. The majority of its passengers (34 per cent) come from 28 catchments that it shares with the three other London airports.

D314 The catchment area analysis shows the potential for competition amongst airports. In particular, it shows that the majority of passengers at Gatwick (66 per cent) historically come from areas that are served by at least one other London airport. The airport draws a number of passengers (22 per cent) from outside of its catchment area, including Southampton and Bristol where there are airports that are not included within this analysis. The inclusion of these airports would therefore be likely to increase the overlap observed.

Passenger preferences

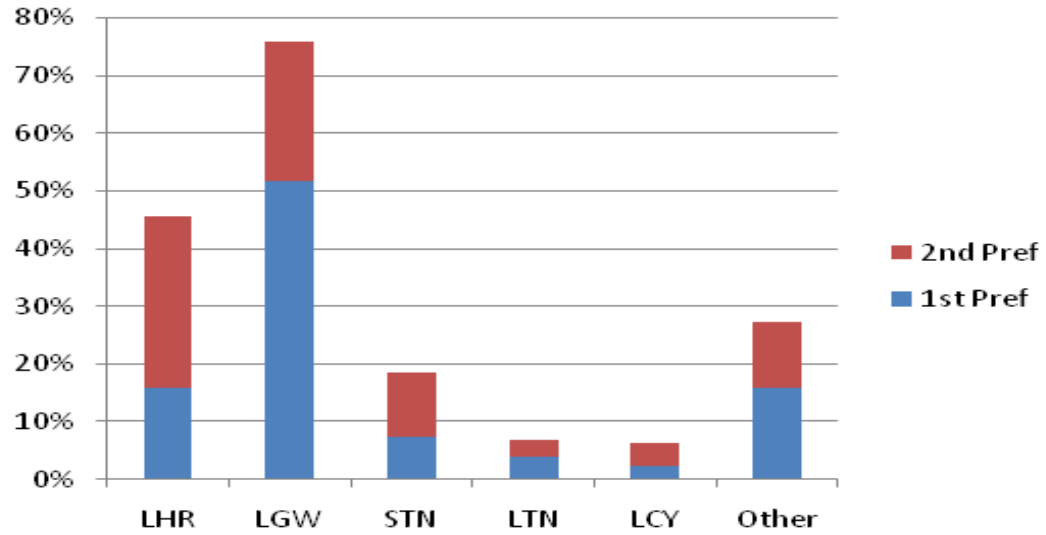
D315 Passenger preferences clearly have an impact on the potential for competition between airports. As noted in section 3.1 (above) passengers' responses to airport pricing are likely to be muted, due to charges levied by airports operators forming a low proportion of the overall airfare.

D316 Furthermore, using passenger data, it is difficult to disentangle the degree to which airport choice is driven by airport or airline preference.

For example, a stated preference to travel from Gatwick may be the result of a preference to fly with easyJet (its largest airline); similarly a preference to travel from Heathrow may be a result of a preference to fly BA.

D317 In late 2011, the CAA produced a working paper on passenger preferences for airports within the South East of England. From this paper, certain relevant insights can be drawn about passenger behaviour.

Figure D.9: First and second preference airports for short haul passengers flying from Gatwick



Source: CAA Passenger Survey Working paper November 2011

D318 Figure D.9 (above), shows Gatwick's passengers' stated preference of airport for short haul flights. The figure shows that:

- Over 50 per cent of passengers flying from Gatwick have Gatwick as their first preference.
- Fifteen per cent of passengers flying from Gatwick cited Heathrow as their first preference airport.
- The remaining London airports as a first preference are all below 10 per cent. Heathrow is cited as second preference by 30 per cent of Gatwick's short haul passengers, while 24 per cent are using Gatwick as their second preference and 11 per cent would choose Stansted as their alternative preference.

D319 This evidence suggests that passengers may be able to fly from a number of the London airports but that passengers value the location of

the airport and route availability, as both these factor highly in the reason for airport choice (see section 1). Likewise, passengers unsurprisingly appear to have an unsurprisingly strong preference for the airport from which they are flying.

Analysis of price elasticity of demand

D320 The CAA has reviewed a number of pieces of evidence with regards to PED for GAL's services.[220] PED is a measure of the responsiveness of the amount of demand for a product in relation to a change in price. It provides an indication of whether it would be profitable or not for an undertaking to raise its prices on a particular product.

D321 Typically, a PED of one[221] would suggest the demand changes on a one-for-one basis with price. A PED greater than one suggests that demand changes by a greater proportion to a price change (i.e. it is elastic); where a PED is less than one, demand changes by a lesser proportion than the change in price (inelastic demand).

D322 Given the interactions of the ancillary revenues that Gatwick derives from retail and car parking, a PED which is at or just below one would be likely to result in an unprofitable price increase due to the additional losses of these revenues. The CAA's evidence suggests that for the airport operator to be able to profitably raise prices it would need to face a PED of less than approximately 0.7.[222]

D323 The CAA's review of the evidence for Gatwick suggests that GAL faces a passenger base[223] with an elasticity of demand of 0.3 to 0.5 (i.e. it is very inelastic). This suggests that, given the substitution possibilities available to GAL's passenger base, a SSNIP would be profitable. This strengthens the case for a geographical market definition that is restricted to Gatwick.

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220 A fuller discussion of the PED analysis is provided in appendix F.

221 For most goods and services elasticities are negative numbers. By convention they are cited as absolute numbers.

222 See critical loss analysis in appendix F.

223 The studies focus mostly on passenger demand rather than the strategic actions of airlines (and they have assumed that airlines follow passengers). The analysis also assumes airlines are, in effect, free to switch their service to an equivalent service from one of the other airports, which assumes no capacity constraints, no significant switching costs, and that the airlines' route would have a viable catchment to serve at the new airport to replace the business that would not switch. These are very strong assumptions that are unlikely to hold in many cases and that as a result it can be considered that these are reflective of an unconstrained passenger PED.

Summary of passenger analysis

D324 The evidence on catchment areas suggests that Gatwick has a large catchment that overlaps with those of a number of other airports. However, while this shows a wide choice for passengers, it shows only the maximum potential of switching, as it does not take into account passengers' sensitivities to price and service or airline preference.

D325 The analysis on customer preference shows that passengers have a strong preference for particular airports. It shows that the majority of passengers using Gatwick have a strong preference to fly from that airport, but a significant minority would prefer other airports.

D326 The PED analysis is a particularly strong indicator that Gatwick is a market by itself. This is a different conclusion to that derived from the evidence on airline competition, which suggests that there are airline competitive interactions across the system of London airports. But, as noted previously, this conclusion applies to the downstream air transport market, while the PED analysis is specifically derived from the airport market.

D327 Passenger preference and the PED evidence highlight the limitations of the catchment analysis. Taking these together, the evidence suggests a narrow geographic definition for the market(s) in which GAL operates. In particular, the PED analysis clearly indicates passengers' insensitivity to airport pricing changes. This means that not enough marginal passengers would be likely to switch and consequently a SSNIP introduced by GAL is likely to be profitable.

Supply side substitution

D328 As noted in the discussion on supply side substitution on the product market, competition for airport operation services will only take place on the currently available infrastructure. Planned infrastructure development and those in the process of construction are only going to be relevant to competition if they become operational over the medium term. However, most airport developments are only likely affect potential for other London airport operators to compete with GAL over the long term.

D329 With regards to supply side substitution on the geographic market the CAA is considering the ability of airport operators to supply services to airlines in response to a SSNIP, and in turn the ability of airlines to substitute to that new supply. As discussed at D17 to provide a constraint on the behaviour of other market players alternative airport

are required to be and *'effective'* substitute. Available capacity at an airport is a key factor in whether the airport can be used as an effective substitute.

D330 VAA has, for example, highlighted a number of supply side issues it considers have limited substitutability in terms of operating long-haul services from regional airports including that of runway length:

Many regional airports do not have runways that can accommodate long-haul aircraft. ...which means that, we could not operate services using our current fleet without altering the passenger payload and/or the cargo carrying capabilities.

Many regional airports do not have the terminal capacity or suitable facilities to operate regular long-haul services. For example, due to the high passenger density, check-in desks and immigration services need to be designed for the high volume of passengers which need to be processed in a condensed space of time. We operate our aircraft in a high density configuration of up to 451 seats. To compete effectively as a full-service airline, we require airport facilities to accommodate particular service standards including separate designated, differential queue standards and the use of business class lounges, as well as facilities for transfer passengers. Many regional airports have insufficient airside facilities to handle wide-body aircraft used for long haul routes. For example, we prefer to use contact stands with direct airbridge access on to the aircraft.[224]

D331 With one runway of 3,316 metres in length, GAL is able to offer services to all currently available commercial passenger aircraft.[225] While similar services can be accommodated at both Stansted and Heathrow[226], nearby airports, such as Luton and London City, are restricted in the type of operations they can support due to runway length.

D332 London City Airport Limited's website states the limited range of aircraft that it can offer services to:

All aircraft using the Airport must be of an approved type. To qualify for approval an aircraft must meet specific noise criteria and be capable of

[224] Source: VAA, [✂].

[225] The A380 was first landed at Gatwick on 6 July 2012, see: http://www.businesstraveller.com/news/emirates-a380-lands-at-gatwick (accessed 29 October 2013).

[226] However, the effectiveness of this constraint is discussed below in the geographic market.

making an approach at 5.5 degrees or steeper (this compares with 3 degrees at most other airports). Helicopters and other vertical take-off and landing (VTOL) aircraft, and single-engined aircraft, are prohibited. Flying for club or leisure purposes is not permitted. Type approval is given by the Airport's Operations and Control Department:

Main scheduled aircraft currently approved for LCY: Avro RJ's; EMB 135/170/190; DH-8 Q100,200,300,400; F50/70; ATR42/72; S2000; D328.[227]

D333 Given the fleets in operation at Gatwick (or indeed the other London airports), the CAA considers that London City would be unable to compete across a sufficient range of aircraft sizes to provide an effective constraint on pricing at other London airports.[228] The difference in operating fleets is illustrated in Figure D.10 (below), which considers passenger numbers by maximum takeoff weight (MTOW) of the aircraft.

D334 Figure D.3 shows that 16 per cent of passengers using Gatwick fly on aircraft that are similar to those on which passengers fly from London City. It also shows that the other passengers at the other London airport fly on similarly size aircraft. However, this chart has to read with some caution as:

- Flybe, which operates a fleet of small aircraft has recently exited Gatwick and this will affect the distribution shown above;[229] and
- GAL has a stated policy of incentivising the use of larger aircraft at the airport as was the focus of a recent section 41 of the Airports Act 1986 (S41) case taken by the CAA.[230]

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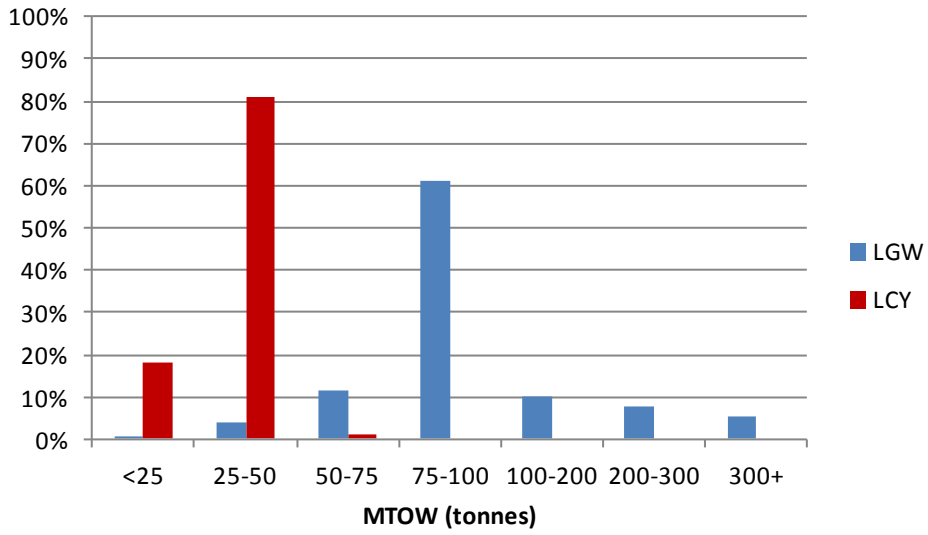
227 London City Airport Limited, Permitted aircraft, available at: http://www.londoncityairport.com/AboutAndCorporate/page/AirlinePartnersFacilities (accessed 11 July 2013).

228 The fleets operating at London City tend to carry less than 100 passengers. Whereas those employed by airlines at GAL have capacity in excess of 100 seats. easyJet's A319 (one of its smaller aircraft) have a capacity of 156 seats, Ryanair's Boeing 737-800s have a capacity of 189 passengers. See: www.seatguru.com (accessed 11 July 2013).

229 See http://www.flybe.com/corporate/media/news/1305/23.htm.

230 CAA (2013), Investigation under section 41 of the Airports Act 1986 of the structure of airport charges levied by Gatwick Airport Limited - CAA decision; available at: http://www.caa.co.uk/docs/5/S41GatwickFlybeDecision.pdf.

Figure D.10: Proportion of passengers by MTOW of aircraft flown in 2012



Source: CAA analysis

D335 With respect to Luton, the CAA considers that: [231]

- It is likely to have sufficient capacity for inbound aircraft to substitute to it in the morning peak period.
- There is insufficient capacity at Luton for the substitution of based aircraft from Gatwick due to binding stand capacity constraints.
- It is near terminal capacity at peak times.
- The runway at Luton is 2,160 meters in length some 1000 meters shorter than Gatwick which impacts on the aircraft sizes that it can service. For example, London Luton Airport Operations Limited (LLAOL) told the CAA that:

  The [Luton] runway of approximately 2km in length largely precludes long-haul traffic from operating.[232] *The model is based on high frequency; short sector (mostly 2 hours and a couple of 5/6hours)*.

D336 For Heathrow, which is operating at 98 per cent of its declared landing slot capacity and has been effectively full for a number of years, the CAA considers that there are significant barriers of entry present at Heathrow in terms of the acquisition of landing slots (which range up to

231 CAA, STAL Minded to consultation, Appendix 4, paragraphs 3.29.

232 Luton has since stated that with recent improvements to aircraft technology, new aircraft such as the B787, which have shorter take off distances, could potentially facilitate long-haul aircraft.

£15 million per pair).[233] The CAA considers that this cost is likely to outweigh the costs incurred in a 5 to 10 per cent price rise by GAL.

D337 This has, however, not stopped airlines developing their operations at Heathrow, as evidenced by the observed airline switching from Gatwick to Heathrow and the continued growth in passengers at Heathrow. For airlines that are present at Heathrow, unless they are able to acquire additional slots, the ability to grow is limited to increasing aircraft size, such as to the 525 seat A380, to serve additional passengers. The CAA notes that a number of airlines current fly the A380 into Heathrow, BA being the latest airline to do so[234] and it is expected that BA will fly all of its A380s from Heathrow. However, for other airlines this may not be possible as they will have a limited number of A380s available on their networks. The CAA notes that wider issues than airport charges have resulted in some carriers deferring the deployment of new aircraft.[235]

D338 Effectively the development of airlines at Heathrow currently is on a one in one out basis. Given the capacity constraints and excess demand at the airport access to Heathrow is likely to be limited. The CAA has considerable reservations over the ability of the airport to exert a constraint on neighbouring airports given the capacity constraints and supply issues. This is especially the case for LCCs which require quick turnaround times and access to the airport at regular intervals during the day to maximise their rotations. With the development of the A380, there may be greater scope for passengers to substitute Heathrow for Gatwick where the same routes are operated. However, this is unlikely to lead to significant substitution of Heathrow for Gatwick given the latter's passenger base generally flies short haul.[236]

D339 Stansted is relatively unconstrained in its ability to accept new services, although its growth deals with its current airlines will over time reduce spare capacity at the airport. Given the infrastructure at Stansted and

[233] Detailed analysis of the barriers to entry stemming from the capacity constraints at Heathrow can be found in Appendix E.

[234] BA has ordered 12 A380s and took its initial delivery in July 2013. BA press release http://press.ba.com/?p=3193 (accessed 14 August 2013).

[235] Bloomberg http://www.bloomberg.com/news/2013-07-17/virgin-atlantic-delays-buying-airbus-a380-monitors-boeing-787.html (accessed 14 August 2013).

[236] The majority of routes from Gatwick are generally considered to be flying short haul to holiday destinations intra-Europe, around the Mediterranean and to North Africa.

its current spare capacity[237] it is likely airlines of a range of business models would be able to substitute to Stansted. Under new and separate ownership the airport operator also has a direct incentive to compete for new traffic at, amongst other airports, Gatwick.

D340 As noted above, the CAA is unclear as to the position of Southend. It does, however, appear unlikely that it would be a substitute for a sufficient proportion of the operators at Gatwick. The airport operator notes that it can only take narrow bodied aircraft up to the size of a B757; this includes most of the A320 and B737 families.[238] Ryanair has also stated that it cannot operate its fleet from Southend and easyJet appears to operating only the smaller A319s from the airport and not its larger A320.[239] LSACL, the operator of Southend, is also aiming to grow the airport to 2 million by 2020, which is around 5 per cent of GAL's current passenger base.

Conclusion on geographic markets

D341 In light of the above considerations, the CAA concludes that the geographic market in which GAL operates is limited to the airport operation services provided at Gatwick. The CAA places particular weight on the following considerations in reaching this decision.

D342 The evidence presented by the airlines suggests a possible wide set of airports as potential substitutes. The evidence from HAL of direct comparison between Heathrow and Gatwick suggests that Heathrow may be a higher quality product.

D343 The evidence from airlines shows a much narrower option of alternative airports for Gatwick. It appears that there is a very strong brand at Gatwick that differentiates it from other airports. However, it does not appear that there would be significant demand side substitution away from Gatwick to the north London airports. The evidence does, however, suggest that there would be a significant shift of demand to Heathrow. The evidence is such that the CAA considers airlines would switch from Gatwick to Heathrow even with the current price differentials.

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237 CAA, STAL Minded to consultation, Appendix 4, paragraphs 2.35 to 2.41.

238 LSACL URL: http://www.southendairport.com/airport-facilities/operational-information/aviation-services/aircraft-noise-restriction-amp-maximum-size/ (accessed 14 August 2013).

239 See: http://corporate.easyjet.com/media/latest-news/news-year-2011/16-06-2011.aspx and http://www.routes-news.com/news/1-news/1552-easyjet-moves-fourth-plane-to-southend (accessed 25 October 2013).

D344 From a demand perspective, it appears that Gatwick sits in the middle of a hierarchy in which substitution would happen from Gatwick to Heathrow and to Gatwick from the north London airports. This is supported by both the airlines' views and observed switching.

D345 The CAA is aware of a number of deals signed by STAL and its airlines in the months since MAG took ownership in early 2013. However, it does not consider that this alters the evidence previously provided by the airlines, as they appear to be developing the airports as complements rather than as substitutes

D346 The passenger analysis shows that there is possibility for substitution to happen across the London airports while catchment analysis shows significant overlaps and passengers indicating a preference for other London airports other than from the particular one from which they are travelling. However, the PED analysis strongly suggests that passengers are unlikely to exercise the possible choice available to them as the range of PED estimates available are lower than the CAA's estimated critical level.

D347 With respect to supply side substitutability, it is apparent that the other London airports (apart from London City and Southend) are able to compete across a sufficient range of aircraft size to be substitutable for services at Gatwick. However, Heathrow is effectively full.

D348 Absent the capacity constraints at Heathrow, the CAA considers that as the result of a 5 to 10 per cent sustained price rise by GAL sufficient substitution to Heathrow would likely take place to render the price rise unprofitable. However, given the capacity constraints Heathrow is unlikely to be a credible switching opportunity for airlines or their passengers and is therefore not an effective substitute.

D349 Likewise, although there is sufficient spare capacity at Luton and Stansted the demand side analysis suggests that this does not pose a credible switching response for the airlines. Airlines do not consider that they are substitutable for Gatwick given issues with catchment and surface access. As a result of a sustained 5 to 10 per cent price rise by GAL the CAA considers that insufficient demand would switch as to render the price rise unprofitable.

Section 3.4: Temporal markets

D350 In the Consultation, the CAA considered that it was not appropriate to segment the market by time of day or season.[240] In particular, the CAA considered:

- That GAL's winter charge's policy is a rational response to price cap regulation at an airport with seasonal traffic.[241]
- That demand changes due to season impact on the inherent competitive structure of the market between the seasons, such that its analysis would not benefit from segmenting the market in this way.
- It has not seen evidence to suggest that passengers become more price sensitive in either season.[242]

D351 The CAA received no further representation on its position not to segment the market by time of day or season.

D352 Based on the above, the CAA therefore concludes that it would be inappropriate to segment the market by time of day or season.

Section 4: Conclusion on market definition

D353 Based on the evidence outlined above the CAA considers that there is a single market for the provision of airport operation services to passenger airlines at Gatwick; this market is limited geographically to the services provided to airlines at Gatwick. The particular services provided by GAL at Gatwick consists of at least the following airport operation services:

- the use of the runway and taxiways;
- ATC;
- aircraft parking;
- the provision of access and infrastructure needed for the provision of other airside and landside groundhandling services;
- the provision of facilities for check-in;
- baggage handling;

240 The Consultation, paragraphs 5.226 to 5.237.

241 The Consultation, paragraphs 5.234 to 5.236.

242 The Consultation, paragraphs 5.227 and 5.237.

- security screening;
- Holding passenger facilities;
- Airline staff processing facilities
- passenger transit facilities
- Premium passenger facilities; and
- Integrated transfer facilities.

D354 In coming to this view, the CAA notes:

- There is likely to be sufficient competition between airline business models competing at the airport such that passenger arbitrage would likely defeat attempts by the airport operator to discriminate between any particular airline business model.
- The demand side analysis suggests that Heathrow is in theory substitutable for Gatwick but that other London airports and non-London airports do not appear substitutable.
- Supply side analysis indicates that Stansted would present the only credible substitute given its facilities and significant available capacity however the demand side analysis negates its credibility as an alternative due to its location, poor catchment area, lack of interlining and alliance networks and poor surface links.
- Capacity constraints and other entry barriers that are currently imposed at Heathrow remove it as a credible alternative for airlines to switch to. It has therefore limited effectiveness as a substitute to enlarge the scope of the geographic market beyond that of services provided at Gatwick.