STANSTED
MARKET POWER ASSESSMENT:

Developing our 'minded to' position

January 2013

UK Civil Aviation Authority
CAA House, 45-59 Kingsway, London WC2B 6TE

TABLE OF CONTENTS

Annexes (which are published as separate documents)

SUMMARY

1. Summary

Purpose of this document

1. The CAA is minded to find, consistent with its section 1 duties under the Civil Aviation Act 2012 ("the CA Act"), that the market power test as set out in the CA Act[1] is met in relation to Stansted airport (Stansted). This document sets out the reasons for this provisional view. The CAA wishes to consult on its provisional view and will now consider representations and reach a final decision in 2013 by determining whether the test is met in relation to Stansted. The CAA especially welcomes new evidence from stakeholders and also their views on how the CAA should weight evidence that has so far been provided and presented in this document.

Potential implications for regulation of the operator of Stansted

2. The practical consequence of the market power test being met is that the airport operator would be unable to charge for most services unless it has a licence granted by the CAA.[2] The CA Act sets out the primary duty of the CAA as being to further users' (which is to say, passengers' and cargo owners') interests in the provision of airport operation services; and, where appropriate, to do this by promoting competition.[3] It also sets out the provisions for the grant of a licence and what a licence may contain.[4] A licence may include such conditions as the CAA considers necessary or expedient in relation to risks of abuse of market power. This may include price control conditions. Any regulatory intervention must be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed.[5]

3. The CAA has consulted in general terms about options for the form of future regulation, but has not taken any decisions about the precise form of any licence issued to Stansted's operator, nor whether a licence should contain a price control condition at all. Stakeholders should not draw conclusions about how these questions will be answered from the content of the present consultation. The CAA will consult on these issues in April 2013.

1 Section 6 of the CA Act
2 Section 3 of the CA Act
3 Section 1 of the CA Act
4 Chapter 1 of the CA Act
5 Sections 1(3) and (4) of the CA Act

The market power test

4. The market power test has three parts:

   - Test A is that the relevant operator has, or is likely to acquire, substantial market power. This must be in a market for or including one or more types of airport operation services provided in the airport area and that market must include geographically all or part of the airport area.
   - Test B is that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that substantial market power. Such conduct may, in particular, include behaviour defined under UK competition law as abuse of a dominant position. However, "competition law" in this context is not limited to UK anti-trust law aimed at abuse of dominance but also includes UK prohibitions on anti-competitive agreements, the European competition rules on anti-competitive conduct, and the UK market investigation regime.
   - Test C is that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.

5. The CAA's assessment has focused broadly on the current position and the period 2014-2019, although some of the trends reviewed seem likely to extend beyond that period.

Test A

Market definition

6. The CAA has adopted the standard approach of regulators engaged in assessing market power and has sought, as a starting point for its analysis, to define the relevant markets in which Stansted Airport Limited (STAL) operates. This provides the framework for analysing competitive constraints, whether they come from within or outside the market. The CAA is minded to take the view that STAL currently operates in two distinct markets, combining the product and geographic dimensions of market definition[6]:

   - Core aeronautical services[7] for Low Cost Carriers (LCC) and charter airlines covering a geographic market that includes at least Stansted, Luton, Southend and possibly Gatwick. This market is referred to as the Stansted short-haul market.

[6] Note that at this stage, the CAA has not defined the markets for non-aeronautical services. The CAA has also not defined a separate market for the small amounts of long-haul and non-commercial aviation at Stansted, as it considers these to be marginal to the question of market power.

[7] These activities include facilitating the use of runway and taxi-ways, aerodrome ATC, aircraft parking, ramp handling services, fuel and oil handling, and aircraft maintenance, as well as the minimum activities required for the processing of passengers at the airport, the provision of a terminal and the facilities for check-in, baggage handling, security screening and the transit of passengers to and from the aircraft.

- Core cargo aeronautical services[8] provided to cargo-only airlines at Stansted. This market is referred to as the Stansted cargo market.

7. These market definitions are based on evidence including the views of airlines and airport operators on the substitutability of other airports for Stansted, evidence on switching behaviour and the analysis of passenger preferences and behaviour.

8. In February 2012, the CAA published its Initial Views on STAL's market power[9]. That document discussed whether Stansted should be considered as part of a Europe-wide market. However, further information gathered since then has shown that the competitive constraints posed by airline switching (or threat of switching) to European airports from UK airports including Stansted appears to be relatively weak, and little evidence has come to light of actual switching of established airline capacity from London airports to European airports. The Initial Views document also explored whether a temporal market definition might be relevant (morning peak versus non-peak hours). Information gathered subsequently has suggested that there are in fact several peak periods through the day (because LCCs need access to a range of slots throughout the day to allow for the aircraft to fly out and return). Defining a "morning peak" separately would therefore not properly capture the actual dynamics of this market.

9. For ease of reference this summary sets out the CAA's views first on the short-haul market, and then returns to consider the cargo market.

Current and future competitive constraints on the airport operator

10. The CAA has examined whether there are sufficiently strong competitive constraints (from within and outside the relevant markets defined above) such that STAL cannot profitably raise its charges above the competitive price. The CAA has carefully considered evidence on the possibility of airline and passenger switching and the constraints they face in doing so. Switching costs faced by Stansted's airlines are found to be relatively low, compared to the turnover and profitability of these airlines on relevant routes, and airlines including LCCs have reduced their capacity at Stansted over the past few years. However, the response of STAL to the actual withdrawal of capacity or threat of switching by both easyJet and Ryanair appears to have been muted.

11. Looking to the future, LCCs with based aircraft at Stansted (especially Ryanair, less so easyJet) appear constrained in their ability to switch significantly more based aircraft. This is because serving London has major strategic importance to their business models, and capacity constraints at other London airports mean they do not have the option to switch away from

[8] These activities include facilitating the use of runway and taxi-ways, aerodrome ATC, aircraft parking, ramp handling services, fuel and oil handling, and aircraft maintenance, as well as the minimum activities required for the processing of cargo at the airport.

[9] The CAA's initial views on Stansted Market Power Assessment published February 2012

Stansted and still serve London. This is likely to become an increasing factor as demand recovers in line with economic growth and capacity constraints in the London region further tighten.

12. With regards to passenger switching, there are some significant overlaps between passenger catchment areas in the London system, which might suggest that passengers have significant choice. However, the CAA considers it unlikely that enough passengers would choose to switch to another airport such that this would constrain the airport operator's pricing. To reach this view the CAA has in particular considered evidence relating to: the limits to route choice; passenger preferences as to airport choice; and relatively low passenger sensitivity to increases in airport charges (as opposed to increases in airfares).[10]

Indicators of market power

13. In addition to competitive constraints, the CAA has also considered the following potential indicators of market power.

- Stansted has a high market share – 70 per cent - of the relevant short-haul passenger market when Gatwick is excluded and 37 per cent when Gatwick is included within the relevant market. Given the limitations of market share data, the CAA does not draw strong conclusions from this analysis on its own and has therefore sought to review other relevant evidence.
- STAL is pricing to its regulatory price cap, and there is evidence to suggest that it is pricing above the competitive level. For example, the CAA has commissioned an independent benchmarking study which shows that Stansted's prices are likely to be above the level of comparator airports.
- The CAA has reviewed trends since 2007. In that year the airport operator withdrew pre-existing large discounts on the regulated price from Ryanair and easyJet. This was profitable for STAL for some time but the increase in profitability was eroded with subsequent traffic reductions. This reduction in traffic could be a response to the price increase, or a consequence of economic pressures that bear on many other UK airports, particularly ones serving LCCs, or partly of both or of other factors. In any case, the reduction does not appear to have disciplined STAL's pricing. For instance, it has not to date concluded agreements with existing airlines to discount prices significantly, despite the decline in overall traffic. It has, however, offered significant discounts to attract new airlines or new traffic in non-peak periods,

[10] This analysis reflects the current pattern of airport competition. The CAA recognises that changes in passenger or airline behaviour could lead in time to greater interactions between Stansted and other airports such as Heathrow.

although these pricing initiatives have not generally been taken up by the airlines.

- The CAA has seen some evidence from internal company documents that STAL may be accepting a short-term decline in profitability because it sees long-term gains from not concluding discounted long-term agreements with existing user airlines.
- The CAA has seen no evidence that competitive constraints have driven efficiency initiatives at Stansted. However, the unique circumstances must be borne in mind within which STAL and its airlines have been conducting business in the past three years: a deep recession; uncertainty linked to the forced sale of Stansted; and potential distortions of STAL's behaviour owing to its joint ownership with Heathrow. These may have artificially distorted the incentives and behaviours of both the airport operator and its airlines.

The CAA's 'minded to' conclusion for the short-haul market

14. The CAA appreciates that the evidence does not all point in one direction and a judgement is therefore needed on the balance of the evidence it has reviewed. On this basis, the CAA is minded to conclude that, in relation to the Stansted short-haul market, STAL holds a degree of market power which *may* currently be substantial, and *is likely* to become substantial over the period 2014-2019.

15. The most likely source of market power possessed by STAL is the inherent attractiveness of the London market and its strategic importance to airlines, combined with capacity constraints in the London system, which limit the number and size of available alternatives. Over 2014-2019 these capacity constraints are expected to tighten further and lead to a spill of traffic from other London airports to Stansted. This tightening can be expected to reduce STAL's incentive to price keenly to incentivise growth.

16. The CAA acknowledges there are some uncertainties and that in the future its analysis could change over the longer term. For example, the change of ownership of Stansted could establish different behaviours and relationships with the airlines. The outlook for the economy is uncertain and future government policy in relation to new capacity in the South East could change. Moreover, the airlines operate in a market that is characterised by change and hence the business models operating at Stansted could change, as could passenger preferences.

The CAA's 'minded to' conclusion for cargo

17. In relation to cargo services, the CAA has received consistent and credible evidence from STAL's cargo customers that access to London is essential to their operation and that they have no ability to switch to other airports. The

CAA is therefore minded to conclude that STAL currently *has* substantial market power in the Stansted cargo market.

18. This market was not covered in the CAA's Initial Views document, so evidence on this market has not been tested previously by public consultation. The CAA will therefore consider carefully representations relating to this market, and will in particular consider further whether the ability of downstream customers to switch from cargo-only carriers operating from Stansted to belly-hold carriers operating from other London airports could indirectly constrain the behaviour of STAL.

Test B

19. The CA Act gives the CAA the power to enforce competition law in relation to the provision of airport operation services concurrently with the UK's general competition authorities. The CAA has welcomed these new powers and expects that they will provide important new ways to protect users and competition. Test B does not require the CAA to take a view about whether competition powers are in some sense more or less effective than regulatory powers, but rather to assess whether competition powers alone are sufficient to address the risk of abuse. In other words, the assessment addresses whether a licence could offer additional protection that is necessary if risks of abuse are to be sufficiently mitigated.

20. The CAA has considered the aims of regulation and those of competition law, identifying some limits to how, in general, competition law can mitigate risks of abuse. These limits relate to: the timing of cases; potential mis-matches in some cases between abuses and the formal tests of competition law; and the limitations of potential remedies. These factors have led some authorities to argue that regulation might continue to play a role until competition is firmly established.

21. Regarding the airports sector in particular, two behaviours are particularly relevant, exclusionary and exploitative behaviour:

- The courts have examined exclusionary behaviour by airport operators. The precedents share the fact that the operators in question have had an interest within the downstream market. Since this is not the case for STAL, this could limit their applicability in this case.
- However, even without a downstream presence, airport operators that favour a particular airline or group of airlines can in principle face sanctions under the competition law regime. For this reason, exclusionary behaviours could in principle be tackled adequately by competition law alone.
- However, there are some grounds to doubt whether a competition investigation, which would typically be prompted by the concerns of a particular complainant, would necessarily produce a sufficiently

comprehensive solution; and also whether it would be a swift enough process to avoid irreparable harm to competition in the market. It may also be appropriate to look to licensing under the CA Act where there are concerns around issues such as cross-subsidisation and lack of information.

- With regard to exploitative behaviour, the case law on excessive pricing is still developing but at present sets a relatively high evidential hurdle. These tests might, for various reasons, be difficult to apply in the airports sector. There have been some infringement decisions, but those cases contain circumstances which off-set the challenges associated with the relevant legal tests. The CAA is minded to consider that the evidential threshold for a finding of infringement based on excessive pricing limits the ability of competition law to discipline this behaviour. Given that the law in this area is still relatively early in its development, the uncertainties associated with this type of investigation are high. As competition law develops in this area the CAA will adjust its approach accordingly.
- In principle, competition law could address exploitative abuse arising from service quality or product quality. However, to the CAA's knowledge no competition law cases have been pursued on such a basis. It is therefore difficult to assess whether the evidential hurdle would be as high. In these circumstances, it appears risky to see competition cases as the way consumers might be protected from exploitative abuse arising from service quality or product quality.

22. The CAA therefore tends to the view that competition law may be a useful tool to respond to some kinds of abuses. However, in the instance where an airport operator has substantial market power, regulation might prove incrementally beneficial in some cases: for instance, in relation to concerns about cross-subsidisation and lack of information. The CAA also tends to consider that, for some kinds of cases (e.g. in relation to exploitative abuse), there must be some uncertainty about whether the tests flowing from competition case law can be successfully applied in the airports sector, and so whether competition cases could actually bring such abuses to an end.

23. Regarding STAL in particular, our 'minded to' position in relation to test A tends to suggest that there may be a risk of STAL being in a position to engage in exploitative behaviour. Given the size of the operation at Stansted, the potential harm to the user from any such abuse could be significant. The CAA's responses to emerging problems might be slower if it had to prove established dominance and the remedies for such exploitation might also take time to formulate and implement, during which time damage to the structure of competition might continue. Further, the current moratorium on airport expansion within the South East means that scarcity will not in the short term lead to investment to produce extra capacity. As such, reliance only on the functioning of the market could see higher prices. Although these

might not be enough to motivate individual passengers to change which airport they use, nevertheless collectively these will not necessarily be in the best interests of passengers and cargo owners, as they will not drive market entry or additional capacity expansion. Therefore, this approach may not be consistent with the CAA's duty under the CA Act to promote the interests of passengers and cargo owners.

24. On balance, the CAA is presently minded to find that test B is met. It is likely that some form of regulation under the CA Act would provide a more effective safeguard than competition law alone against the risk of exploitative abuse. This is particularly because regulation under the CA Act can be tailored so as to protect the interests of passengers and cargo owners from exploitation. Regulation would potentially allow a range of safeguards, such as (for example) on-going monitoring of prices and quality, to be put in place with a view to maintaining effective competition as the market and the wider economic context develops over the short to medium term.

25. The CAA appreciates that this is the first time it has explored these issues in detail in relation to Stansted and therefore it is keen to understand stakeholder views before coming to a final decision.

Test C

26. Test C requires the CAA to assess whether the benefits of a licence regime are likely to outweigh the adverse effects. The CAA does not consider that, given the level of market power identified in relation to Stansted, the Airport Charges Regulations or Airport Groundhandling Regulations would necessarily provide sufficient protection for users. The CAA's assessment of licence regulation focuses on the topics most commonly addressed by economic regulation, in assessing the likely impact at Stansted.

- Price. As STAL is currently pricing at its regulatory cap, and there is evidence to suggest this is above the competitive level, there is a reasonable expectation that if the price cap were removed then charges would rise. Potential risks from setting prices too low under a licence are likely to be reduced by improved knowledge of the competitive price level. Also, Luton appears to be taking forward investment plans irrespective of the uncertainty over future prices at Stansted, which suggests the risks of stifling investment are limited at present.
- Efficiency (which impacts on future prices). The impact of regulation on efficiency is difficult to judge. However, the CAA has not seen evidence to suggest that competition has significantly driven improved efficiency at Stansted, and it appears unlikely that the removal of licence regulation would lead to an improvement in efficiency in and of itself. Given the potential reduction in competitive pressure forecast during 2014-2019, the incremental benefits of licence regulation on efficiency

are likely to increase, although the distortions of incentives, from RAB-based regulation in particular, should be acknowledged.

- Service quality, in terms of the range and level of services. STAL's improved service quality performance appears to coincide with greater regulatory scrutiny since the start of the Q5 review and the introduction of the SQR scheme in quarter 2 2009. While it cannot be said for certain that this improved service quality performance reflects the impact of regulation, the CAA has not seen evidence to suggest that competition itself has driven the improved performance. The CAA was concerned at one time that regulation might reduce service quality as a by-product of greater pressures for operational efficiency, but such a trend has not in fact been observed. Service quality could be set by regulation higher than passengers actually want, but evidence suggests this has not happened in practice.
- Investment, which can affect future levels of service quality. Regulation can distort investment incentives, with a potential bias of RAB-based regulation towards capital spend. However, although such a distortion may exist in principle, evidence has not been found that it has had a significant impact on STAL's recent behaviour. Some distortive effects (e.g. fixing investment too far in advance and dis-incentivising investment for new customers) can be addressed by modifying the detail of regulatory process. Nevertheless, licence regulation would necessarily lead to some costs in terms of rigidity, particularly in terms of investment consultation and changes to service quality and charges.

27. The assessment also considers whether users may benefit from other additional licence requirements that are not directly related to market power, but that the CAA considers necessary or expedient having regard to its statutory duties. Some such benefits are expected from a licence containing provisions on operational resilience.

28. The assessment has considered the adverse effects of licence regulation in terms of:

- direct costs to the CAA, regulated companies and their users for example in manpower and consultancy. Depending on the form of regulation, these are estimated as £2m - £5m per annum; and
- indirect costs/effects (which are difficult to quantify). These include those mentioned above and also: management distraction; distortions to incentives; crowding out of a more commercial approach; and distortions to competition more widely, for example on other airports.

29. The costs of regulation under the CA Act can be lower than under the Airports Act 1986 since regulation can now be tailored to the particular circumstances of the case. It is also noted that the potential distortion-costs of regulation may be lower now than when this question was considered in

2007, given that airlines at Stansted are not being asked to fund the significant costs of a new runway and terminal through a RAB.

30. It is not necessary, in assessing whether test C is met, to define precisely the type of regulation that would apply; only whether the benefits of some form of licence-based regulation are likely to outweigh the adverse effects. Overall, the CAA is minded to find that test C is met and that some form of licence regulation should apply to STAL.

31. The CAA would ensure that a licence is proportionate to the specifics of Stansted and any conclusions under the market power assessment. The CAA will make proposals on the form of regulation that would apply at Stansted as part of its Q6 initial proposals, published in April 2013.

32. The CAA appreciates that this document is the first time it has explored these issues in detail in relation to Stansted and therefore it is keen to understand stakeholder views before coming to a final decision.

CAA January 2013

FIRST PART: TEST A

2. Introduction

2.1 This is the non-confidential version of the CAA's 'Minded to' views on the degree of Stansted Airport Limited (STAL)'s market power. Excisions from the text are marked with [✂].

Rationale and context

2.2 In 2011, the CAA commenced a project to understand the extent and nature of market power[11] held by the operators of the airports that are currently 'designated' under the Airports Act 1986 (the Airports Act) and that are subject to price regulation, i.e. Heathrow, Gatwick and Stansted.[12]

2.3 In April 2012, STAL asked the CAA to use its powers under the Airports Act to carry out a market power examination in relation to Stansted. The Government's Civil Aviation Bill (the CAB) that reforms the framework for airport economic regulation and replaces Part 4 of the Airports Act received Royal Assent on 19 December 2012. The Department for Transport (DfT) has consulted on transitional arrangements[13] and it expects that the economic regulation of airports provisions in Part 1 of the Civil Aviation Act 2012 (the CA Act) will commence on or shortly after 1 April 2013. From this date, the CAA's powers to conduct market power determinations under the CA Act will replace its powers to conduct market power examinations under the Airports Act. The CAA therefore considers it is more appropriate for this 'minded to' decision to be consistent with its new primary duty to further passengers' and cargo owners' interests in the provision of airport operation services, where appropriate, by promoting competition and the market power test under the CA Act rather than the CAA's duties and test under the Airports Act.

2.4 The CA Act only permits economic regulation of an airport operator and the granting of a licence by the CAA if three tests set out in section 6 (market power test) are met. Test A, requires the CAA to establish whether "the relevant operator[14] has, or is likely to acquire, substantial market power

[11] The European Commission in DG COMP *Discussion paper on the application of Article 82 of the Treaty to exclusionary abuses* December 2005, notes that "market power is the power to influence market prices, output, innovation, the variety or quality of goods and services, or other parameters of competition on the market for a significant period of time", paragraph 24. The OFT notes in its *Assessment of Market Power* guideline (OFT415), that "market power is not an absolute term but a matter of degree, and the degree of market power will depend on the circumstances", paragraph 2.10.
[12] The project also sought to address the Competition Commission (the CC)'s view that the CAA should keep competition between airports under review, and that the economic regulation of Gatwick and Stansted might need to adapt to facilitate competition. Source: CC, BAA Airports Market Investigation – Final Report, March 2009, paragraph 10.339.
[13] DfT, https://www.gov.uk/government/consultations/civil-aviation-bill-making-the-transition-to-the-new-airport-economic-regulation-framework, (accessed December 2012).
[14] Pursuant to section 6(2) of the CA Act, the relevant operator is the person who is the operator of the airport area at the time the test is applied.

(SMP) in a market[15] either alone or taken with such other persons as the CAA considers appropriate". Test B is that competition law does not provide sufficient protection against the risk of abuse of SMP. Test C requires the CAA to be satisfied with the benefits of licence regulation against its potential adverse effects.

2.5 In February 2012, the CAA published "Stansted – Market Power Assessment: the CAA's Initial Views" (the Initial Views).[16]

2.6 In the Initial Views, the CAA indicated that Stansted enjoyed the least market power of the three airports being assessed and that while the evidence was insufficiently clear to reach a definitive view, it appeared that any position of market power would arise from the relative bargaining power of the airport operator and airlines during a relatively narrow peak period.

2.7 Since the publication of the Initial Views, the CAA has strengthened its evidence base by undertaking additional analysis on the existing evidence as well as considering new material, including material submitted in response to the Initial Views and material obtained from further stakeholder engagement.

2.8 In particular, since the publication of the Initial Views the CAA's thinking has evolved with respect to (amongst other issues):

- Defining the market(s) that STAL operates in (see section 4). This is a key step in any competition assessment and since the release of the Initial Views, the CAA has clarified its position on the relevant markets and their geographic scope for Stansted. Broadly speaking, the CAA considers that the evidence it has recently reviewed leads to a narrower market than those suggested in the Initial Views.
- The ability of airlines to switch from Stansted (see section 5). The ability of an airline to switch airports is important for a number of reasons, not least that it influences the reliance on market share analysis as part of a competition assessment. Without appropriate consideration of an airline's ability to switch (which includes consideration of airport capacity constraints and airline switching costs), the level of market power an airport operator may hold, when measured by market share analysis alone, may be under or over represented. However, the CAA also considers that there are many limitations associated with market share analysis which limits its usefulness as a 'stand alone' indicator of market power (this issue is discussed further below).

[15] The relevant product and geographic market is to be defined pursuant to section 6(6) (a) and (b) of the CA Act, namely a market for one or more types of airport operation service provided within all of part of an airport area (or for services that include one or more of those types of service).
[16] This document is available at: http://www.caa.co.uk/docs/5/StanstedMarketPowerAssessment.pdf.

2.9 In 2013, the CAA will make a formal decision on whether Stansted, in relation to its core area[17], passes the market power test as set out in the CA Act 2012. However, a number of stakeholders requested that the CAA bring forward, for consultation, a "minded to" document on the issue. This recognises that the airport will be sold early in 2013 as a result of the divestment forced by the Competition Commission (CC).

2.10 In addition to outlining the CAA's views on Test A, this document also sets out the CAA's views on Tests B and C.

Positions and key arguments put forward by Stansted and its airlines

2.11 STAL did not make a formal submission to the CAA, but presented its views on its level of market power in two presentations (made on 12 October 2011 and 17 October 2012), and in its response to the Initial Views[18].

2.12 STAL has stated that it agrees with much of the Initial Views, except regarding the issues of capacity and switching. Its main arguments can be summarised as follows:

- Traffic at Stansted has declined in recent years and there is now ample spare runway and terminal capacity. As at 2012, the percentage of unallocated capacity at Stansted in the peak week was broadly similar to Manchester and Luton and Stansted had more spare capacity in the morning peak than Luton.
- Between 2007 and 2012, the amount of traffic carried by easyJet and Ryanair out of Stansted in the summer has declined by 37 per cent and 17 per cent respectively.
- STAL is operationally efficient. Its operating costs have fallen in real terms over the period since 2005/06. The airport has the best punctuality record of any major airport in the UK, as measured by on-time performance and average delay.
- The airport operator has been offering significant discounts and marketing support both to its large incumbent airlines, Ryanair and easyJet, and new airlines. Discounts are linked to volume growth targets, but both Ryanair and easyJet have sought discounts on all traffic. The airport has not been successful at attracting new airlines despite its very attractive offers, partly because of the perceived challenging competitive environment at the airport.
- Low Cost Carrier (LCCs) operate very flexible business models, as illustrated by the numerous changes to routes they operate from Stansted. They can easily switch capacity between airports and have been switching capacity away from the UK to other markets, most

[17] As defined in section 5(2)-(4) of the CA Act. In practice, this means that the CAA has focused its assessment on the provision of airport services to airlines and passengers in the airfield, passenger terminals and cargo processing areas.
[18] This document is available at: http://www.caa.co.uk/docs/5/rpg2012/StanstedApril12.pdf.

notably Spain, Portugal and Italy. They are able to do this because of the many bases which they can switch traffic to and also because they are able and willing to close bases.

- Over the last fifteen years Stansted has gone from a position where it was fundamental to Ryanair's business (handling more than half of its passengers at Stansted) to a position where it handles less than one in six of Ryanair's passengers. Ryanair has gone from a position in the 1990s where it accounted for around one in six passengers at Stansted, to the current position where seven out of ten passengers at Stansted are flying with Ryanair. This 'switch' of positions has significantly increased Ryanair's ability to exert buyer power and to constrain Stansted.

2.13 Stansted's main airline, Ryanair, has argued that Stansted has SMP and made several written representations to the CAA.[19] The main arguments that Ryanair has made to the CAA are summarised below:

- Stansted's doubling of airport charges in 2007 led to a 23 per cent collapse in traffic. There is no evidence that the reduction in airline use at Stansted reflects economic trends or that traffic at Stansted will recover as the economy recovers. High levels of spare capacity and declining traffic have not prevented Stansted from doubling and profitably sustaining its airport charges (to the level of the cap). This increase is much higher than what Ryanair has experienced at the other airports from which it operates. In setting price caps, the CAA has erred on the upside.
- Neither Ryanair nor easyJet were able to resist the doubling of charges is evidence of Stansted's market power.
- Stansted has refused to adopt off-peak pricing is evidence of its market power (and willingness to abuse it) both at peak and off-peak
- The airport is inefficient: this is illustrated by the overinvestment carried out by the airport, the arbitrary allocation of BAA overhead and increasing staff costs.
- All the growth offers made by Ryanair to Stansted have been turned down. Stansted has repeatedly refused to engage in competitive pricing, even for marginal traffic growth, despite the fact that its existing commercial profit of £4 per passenger would make up for any discounted airport fees for this incremental traffic
- The market power of Stansted is due to: 1) the absence of spare capacity at other London airports; and 2) the fact that London airports are not fully substitutable, Passengers have a strong preference for their local airport. To move an aircraft away from an airport, airlines must also exit a market. This is against the background of a highly

[19] Source: Ryanair

competitive airline market that is nearly perfectly transparent and commoditised. Based carriers have no ability to switch to neighbouring airports due to physical or capacity constraints at those airports. Furthermore, Stansted does not compete with airports elsewhere in the UK or Europe as London is a "must-have" destination in Ryanair's airport network.

- Ryanair has reduced its traffic at Stansted by more than any other airline and yet its market share has increased is evidence of Stansted's market power over Ryanair and all its other airline customers.

Analytical framework

2.14 In April 2011, the CAA published guidance on the assessment of airport market power (the Guidelines). The Guidelines are designed as a high-level guide and, while they form an important part of any competition assessment, it is possible that there will be reasons to depart from them in the specific circumstances of an individual case.[20]

2.15 In line with those Guidelines, the first step of a competition assessment is the definition of the economic market within which the airport operates. This sets the frame of reference for the required analysis.[21]

2.16 As stated in the Guidelines, the objective of a competition assessment is to establish the existence and strength of the competitive constraints facing an airport operator, and consequently to understand the nature and extent of its market power. This involves assessing two main issues:

- the degree to which users can respond to a failure to provide a reasonable price-service offering and discipline the airport operator's behaviour through their ability to reduce their use of the airport, and
- the impact that these responses might have on the behaviour of the airport operator, and whether they sufficiently discipline the airport operator's pricing, investment and provision of service quality.[22]

2.17 The Guidelines further advise that the assessment of competitive constraints should include a consideration of buyer power and potential competition.

[20] Guidelines, paragraph 1.8
[21] Guidelines, paragraphs 3.3 and 3.4
[22] Guidelines, paragraphs 2.1 and 2.2

2.18 The structure of our assessment of STAL's market power follows this framework:

- section 3 describes STAL's business and operations;
- section 4 defines the market within which STAL operates;
- section 5 assesses competitive constraints, including airport users' ability to discipline the airport operator through switching or the threat of switching, buyer power and potential entry and expansion;
- section 6 investigates indicators of market power, including pricing, profitability, efficiency and service quality; and
- section 7 sets out our 'Minded to' Decision on Test A.

2.19 As stated in the Guidelines[23], and consistently with sections 6(3) of the CA Act, when considering whether or how best to regulate an airport operator, it will be important for the CAA to understand not just the level of market power currently held, but also the likely degree of market power that an airport operator may have in the future. This assessment is forward-looking and, forming part of the Q6 review covers the period from now until 2019/20.

2.20 Likely future developments in the market and their potential implications form a key part of this assessment, although evidence about the degree of market power currently held and previously held would also be taken into account. Most notably, on 18 January 2013, it was announced that Heathrow Airport Holdings Limited (previously BAA) would be selling Stansted to Manchester Airports Group.[24] Any assessment of the future market power of STAL will therefore take appropriate account of this key development.[25]

2.21 In the Guidelines, "substantial market power" is regarded as being equivalent to the level of market power enjoyed by a dominant undertaking under competition law.[26] The assessment of whether an operator is "likely" to acquire substantial market power is based on the ordinary meaning of the words; that is, whether it seems more probable than not that the operator would acquire substantial market power.

[23] Guidelines, paragraph 2.18
[24] '*M.A.G successful in bid for Stansted airport*', available at: http://www.manchesterairport.co.uk/manweb.nsf/content/M.A.GSUCCESSFULINBIDFORSTANSTEDAIRPORT (accessed 25 January 2013).
[25] Under section 6(3) of the CA Act, the operator's market power can be considered either alone or taken with other persons as the CAA considers appropriate. In the Initial Views, the CAA considered whether STAL held market power by virtue of its common ownership with Heathrow. The proposed change of ownership therefore marks an important difference to the situation at the time of the Initial Views. The findings of the market power test in s.6 of the CA Act will not be disturbed by a change in ownership (see Explanatory Notes to the Civil Aviation Bill, paragraph 52) but the new owner is free to apply for an advance operator determination under section 12 of the CA Act if it sees fit.
[26] Guidelines, paragraphs 2.8 – 2.11

CAA's approach to consultation and evidence gathering

2.22 There has been extensive stakeholder engagement, including with STAL, a number of unregulated airport operators and the main airlines of Stansted. This engagement and evidence gathering activities are set out in more detail in Annex 1 and have taken the form of:

- one-to-one meetings with STAL and its airlines to discuss relevant evidence;
- stakeholder feedback and discussion on work in progress;
- the submission of evidence by stakeholders (including reports commissioned from economic consultancies);
- the CAA's stakeholder workshops held on 15 November 2011 and 17 October 2012;
- questionnaires issued by the CAA to both airport operator and airlines and gathered documentary evidence from both; and
- consultants' studies commissioned by the CAA.[27]

2.23 The CAA has also published a number of working papers in 2011[28], including:

- empirical methods relating to geographical market definition and updates focusing on competitive constraints between neighbouring airports;
- empirical methods for assessing behaviour, performance and profitability of airports;
- general market context;
- catchment area analysis; and
- passengers' airport preferences.

2.24 Since 2006, Stansted has been the subject of a number of reviews that have explored, to varying degrees, issues and evidence relevant to the questions the CAA is looking to answer in the present process, including:

- The CC investigation into whether a feature or a combination of features of the market or markets in which airport services are supplied by BAA prevents, restricts or distorts competition in connection with the supply of airport services in the United Kingdom.[29] The CC published its final report on 19 March 2009 and found that BAA's common ownership of Heathrow, Gatwick and Stansted was a feature that distorted competition.

[27] For example, the CAA engaged Leigh Fisher to undertake a benchmarking study, 'Comparing and capping airport charges at regulated airports. This report will be made available on the CAA's website.
[28] Further detail can be found in Annex 1.
[29] The CC undertook this investigation following a reference by the Office of Fair Trading to the CC on 29 March 2007 under section 131 and 133 of the Enterprise Act 2002.

- In July 2007, the CAA provided advice to the Secretary of State that Stansted should be de-designated, as it did not meet the criteria that DfT had set to decide whether an airport should be designated under the Airports Act 1986. In January 2008, having considered the evidence on the constraints that airports outside of London could exercise on Stansted, DfT concluded that it was more likely than not that Stansted alone would acquire substantial market power in the future, although the decision was finely balanced.
- On 29 April 2008, the CAA made a reference to the CC under sections 40(9) and 43(1) and paragraph 6 of schedule 1 of the Airports Act 1986 with regards to the regulation of Stansted over the period of five years beginning on 1 April 2009. The assessment included a review of the competitive constraints at Stansted and, in particular, how the degree of STAL's market power should inform the choice of the appropriate regulatory approach at Stansted. The CC concluded that if there were to be a price cap similar to the existing level over the course of Q5, it would be likely to restrain BAA's prices below what they otherwise would have been.
- Following an unsuccessful appeal of its 2009 decision by BAA, the CC considered in 2011 whether there had been a material change of circumstances (MCC) since the publication of its 2009 report that would call into question the appropriateness of the requirement for BAA to sell Stansted within the time period set out in the 2009 report. The CC concluded that there were not any MCC or special reasons that should lead it to change its remedy. This decision was upheld by the Competition Appeal Tribunal and Court of Appeals in 2012.

2.25 It is against this general background that the CAA is making this assessment. Where appropriate the CAA has drawn on the evidence gathered for the purposes of the previous studies. The CAA's present assessment is, however, carried out under a different legislative framework and different circumstances due to the passing of time and changes that have taken place in the market place, including the sale of Gatwick by BAA in 2010. Consequently, the analysis and conclusions in this report are generally not reliant on the analysis carried out for the purpose of these previous studies. However, throughout this report, the CAA has compared its views and/or conclusions with those expressed in the above reports where appropriate.

Views invited

2.26 The CAA welcome stakeholders' views on the information presented in this paper. Those wishing to respond to this consultation should do so in writing, by no later than **5 pm on 26 April 2013**. Responses should be emailed to Barbara.Peratasmith@caa.co.uk.

2.27 If you would like to discuss the contents of this paper, and the CAA's work on assessing airport competition, please contact Alexander Dunki (email: alexander.dunki@caa.co.uk, Tel: 0207 453 6212) or Ian McNicol (email: ian.mcnicol@caa.co.uk, Tel: 0207 453 6234) in the first instance.

Next steps

The CAA intends to publish its formal decision under the CA Act on the market power determination for STAL before the end of 2013.

3. The business of STAL

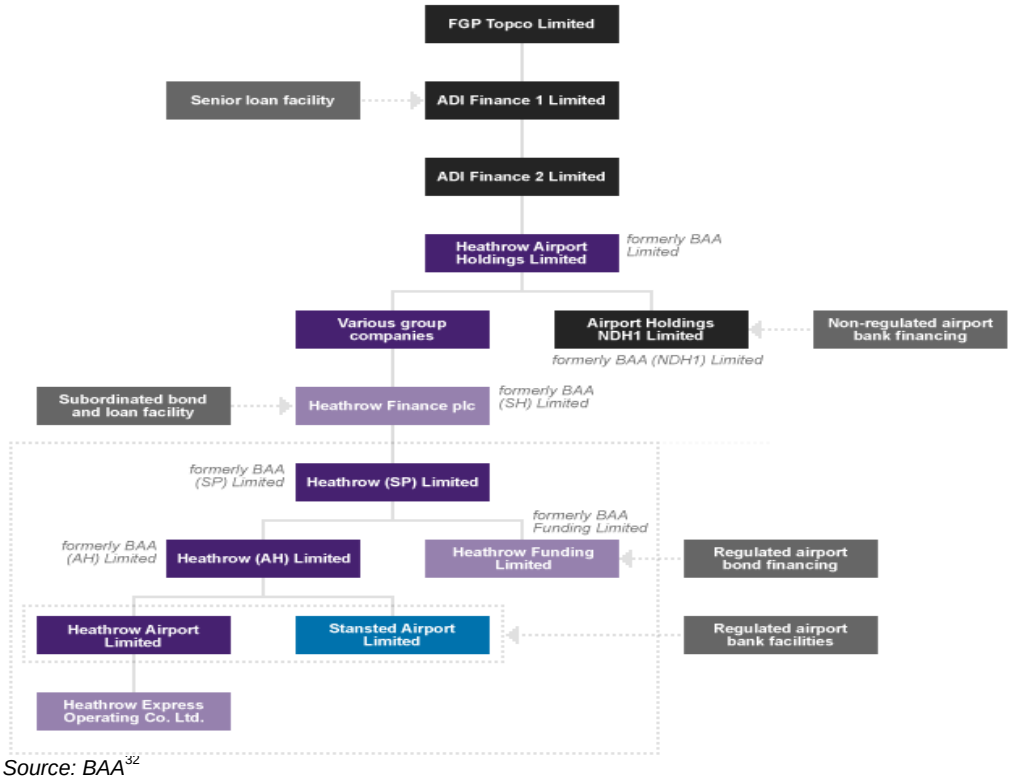
Introduction

3.1 This section provides an overview of the current ownership and history of Stansted and the business of STAL. In particular, it looks at the services the airport provides to different users as well as the different sources of revenue for the airport.

The ownership of Stansted

3.2 Stansted is currently owned by Heathrow Airport Holdings Limited (previously BAA). However, on 18 January 2013, it was announced that the airport will be sold to Manchester Airports Group.[30] This sale was mandated by the CC, which found "common ownership of the three BAA London airports is a feature of the market which prevents competition between them".[31] The airport's position within the BAA group structure is illustrated in Figure 3.1.

Figure 3.1: BAA group structure



Source: BAA[32]

[30] '*M.A.G successful in bid for Stansted airport*', available at: http://www.manchesterairport.co.uk/manweb.nsf/content/M.A.GSUCCESSFULINBIDFORSTANSTEDAIRPORT (accessed 25 January 2013).

[31] CC, '*BAA ordered to sell three airports*', 19 March 2009, available at: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/press_rel/2009/mar/pdf/11-09.pdf (accessed 26 November 2012).

[32] BAA,'*Debt in the Group's structure*', available at: http://www.baa.com/investor-centre/debt-information/debt-summary/debt-in-the-group's-structure (accessed 5 December 2012).

The development of Stansted

3.3 Stansted's origins date back to the Second World War, when it was built to provide an airfield base for the army of the United States of America. It is a single runway airport approximately 38 miles by road to the north of London and around 20 miles south of Cambridge.[33]

3.4 Following the Second World War, the airport served many purposes – including civil pilot training, aircraft production, and charter passenger and cargo flights – but it was not until the late 1970s that the Government White Paper 'Airport Policy' proposed major expansion of Stansted.

3.5 In 1980, the then British Airports Authority (which later became BAA) sought planning approval to develop Stansted. In 1985, following a public enquiry, the Government granted permission for Stansted to be developed to a capacity of 15 million passengers per annum (mppa). This was to be undertaken through a phased development, first to 8 and then to 15 mppa, with a cap on the number of take-offs and landings by passenger aircraft.[34]

3.6 In 1986, work commenced at Stansted and in 1991 the new terminal, aprons and taxiways were officially opened. A further capacity increase would follow, supported by planning permission in 2002 for Stansted to handle around 25 mppa.[35]

3.7 At that time Stansted was seen as an important component of the future development of the London airport system and its design took into account the future development of new generation large aircraft. In other words, the airport was designed to help address capacity across the London system by serving a mix of traffic.

3.8 In 2003, the Government issued 'The Future of Air Transport' (White paper), which set out a strategic framework for the development of airport capacity in the United Kingdom over the next 30 years. Among other issues, this document examined current and future capacity requirements and found that there was a need to make the best possible use of existing runways at the major South East airports. It also recognised that new runway capacity in the South East was required and Government policy supported the development of a second runway at Stansted as soon as possible.[36]

3.9 In 2008, STAL gained planning permission to handle 264,000 air traffic movements (ATMs), equivalent to a maximum capacity of 35 mppa within existing runway capacity constraints. In the same year, in line with the policy outlined in the Government's White paper, STAL submitted planning

[33] Competition Commission, Stansted Airport Limited, Q5 price control Review, October 2008, p. 16.
[34] STAL, '*Airport history*', available at: http://www.stanstedairport.com/about-us/stansted-facts-and-figures/airport-history (accessed 26 November 2012).
[35] STAL, '*Airport history*', available at: http://www.stanstedairport.com/about-us/stansted-facts-and-figures/airport-history (accessed 26 November 2012).
[36] The Future of Air Transport – White Paper, available at: http://collections.europarchive.org/tna/20050301192906/http://dft.gov.uk/stellent/groups/dft_aviation/documents/page/dft_aviation_031504.hcsp (accessed 9 November 2012).

applications to build a second runway, terminal and associated facilities (with a proposed opening date of 2015).[37]

3.10 In 2009, as is common practice for large developments, the application was 'called in' by the Government, which meant that the decision on whether the airport could expand was to be decided by the Secretary of State.[38]

3.11 In 2010, following a change in government, the Government indicated that it would not permit further runway expansion at the designated airports[39] until its new aviation strategy had been developed. STAL subsequently withdrew its planning application for a second runway.[40]

3.12 STAL has been regulated by the CAA in accordance with the Airports Act 1986. Under the Airports Act, an airport with an annual turnover of at least £1 million requires a 'permission to levy airport charges' from the CAA. Specifically, the Airports Act requires the CAA to impose conditions on designated airports for regulating the maximum amounts that may be levied by an airport operator by way of airport charges during a specified five-year period. In 1986, the CAA first gave permission to STAL to levy airport charges and the airport has been subject to this form of regulation since. While the CAA sets a maximum level of charges that an airport operator can set, an airport can enter bilateral agreements with airlines to agree terms, which means that the charges incurred by an airline can be lower than the cap that has been set.

Stansted's facilities

3.13 This section describes the scale and disposition of the airport's facilities as at 2011.

The runway

3.14 Stansted's airfield contains the airport's single runway (3048 metres long by 46 metres wide) south side twin parallel taxiways, a north side parallel taxiway and various aircraft holding points. The developed area is surrounded by extensive grassland. When the airfield layout was planned very large aircraft were anticipated, and the airfield has the capability to accommodate the Airbus A380 and the Boeing 747-800.[41]

[37] STAL, '*Airport history*', available at: http://www.stanstedairport.com/about-us/stansted-facts-and-figures/airport-history (accessed 26 November 2012).
[38] When an application is 'called in' this means that the normal Local Planning Authority (LPA) process is not followed. Applications that are called in tend to be the most complex and controversial applications and will usually be considered at a public inquiry. The Secretary of State will then make a decision, following the report and recommendations of a planning inspector. Information taken from: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/545_4_3.pdf.
[39] DfT, '*Eversheds aviation seminar'*, available at: http://www.dft.gov.uk/news/speeches/villiers-20101214/ (accessed 8 November 2012).
[40] STAL, '*Facts and figures*', available at: http://www.stanstedairport.com/about-us/stansted-facts-and-figures (accessed 22 October 2012).
[41] Source: STAL

The terminal

3.15 Stansted has one terminal (around 46 450 square metres) and all arriving and departing passengers on commercial flights are processed there. For departing passengers, facilities include check-in, security, lounge areas, shops and catering facilities, and access to the tracked transit system for travel to some of the satellites. On arrival, passenger facilities include immigration, baggage reclaim, and customs control and arrivals concourse with onward travel information areas. The lower levels of the terminal are primarily used for baggage processing and other activities including plant rooms, offices, storage and deliveries.[42]

3.16 Within the terminal there is also around 10 600 square metres of retail space, with approximately 60 retail clients operating around 80 retail outlets. Approximately 60 per cent of the retail space is located airside and most retail facilities are located in Stansted's main passenger terminal building, supplemented by additional outlets located within the three boarding gate satellites.[43]

Aprons and satellites

3.17 There are currently three satellite buildings at Stansted – Satellites 1 and 3 are used by international passengers and Satellite 2 is used by both international and domestic passengers. These three satellites provide departing passengers with gate room areas prior to boarding the aircraft and for arriving passengers a route to the terminal.[44]

Aircraft stands

3.18 The aircraft stands at Stansted are designed so as to be able to be used flexibly for a range of different aircraft sizes. That is, some of the stands can be configured so that they can be used for one large aircraft or two small aircraft. STAL has indicated that it has 110 stands where all stands are used for small aircraft or 70 stands if its stands are used for a combination of large and small aircraft.[45]

Surface transport facilities and car parks

3.19 Key components of Stansted's surface access infrastructure are its rail links, rail station, bus and coach station, road network, car parks, hire car and taxi facilities, and pedestrian and cycle facilities:

[42] Stansted was designed to serve a range of different airlines but most passengers that use this airport fly with low cost carriers (LCCs). While there is no exact definition of what a LCC is, the distinction between a LCC and a full service carrier is becoming harder to draw as airlines from each category have each adopted some of the practices of the other. For the purpose of this chapter we have deemed both easyJet and Ryanair to be LCCs. The LCC operating model is typically seen as having several elements, all of which help reduce operating costs: (1) flights are normally only available on a point-to-point basis; (2) a single class of service on board; (3) greater use of secondary airports; (4) ticket sales are carried out directly by the airline; (5) focus is on shorter routes; (6) a simplified fleet structure (often with only a single aircraft type); and (7) quick turnaround times. Information taken from: http://www.caa.co.uk/docs/33/CAP770.pdf.
[43] Source: STAL
[44] Source: STAL
[45] Source: STAL

- the rail station, which has three platforms, is located beneath the terminal building and forecourt;
- the bus and coach station, which includes a waiting area for passengers, has 40 bays for scheduled bus and coach services, internal hotel shuttle buses and charter coaches. There are a further 20 bays in an adjacent bus and coach layover area; and
- car parks which provide around 26 000 car park spaces for short, mid or long stay. There is also a valet-parking car storage area. Facilities are also provided for other road-based users including car rental companies and taxis.[46]

Cargo facilities

3.20 Stansted's cargo centre is an approximately 88 200 square metres facility immediately to the southwest of the passenger terminal which includes storage and handling buildings with full airside access to dedicated aircraft cargo stands. This makes this facility the largest dedicated air cargo facility in the South of England.[47] Depending on aircraft type there are 10 - 16 dedicated cargo aircraft stands available, enabling the loading of freight on adjacent stand areas.[48]

Aircraft maintenance

3.21 Stansted has maintenance facilities on both the north and south sides of the airport. The maintenance activities that typically occur are scheduled servicing, overnight maintenance and repair work.[49]

Other facilities

3.22 Stansted also has a number of other facilities that help support the airport's operations, including three hotels, two principal stand-alone office developments, a flight catering base, airport vehicle maintenance facilities, aviation fuel storage and STAL's general aviation operations.[50]

3.23 In addition to the properties outlined above, Stansted also holds various residential properties it acquired under blight schemes associated with the two generations of Stansted's planning development (SG1 and SG2).[51]

Stansted's traffic and customers

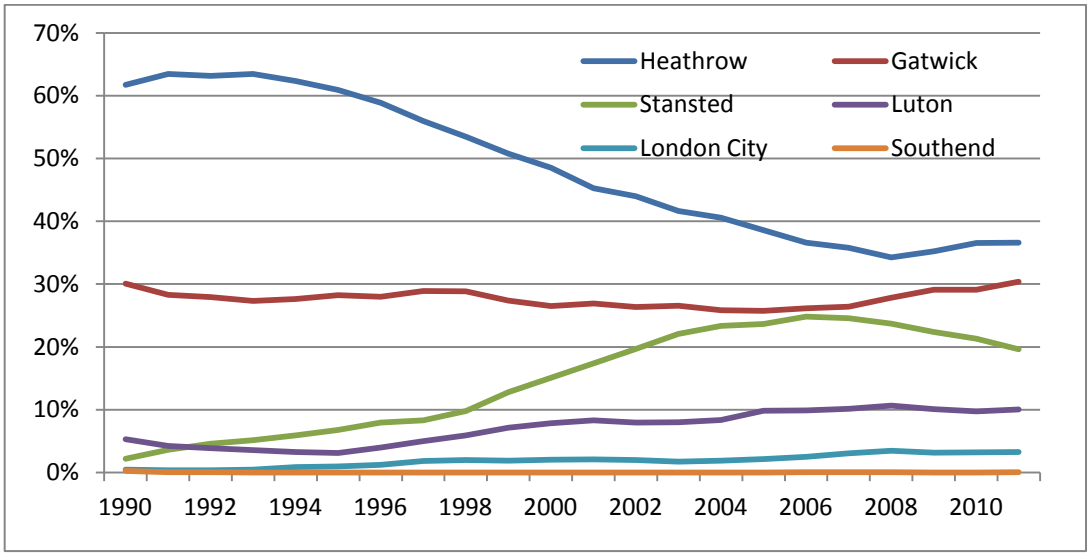
Traffic trends

3.24 In 2011, Stansted had 15 airlines each serving more than 10000 passengers a year and was the third busiest London airport in terms of passenger

[46] Source: STAL
[47] Source: STAL
[48] Source: STAL
[49] Source: STAL
[50] Source: STAL
[51] Source: STAL

numbers.[52] This is illustrated in Figure 3.2, which shows that in 2011 the airport accommodated around 20 per cent of London's passengers to UK and European destinations, compared to the 37 per cent achieved by Heathrow and the 30 per cent achieved by Gatwick.

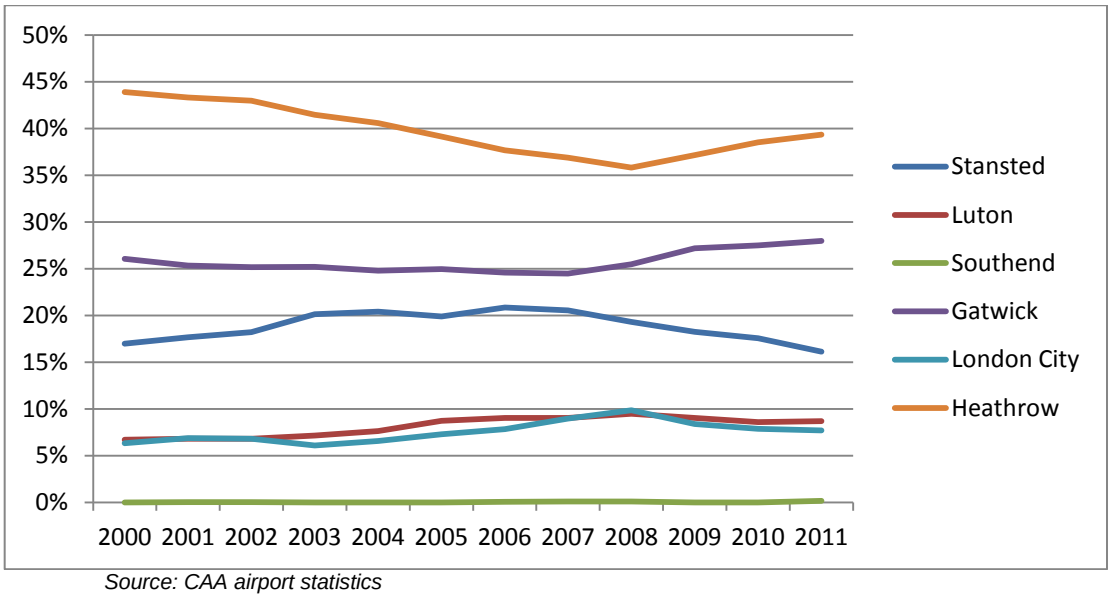
Figure 3.2: London airports' share of passengers from London to UK and European destinations in 2011



Source: CAA airport statistics

3.25 Stansted was also the third largest London airport when measured by ATMs (see below). Figure 3.3 shows that in 2011 the airport accounted for around 16 per cent of London's ATMs to the UK and European destinations, compared to the 39 per cent achieved by Heathrow and the 28 per cent achieved by Gatwick.

Figure 3.3: London airports' share of ATMs to the UK and European destinations in 2011



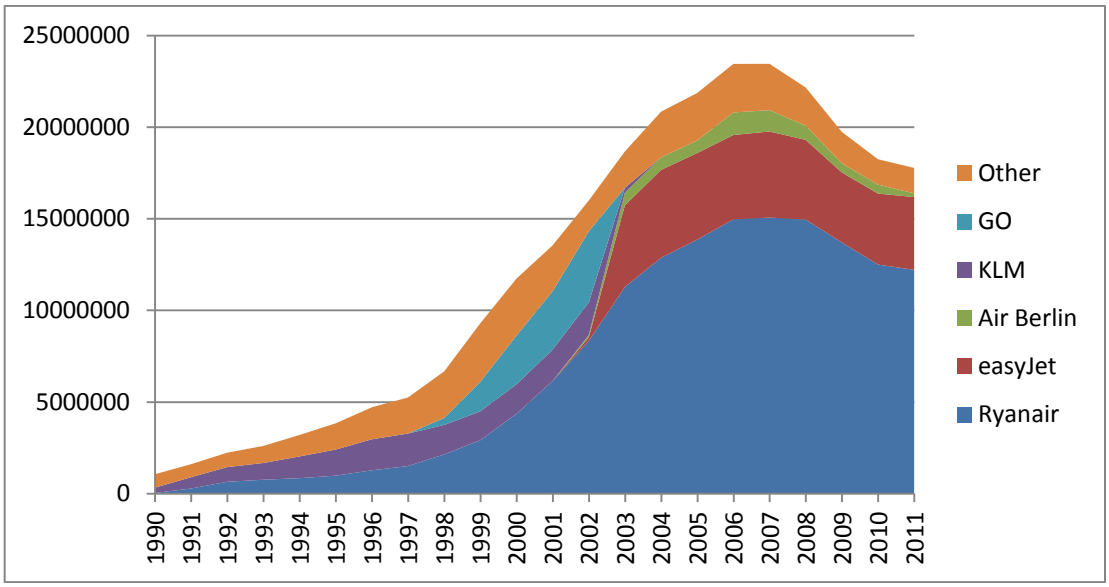
Source: CAA airport statistics

[52] CAA airport statistics.

Passenger airlines

3.26 In 2011/12, the airport served 17.9 million passengers (see Figure 3.4). This figure shows that the airport experienced significant passenger growth up until 2006/07, where the airport reached a peak of 23.5 million passengers. Over this period, the macroeconomic climate and the expansion of Ryanair and easyJet's UK operations were the key drivers of this growth.[53] Since the 2006/07 peak the airport has experienced a decline of 5.6 million passengers.

Figure 3.4: Airline passenger numbers at Stansted



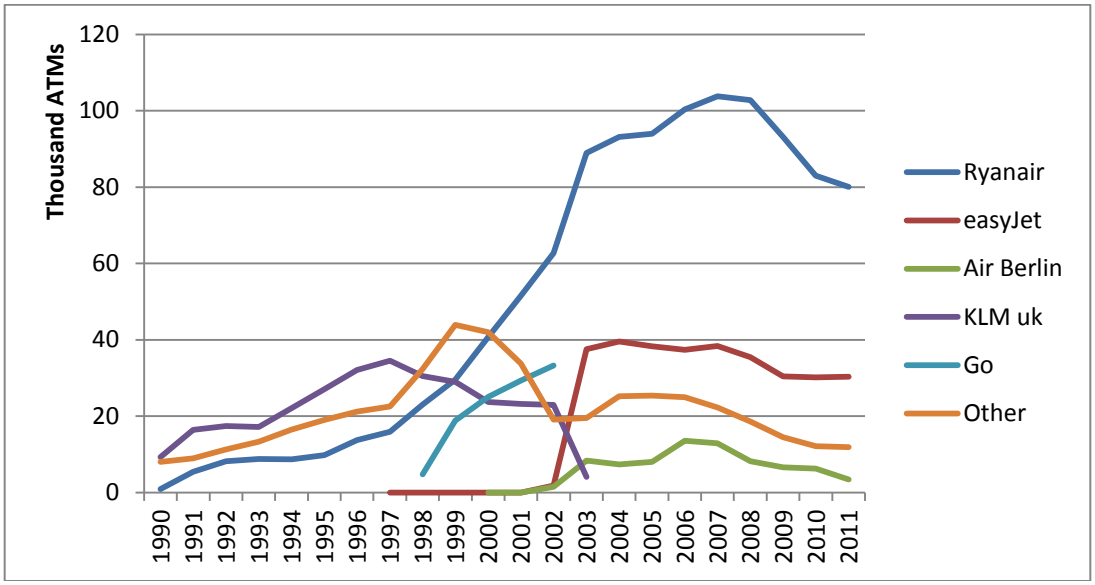
Source: CAA airport statistics

3.27 Figure 3.4 also shows that in 2011/12, Ryanair and easyJet comprised over 90 per cent of the airport's passenger traffic (69 per cent Ryanair, 22 per cent easyJet). Other airlines present at the airport in 2011/12 include Thomson Airways, with 2 per cent of the airport's passengers, and Air Berlin with 1 per cent of the airport's passengers.

3.28 The strong presence of Ryanair and easyJet is also highlighted by Figure 3.5. In particular, this figure illustrates that easyJet and Ryanair represented the vast majority of ATMs to the UK and Europe at Stansted with, respectively, approximately 30 000 and 80 000 ATMs in 2011.

[53] The growth of Ryanair and easyJet's operations at Stansted was supported by a number of long term deals the airport signed with these carriers in 2001 (and which, in general, expired in 2007).

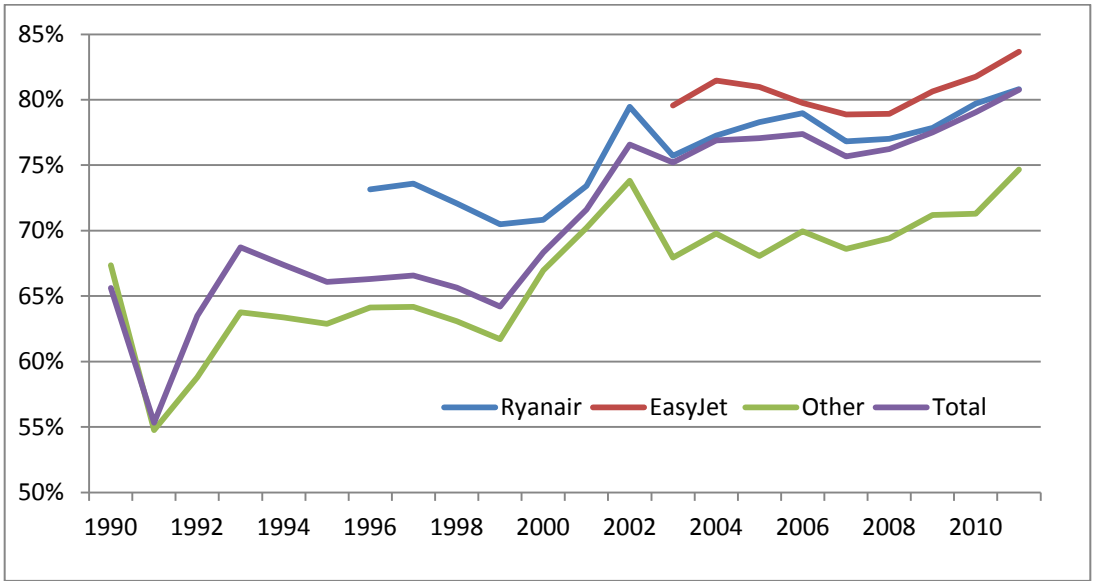
Figure 3.5: ATMs to the UK and Europe by passenger airline



Source: CAA airport statistics
Note: easyJet acquired GO in 2002 and Ryanair acquired Buzz in 2003.

3.29 The average load factor achieved by airlines at the airport is also relatively high, with a load factor of around 81 per cent in 2011, up from the 65 per cent in 1990 – see Figure 3.6.

Figure 3.6: Average load factors at Stansted



Source: CAA airport statistics
Note: Load factors are estimates based on CAA airport statistics

3.30 Over the last five years, a period covering challenging macroeconomic conditions, the airport has been relatively unsuccessful at attracting (and keeping) new passenger airlines. While the airport managed to secure a number of new airlines, including Air Asia X, bmibaby and WOW, its success was relatively short lived, with carriers either moving to another UK airport or ceasing UK operations. Over the same period, the airport also lost a number of airlines that had been operating at the airport, with the number of airlines

at the airport that served more than 10 000 passengers a year falling from around 40 to the 15 currently seen.[54]

3.31 The lack of new airlines operating at the airport, combined with a number of departures, has translated into Ryanair and easyJet now representing a significant percentage of Stansted traffic be it measured through passenger numbers or ATMs.[55]

Cargo airlines

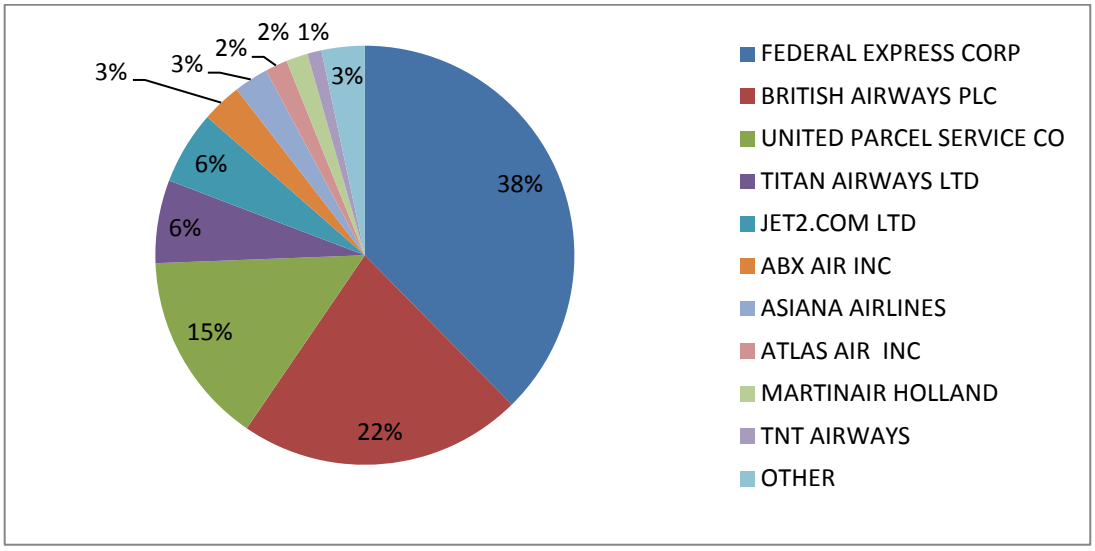
3.32 Stansted also has a number of cargo only carriers operating out of it.[56] Based on 2011 data, there were 35 cargo-specific carriers that used the airport. However, the CAA understands that a number of these carriers used the airport in a one-off manner rather than as part of a regular service. Of the 35 cargo airlines identified, the majority of the cargo was carried by 10 companies:

- Federal Express;
- British Airways;
- United Parcel Service;
- Titan Airways;
- Jet2.com;
- Abx air;
- Asiana Airlines;
- Atlas Air;
- Martinair Holland; and
- TNT Airways.[57]

3.33 In terms of air cargo tonnage, Stansted is the third most important airport in the UK with 9 per cent of the volume, this compares with Heathrow with 61 per cent and East Midlands with 12 per cent. There are, however, differences in the type of carriers operating at each of these airports. For example, Stansted (and East Midlands) have hardly any bellyhold cargo, due in part to it not usually being carried by low cost carriers, but are important airports for cargo-only operations. Figure 3.7 highlights Stansted's airport tonnage per carrier.

[54] CAA airport statistics.
[55] Evidence submitted by Stansted for example illustrates that over the period 07/08/2011 to 13/08/2011 the split of Ryanair aircraft that departed first in an operating day and those that arrived first was 85.9 per cent and 14.1 per cent respectively. Analysis of Ryanair slot utilisation 2011.
[56] A cargo only carrier is, in general, an airline that specialises in the transportation of cargo (freight and/or mail) rather than passengers.
[57] CAA airport statistics.

Figure 3.7: Stansted cargo tonnage per carrier (2011)

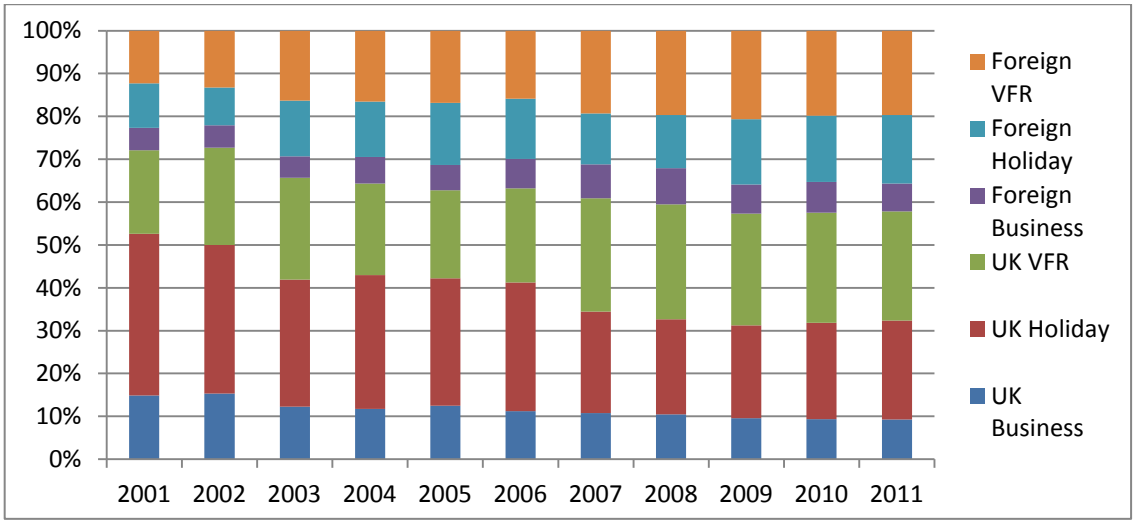


Source: CAA airport statistics

Passenger types

3.34 While the airport caters to all passenger types, the airport is particularly important to the non-business passenger segment, with the vast majority of passengers travelling for holidays and to visit friends and family (see Figure 3.8). While business travellers do use the airport to a limited extent, their share of traffic has declined over the years. This can be seen by reference to the 2011 calendar year data that shows that 85 per cent of the passengers at Stansted were using the airport for holidays and to visit friends and family, with business passengers accounting for only 15 per cent.

Figure 3.8: Stansted passenger types



Source: CAA Passenger Survey

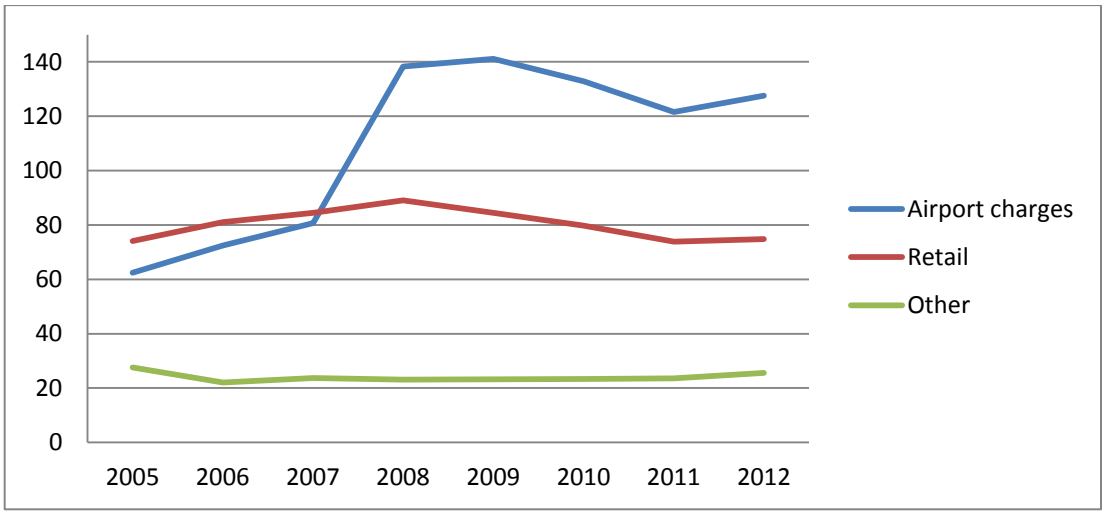
Stansted's business model

3.35 The airport operator generates revenue from three main sources:

- airport charges, including charges on landing, charges on departing passengers and aircraft parking charges;
- commercial income, such as revenue from retail concessions (and associated retail revenue sharing arrangements), car parking and property; and
- other income, specifically income from non-regulated aeronautical charges (ie revenue from charges levied on airlines for other services, including the servicing of aircraft and the use of airport property and fuel).

3.36 Figure 3.9 shows the various revenues that the airport operator has received over the last seven years.[58] In particular, it shows that the revenue the airport operator receives from airport charges has experienced a strong upward movement, with a significant increase in 2007, which is consistent with a number of the airport operator's long term (discounted) pricing contracts with airlines ending.[59] On the other hand, retail revenue showed a modest increase in the three years to 2008 but has, in general, experienced a decline since then. The revenue from other charges has remained relatively flat over the period.

Figure 3.9: Stansted's revenues (£m)



Source: Stansted, Statutory Accounts

3.37 As Stansted is a designated airport that is subject to price controls, the maximum airport charge that the airport operator is permitted to charge is based on the CAA's assessment of an efficient level of costs, its view on the appropriate return of capital to be allowed and how the resulting price cap would facilitate competition between airports. Each airport is separately

[58] This information has been taken from STAL's statutory accounts which are available online.
[59] These contracts were struck after 11 September 2001, following the aviation downturn. They were struck at prices that were substantially lower than the prevailing price cap.

regulated, with price controls closely linked to the specific circumstances of the airport and the needs of the airlines and passengers at that airport. Through the 'single till' approach to regulation, users benefit from the co-funding of the airport's costs from unregulated commercial income (for example, retail and car parking revenues) generated at each airport, thereby providing scope for the airport charges to be reduced.

3.38 The actual airport tariffs that STAL sets are published in its 'Conditions of Use', which are available on the airport's website.[60] By considering these charges and passenger numbers, weight of aircraft, noise levels etc, an estimate of an airport operator's revenue can be calculated. However, the charges outlined in the airport operator's 'Conditions of Use' may not represent the charges that are actually paid by an airline, as the airport operator can enter into bilateral agreements with airlines that can result in lower charges being paid.

3.39 Figure 3.10 outlines the regulated price caps that were set for Stansted as well as the revenue yields that the airport operator has achieved over the period 2003/04 – 2011/12.

Figure 3.10: Stansted's aeronautical revenues and revenue yields

Source: CAA analysis of regulatory returns

3.40 Figure 3.10 shows that since 2009/10 STAL has set tariffs close to the cap. However, the CAA notes that the airport operator had started pricing close to the cap from 2007/08 but that this excluded the correction factor (the K factor)[61] which resulted in the yield being slightly lower than the allowed price cap. The small difference between the actual revenue yield and the yield

[60] See: http://www.stanstedairport.com/static/Stansted/Downloads/PDF/STN_Conditions_of_Use_2011-12.pdf (accessed 30 October 2012).
[61] The correction factor (K) is a factor designed to address any over or under recovery of allowable yield that may have occurred in prior years. For example, in 2007/08 the airport operator's allowable yield was £6.437 per pax when the K factor is excluded but £5.50 when the K factor is included.

based on published charges indicates that the impact of any bilateral airline deals is small in comparison to overall charges. In 2011/12, this difference was only 3 per cent.

3.41 The airport operator's approach to pricing to the cap is also apparent when we examine the different airline revenue yields that the airport has achieved through its bilateral agreements with different airlines.[62]

Table 3.1: Revenue yields per major passenger airline (2011/12)

Passenger Airlines	Income (£m)	Passengers (m)	Yield per passenger (£)
Ryanair	[✂]	12.2	[✂]
easyJet	[✂]	3.9	[✂]
Air Berlin	[✂]	0.2	[✂]
Germanwings	[✂]	0.5	[✂]
Thomson Airways	[✂]	0.3	[✂]
Thomas Cook	[✂]	0.2	[✂]
Air Asia	[✂]	0.1	[✂]
Turkish Airlines	[✂]	0.0	[✂]
Aurigny	[✂]	0.0	[✂]
Pegasus Airlines	[✂]	0.2	[✂]

Source: STAL

3.42 The airport also generates revenue from its cargo operations. Table 3.2 outlines the revenue and cargo tonnage that the airport operator has achieved over recent years.

Table 3.2: STAL cargo revenue per tonne

	Income (£m)	Tonnage (m)	Income per tonne (£m)
2007/08	[✂]	0.23	[✂]
2008/09	[✂]	0.22	[✂]
2009/10	[✂]	0.22	[✂]
2010/11	[✂]	0.23	[✂]
2011/12	[✂]	0.23	[✂]

Source: STAL

Airport charges

3.43 As outlined earlier, STAL's airport charges are comprised of three types of charges – charges on landing, departing passengers and aircraft parking – each of these is explored below.

[62] As each airline is unique the yields that an airport will be able to achieve will reflect a number of factors, including the airport operator's approach to its negotiations, the airline's approach to its negotiations and the operating characteristics of the airline.

Charges on landing

3.44 The charge on landing is a charge for the landing and departure of an aircraft that is based on the weight of the aircraft, including its contents, and noise – with aircraft failing to meet set noise standards subject to a higher charge. At Stansted, a higher amount is also charged for aircraft landing at peak periods (1 April to 31 October) compared to off peak periods (1 November to 31 March).[63]

Charges on departing passengers

3.45 The charge on departing passengers is a charge that the airport operator imposes for each departing passenger. It is a charge that a passenger does not face directly as it is paid by the airline. The level of this airport specific charge is not typically visible to the customer, although airport fees can be listed as a component of the headline airfare.

3.46 As of 2008, the airport operator applied three different departing passenger charges based on the destination (and therefore the infrastructure and services) that the passenger was going to use. A rebate on these charges was offered if the passenger left from a remote stand. The level of passenger charges at Stansted over the past four years is illustrated in Table 3.3.

Table 3.3: Charges on departing passengers 2008/09 – 2011/12 (£ per passenger)

	Domestic	International	International (Republic of Ireland)	Remote stand rebate
2008/09	6.01	9.13	7.35	1.97
2009/10	6.13	9.30	7.50	2.00
2010/11	6.11	9.27	7.48	2.00
2011/12	6.50	9.86	7.95	2.13

Source: STAL, Conditions of Use 2008, 2009, 2010, 2011

3.47 The structure of the airport passenger charges remained largely static over the period 2008/09 – 2011/12 but in 2012/13, the airport operator removed the distinction between domestic and international passengers to eliminate the differential in charges between international and domestic passengers. Consequently, all departing passengers now face the same (equalised) departing charge of £9.90 per passenger.[64] While this change represented a minimal increase in the international per passenger charge (less than 1 per cent), it represented a significant increase in the charge for domestic passengers (52 per cent increase) and for international (Republic of Ireland) passengers (25 per cent increase).[65]

[63] In addition, an Air Navigation Services charge per landing applies to all flights.
[64] Further information on airport charges is available at: http://www.stanstedairport.com/about-us/doing-business-with-us/conditions-of-use (accessed 1 November 2012).
[65] The airport operator has indicated that this change was introduced within the constraints of the CAA's price cap and was effectively revenue neutral to the airport operator.

Aircraft parking charges

3.48 Aircraft parking charges are the charges that the airport operator imposes for the parking of aircraft at the airport which, in general, are based on an aircraft's weight and the duration of stay.[66] Table 3.4 highlights the level of charge that the airport has imposed for this service over the last 6 years.

Table 3.4: Airport parking charges

	Not exceeding 15 metric tonnes	**Over 15 tonnes**	
	Per 24 hrs (£)	**Per quarter hour (£)**	**Per metric tonne (£)**
2007/08	98.00	2.79	0.18
2008/09	100.00	2.87	0.18
2009/10	102.00	2.94	0.18
2010/11	101.70	2.94	0.18
2011/12	108.14	3.13	0.19
2012/13	113.00	3.27	0.20

Source: STAL, Conditions of Use, 2007–2012

Cargo charges

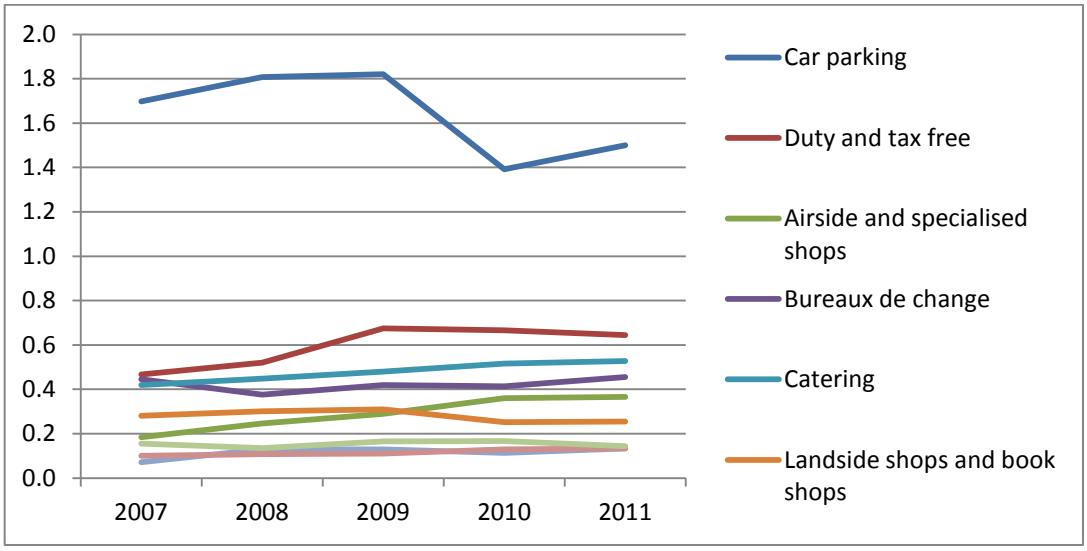
3.49 As stated above, STAL also provides infrastructure and infrastructure services to cargo only carriers. This includes the provision of runway and apron space, as well as providing access to cargo handlers, access to warehousing facilities and infrastructure to allow the efficient onward transfer of cargo.

Commercial income

3.50 STAL generates revenue from a number of commercial activities including car parking, various (airside and landside) retail outlets and catering. The revenue per passenger that the airport operator has captured is illustrated in Figure 3.11.

[66] STAL, Conditions of Use, Including Airport Charges from 1 April 2011, available at: http://www.stanstedairport.com/static/Stansted/Downloads/PDF/STN_Conditions_of_Use_2011-12.pdf (accessed 30 October 2012).

Figure 3.11: Commercial revenue per passenger



Source: STAL, Financial statements

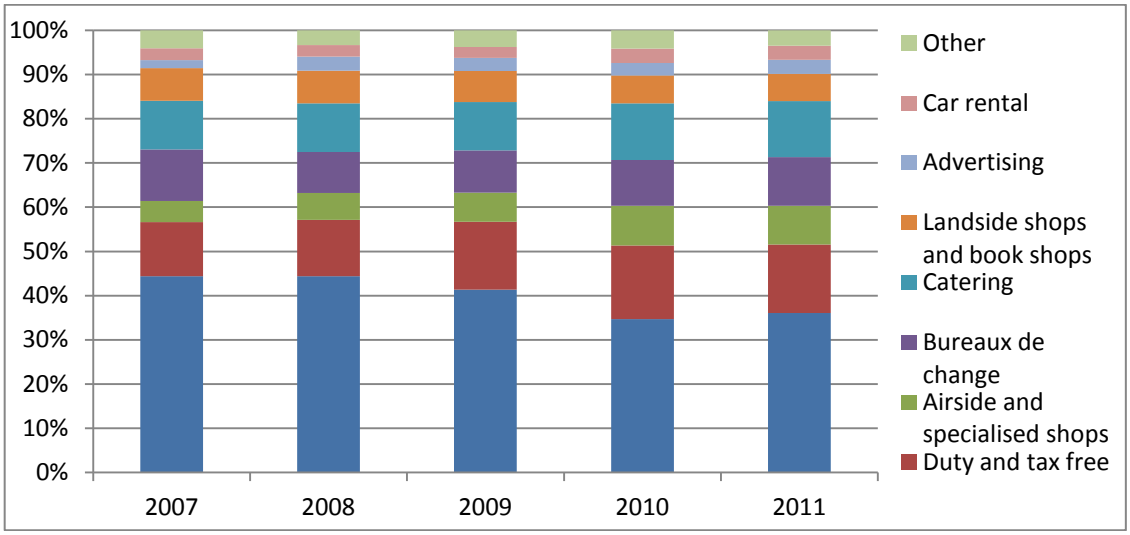
3.51 Figure 3.11 suggests that:

- car park revenue per passenger has declined over the period – a decline that the airport has attributed to a decline in domestic traffic, a decline in the 'roll-up' market and the migration of passengers to public transport;
- shopping (airside and landside) revenue per passenger has increased – a rise attributed to a number of shops experiencing double digit annual growth; and
- in general, a slight increase in the other measures.[67]

3.52 Another way of examining the revenue that the airport operator has received can be seen by reference to Figure 3.12, which shows, on a percentage basis, the various sources of the airport operator's commercial revenue.

[67] Rationale for the various changes taken from information provided by STAL

Figure 3.12: STAL's sources of commercial income



Source: STAL, Financial Statements 2008, 2009 and 2011

3.53 In particular, Figure 3.12 shows (amongst other things) that:

- parking revenue has declined from around 44 per cent of the airport operator's revenue to around 36 per cent, with an average of around 40 per cent over the period examined;
- catering revenue has increased slightly from around 11 per cent to around 13 percent, with an average of 12 per cent; and
- revenue from duty free, airside and specialised shops, and bureaux de change have all increased over the period and, on average, represent over 30 per cent of the airport's revenue.

3.54 Given the relative importance of both retail and car parking to the airport operator's revenue, we explore both these issues in slightly more detail below.

Retail

3.55 Retail outlets are typically operated by a third party with the airport operator receiving a concession fee. The significant majority of concession agreements for terminal retail outlets work on the basis of a percentage of retail income that accrues to the airport operator, typically underwritten by minimum guarantees.[68] STAL told the CAA that it also makes arrangements with its retailers to ensure that the prices that are quoted are no more that expensive than their equivalent on the UK high street.[69]

Car parking

3.56 The commercial aspects of these car parks are managed by STAL and it uses yield management techniques to optimise revenue between the different car parks. The prices that are set are done so dynamically, that is

[68] Source: STAL
[69] Source: STAL

they change to reflect market conditions, and discounted rates are available through pre-booking on the airport operator's website. Table 3.5 shows the average transaction values that the airport achieved in 2007 – 2011:

Table 3.5: [✂]

[✂]

Source: STAL

3.57 In 2006, the airport operator introduced a £1 per vehicle fee for passenger pick-up, with the passenger pick-up area located adjacent to the short-term car park. In 2009, this charge was increased to £2 per vehicle. During this period the airport operator did not impose a passenger drop-off fee.

3.58 In November 2012, STAL introduced a number of changes to its car parking arrangements, including:

- introducing a charge for passenger drop-off near the terminal;
- replacing the previous pick-up and drop-off areas that were close to the short term car parks with a 'pick-up and drop-off' area in the mid-term car park, from where passengers catch a bus to access the terminal building; and
- introducing a new express set-down area, adjacent to the short-stay car parks, for customers willing to incur a charge.[70]

[70] Source: STAL

4. Market definition

Introduction

4.1 This section seeks to define the market(s) in which STAL operates. As outlined in the Guidelines, defining the relevant market(s) is a first step of a competition assessment and is standard practice in competition analysis. In addition, under the CA Act, Test A of the market power test requires that the CAA finds there to be SMP on the part of the airport operator in a market for one or more types of airport operation services. This therefore requires the identification of the market(s) in which the market power assessment is carried out.[71]

Analytical framework

4.2 The Guidelines outline broadly the assumptions and approach taken in the process of market definition. In particular, similarly to the OFT, the CAA does not regard market definition as an end in itself, but rather as a framework within which to analyse the market[72]. It is a useful tool for identifying the competitive constraints present in the market. There may, however, be characteristics of the airport sector that make it difficult to define the market precisely. As explained in the Guidelines, the market power assessment should seek to analyse all the competitive constraints faced by STAL in the round, regardless of whether they arise from within or outside the market or markets as defined in this section of the report[73].

4.3 The Guidelines state that, wherever feasible, we should adopt the hypothetical monopolist test as a useful starting point for defining the relevant market[74]. This involves starting with the narrowest possible bundle of products and geographical market and widening them to the last set of products and geographic area over which a hypothetical monopolist could profitably impose a small but sustainable non-transitory increase in price (SSNIP), generally considered as being 5 to 10 per cent. This provides the boundaries of the market as the widest set of products and geographic area over which the hypothetical monopolist could profitably increase its prices. However, as noted in the Guidelines, it is rarely possible to apply the test in a precise sense because of data and evidential restrictions and it is therefore likely to necessitate the CAA to infer, from a range of information, both qualitative and quantitative, what the likely outcome of the test would be[75].

[71] Section 6(3) and 6(6) (a) and (b)
[72] Guidelines, paragraphs 3.3 and 3.4
[73] Guidelines, paragraph 3.5
[74] Guidelines, paragraphs 3.10 to 3.12
[75] Guidelines, paragraph 3.13

4.4 Further, the SSNIP test is less than ideal for assessing the current level of competition in some markets, since it is intended to be carried out by reference to the competitive price level. In particular, it is possible that the prevailing price levels observed in the market may not be reflective of the competitive price. It may be that the current price level is already above the competitive price level due to market distortions, such as the presence of a profit maximising monopolist or historical regulation. In such cases, it would be unlikely that a company could viably sustain a SSNIP over the relevant timeframe. Therefore, it would be wrong to argue that the comparator products would limit the firm's ability to exercise market power. The application of the SSNIP test in such circumstances would lead to an erroneously wide market definition. Likewise, the current prices could be below the competitive level that could lead to a narrower market being defined.[76] Caution must be exercised, for example, when considering evidence of switching patterns as this may not be a reliable guide as to what would happen in a competitive market[77]. The possibility that the market analysis may be distorted will need to be accounted for when the evidence is considered in the round.

4.5 For these reasons, and given the circumstances of Stansted, the CAA has not been able to carry out a formal SSNIP test in a strict sense. However, it has followed the principles of the SSNIP test in a consistent hypothetical monopolist framework by gathering and interpreting a range of evidence, including catchment area analysis, passenger surveys, documentary evidence and the views of airlines and relevant airport operators on substitutability.

Interdependence of demand from different user groups

4.6 The Guidelines state that airports can be viewed as platforms in a multi-sided market. It recommends that, where airport operators take account of interdependent demands of different user groups and levy different charges for different services to different users, account should be taken of any interactions and interdependencies between the various activities that the airport operator undertakes[78]. The extent to which common (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 services.

4.7 There are a number of issues that the CAA considers relevant to whether the process of market definition for Stansted can be carried out primarily using conventional market definition methods, treating the relationship between airlines and their passengers as a vertical one, or whether such methods should be modified significantly to take into account the possible role of an

[76] The CAA considers further the competitive price level in chapter 6
[77] Guidelines, paragraphs 3.15 to 3.16
[78] Guidelines, paragraphs 3.18 and 3.21

airport as a multi-sided platform. The key characteristics of a multi-sided market in the context of airports have been set out in a paper prepared by David Starkie and George Yarrow for the CAA in 2010:[79]

- the airport is the platform;
- 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, higher 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 takes account of the different demand conditions – on the one hand, the airline's demand for the access to the airport and its facilities, and, on the other, the demand of the passenger for services from the airport; and
- 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 services providers, then the airport operator has a revenue stream from each of these two groups, and has to consider two sets of prices

4.8 Broadly, the above arguments fall into three categories: the existence of network effects; marketing activities carried out by the airport operator to attract passengers and airlines separately to the airport; and the existence of a stream of commercial revenue driven by passenger volumes.

4.9 The available evidence does not suggest that network effects are significant.

- Stansted currently does not have any airlines providing significant network services. Its main airline, Ryanair, provides short-haul origin and destination (O&D) routes without a significant share[80] of passengers interlining.[81]
- The CAA has received evidence that inter-connection opportunities at Stansted are lesser than at Gatwick[82] and that conventional interlining carriers at Gatwick are not attracted to Stansted for this reason[83]. Air Asia X told us that although a proportion of its passengers used Ryanair's flights to self-connect onwards to short-haul destinations from Stansted, there were more carriers and destinations with which to do

[79] 'Market definition in the airports sector' at http://www.caa.co.uk/docs/5/ergdocs/MarketDefAirports.pdf, page 13
[80] The CAA survey suggests that only 4.5 per cent of passengers at Stansted were connecting between flights in 2011 (see www.caa.co.uk/surveys).
[81] Although there is no integrated interlining at Stansted, a small proportion of passengers may self connect between flights by purchasing two separate tickets.
[82] Source: **[✂]** and **[✂]**
[83] Source: **[✂]**

this at Gatwick[84]. Similarly, commenting on the possibility of moving from Gatwick to Stansted, **[✂]**[85]

- The CAA's understanding is that the significant expansion of Stansted traffic between 2001 and 2007 appears to have been primarily the result of the development and marketing activities of Ryanair and to a lesser extent easyJet, rather than the active efforts of the airport operator. Although given this growth it might be assumed that the attractiveness of the airport to other airlines would have increased as passenger numbers have increased (thus resulting in network effects, a characteristic of multi-sided platforms), the evidence the CAA has seen suggests that the large presence of Ryanair has, if anything, reduced the airport's attractiveness to other airlines.

4.10 Second, STAL does not appear to directly approach passengers and airlines as two separate, parallel user groups:

- STAL told the CAA that it does not tend to market itself to passengers as a brand, but concentrates on supporting airlines in their marketing to passengers. The primary focus of its marketing activities is on attracting airlines to the airport and supporting the airlines business. Where advertising is targeted directly at passengers this is on a route by route basis for specific airlines (and agreed as part of the price negotiations with airlines).[86]
- This is consistent with the views expressed by its parent company, Heathrow Airports Group Limited (formerly BAA), about its approach:[87] **[✂]**
- The airport operator has a limited direct commercial relationship with passengers, other than through charges for its car parks or access to the operator's forecourt. In addition, to the extent that an airline decides to pass on any increase in airport charges, this is only visible to the passenger through an increase in airfares imposed by the airline.

4.11 These points highlight that STAL currently does little in the way of matching airlines to passengers.[88] Its focus appears to be on gaining airlines which then generate passengers and there are currently limited network effects at Stansted.

4.12 Notwithstanding the above, the CAA does recognise the existence of "complementarities" between aeronautical and non-aeronautical revenue of the type identified by Yarrow and Starkie. By impacting on passenger volumes, an increase in aeronautical charges may impact on revenues

[84] Source: Air Asia X
[85] Source: [✂]
[86] Source: STAL
[87] Source STAL
[88] It is however possible that in future, under different ownership, STAL might seek to market its services to passengers actively, should the market develop in such a way following the divestment of Stansted, so as to create incentives for it to do so.

derived from commercial services and in principle, an airport operator may take this into account in its pricing decisions for aeronautical services.[89]

4.13 The strength of these complementarities will depend on the extent to which the non-aeronautical revenue generated by the airport operator is linked to passenger volume and on the amount of revenue the airport operator generates from aeronautical services relative to non-aeronautical services. It will also depend on the extent to which the airport operator's pricing decisions in relation to aeronautical services take account of the revenue potential for non-aeronautical services. This will be taken into account when assessing the impact on profitability of a small price rise later. However, the CAA notes:

- In 2007, STAL began pricing up to the cap after pricing below it for a number of years. There is no indication that consideration was taken on the possible effects of income derived from the commercial operations. Similarly the design of regulation does not take into consideration cross-elasticities between the commercial and aeronautical revenue streams. The aeronautical charges are derived to cover the remainder of cost left in the single till following an independent forecast of commercial revenues.
- STAL operates a two-tier pricing structure in that its revenue from retail stems from both a flat concession fee and a percentage of retail income. As such, regardless of the passenger throughput a certain level of income is earned.[90] It should be noted that in relation to the management of car parks, STAL receives income directly and is responsible for commercial decisions including pricing decisions.[91]
- The 'one bag rule' imposed by Ryanair on its passengers may, other things being equal, act to suppress demand for non-aeronautical services as it limits the purchases that passengers can take onboard.
- The CAA has seen no evidence that the airport operator's pricing decisions for aeronautical services are made taking into account the potential impact on commercial income, although we note that during negotiations with Ryanair, STAL [✂]

4.14 Taking the evidence in the round the CAA's considers that STAL does not strongly exhibit in practice the characteristics of a multi-sided platform. The evidence would appear to lean towards the main relationship being vertical in nature whereby the airport in the upstream market provides a key facilities input to airlines operating in the downstream air transport market. Accordingly, the CAA proposes to adopt a conventional approach based on derived demand in a vertical relationship.

[89] The CAA is aware that competitive airports typically behave in this way.
[90] STAL noted the minimum guarantees are also affected by traffic growth as retailers are likely to provide higher guarantees if there are greater passenger numbers at the airport.
[91] Source: STAL

4.15 In assessing derived demand the CAA needs to consider direct and indirect impacts on the demand for airport services. The derived demand process is illustrated as follows.

4.16 Following an increase in airport charges the airline makes the initial response broadly either to absorb the cost increase or to pass it on to its passengers and/or to switch some services to another airport. Should it 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 onto its passengers, the passenger becomes indirectly exposed to the airport operator's pricing decision. To the extent that a similar flight is available at another airport, the passenger may then decide to switch to that airport in response to the price rise thus affecting the level of derived demand.

4.17 The CAA considers that its analysis should start with the evaluation of airlines of the substitutability of other airports for Stansted and where possible evidence on airlines' actual switching behaviour, as they provide the initial response to a pricing change. Passenger ability to respond to the price increase is derived as they are impacted by the airlines response only being exposed to the pricing of the airport after the airline has enacted its response.

4.18 Markets are generally defined in two dimensions: product and geographic. The CAA considers each in turn then bring the two together.

Product market definition

4.19 In this section we consider product market definition. As defined in both European Commission[92] and the OFT[93] 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. This section first examines what is an appropriate bundle of services with a focus on services provided in the 'core area' of the airport as defined in the CA Act[94].

Service bundle

4.20 STAL provides a number of services to airlines, passengers, and a range of other companies (groundhandlers, concessionaires etc) for the use of the infrastructure at Stansted. However the primary function of STAL is to provide access to the infrastructure of Stansted for the landing of aircraft and processing of passengers and cargo.

[92] Commission Notice on the definition of relevant market for the purposes of Community competition law OJ C 372, 9.12.1997, p. 5–13, available at:
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y1209(01):EN:HTML
[93] OFT, Understanding Competition Law: Market Definition, 2004, available at:
http://www.oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft403.pdf
[94] Section 5(4).

4.21 The new legislation provides a logical starting point for the process of product market definition.

4.22 Section 66 of the CA Act states that an airport:

"means an aerodrome within the meaning of the Civil Aviation Act 1982[95] *together with other land, buildings and structures used for the purposes of— .*

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

(b) the manoeuvring, parking or servicing[96] *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 services(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."[97]

4.23 The CA Act defines airport operations services in section 68 as:

"services provided at an airport [as defined in section 66] for the purposes of –

(a) the landing and taking off of aircraft,

(b) the manoeuvring, parking or servicing of aircraft,

(c) the arrival or departure of passengers and their baggage,

(d) the arrival or departure of cargo,

(e) the processing of passengers, baggage or cargo between their arrival and departure, or

(f) the arrival or departure of persons who work at the airport."[98]

4.24 These definitions feed into Section 6 of the Act which sets out the market power test (the Test). Section 6 requires that an assessment must be made by reference to a market for one or more airport operation services which are provided in the airport area in question.

[95] 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 interpretation an aerodrome can be consider as the runway.

[96] Section 67 defines servicing as the supply of fuel and the repair, maintenance and overhaul of aircraft that land at the aerodrome.

[97] 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.

[98] The definition of airport operation services does not include air transport services, air traffic services or services provided in shops and other retail businesses.

4.25 Section 5 of the Act requires that for an airport to be considered dominant, the market power Test must be satisfied in relation to all or part of its core area. The core area is defined as follows:

"(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."

4.26 Given how the proposed legislation sets out the Test by reference to a market for airport operation services and given that an airport can only be found to be dominant if the Test is met for services provided within the core area, we consider that the airport operation services provided in the core area of the airport is the most logical place from which to start defining the product market. This would cover what is generally described as aeronautical services and the provision of facilities for retail activities. It excludes the provision of facilities for car parking and other commercial activities such as the provision of office space to airlines.

4.27 Aeronautical services at Stansted are likely to consist of the use of the runway and taxi-ways, aerodrome ATC[99], aircraft parking, ramp handling services, fuel and oil handling, the provision of facilities for aircraft maintenance, and the provision of infrastructure needed for the provision of other airside groundhandling services[100]. They also include the provision of facilities for check-in, baggage handling, security screening and the transit of passengers to and from the aircraft (in the case of a passenger airline) and the provision of facilities for the processing of cargo (in the case of a cargo airline).

4.28 These services are likely to form the key bundle of services that an airline would require to operate from an airport. The CAA considers that an airline would be required to bear the costs of all of these services in order to provide air transport services[101] and that in deciding whether to land at an airport, an airline would take account of the total bundle of charges rather than focusing

[99] Aircraft landing at Stansted 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 Civil Aviation Bill currently formally excludes ATS as defined in the Transport Act 2000 from airport operations services. However 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.

[100] The CAA notes that 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.

[101] Defined in the CA Act as "a service for the carriage by air of passengers or cargo to or from an airport."

on any one charge in isolation (even though services may be priced individually by the airport operator to reflect different cost drivers). Evidence from recent negotiations conducted by STAL[102] suggests **[✂]** has been discussed. It would be appropriate therefore to treat this basket of services as a single product. This is also consistent with information provided by airlines regarding the factors taken into account in making their initial choice of airport. For example Wizz Air has stated that it considers costs holistically including aeronautical charges, the charges of groundhandling agencies, and more widely opportunities with commercial agreements with travel agents.[103]

4.29 The CAA notes that this approach is also consistent with that adopted by the CC in its consideration of market definition for the BAA airports market reference.[104]

4.30 In relation to the provision of facilities for retail activities, the CAA would need to be assured that aeronautical services and retail services are interdependent[105] for them to be in the same market. Although retail services would not be needed if the airport did not operate, in principle an airport could operate without the provision of facilities for retail activities. In addition, 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 and airport with which they choose to fly, available evidence suggests that this varies across heterogeneous passenger groups, and expectations vary by airport[106]. The CAA considers that in reality this is unlikely to impact on passengers' choice of an airline or airport in a significant way. To phrase it another way, 'all shoppers are fliers, but not all fliers shop.' Further, 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.

4.31 The CAA's current view is that it is likely to be more appropriate for Stansted to define a separate market for the provision of facilities for retail activities that is distinct from that of the aeronautical product market. At this stage, we do not consider it is necessary to define this distinct retail market in more detail for Stansted.

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[102] Source STAL
[103] Source: Wizz Air
[104] 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.
[105] In this context the CAA defined interdependent such that an increase (decrease) in the price on one side of the platform impacts on the demand from the other side of the platform 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.
[106] "*Understanding Airport Passenger Experience*", Independent Social Research on behalf of the DfT, March 2009: http://webarchive.nationalarchives.gov.uk/+/http://www.dft.gov.uk/pgr/aviation/airports/reviewregulatiouk airports/understandingexperience.pdf; Consumer Research, Accent for CAA, May 2011: http://www.caa.co.uk/docs/2107/2131ConsumerResearch06122011.pdf

Market segments[107]

4.32 This section considers whether there is any evidence based on analysing airport operation services from both the demand-side and supply-side perspectives, which supports segregation of the market further. It considers the following:

- long haul versus short haul passenger airlines;
- cargo airlines; and
- based vs. inbound operations.

Facility requirements of different types of passenger airlines: long haul and short haul

4.33 The CAA's evidence suggests that differentiation by long-haul and short-haul carriers is the most relevant segmentation.

Demand side

4.34 Just over half of short-haul services in the UK are provided by the LCCs[108]. Generally LCCs require quick turnaround times and minimal use of airport facilities based on all customers using the same basic service without differentiation. Further there is no explicit reliance on additional traffic at the airport for interlining as this is not possible in as an integrated manner with LCCs as with their full service counterparts. Given the fleet types employed by the LCCs some may also have lower requirements on airport infrastructure in terms of runway length. The CAA considers that charter airlines are similar in many respects to the LCC, in terms of their requirement from an airport, as they also deal with a homogenous passenger class operating point-to-point services without the requirement for interlining.

4.35 By comparison to LCCs, long-haul carriers have significantly greater price and service differentiation in passengers with three distinct groupings; economy, business, and first class. In order to meet the needs of certain classes long-haul carriers may require access to additional airport facilities, such as lounges and priority security lanes for business and first class passengers. Some long-haul carriers also require an extensive short-haul network from which to feed their long haul services, to ensure sufficient load factors on these flights. The use of feeder traffic requires additional airport facility to transfer passengers between aircraft without the passengers leaving the airport, such as a transfer baggage system. Some airlines, such as BA or Lufthansa, provide the majority of their own network. Other airlines such as Virgin Atlantic Ltd. (Virgin) operate using code share agreements allowing passengers to transfer from other carriers such as Flybe. In contrast,

[107] In the Initial Views we examined the requirements of different passenger segments. The CAA did not reach a conclusion at the time. Given that at least 90 per cent of passengers fly short haul and 83 per cent are travelling to VFR or for leisure the CAA does not consider that is necessary to consider this in further detail here.

[108] For 2011 CAA airport statistics show that 54 per cent of passenger flew short-haul with a LCC.

the LCC business model does not allow for this to take place in an integrated manner.[109]

4.36 The CAA notes that there is some differentiation in the charges levied by airport operators, which tend to be based on the maximum takeoff weight of aircraft. This could be considered to reflect in part different charges for long-haul and short-haul services.

4.37 As discussed in section 3, Stansted was initially developed as a full service airport capable of meeting the demands of both long-haul and short-haul traffic. STAL has spent some resource and focus on building business cases to present to long-haul carriers, showing Stansted as a viable airport for feeder traffic to a distant hub. However, in its negotiations it has stated that it sees a [✂].[110]

4.38 Similarly, the CAA's consultation responses from long-haul operators have revealed that, although Stansted was initially designed as a full service airport, it has not been successful in attracting long-haul business due to the characteristic of its catchment area and limited accessibility.[111] Evidence suggests that the brand of Stansted is currently associated with LCCs, which is driven by the strong presence of Ryanair and the growth it has achieved at Stansted. Stansted has also won two Sky Trax awards as a low cost airport[112]. The CAA has seen evidence to indicate that this perception may be hindering Stansted's ability to attract long haul airlines[113]. Given the significant presence of LCCs at Stansted there is also a lack of interlining possibilities. This was summarised by one airline as follows:

'...Operating long-haul flights from Stansted would not work. [The airline] indicated that [it considered] Gatwick passenger would not travel to Stansted due to the distance. Long-haul flights have not proved to be profitable for any airline at Stansted, in spite of several attempts. However, [the airline] indicated that, in principle, Stansted should be able to sustain these operations. One possible reason for Stansted's continual failure could be that, due to the significant presence of easyJet and Ryanair, the airport is perceived as a low cost airport by passengers.' [114]

Supply side

4.39 As well as considering issues of demand, the CAA also needs to consider issues relating to the supply of services. Supply-side substitutability relates to the ability of a supplier to rapidly enter the market at short notice and provide

[109] It is possible to self connect with LCCs (as with FSCs). However, this requires no additional airport infrastructure as the passenger arrives at the airport to go through the entire departure process. This takes place in the same manner as a passenger arriving at the airport by car or train.
[110] Source: STAL
[111] Source: [✂]
[112] http://www.stanstedairport.com/about-us/media-centre/press-releases/double-top-for-stansted-as-world%E2%80%99s-best-airport-for-low_cost-airlines
[113] Source: [✂]
[114] Source: [✂]

services in competition with the current provider(s) without incurring substantial sunk costs[115].

4.40 In principle, there could be a number of ways in which supply-side substitution may take place; such as conversion of a military airfield to civilian use or, investment in infrastructure at a current general aviation airport to allow the use of commercial passenger flights, or a commercial airport improving its current infrastructure to accommodate larger aircraft. The amount of investment needed will depend on a number of factors as there are many constraints on the type and volume of traffic that an airport can handle.

4.41 To illustrate this we focus on one of the main factors that has an impact on the ability of certain airlines to operate from particular airports that is the length of the runway. Long-haul services for example in the main tend to be operated with larger aircraft than those used by short-haul operators, and therefore require longer runways for take-off and landing. We note that with a 3km runway, Stansted is able to offer both short-haul and long-haul services, whereas nearby airports such as Luton and Southend are restricted in terms of the type of operators they can support.

- Luton told the CAA that "*The [Luton] runway of approximately 2km in length largely precludes long-haul traffic from operating. The model is based on high frequency; short sector (mostly 2 hours and a couple of 5/6hours)*"[116].
- Southend noted that it considers that one reason why easyJet is at its airport is that Ryanair would have challenges operating its type of aircraft from the airport and that this represents a good opportunity for growth. There may be a parallel with Flybe's success from Southampton because easyJet and Ryanair cannot effectively operate there.[117]

4.42 Investment in a runway extension (or other airport infrastructure) is a significant capital and resource cost for an airport and is subject to local and possible national planning restrictions[118]. There are also potentially physical restrictions that are site specific. The precise costs and practicalities are likely to depend on the location of the airport and the technical nature of the project.

4.43 However, the CAA considers that it is likely that costs involved in supply-side substitution would be of a level that would rule it out as a short-term response to direct airport competition. The CAA therefore considers on the supply side that the market is likely segmented by the provision of infrastructure and as a

[115] The CAA refers here to sunk costs specifically as costs incurred in entering the market that are not recoverable on market exit.
[116] Source: Luton Airport
[117] Source: Southend Airport
[118] For example, there is currently a government moratorium on airport expansion in the South East.

result by the types of aircraft that can be served from the present infrastructure.

Initial conclusion on passenger services

4.44 At this stage, the CAA is minded to consider that it is appropriate to segregate the airport operation service market by service provided to short-haul LCC and charter operators against those provided to full service Long-Haul carriers and associated feeder traffic. This segregation is based on the demand characteristics of these broad airline groups as well as limited opportunities for supply-side substitution.

Cargo airlines

4.45 The Guidelines highlight the likely consideration of differing facilities at the airport for passengers and cargo[119]. In assessing the evidence from both a supply and demand perspective, it appears that there is good reason to segregate the market in terms of facilities required for passenger airlines and those required for cargo only airlines.

4.46 The CAA notes that the processing of cargo requires different facilities from those for passengers. Cargo requires specialist handling and infrastructure at the airport, from the point it arrives at a cargo carrier's (or handler's) warehouse to the loading to and unloading from the aircraft. The facilities for the handling of passengers are therefore unlikely to be appropriate for the processing of cargo and vice versa. The CAA considers that there is a different product for the provision of facilities for the processing of cargo at the airport. The CAA considers it likely that there is an additional product provided at Stansted consisting of the services described in paragraph 4.27 and the service required to allow the processing of cargo.

4.47 In light of this evidence, the CAA is minded to consider that there is a separate product market for cargo airlines at Stansted.

Requirements of based vs. inbound operators

4.48 In the CAA's Initial Views document it considered whether there were separate markets for based and inbound carriers, but it did not conclude on this issue at the time.[120]

4.49 With regards to the product purchased by inbound carriers the main variation in the product bundle is the lack of a requirement to purchase overnight parking for aircraft. The CAA's analysis of charges at Stansted suggests that parking charges which include overnight charges accounts for around 13 per cent of total charges for based carriers and 5 per cent of total charges for inbound carriers.

4.50 Further, the CAA considers that the competitive options of an inbound carrier are similar to those of a based carrier. This is highlighted in our discussion of

[119] Guidelines, paragraphs 3.30 and 3.43-47
[120] Initial Views, paragraphs 2.57-2.64

the geographic market below where airlines[121] are concerned with whether they can serve their passenger base from a different airport due to catchment overlaps and whether a competitor airline would take that custom if they moved.

4.51 It has been considered whether a lack of a requirement for access to the morning peak may also have differentiated inbound from based carriers. As noted below in our discussion on temporal markets the CAA does not consider that this is the case. Inbound operators still require access to inbound peak slots to allow them to provide early morning services for their inbound passengers. Setting aside those carriers that operate a low weekly frequency those inbound carriers offering daily flights are also likely to require access to the airport facilities throughout the day in order to operate an efficient flying schedule.

4.52 The CAA is therefore minded to consider that it is not appropriate to segregate the product market between inbound and based carriers.

Geographic market definition

4.53 In this section, the CAA considers the geographic market definition. It is important to note that there may be different relevant geographic markets for different groups of users.[122] The CAA's Guidelines state:

'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.'[123]

4.54 In common with other authorities carrying out such analysis,[124] the CAA has sought to understand passengers' likelihood to switch in response to a price rise using passenger surveys and catchment area analysis. However, as part of the analysis of derived demand, the CAA considers that in making decisions as to whether to switch or discontinue a service in response to a price rise at an airport, an airline could be expected to have taken account of the likely behaviour of their passengers in the downstream market and in

[121] Source: Wizz Air
[122] Guidelines, paragraph 3.59
[123] Guidelines, paragraphs 3.60 and 3.61
[124] See for example the CC's 2009 report into BAA.

particular their willingness to use that other airport. The CAA considers that it is possible to assume, therefore, 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. Consequently, where an airline's decision-making process in this respect is 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. The CAA has complemented such evidence with interviews with a number of airlines and airport operators.

4.55 The CAA notes, however, that airlines' propensity to switch may not be fully aligned with that of passengers, as they face different switching costs and constraints. Further, 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.

4.56 That said, analysis in the Initial Views regarding the cost structure of airlines suggested that for LCC the airport charges (in a general sense as charges levied by the airport operator on the airlines) make up around 30 per cent of their cost base. For long-haul carriers, airport charges account for around 10 per cent of their cost base. This suggests that a 5-10 per cent increase in airport charges to the airline if passed on fully to passengers may only translate, at most (in the case of LCC), into a 3 per cent increase in charges to the passenger[125]. Passenger responses to an airport SSNIP are therefore likely to be muted. If we consider passengers' use of airports in the wider decision-making process of air transportation services whether 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 goods[126].

4.57 The CAA considers in turn: evidence received[127] from airlines and airports on the size of catchments around Stansted and other relevant airports; substitutability of airports and whether remote airports form part of the market. The CAA then examines actual occurrences of airline switching that have taken place in the last few years. Finally, the CAA examines evidence derived from survey and catchment area analysis carried out by the CAA.

Airlines' and airports' views on substitutability

4.58 In the CAA's interviews with various airlines a number of airports have been suggested as alternatives to Stansted. Primarily these have been Luton and Southend airports and to a lesser extent Gatwick. The CAA considers first

[125] For a long haul full service carrier we expect that and airport SSNIP could represent less than a 1 per cent change in the ticket price.
[126] In this context a list, by no means exhaustive, that may be purchased includes surface access charges, flights, and hotels.
[127] The CAA notes that some of the evidence deployed in the assessment of the geographic market is akin to the analysis of isochrones. Isochronal analysis has been criticised for abstracting from market characteristics. However, where this evidence has been employed it has been supplemented with evidence from other sources and not relied on in isolation.

the views put forward by airlines, following those presented by airport operators.

Airlines

4.59 Thomson Airways considered that both Birmingham and Luton are operationally substitutable for Stansted, however on a commercial basis Stansted competes with Luton. Additionally, it noted that Stansted competes at the margins with Norwich, although it considers that they serve separate catchment areas. Further, it noted that with regards to London there is a North/South barrier where passengers south of the Thames do not typically travel north to Luton or Stansted to fly. Conversely, it noted that Gatwick has a pull even in the north of London.[128]

4.60 Wizz, an inbound carrier, had considered other London airports when deciding to open operations at Luton. Of these, it considered Heathrow was least accessible due to high costs and the scarcity of suitable slots. By contrast, Gatwick, Luton and Stansted are a much better strategic fit for Wizz's business model.

4.61 Wizz illustrated to us the decision-making process it undertakes when considering switching between airports as catchment and current airline competition.

- A key consideration was the extent of catchment overlap between the airports, and 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 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 would need to be considered. 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. 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.
- Wizz considered that:
  - Luton and Stansted catchments overlap and both airports predominantly have low cost carriers and are in competition. Their catchment overlap covers approximately 60-70 per cent of Wizz's passenger base.

[128] Source: Thomson Airways

- 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 do Luton and Stansted, due to its location in the south of London. Its catchment overlaps with approximately 30-40 per cent of Wizz's Luton catchment.

4.62 The CAA has received evidence from **[✂].**[129]

4.63 In 2012, easyJet opened its operation at Southend. In doing this it has switched three based aircraft from Stansted to Southend. In the evidence that has been presented the 60 minute catchment for Southend sits within the 60 minute of Stansted. This clearly shows that there is significant overlap in the customer base for easyJet for these two airports. In this sense, the Southend catchment could be viewed as a subset of the Stansted catchment.

4.64 **[✂].**[130] When questioned on how it could serve the Stansted catchment area without serving Stansted, it did not consider it would be possible. Firstly, it noted that the routes that it currently flies would likely be picked up at the airport by competitor airlines, which we note also factors into Wizz's considerations set out above. **[✂].**[131]

4.65 The evidence from **[✂]** is also consistent with the views put forward by charter airlines. Charter airlines do not appear to consider Stansted as a strong substitute for Gatwick as they consider that their passengers do not view the airports as substitutable.[132] However, where airlines have suggested Gatwick competes, in a broader sense, with the north of London airports this appears to be asymmetric in nature; Gatwick can serve 'north' but the north of London airports do not serve the Gatwick catchment.

4.66 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.

...The European Commission has ruled that LHR, LGW, LTN and LCY are substitutable but capacity constraints mean that Ryanair cannot move there."[133]

4.67 Ryanair's statements show that it considers there is to some extent a generic airport product. However, Ryanair highlights that the opportunities for

[129] Source: [✂]
[130] Source: [✂]
[131] Source: [✂]
[132] Source: Thomson Airways and [✂]
[133] Source: Ryanair

substitutability between airports are constrained to a high degree by 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."[134]

4.68 Ryanair also doubts whether passengers originating from Stansted's catchment area to the north of London consider Gatwick as a suitable substitute for Stansted[135].

4.69 Looking forward Ryanair press notices show that Ryanair is seeking expansion at Manchester, Liverpool and East Midlands airports in 2013. The CAA questioned Ryanair as to the motivation behind this development of its network. In response Ryanair noted that the expansion was driven by the low level of charges at these airports. However, it noted that these airports served different markets to Stansted. When questioned about the aircraft used for the expansion, Ryanair noted that the aircraft would be coming from higher cost airports (they did not confirm which but stated it would not be from Stansted) and 11 new aircraft for this winter season.

Airports

4.70 STAL consider Edinburgh, Manchester, Birmingham, East Midlands and Leeds Bradford as competitors as airlines are developing their route offering at these airports.[136] STAL noted that the airport is not currently served by Monarch and provided evidence of Monarch's expansion with relevant press releases.[137] Although the CAA notes that the press release shows Monarch has expanded its operations significantly in the last year, the CAA does not see that this necessarily indicate that a choice was made between Stansted and these airports for routes. The CAA notes the Monarch press release mentions the 'market' that it is looking to serve through these expansions. Notably the Midlands which Monarch considered to be underserved and expansion at Leeds Bradford as strengthening its position in the north of England.

4.71 STAL's responses 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 Luton and Gatwick. The CAA notes there has been some switching from Stansted to Gatwick and Southend, which is discussed below.

[134] Source: Ryanair
[135] Source: Ryanair
[136] Source: STAL
[137] Source: STAL

4.72 Evidence from Luton airport suggests that it competes with Stansted for airlines. It has also suggested that it competes with Birmingham. Luton considers that its catchment area consists of the distance of **[✂]** from the airport, roughly **[✂]** minutes.[138] Similarly, Manchester airport considered that its selling point to airlines was the 22 million people within a 120 minute catchment area.[139]

4.73 Birmingham airport considers that Manchester and East Midlands pose the strongest competitive constraint on its pricing and service offer: considering that both have significant utilisation of their 60 minute catchment (c.90 per cent of passengers). Birmingham stated that it currently captures around 40 per cent of its 60 minute catchment and that there is significant overlap within Birmingham, Manchester and East Midlands catchments. Birmingham considers that competition with Stansted is only at the margins.[140] Birmingham considers that for long-haul services it competes additionally with Heathrow. The evidence from Birmingham suggests there is a strong focus on marketing its 60 minute catchment to airlines.[141]

4.74 In evidence from East Midlands it considered that a 60 minute catchment was the core of its offering to airlines and that this does not include Stansted. The evidence from East Midlands suggests that competition with Stansted is marginal.[142]

4.75 Southend has indicated that its core focus is on its 20 minute catchment area, inbound London passengers and passengers that are equidistant between Stansted and it by rail (i.e. London based outbound passengers).[143]

4.76 The responses from the airport operators and airlines appear to be broadly consistent in suggesting that airports face greater competition from airports in close proximity. The evidence suggests that the local catchment area of the airport is the primary focus for the airline when considering where to purchase airport services, as the local catchment is what allows the airline to generate and sustain its route profitability. Other airports have been noted such as Norwich, Heathrow, Birmingham, and East Midlands. However, in the majority of cases these have been not been considered to be competitors to Stansted. The evidence from both airlines and airport operators suggest that Luton and Southend provide the greatest constraint on Stansted. Gatwick has also been mentioned; however some airlines have raised doubt over the strength of constraint that it may pose on Stansted.

4.77 The evidence suggests that the key catchment size for competition between airports relates to a 60-90 minute travel time with competition weakening in catchments beyond this. This has been shown as a key focus for airlines and airports. As noted by Birmingham the geographic market may be different for

[138] Source: Luton Airport
[139] Source: Manchester Airport
[140] Source: Birmingham Airport
[141] Source: Birmingham Airport
[142] Source: East Midlands Airport
[143] Source: Southend Airport

long-haul operators than for LCC as it appears that long-haul passengers may be willing to travel a longer distance than LCC passengers.[144]

Instances of actual airline switching

4.78 The CAA has been made aware of a small number of instances of switching from Stansted in the past couple of years: Air Asia X, Air Berlin and Norwegian, accounting for less than 4 per cent of passengers between them in 2010. As noted above the CAA is also aware that easyJet has switched three aircraft out of Stansted to Southend, [✂].[145]

4.79 In October 2011, Air Asia X, 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; and
- **[✂]**

4.80 **[✂]**

4.81 Air Berlin has also switched traffic in recent years from Stansted to Gatwick, and, again, charges were 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. Also factoring into its decision was that Gatwick is a base for its One World alliance partners.[146]

4.82 The CAA considers that the Air Asia X and Air Berlin moves are illustrative of switching that has taken place between Stansted and Gatwick in recent years. Airlines that have switched from Stansted have generally been small inbound operations, where the motivation to switch has been less concerned with factors that are related to price and more influenced by the passenger base or the possibilities for connections. Given the level of the switching observed, and the lack of a price motivation the CAA does not consider that this switching provides sufficiently strong evidence to support the inclusion of Gatwick within the same market as Stansted.

4.83 The evidence from inbound carriers suggests that they are considering access to the London area when deciding which airport to operate from. In consideration of this an airline may have a preference for a particular airport but due to capacity constraints, decides to serve their passenger base from a different London airport. For example **[✂]**

[144] Source: Birmingham Airport
[145] Source: easyJet
[146] Source: Air Berlin

4.84 As the capacity constraints around London start to bite airlines seeking access to the London area may have to consider operating from less favoured airports. The CAA has seen evidence from STAL suggesting that at that time it expected the spill caused by capacity constraints to be a driver of passenger growth at the airport between 2012 and 2016.[147]

4.85 While the CAA recognises that there are likely to be impacts arising from capacity constraints in the London system it does not consider that there is sufficient evidence to consider the London airports as a single market. The competitive interactions between London airports are discussed in more detail in section four.

Airline route overlap decisions

4.86 As well as switching behaviour the CAA considers that it is important to consider airlines' decisions on route planning. The CAA's Initial Views document considered route overlaps within the London area where 60 per cent of the routes at Stansted were served at the other London airports in 2010. The CAA has reviewed the route overlaps at Stansted for the 2011 summer season. Out of the routes served from Stansted 70 per cent of those routes were also served at one of Birmingham, East Midlands, Gatwick or Luton. As noted in the Initial Views document this appears to suggest significant choice for the passenger.

4.87 Route overlap at this aggregate level has been considered as an indicator of choice available to the passenger and in turn indicator that airports are in competition. However looking at the route overlap in isolation ignores passenger preferences to use local airports, and assumes implicitly that the routes are in competition with each other. An alternative view is that route overlap may not be indicative of airport competition if they are offered by the same airline.

4.88 East Midlands noted that it has a significant degree of route overlap with Stansted, including with a significant degree of routes operated by Ryanair at both airports.[148] It considered that this was illustrative that it operated in an independent market. Further easyJet has stated that where a route is popular from one airport they will trial the route at alternative airports. This is especially the case on thick routes[149] which have unmet/high passenger demand. Whereas on thin routes lower passenger demand requires a wider catchment to ensure sufficient load factors.[150] This is supported by the view put forward by airport operators and by the CAA's passenger survey suggesting that passengers will travel further for a unique route.

4.89 This would suggest that airlines may plan less route overlap at airports where there is a higher degree of substitutability between the airports as

[147] Source: STAL
[148] Source: East Midlands Airport
[149] In this context a thick route refers to a route whether is significant demand for air transport services, thin routes refers to routes which face a low demand.
[150] Source: easyJet

passengers would travel to the neighbouring airport to access the unique route from their chosen airline, as the airline would not wish to compete with their own services for passengers. In this case route overlap by an airline with itself could be interpreted to indicate that the airports served differing markets. As a simple metric the CAA would expect greater overlap in routes from the same airline at airports that are not substitutable.

Table 4.1 – Ryanair route overlaps

	Ryanair Routes	Ryanair Routes also served from STN	Overlap
BHX	23	21	91%
EMA	33	31	94%
LGW	10	10	100%
LTN	19	14	74%

Source: CAA Data

4.90 For summer 2011 Ryanair had 106 routes from Stansted, the majority of which were unique Ryanair routes (i.e. not served by Ryanair at a neighbouring airport). On average of the routes offered by Ryanair at the other airports shown, 89 per cent were also offered at Stansted. Table 3.1 shows that there was significant route overlap at all of the Ryanair airports considered. Similar figures for easyJet show that, for the 2011 summer season easyJet had 28 routes from Stansted, 31 routes at Luton and 89 routes at Gatwick. Of the 28 routes that were served from Stansted 79 per cent were also served from Gatwick and 43 per cent were also served from Luton.

4.91 Additional analysis of easyJet routes[151] operated from London airports from 2006-2012 suggests that there has been little movement of routes between Gatwick, Stansted and Southend. There has been some rebalancing of capacity between the three airports, but they appear to be treated as a complementary portfolio of airports enabling easyJet to have full coverage of the London system. Some routes launched at one of the airports (mainly Gatwick, but not always), have then been launched at one or two of the other airports. Southend, however, appears to have taken some route frequencies from Stansted and Luton, but not entire routes, suggesting it has been launched as a clear substitute for these airports.

4.92 Although far from definitive this is supportive of the evidence that the CAA has received to date showing that for both of Stansted's largest airlines there is lower route overlap between Stansted and Luton than between Stansted and other possible competing airports, thus suggesting that from an airline perspective, Luton may be perceived as a closer substitute to Stansted than other London airports.

[151] CAA analysis of route level data

Analysis of passengers' ability and propensity to switch

4.93 To supplement the evidence gained from the airport operators and airlines the CAA considers the implications of its passenger survey and catchment analysis. Unless otherwise stated this section draws on the evidence presented within the working papers "*Passengers' airport preferences: results from the CAA passenger survey* and *catchment area analysis",* both published in 2011.

Evidence on Passenger Preferences

4.94 The travel times that passengers will be willing to make to catch a flight are likely to be heterogeneous and dependent on a number of factors such as purpose of travel, frequency of travel, and the flight which they are taking. It has been suggested that for short-haul and LCC the catchment area is likely tighter than for long-haul airlines.[152]

4.95 Analysis of the 2011 CAA passenger survey supports this view; showing that location of and access to the airport are the primary reason for choosing departure airport, although this was the reason given by only 36 per cent of passengers for a London airport, compared to 62 per cent for a non-London airport[153]. This suggests that passengers for London airports are less concerned with location. This could be driven by the fact that a high proportion of passengers at these airports come from the central London districts (as illustrated below) where there are a number of surface access options available to all of the London airports. The evidence also shows that this varies by service.

4.96 Additionally, the CAA's working paper considering passengers' airport preferences[154] suggests that for the majority of passengers flying short-haul from Stansted, Stansted is their airport of choice. Heathrow, Gatwick, London City, and Luton were all named as a preferred airport but each with less than 10 per cent of responses. Gatwick appears to be a strong second preference to Stansted but it is similar in magnitude to passengers using Stansted as their second preference airport.

Evidence from review of catchment areas

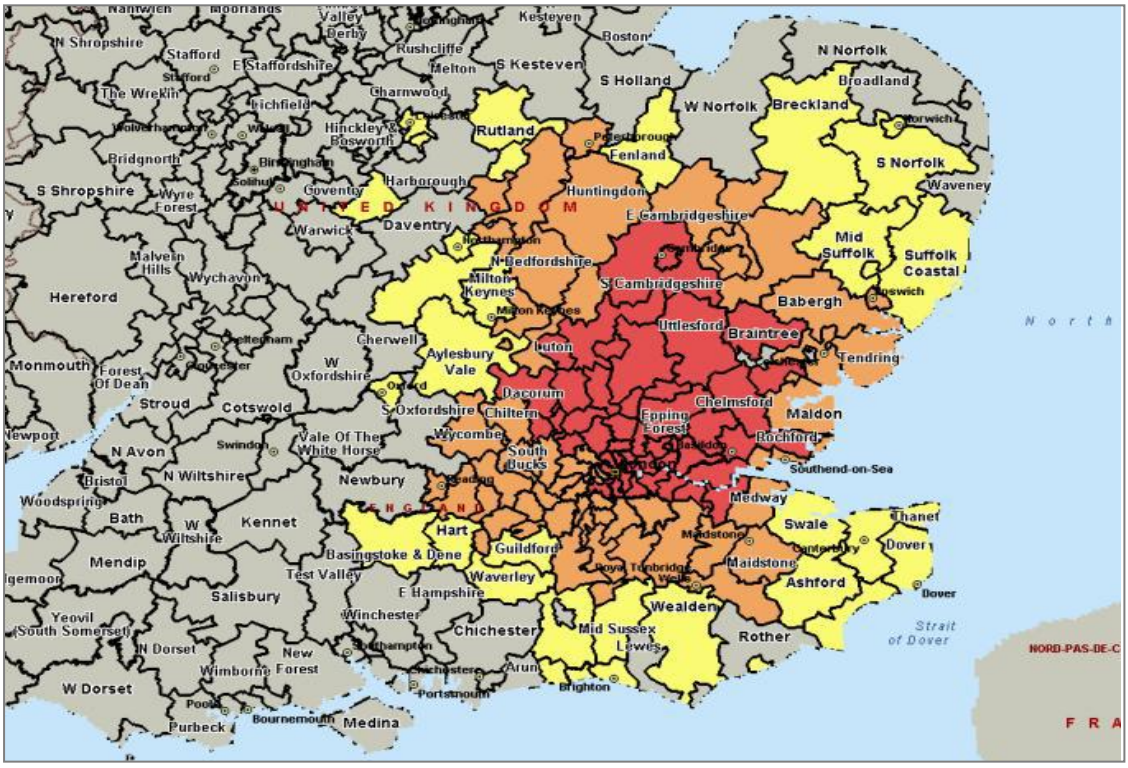
4.97 In 2011, the CAA conducted catchment analysis for the four largest London airports Heathrow, Gatwick, Stansted and Luton. As noted in the CAA's working paper, catchment analysis can provide useful evidence regarding an airport's passenger base. It is a way of estimating the geographic area from which a large proportion of an airport's outbound passengers originate. The size of catchment areas and overlaps between catchment areas[155] of neighbouring airports could provide useful evidence of the potential

[152] Source: [✂]
[153] For the 2011 data set non-London airports consist of Manchester, Birmingham, and East Midlands.
[154] Passengers' airport preferences, CAA working paper 2011.
[155] It should be noted that the overlaps presented from catchment areas are to some degree impacted by the travel time selected, as travel time increases so will overlap. To limit the impact of this the CAA has considered a number of possible travel times and historic passenger behaviour.

competition between these airports. It is therefore a useful tool in aiding the understanding of possible geographic markets. It does not however provide price sensitivities of the passenger base as it only considers the location of passengers and the travel times that they may face and may therefore overestimate the competitive constraint arising from passengers' ability to switch.

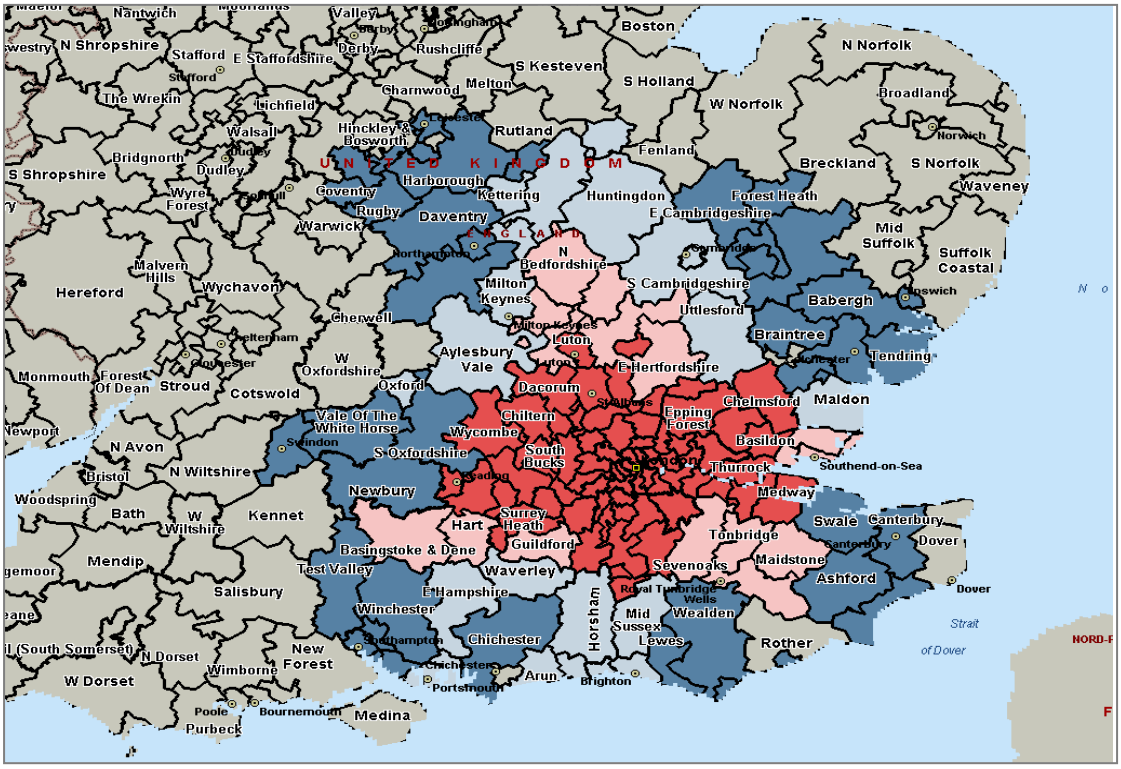
4.98 The CAA's catchment analysis looked at travel time at 60, 90 and 120 minutes. This shows there is significant potential overlap of passengers between the airports. This is illustrated in Figure 4.1, which shows the travel time isochrones for the differing time intervals at the four London airports. Figure 4.2 shows a comparison of the overlaps at 90 minutes travel time. The catchment analysis shows that 60 per cent of the passengers using Stansted have travelled up to 60 minutes to reach the airport, with 80 per cent having travelled up to 90 minutes.

Figure 4.1: Stansted's surface travel map



Source: CAA analysis of DfT surface access data
Red: 60 minutes; Orange: 90 minutes: Yellow; 120 minutes

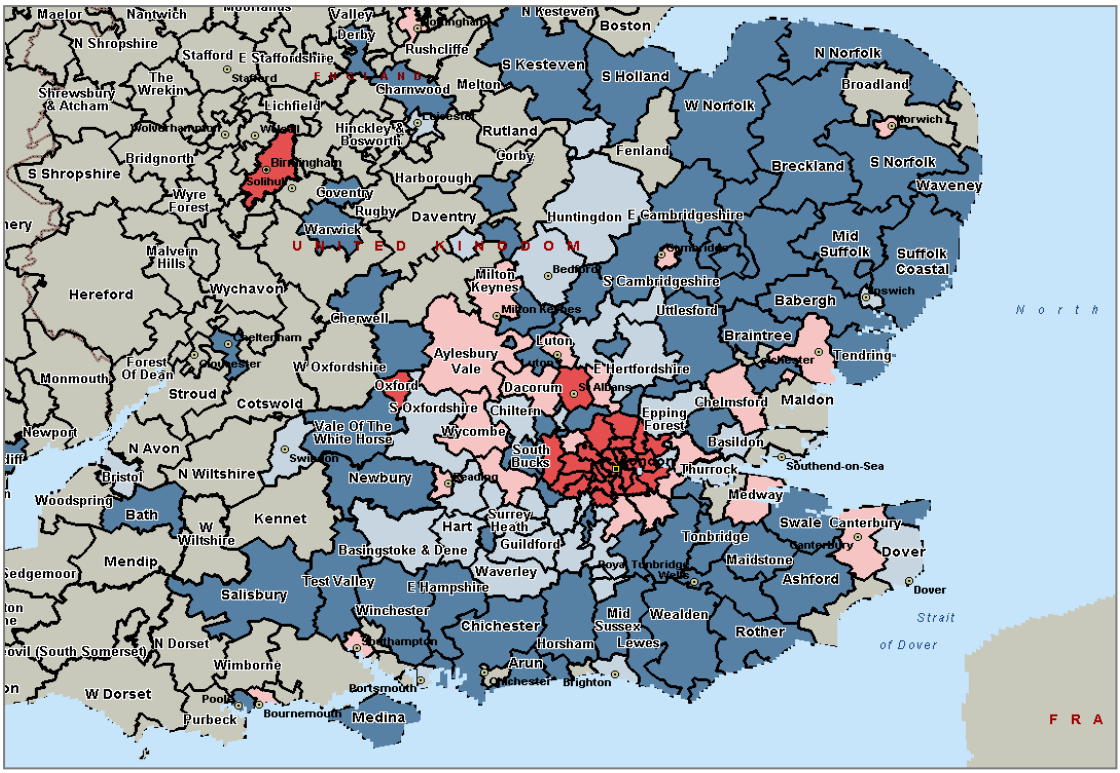
Figure 4.2: Overlap of districts within 90 minutes



Source: CAA analysis of DfT surface access data
Blue: 1 airport; Light blue: 2 airports; Light red: 3 airports; Red: 4 airports

4.99 Considering historic usage of the airports reduced the amount of overlap observed in catchment areas. This can be seen comparing Figure 4.2 and Figure 4.3. The historic usage isochrones show a number of different areas being included within the isochrones.

Figure 4.3: Catchment overlaps based on where 80 per cent of passengers originate



Source: CAA analysis of the CAA Passenger Survey (2010)
Blue: 1 airport; Light blue: 2 airports; Light red: 3 airports; Red: 4 airports

Table 4.2: Stansted historical catchment area

Overlaps	#Districts	4 Airport Pax	STN Pax	Proportion (4 APTS)	Proportion (STN)	STN Share
STN/	18	3,588,346	1,916,219	4%	11%	53%
LHR/STN/	1	243,260	72,598	0%	0%	30%
LGW/STN/	4	1,301,449	467,600	1%	3%	36%
STN/LTN/	6	2,227,400	901,012	2%	5%	40%
LHR/LGW/STN/	7	3,528,403	954,858	4%	6%	27%
LHR/STN/LTN/	7	4,047,482	1,194,776	4%	7%	30%
LHR/LGW/STN/LTN/	28	40,577,229	8,002,654	43%	47%	20%
Total STN Catchment	71	55,513,569	13,509,717	58%	79%	24%
Out of Catchment		39,515,286	3,679,669	42%	21%	9%
Total		95,028,855	17,189,387	100%	100%	18%

Source: CAA analysis of the CAA Passenger Survey (2010)

4.100 Table 4.2 focuses on the overlaps of the other London airports with Stansted. It shows that 11 per cent of Stansted passengers have historically come from districts 'unique' to Stansted the key finding being that there is significant overlap in the historic passenger usage from the central London area whereas outside of this Stansted faces significantly less overlap in its catchment. In 2010, 43 per cent of passengers using airline services at Stansted came from areas where the three other London airports drew passengers from.

4.101 As part of the analysis of historic catchment the CAA also considered travel times by reference to both long and short-haul passengers. The evidence shows that 80 per cent of passengers taking a short-haul flight travel up to 90 minutes, whereas for long-haul they travel up to 120 minutes. Comparing short-haul routes at Stansted where the routes are available at the other three large London airports the CAA sees that Stansted passengers are likely to travel further for a flight where it is only available at Stansted around 75 minutes. This drops to a little under 60 minutes where routes are available at all of the London airports.

4.102 The CAA's catchment analysis considered non-London airports in a limited light showing comparators of 60 and 120 minute isochrones. At 60 minutes Stansted only sees overlap with the Luton catchment whereas at 120 minutes there is some additional overlap with Birmingham, East Midlands and Bristol.

Summary of passengers' ability and propensity to switch

4.103 The CAA notes from the passenger analysis that a number of passengers travel for longer than 60 minutes and go as long as 120 minutes to an airport to catch a flight regardless of the service they are accessing. For example, if a route was only available at an airport it would not be unexpected for people to travel the breadth of the country to access that service.

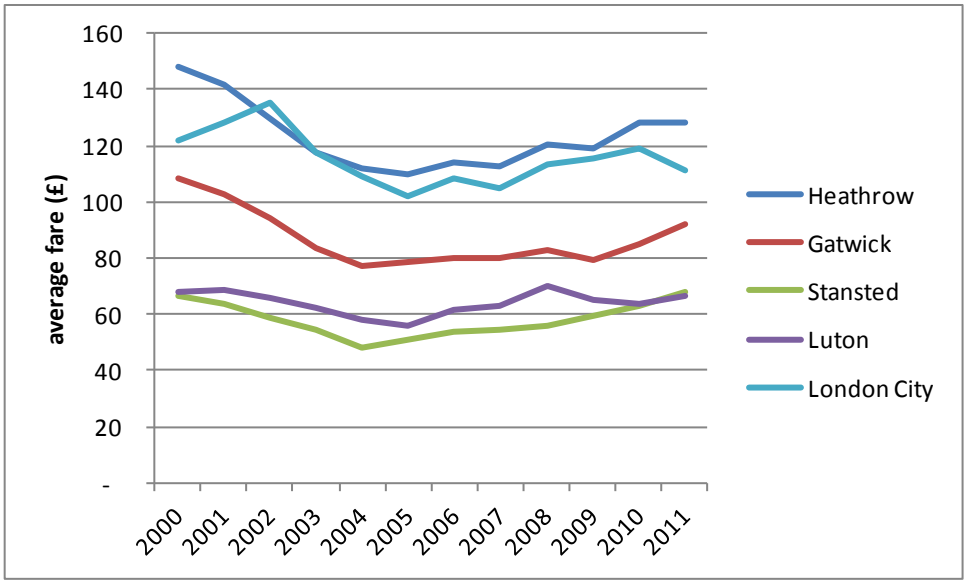
4.104 However, considering the catchment analysis in light of the airline decision making process the CAA considers that they are both supportive of a 60 to 90 minute catchment for LCCs. Airlines and a number of airport operators have stated the importance of the 60 minute catchment and the CAA's catchment analysis shows that for Stansted the majority (60 per cent) of passengers travel up to 60 minutes, with 80 per cent travelling for up to 90 minutes. Further, where there is route overlap with other airports the travel time at Stansted is reduced to 60 minutes. The CAA considers this evidence suggests that as a result of a 5-10 per cent price rise at an airport, subject to the availability of spare capacity, an LCC could move sufficient traffic to an alternative airport serving a significant proportion of the 60 minute of catchment of the original airport, such as to make the price rise unprofitable. The CAA considers that its evidence suggests that without significant overlap in the 60 minute catchment the airline move would be more akin to market exit as they would be sacrificing the revenues earned on that segment of their passenger base.

4.105 The CAA is disinclined to consider that the 60 to 90 minute catchment is relevant for long-haul airlines and their short-haul feeder traffic. The CAA's evidence suggests that for these services the catchment area could be at least up to 120 minutes. However, given the negligible long-haul traffic at Stansted, with its resulting likely low share, the CAA has not fully investigated this possible market to closely define its boundaries.

Prices faced by passengers

4.106 As noted above, the airport charges element of a ticket can be quite low with fuel, staff and other overheads to consider.[156] Figure 4.4 below shows the average cost of a short-haul fare from each of the London airports. It should be noted that there are limitation to this comparison given the wide variety of differing airline business models and routes operated from each of the airports. However, figure 3.4 shows that there is a material and persistent difference between the fares charged at these airports. As an average for the 11 year period it was 114 per cent more expensive to fly from Heathrow than it was from Stansted, it was 51 per cent, 11 per cent and 101 per cent more expensive to travel from Gatwick, Luton, and London City respectively. If the CAA considers an average of the last three years only these differences are marginally lower 98 per cent, 35 per cent, 2 per cent, and 82 per cent respectively.

Figure 4.4: comparison of average cost of short haul fare from various airports



Source: International Passenger Survey

4.107 Notwithstanding the limitations associated with such a comparison, it may be indicative that airlines are pricing to different passenger markets at these airports. Stansted and Luton show broadly similar pricing such that an airport SSNIP if passed through to pricing may make a difference in the relative fares at these airports. However, for Gatwick, Heathrow and London City the average fare is significantly higher such that the margin would be maintained to a high degree as the result of a Stansted SSNIP.

4.108 The CAA considers this is further evidence that suggests that Stansted and Luton form part of the same market, whereas Heathrow and London City are likely to be outside of this market. Given the relative positions of airfares at

[156] A more detailed look at the ticket break down can be seen in the CAA's Initial View document, paragraph 2.70-2.71.

Stansted and Gatwick it is not certain whether Gatwick could be definitively ruled out of the Stansted market.

Price Elasticies of Demand (PED)

4.109 In addition to the catchment analysis and passenger survey, the CAA has reviewed a number of pieces of evidence with regards to own-price elasticities of demand (PED) at Stansted. This is a measure of the responsiveness of the amount of demand for a product in relation to a change in price. Typically, a PED of 1[157] would suggest the demand changes on a one-for-one basis with price. A PED greater than 1 suggests that demand changes by a greater proportion to a price change. Where a PED is less than 1, demand changes by a lesser proportion than the change in price. The CAA notes that given the interactions of the ancillary revenues that Stansted derives from retail and car parking a PED which is at or just above 1 would likely result in a price increase being unprofitable due to the additional losses of these revenues. The CAA's evidence suggests that for an airport to be able to profitably raise prices it would need to face a PED of less than 0.7.[158]

4.110 The CAA's review of the evidence on this for Stansted suggests that Stansted faces a passenger base[159] with an elasticity of demand of 0.2 to 0.6. This suggests that, given the substitution possibilities available to Stansted's customer base, Stansted would be able to sustain profitably a SSNIP. The CAA considers that it strengthens the argument for a Stansted-focused geographical definition.

4.111 Following the divestment of Stansted in 2013, it is possible that the price elasticity of demand of passengers could change (i.e. passengers' propensity to switch to other airports in response to a price rise may increase under separate ownership), although the CAA cannot take this into account in our present market definition assessment given the level of uncertainty (both in terms of timing and scale) attached to this potential change.

Impact of Airline Competition

4.112 Another useful way to assess the potential for passenger switching across airports is to consider the extent airlines compete across airports. A 2008 working paper by the Competition Commission analysed airline yield data and found some evidence that BAA airports (Heathrow, Gatwick and

[157] For most goods and services elasticities are negative numbers. By convention they are cited to as absolute numbers.
[158] Based on the CAA's critical loss analysis which implies that a PED of 0.7 to 0.9 would be required for a 5 to 10 per cent increase in aeronautical charges to be profitable. The assumptions and calculations for the critical loss are shown in Annex 2. Additional information on PED is covered in Annex 3.
[159] It should be noted that the studies focus mostly on passenger demand rather than the strategic actions of airlines. It has generally been conducted on the assumed basis that airlines follow passengers. It can therefore be considered that these are reflective of an unconstrained passenger PED.

Stansted) are substitutes for passengers. In that analysis the CC considered that:[160]

"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."

4.113 The CAA has analysed easyJet route revenue and profitability data. The CAA used this data to try to understand the extent to which there is competition between airlines across the London airports and to aid in our understanding of the extent to which passengers substitute between London airports.

4.114 The CAA constructed a panel dataset of easyJet's London routes' annual revenue and annual profitability. To this data the CAA matched information from the CAA Airport Statistics about alternative seat capacity at the same airport and at other London airports for each route year considered. The CAA then used a panel fixed effects model where easyJet revenue was regressed against easyJet seat capacity and seat capacity provided at alternative airports to assess the extent to which airport seat capacity at alternative London airports constrains easyJet route revenue and profitability at Stansted. The results for easyJet's Stansted routes indicated the following.

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

4.115 The CAA tentatively concludes that there are signs of airline competition for passenger demand at and across London airports. It appears that on airport competition seems to be stronger than competition from other London airports. However, air services from different London airports may place different constraints on easyJet routes, but it is difficult to say from where from the constraint is larger.

European market

4.116 As set out above the evidence the CAA has seen to date indicates that both airlines and airport operators in the main consider a rather limited geography

[160] Competition Commission,
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

around the airport. The 60-90 minute catchment appears to be the key selling point for airports in their negotiations with airlines and airlines' strategy also seems to focus closely on this. That said, as we intimated in our Guidelines[161], it has been suggested that airports operate in a European market.

4.117 The CAA's Initial Views for Stansted considered that it may be the case that Stansted operates in a European market. The reasoning behind this was based on the flexibility of the LCC business model and the number of bases that they operated out of across Europe. The CAA considered at the time that this lowered the switching costs faced by these airlines. Additionally the Initial Views considered that inbound carriers could easily switch between arrival airports given limited sunk costs.

4.118 STAL has stated that it competes with some 200 airports across Europe. Additionally STAL[162] stated that it has been considered as **[✂]**, whereby **[✂]** looked to remove aircraft for use on routes from other bases. STAL note that for non-neighbouring airports, charges are one of a number of issues that are taken into consideration by airlines and are likely to be considered after market development and the presence of competitor operations offering similar services.[163]

4.119 Manchester airport had a similar view to STAL: it considered that it competes with secondary hubs across Europe. However, it stated this is for network carrier growth.[164]

4.120 On the other hand Birmingham airport told the CAA that it considers European airports provide a competitive constraint only at the margins. As with aircraft being moved to Stansted, Birmingham considered that an LCC moving aircraft to European airports was tantamount to the LCC using its assets to serve a different market.[165]

4.121 The only evidence the CAA has been presented with of actual pan-European switching is at **[✂]** in relation to **[✂]** services. **[✂]**

4.122 The CAA considers the switching from **[✂]** is consistent with the view that **[✂]** switches capacity from one market to another. In such circumstances it would not appear to be a competitive constraint within the same market. Despite the historic switching, **[✂]** [166] has expressly stated that it does not monitor the prices charged at European airports. Neither have we seen evidence to suggest that STAL reviews these charges. This suggests that STAL are not considering how its price/service offer matches with European airports. It would be expected that it would monitor prices at those airports it considers competitors. In contrast STAL does monitor the prices of airports within the UK.

[161] Guidelines, paragraph 3.67
[162] Source: STAL
[163] Source: STAL
[164] Source: Manchester Airport
[165] Source: Birmingham Airport
[166] Source: [✂]

4.123 The CAA considers that the theory of a pan-European airport market is not supported by the evidence it has seen in relation to Stansted. The CAA considers that within the Initial Views it understated the costs and strategic implications involved in the switching for LCCs. The CAA also considered that insufficient weight was given at the time to the impact on passengers. The CAA therefore considers that it would be inappropriate to widen the geographic scope of the market to a European level. The CC reached a similar conclusion with regards to airport markets as part of the BAA airports investigation (and subsequently in its report considering possible changes of circumstances). The CC view is summarised as:

"...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."[167]

4.124 Although the CAA does not consider that the market should be widened to include European airports it does recognise that the LCC business model, which dominates at Stansted does operate a pan-European network. The network yield optimisation of these carriers 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 pricing. However, when moving capacity from Stansted to a European airport, more so than to a neighbouring UK airport, the airline will be giving up on its competitive position at Stansted and the customers it serves. The likely revenue loss to the airline of a sufficient pan-European switch of capacity from Stansted is likely to exceed the impact of a 5-10 per cent increase in airport charges. Section 5 further discusses the likely strength of the European dynamics constraint.

Temporal markets

4.125 In the Guidelines[168], the CAA highlighted the possibility of temporal markets that is markets segmented across time periods. The Initial Views[169] highlighted that demand for airline services varies across the day and the importance that LCC airlines place on morning departures was also discussed. The CAA noted:

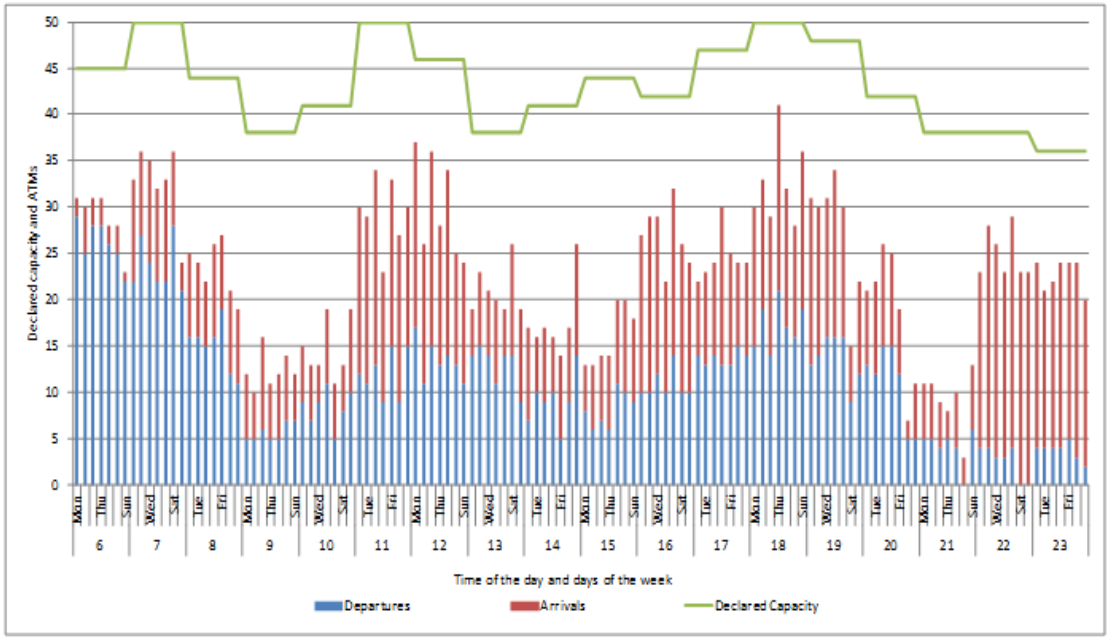
"This may imply separate markets for the provision of peak and off-peak slots since airlines currently using morning peak slots could not easily switch to off-peak slots. Although Stansted does not currently price differentiate by time of day, other airports do and there are no legal barriers to such a charging structure. The need to distinguish between peak and off-peak (and adopt a narrower product market definition) will, therefore, depend upon the

[167] CC's 2011 report, paragraph 181
[168] Guidelines paragraph 3.54
[169] Stansted Initial Views 2.78-2.82

ability of airlines to reduce their use of peak capacity in response to price, either by switching to off-peak periods, or to other airports."[170]

4.126 The CAA has reviewed the evidence submitted with regards to the assessment of temporal markets at Stansted. Figure 4.5 shows the allocation of slots across the day at Stansted for summer 2012. It shows that Stansted has several peak periods throughout the day.

Figure 4.5: Summer allocation of capacity at Stansted



Source: CAA Airport Statistics

4.127 The pattern in peaks is driven in by the LCC business model that relies on significant utilisation of their aircraft. Within this model morning peak slots are critical to ensuring sufficient rotations within a day. However, evidence from the airlines suggests that they require not only access to the morning peak but to a range of slots throughout the day to allow for the aircraft to fly out and return. Without access to the peak departure slot a based carrier may choose not to operate the matched slots throughout the day.

4.128 Previously it had been considered that the ability of carriers to operate 'W' flying patterns would allow based carriers to operate from alternative airports during the off-peak period. The CAA now considers, however, that the ability of LCC to operate 'W' pattern routes may have been overstated and that these are currently operated only in specific circumstances. This is discussed further in section 5.

4.129 Given the pattern of 'peak' traffic across the day at Stansted the CAA considers there would be little benefit for Stansted in modulating prices across the day as gains in the morning peak would likely be offset by the additional peak periods during the day. Further, it is clear that LCCs require access to Stansted at a number of periods during a day to gain sufficient

[170] Stansted Initial Views 2.81

rotations of their aircraft. The CAA recognises that limited access to peak slots may limit the development of an airline at the airport. The CAA also consider it is reasonable to consider that limited access to slots during the day would prove problematic to LCC business model as they would be unable to achieve the necessary number of rotations.

4.130 Another temporal consideration is that of winter vs. the summer season. While the CAA recognises that there are very different demand pattern in the winter and summer seasons both in terms of the routes operated and the absolute number of passengers wanting to fly, evidence the CAA has seen suggests that a number of airlines change their routes (for example to serve the ski resorts) and others redeploy their aircraft to serve different markets. One airline noted that during the winter season in the UK its aircraft are serving passengers in Canada[171] and Scandinavia[172] flying to non-UK destinations. The CAA does not consider that these changes impact on the inherent competitive structure of the market between the seasons, such that our analysis would benefit from segmenting the market in this way. Additionally the CAA has not seen evidence to suggest that passengers become more price sensitive in either season.

4.131 As a result of the evidence above, the CAA is minded to consider that it is not appropriate to define markets at Stansted in relation to daily peak or season. Section 5 discusses potential competitive constraints relating to the daily peak or seasons.

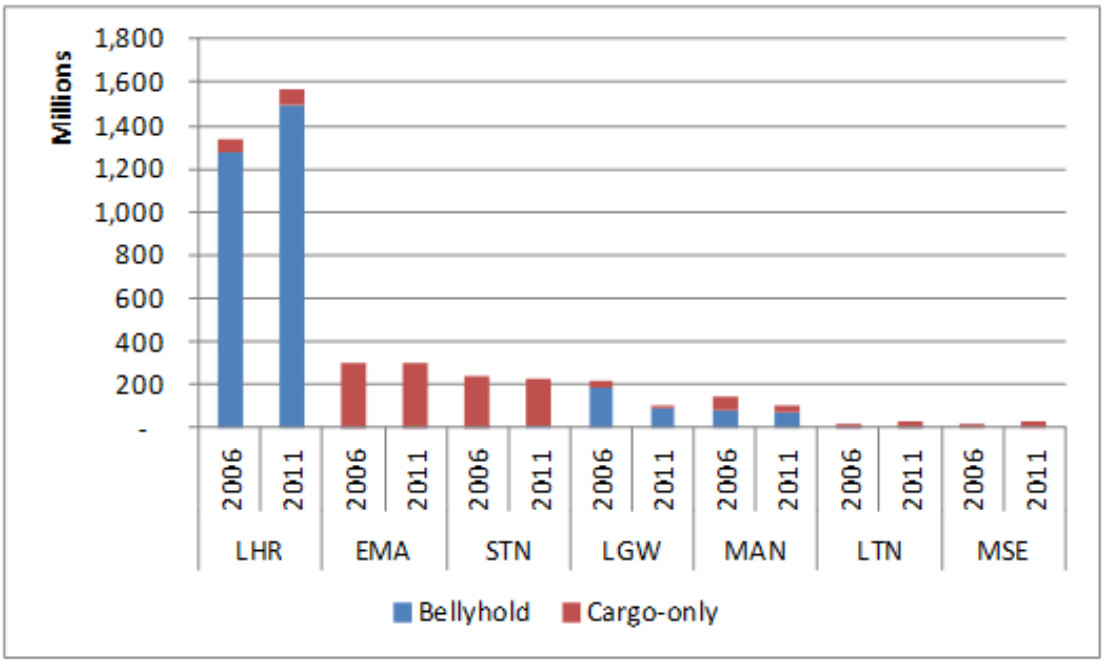
Cargo-only flights geographic market definition

4.132 The CAA notes that in the Initial Views it considered that the airport operated in a very broad market, and competed with a number of airports across the UK and Europe for much of this cargo traffic. At that time, the CAA had not obtained evidence directly from the cargo carriers and the views we expressed were based on our broad understanding of competition in the downstream market rather than an analysis of the substitutability of airports for Stansted from the point of view of cargo carriers. Following engagement with cargo-only carriers at Stansted, the CAA has revised its views on market definition, as set out in this section.

4.133 Air cargo can be carried either in the bellyhold of passenger aircraft or in cargo-only aircraft. Figure 4.6 shows that, although Heathrow has the largest cargo tonnage of UK airports, air cargo at the airport is nearly all carried in the bellyhold of passenger flights. In contrast, East Midlands and Stansted are the two main UK airports from which cargo-only flights are operated. Indeed, in 2011 only 2 per cent of cargo transported from Stansted was carried in the bellyhold of passenger flights.

[171] Source: Thomson Airways
[172] Source: [✂]

Figure 4.6: Bellyhold and cargo-only flight tonnage at selected airports



Source: CAA Airport Statistics

4.134 There is a range of different business models of cargo-only carriers at Stansted, as shown in Table 4.3.

- Integrators specialising in the end-to-end transport of time-sensitive express cargo often with a fixed guaranteed delivery time. They control and internalise each step of the process.
- Freight forwarders who arrange every step of a shipment on behalf of the shipper. Freight forwarders will generally purchase capacity from passenger or freight airlines; however the forwarders will also purchase integrator capacity, or purchase or lease whole aircraft on an ACMI basis[173]. Freight forwarders do not operate aircraft nor, typically, will they run their own trucking network, preferring instead to outsource haulage to a third party.
- General air cargo carriers, who may be cargo-only arms of passenger airlines or standalone cargo-only airlines. These often carry overspill cargo from passenger airlines at Heathrow and/or Gatwick requiring freighter capacity as their bellyhold capacity is insufficient.
- Domestic air mail service providers, that are chartered cargo-only airlines operating on a tender from Royal Mail.

[173] ACMI: Aircraft, Crew, Maintenance, Insurance.

Table 4.3: Business models of top 10 cargo-only operators at Stansted

Company	Business Model	Destinations	Largest aircraft requires above 2500m take-off fully-laden
Federal Express UK (FedEx)	Integrator	EUR, USA, RoW	Yes
British Airways World Cargo (BAWC)	Freight Forwarder	EUR, USA, RoW	Yes
United Parcel Service (UPS)	Integrator	EUR, USA	Yes
Titan Airways	Charter cargo carrier	UK	No
Jet2.com	Charter cargo carrier	UK	No
ABX Air	Charter cargo carrier	UK, EUR	Yes
Asiana Airlines	General Cargo	EUR, RoW	Yes
Atlas Air	Charter cargo carrier	EUR, USA, RoW	Yes
Martinair Holland	General Cargo	EUR, RoW	Yes
TNT Express (Airways)	Integrator	EUR	Yes

Source: CAA Airport Statistics and additional research

4.135 STAL has said that it considers there to be many international and domestic substitutes from an air cargo perspective, and that the global distribution networks of air cargo companies allow them a flexible use of a range of different airports.[174]

4.136 However, cargo-only carriers have emphasised the importance of operating from a London airport.[175] DHL, FedEx and Royal Mail have told the CAA that reasons for this include the need to make their latest pick-up time from the London and south east of England competitive and to ensure they can meet their guaranteed next-day delivery targets[176]. BA World Cargo, the second largest cargo carrier at Stansted, told the CAA that it requires its freighter operations to be near the centre of the freight forwarding community at Heathrow, due to the availability of bellyhold capacity to a large number of required destinations, means that they require the use of a London airport[177]. Royal Mail told the CAA that it needs to operate from a London airport in order to provide air mail services to the London area and south east due to the significant population density and the need to minimise road transit time due to the highly time-sensitive nature of air mail[178]. In addition, Luton has said that it considers there to be a London market for cargo.[179]

4.137 A priori, this could mean that the geographic market includes Stansted, Heathrow, Gatwick, London City, Luton, Southend and potentially Manston (Kent International) as potential alternative airports to which cargo-only carriers might be able to switch. However, there a number of factors which limit the substitutability of the other London airports for cargo-only carriers at Stansted.

4.138 Before considering carrier-specific requirements and how they might affect market definition, it is important to note two exogenous legislative and regulatory factors that restrict the scope of the geographic market. First, the London Air Traffic Distribution Rules (TDRs) essentially prevent cargo and

[174] Source: STAL
[175] Source: Royal Mail, DHL, FedEx, [✂]
[176] Source: DHL, FedEx, Royal Mail
[177] Source: BAWC
[178] Source: Royal Mail
[179] Source: Luton Airport

general aviation operations from Heathrow and Gatwick at peak times (extending to a considerable period of the day), subject to exemptions granted by the airport operator. Indeed, in the provisional findings and provisional remedies of the Competition Commission's March 2009 BAA airports market investigation final report, the CC "considered that the TDRs restricted, prevented or distorted competition, by limiting large cargo aircraft wishing to serve the London area to Stansted, as other airports were either full, too far away, or had runways which were too short, thereby imposing additional costs on some operators who had as a result to split their operation between Stansted and Heathrow and/or Gatwick which they used for belly-hold cargo carried on passenger flights."[180] Further, a number of Stansted's cargo operators have told the CAA that the TDRs were a significant factor in them basing operations at the airport.[181] The stipulation of timing restrictions on the availability of slots for cargo-only movements is likely to create a significant operational barrier in terms of operational flexibility. For example, Royal Mail said that it requires securing precise take-off and landing slots in the morning and evening to meet its regulated Quality of Service targets.[182]

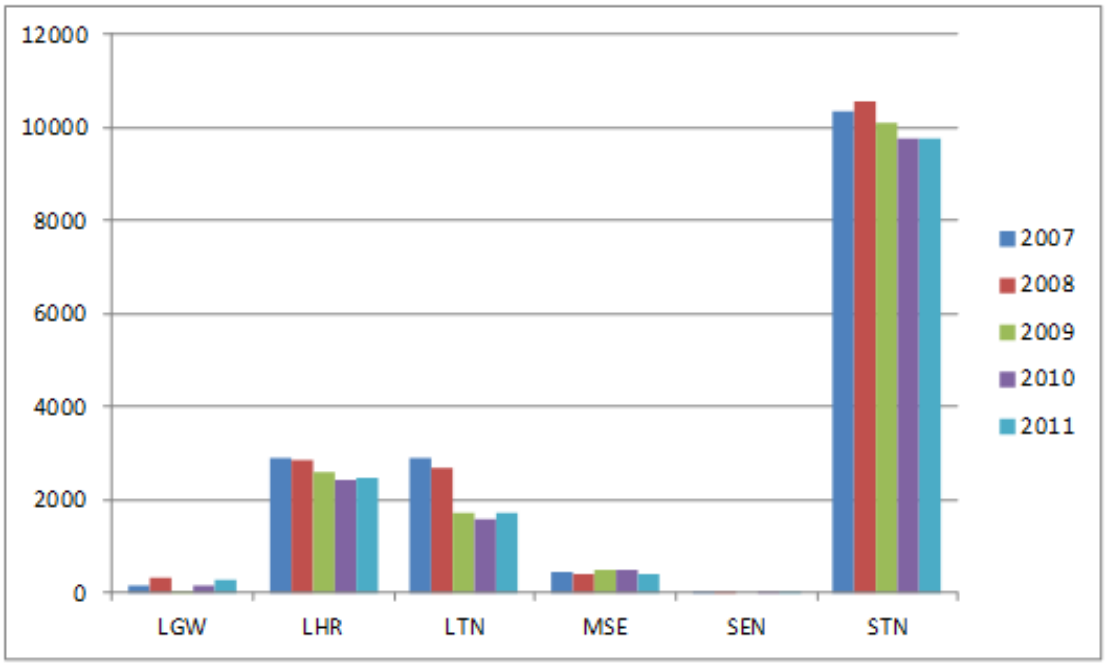
4.139 With the exception of a small number of carriers who hold grandfather rights on operating cargo-only movements at Heathrow and Gatwick, the significant majority of cargo-only movements at London airports have been consistently flown from Stansted, as shown in Figure 4.7.

4.140 In 2011, 67 per cent of cargo-only movements at London airports were operated from Stansted, followed by 17 per cent from Heathrow, 12 per cent from Luton. Manston (3 per cent), Gatwick (2 per cent) and Southend (0.01 per cent) make up the remainder while CAA airport statistics show that there have been no cargo-only movements at London City airport.

4.141 In addition, **[✂]**[183]. As well as the TDRs, cargo operators at Stansted have cited the fact that Heathrow lacks suitable capacity and the considerable level of congestion as reasons why it is not a viable substitute airport.[184]

[180] CC BAA airports market investigation March 2009 paragraph 6.90
[181] Source: FedEx, BAWC, Royal Mail, [✂]
[182] Source: Royal Mail
[183] Source: [✂]
[184] Source: FedEx, [✂], Royal Mail, BAWC

Figure 4.7 Cargo-only ATMs at the London airports and Manston 2007-2011



Source: CAA Airport Statistics

4.142 The change in ownership of Gatwick means that BAA's policy has not applied since 2009 and Gatwick's strategy may change in future to attract cargo-only carriers. Nevertheless, BA World Cargo has told the CAA that Gatwick has not actively approached them since the change of ownership[185]. Further, evidence suggests that there are additional reasons why Gatwick might be unsuitable for the operations of cargo-only carriers, for example FedEx has told the CAA that the airport's location to the south of London and its limited cargo facilities and transport infrastructure could significantly affect road transit times.[186] In addition, Royal Mail also said that Gatwick is geographically too distant from London to achieve sufficiently short road transit times from central London depots and processing centres.[187] East Midlands added that the relatively lower concentration of industrial cities south of London makes Gatwick not ideal for exporters[188].

4.143 [✂].[189] Indeed, some cargo operators have also said that they require the ability to operate from an airport that has a 24-hour operating licence and is relatively unrestricted by noise-related night flying restrictions.[190]

4.144 Alongside these exogenous factors, Stansted's various cargo-only carriers have set out reasons why the other London airports are unsuitable for their operations, which are set out below on an airport-by-airport basis.

[185] Source: BAWC
[186] Source: FedEx
[187] Source: Royal Mail
[188] Source: East Midlands Airport
[189] Source: [✂] Royal Mail, [✂], [✂]
[190] Source: Royal Mail, [✂]

London City

4.145 Although London City is well-located, cargo carriers have told the CAA that its runway is too short for their freighter aircraft[191], and FedEx added that it lacks relevant cargo processing infrastructure[192]. CAA airport statistics show that there were no cargo-only movements at London City in 2011. Further, in light of the limited runway length[193], the types of aircraft that airlines operate from the airport do not generally have significant bellyhold capacity.

Luton

4.146 Luton was described as unsuitable by carriers with different business models for various reasons. **[✂]** and BAWC said that the runway is too short to allow fully-laden wide-bodied freighter aircraft to take-off[194] (**[✂]** and B747-8Fs respectively). FedEx and **[✂]** also told the CAA that Luton was too far from London to allow a sufficiently quick transit time, with the former adding that its cargo facilities and transport infrastructure were limited[195]. However, travel time estimates suggest that Luton airport is approximately equidistant to Stansted from central London, and the travel time can be slightly lower than to Stansted. Despite this, Luton has told the CAA that, while its road surface access was well-connected, the surface access around the airport perimeter is problematic, were cargo to grow significantly as cargo transport would share the access roads with public transport and passenger traffic.

4.147 In addition, table 4.4 suggests that Luton airport might be in principle more suitable than Stansted for freight forwarders using cargo-only flights, as they tend to require access to Heathrow where the freight forwarding community is concentrated. However, a combination of night flight restrictions, insufficient runway length for fully-laden wide-bodied aircraft, and problematic surface access are likely to make Luton airport unsuitable. The night restrictions were also identified by Royal Mail as the principal barrier to operating from Luton, as it requires precisely-timed slots, it also lacks the facilities and infrastructure to support Royal Mail's operations [196]

[191] Source: FedEx, [✂]
[192] Source: FedEx
[193] The runway at London City airport has a TORA of 1199m, compared to 3048m at Stansted. For more details, please see Annex 4 on capacity constraints.
[194] Source: BAWC and [✂]
[195] Source: FedEx and [✂]
[196] Source: Royal Mail

Table 4.4: Estimated travel times and distances[197]

Airport	Uncongested travel time from central London (minutes)	Km	Uncongested travel time to Heathrow (minutes)	Km
Stansted	55	57	78	107
Gatwick	67	50	42	63
Heathrow	41	30	-	-
Luton	51	55	43	58
Manston	107	123	106	161
Southend	70	68	93	133

Source: Google Maps

Southend

4.148 Southend is generally regarded as geographically too distant from London for cargo-only carriers to achieve sufficiently short road transit times from central London depots and processing centres.[198] These views are supported by the distance and travel time estimates, which show that Southend is considerably more distant in terms of both distance and travel time than the other London airport with the exception of Manston.

Manston

4.149 Manston airport (also known as Kent International) is another airport in the proximity of London which is mostly used for cargo-only movements, and could potentially constitute a viable alternative. However, several of Stansted cargo-only carriers have told the CAA that the airport is too distant from London to achieve a suitable road transit time, and that the surface transport links are inadequate[199]. Moreover, FedEx said this is true for non-London airports generally.[200]

4.150 On the basis of the above evidence, which highlights the lack of substitutability of other London airports for the current operations of Stansted's cargo-only airlines, the CAA considers that the relevant geographic market is no wider than Stansted.

[197] Travel distance and times obtained from Google Maps, from departure postcode WC2B 6TE. Travel time estimates are uncongested, so are likely to indicate a lower bound although the relative differences would not be expected to vary significantly.
[198] Source: Royal Mail, [✂]
[199] Source: BAWC, [✂]
[200] Source: FedEx

Minded to conclusions on market definition

4.151 The CAA's analysis suggests that airports supply a broadly generic product. Where the CAA sees differentiation in the product market is in the facilities required to service particular segments; LCCs and charters, full service long-haul carriers and their associated feeder traffic, and cargo-only operators.

4.152 For LCCs and charters the CAA sees limited differentiation in their passenger base which results in the need for generic facilities. Additionally LCCs require the airport be to be able to provide tight turnaround times for their operations.

4.153 Full service long-haul carriers and their associated feeder traffic have a segmented passenger base requiring the provision of facilities for these passengers, i.e. first class and business lounges. There is also a requirement to allow for passengers to interline between the feeder flights and the long-haul flights to ensure efficient load factors.

4.154 For cargo-only airlines there is a requirement for dedicated facilities for the handling of cargo and no requirement of facilities for the processing of passengers.

4.155 The CAA is minded to consider that each of these would form distinct product markets.

4.156 Drawing the evidence together for the geographic market it is clear that given overlapping isochrones it would be possible to define an airport taking in the whole of the UK. However, in all practicality taking in the passenger mix and the evidence that the CAA has seen on the importance of catchment areas it is likely that chains of substitution get thin very quickly.

4.157 The CAA has observed a focus by airlines and airports on a 60-90 minute catchment. The CAA's analysis of passenger surveys and historic movements suggest a catchment of approximately 60-90 minutes for LCC and charter traffic, although up to at least 120 minute for full service long haul and its associated feeder traffic. This is suggestive of an airport product market which is also tightly defined by reference to geographical location for LCCs and charters. Due to the current absence of STAL's provision of services to full service long-haul carriers we have not considered the relevant geography for this product in further detail.

4.158 For LCCs and charters the CAA has evaluated evidence that suggests both Luton and Southend are sufficiently substitutable with Stansted. Whereas the evidence on substitutability of Heathrow, London City, Birmingham, East Midlands and Manchester suggests that these airports are poor substitutes for Stansted. The reasons differ from airport to airport but include congestion, price, infrastructure and remoteness from the Stansted catchment.

4.159 The CAA notes that the evidence on the substitutability of Gatwick for Stansted is inconclusive. It is clear that the infrastructure is suitable due to the operation of both Ryanair and easyJet and charter airlines from the airport. However, despite the overlap in catchment, evidence suggests that

there is an effective north and south London divide with airlines providing equivalent routes at both of the airports. The CAA has also seen evidence of clear price differentiation by the airlines at Gatwick and Stansted. The CAA notes that there may be constraints imposed by Gatwick on Stansted. However, on the balance of the evidence the CAA has seen to date, it does not feel confident that airlines or passengers would seek to switch from Stansted to Gatwick, capacity allowing, on the basis of a SSNIP to such a degree as to render the price increase unprofitable.

4.160 The CAA is minded to consider that the likely geographic market for airport services that consist of those provided from Stansted, Luton, and Southend.

4.161 The CAA also recognise that certain passengers' choice set, taking account of surface travel time and route overlaps, may include flights operating from Stansted and Heathrow and this may develop in the future. For the purpose of market definition, however, the CAA has attached more weight to the views and behaviours of airlines (particularly when supported by internal documents) than to catchment area analysis, to reflect the fact that they are the direct customers of the airports and could be expected to have a strong incentive to internalise their customers' switching behaviour. The CAA has also taken account of the fact that catchment area analysis does not itself provide direct evidence of passengers' propensity to switch in response to a price increase.

4.162 It is also possible that, following the divestment of Stansted and the adoption of different management practices by the new owner of the airport, more airlines may start to view Heathrow and Stansted as substitutes, particularly if Stansted actively markets itself and attracts airlines from Heathrow in the future. However, there is considerable uncertainty as to the speed and extent to which such developments may take place. For these reasons the CAA is minded to conclude that Heathrow is not in the same market as Stansted. The CAA has, however, considered the competitive interactions between the two airports as part of our analysis of airline and passenger switching.

4.163 Given the significant restrictions on airports within the south east and the representations made by cargo-only airlines, the CAA is minded to consider that the cargo-only market at Stansted consists solely of Stansted.

4.164 Bringing both the product and geographic markets together, the CAA is minded to consider that the appropriate market in which to assess STAL market power consists of the activities facilitating the use the runway and taxi-ways, aerodrome ATC, aircraft parking, ramp handling services, fuel and oil handling, and aircraft maintenance as well as the minimum activities required for the process of passengers at the airport, the provision of a terminal and the facilities for check-in, baggage handling, security screening and the transit of passengers to and from the aircraft. These services are provided for LCC and charters airlines. The CAA is minded to consider that it includes the use of similar facilities used by airlines at Luton, Southend and

possibly Gatwick. The CAA refers to this market as the Stansted short-haul market.

4.165 Further, the CAA is minded to consider that there is a differentiated market for the provision of these services to full service long-haul carriers and their associated feeder traffic. The CAA is minded to consider that it includes the use of similar facilities as in the Stansted short-haul market at airports with the appropriate infrastructure within a 120 minute catchment area including but not limited to Heathrow and Gatwick. However, the CAA notes that, Stansted does not currently compete successfully in this market despite trying to get a foothold within this market.

4.166 Moreover, the CAA is minded to consider that there is an additional market on which to assess Stansted market power consisting of the activities facilitating the use the runway and taxi-ways, aerodrome ATC, aircraft parking, ramp handling services, fuel and oil handling, and aircraft maintenance, as well as the minimum activities required for the process of cargo, for the provision of cargo only flights. The CAA is minded to consider that this market extends no further than Stansted. The CAA refers to this market as the Stansted cargo market.

5. Assessment of potential competitive constraints

Introduction

5.1 Users of an airport can respond to a failure by that airport operator to provide a reasonable price-service offering and thus discipline it through their ability to reduce their use of the said airport. The ability of airlines and passengers to switch away their business from an airport is likely to depend on a number of factors that need to be explored as part of a competition assessment.

5.2 Understanding the degree to which an airline can respond to an unattractive price-service offering by an airport operator provides insight into the ability of an airline to constrain the behaviour of an airport operator. If these constraints are sufficient they can prevent an airport operator's prices increasing above, and investment or service quality falling below, the levels to be expected in a well-functioning competitive market.

5.3 The OFT describes competitive constraints as 'market factors that prevent an undertaking from profitably sustaining prices above competitive levels'. The competitive price level is considered in section 6, while this section considers the overall extent to which Stansted's users would be able and likely to switch away from the airport.

5.4 To assess the degree of market power held by an airport operator, the CAA has sought to identify the existence and strength of all competitive constraints affecting Stansted. In particular, this section examines issues surrounding switching, including:

- the ways in which passenger airlines might be able to discipline the airport operator and its ability to do so;
- the likely scale of airline switching required to discipline the airport operator;
- switching costs and the ability of Stansted's passenger airlines to switch in general;
- strategic constraints on passenger airline switching;
- the implications of current capacity constraints;
- the scope and scale of actual switching following the 2007 increase in airport charges;
- evidence of countervailing airline buyer power and the degree of the competitive constraints that may result from entry and/or expansion by other airports;
- the potential implications of future demand forecasts and capacity constraints;
- passengers' ability to switch; and

- the ability of cargo airlines to constrain STAL's behaviour through switching or the threat of switching.

Ability of passenger airlines to constrain STAL's behaviour through switching or the threat of switching

5.5 This section considers the extent to which airlines operating from Stansted can constrain the behaviour of the airport operator through different strategies, including the switching of capacity out of the airport operator. We do this by examining the scale of switching required to discipline Stansted; the size of switching costs faced by the different categories of airlines operating from Stansted; strategic constraints on switching; and capacity constraints. We then examine the behaviour of airlines in practice following the price increase of 2007 and consequences for the airport.

5.6 In undertaking this analysis, where appropriate the CAA draws out differences between the main types of airlines operating from Stansted[201]:

- based LCCs;
- LCCs with inbound services only[202]; and
- charter airlines.

Scale of switching required to discipline STAL

5.7 To impose a competitive constraint on STAL, the level of switching of marginal aircraft or services following a price increase (or fall in service quality or investment) must be sufficiently large to impact the profitability of the airport's price increase.

5.8 In principle, there are several ways by which an airline could try and discipline an airport operator:

- volume growth could be allocated to other airports, by opening new routes or increasing frequencies on routes operated elsewhere;
- decreasing the frequency of existing services to and from the airport, for based and/or inbound aircraft;
- grounding aircraft or reducing the use of based aircraft during a particular traffic season; and/or
- moving based aircraft to other bases, or opening a new base by relocating aircraft currently at the airport.

[201] Distinguishing between these different types of carriers, as these may face different switching costs due to differences in their business models, does not necessarily affect the way in which the relevant market for passenger airlines is defined in section 4. Although Stansted's passenger airlines all broadly consume the same product provided by the airport, it may be the case that certain carriers perceive certain airports outside the defined market as substitutes. As market definition is not an end in itself, the potential impact of this will be taken into account in reaching our overall assessment of the degree of market power held by Stansted airport.

[202] The CAA defines inbound services as those flown by an aircraft based at another airport than Stansted. The same aircraft will, of course, have at least one rotation from Stansted.

Allocating volume growth to other airports

5.9 Allocating volume growth to other airports requires an airline to have access to sufficient spare capacity at other airports across its network and/or at new airports, as well as sufficient aircraft and other relevant assets. However, this form of switching may not, by itself, lead to a reduction in the short term of an airline's existing services at an airport, which means that this strategy might not result in a significant constraint.

5.10 In addition, given the timeframes potentially involved in allocating volume growth to different airports and capacity constraints more broadly, the airport operator may consider that increasing its prices will help increase its profitability over the medium term, as its traffic volume may remain relatively constant while its charges have increased.

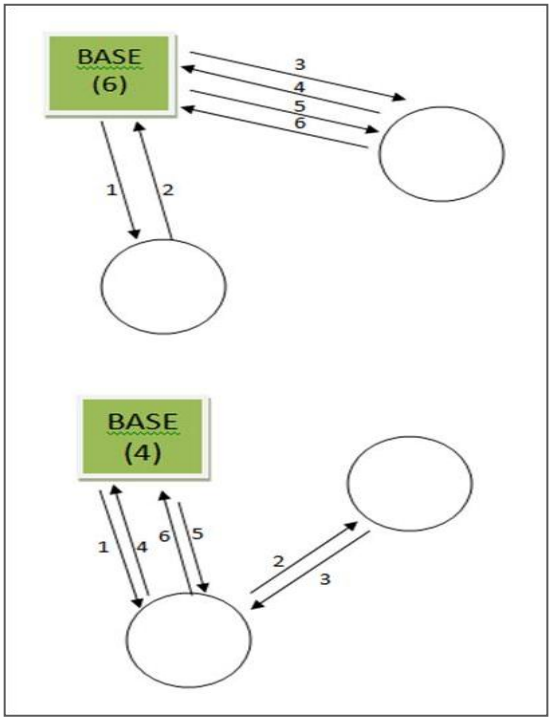
5.11 As noted above, the extent to which this strategy is likely to constrain an airport operator will depend on the level of spare capacity at the airport and the balance between existing traffic and future growth. An airport that has significant spare capacity and is highly dependent on traffic growth is more likely to be constrained by such behaviour than an airport that already has a mature customer base. In the case of Stansted, Ryanair's traffic grew at a high but declining rate over the past decade, increasing by between 12 and 18 per cent per annum between 2001 and 2004, slowing down to between 5 and 7 per cent per annum towards 2007 when there was zero per cent growth. Passenger volumes then began falling, resulting in a fall from approximately 24mppa in 2007 to approximately 18mppa in 2012. In addition, STAL has said in a February 2010 internal document that it did not expect **[✂]** in the future, which is in part due to **[✂]**.[203]

Reducing frequency on existing services

5.12 Reducing the frequency of existing routes to and from the airport might constrain an airport operator if the reduction is of a sufficient scale, although it could have certain service quality implications for the airline's services. An airline could, for example, reduce frequencies on its existing services in a number of ways. **[✂]** told STAL, an airline could simply reduce frequencies (and consequently the utilisation of those particular aircraft), or move towards flying longer sectors with "longer, more niche flying which will improve network quality but regrettably create a further downward pressure on volumes"[204]. Another option could be to alter the flight patterns of its aircraft that serve the airport, for example turning a "back and forth" pattern into a 'W pattern'. Under this option, the aircraft flies from its base to a "non-base" destination and then flies to another (non-base) destination before returning to its base in the evening.

[203] Source: STAL
[204] Source: STAL

Figure 5.1: Illustration of the way capacity can be switched from a base by replacing a "back and forth" pattern of operation with a 'W pattern'



Source: CAA

5.13 Evidence provided by Ryanair suggests that W patterns are rarely operated. For example, Ryanair has indicated the following.

- It currently operates only 30 such routes (mostly through Paris Beauvais and Venice Treviso) out of 1500 routes in its network, and its objective is to eliminate all such routes over time[205].
- Since the summer 2008 traffic season, routes operated on a W pattern from Stansted have represented between 0.6 per cent and 1.6 per cent of Ryanair's weekly departures.[206]
- W patterns are used in exceptional circumstances to facilitate routes between two non-base airports, and are always intended to be a short-term solution until a base can be established at one end of such a route.[207]

5.14 Ryanair also told the CAA that it agreed with the reasons cited by the European Commission for keeping the use of W routes to an absolute minimum.[208] The European Commission found that while there were some examples of carriers operating W patterns, their use were rare and that the majority of carriers tended to avoid using them or only used them on a transitional basis as:

[205] Source: Ryanair
[206] Source: Ryanair
[207] Source: Ryanair
[208] Source: Ryanair

- this model is not regarded as optimal by most carriers as they usually prefer operating from a base;
- operating between two points that are not connected to a base entails an increased risk, for example in case of technical problems on the route, which in turn can expose airline to costs and liabilities generated by delays in service;
- crews could not be simply exchanged in the middle of the day on a non base connected destination; and
- such an approach would only be commercially viable for routes that generate sufficient traffic for 3-4 roundtrips a day since otherwise the dedicated aircraft would not be used sufficiently.[209]

5.15 In addition, a Frontier Economics report commissioned by easyJet similarly states that 99.5 per cent of the airline's routes are operated under the standard "back and forth" pattern, such as A-B-A-C-A-D-A where A is the base airport, while the remainder is operated using other patterns, such as triangular and W patterns. The report notes that the reasons for using "back and forth" patterns are that they:

- provide airlines with a greater ability to respond to delays and incidents;
- lead to economies of scale with regard to maintenance, engineering and management at the base airport; and
- allow crews that are located around the base airport to be home overnight.[210]

5.16 However, easyJet has told the CAA that it can make use of W patterns to take advantage of a profitable opportunity, as a quick, short term, measure to establish a presence on a route, as it did following Sky Europe's exit on the Amsterdam Schiphol-Prague route. It also said that it can use W patterns to establish a presence in new airports without having to establish a base, which is a lengthy and expensive process. In this way, W pattern can then serve to trade off short- and long-term profitability, where an aircraft is put to a less profitable use in order to secure profits over the longer term[211].

5.17 easyJet has also indicated that it deploys aircraft on triangular patterns, though these are a small proportion of total flights (between 5 and 7 per cent of its routes). These patterns are used to ensure that aircraft serve particular markets at appropriate times of day, rather than as a tool with which to explicit attempt to discipline an airport's pricing. There are related cost issues (in particular crew) and added complexities to operating such patterns, which reduce their feasibility when trying to constrain an airport operator.

[209] European Commission M.4439, paragraphs 572 to 577.
[210] However, discussions with some charter operators suggests that the use of W patterns is used not so much as a disciplinary action towards the airport but rather it provides them scope to offer mid haul services and eliminates the need to establish bases in multiple locations (Source: Thomson Airways) The CAA notes that the business models of charter airlines are different from those of LCCs.
[211] Source: easyJet

5.18 As a result, modifying based aircraft flight patterns might not constitute substitution of a sufficient magnitude to constrain the airport operator. For example, Ryanair has indicated that modifying daily flight patterns of based aircraft to W patterns[212] would not effectively constrain the airport since this would not constitute a sufficiently large withdrawal of capacity[213].

5.19 Based on the evidence outlined above, the CAA considers that the scope for an airline to discipline the airport operator by reducing the frequencies of its existing routes to and from Stansted is unlikely to significantly constrain the airport operator's behaviour. In particular, the evidence suggests that there are various operational challenges, highlighted by both airlines and the European Commission, associated with using W patterns over the medium term, and that the need for LCC's to operate high frequency routes suggests that the scope for the airlines to discipline the airport operator in this manner is relatively limited**.**

Grounding and switching based aircraft

5.20 The majority of movements at Stansted are undertaken by aircraft based at the airport. Using ACL Start of Season reports, Frontier Economics estimated on behalf of easyJet that based aircraft represented approximately 82 per cent of movements.[214] STAL's internal documents show that it considers it important to retain a critical mass **[✂]** because of the importance of **[✂]**, and consequently maintaining passenger numbers[215]. Together, this suggests that switching marginal based aircraft away from Stansted is likely to be an effective way to constrain the airport operator.

5.21 Grounding one or more based aircraft, or equivalently reducing their utilisation, is a form of switching that should, in theory have a similar effect to re-basing aircraft. For example, Ryanair has told the CAA that the number of its based aircraft at Stansted (through grounding them or reducing their use) in the Winter traffic seasons was reduced by over 30 per cent between 2006 and 2012, in response to Stansted's doubling of airport costs, a lack of agreement for off-peak growth support, as well as rising fuel costs. Ryanair told the CAA that it has grounded aircraft, but mainly at "high cost monopoly airports such as Stansted and Dublin", and that these decisions are largely driven by high airport charges[216]. In addition, Ryanair indicated that the opportunity cost it faces for suspending routes and grounding aircraft during the summer traffic seasons is very high. As a result, it is only viable for it to consider grounding aircraft during the Winter traffic seasons, where the cost of leaving the aircraft idle on the ground is lower than losses that would be generated on many routes.[217] However, Ryanair has indicated that this has

[212] When operating a W pattern, the aircraft flies from its base to a "non-base" destination and then flies to another "non-base" destination before returning to its base in the evening, giving a A-B-C-B-A pattern.
[213] Source: Ryanair
[214] Source: Frontier Economics Report Commissioned by easyJet (page 18) November 2011
[215] Source: STAL
[216] Source: Ryanair
[217] Source: Ryanair

had no disciplining effect on the airport as it has failed to deliver reductions in airport charges even in the winter months.[218]

5.22 The CAA notes that in the Initial Views, it considered press releases as evidence that Ryanair would be able to move aircraft from Stansted to continental European airports to impose a constraint on STAL. However, when asked to reconcile press releases with actual switching activity, Ryanair said that they "do not provide 'reconciliations' to press releases which are forward looking statements and in some cases are part of a negotiating process with a particular airport."[219]

5.23 Overall, Ryanair grounded 84 aircraft in the 2011 winter traffic season, of which 15 were aircraft based at Stansted. However, Ryanair told the CAA that it did not relocate aircraft away from Stansted during the winter traffic seasons, instead choosing to ground them or reduce their utilisation. For example, following our enquiries about the increase the number of based aircraft at Gatwick in the 2010/11 winter traffic season, Ryanair told the CAA that it allocated four additional aircraft to Gatwick in the 2010/11 winter traffic season to take advantage of a growth discount at the airport, and this had not resulted in a shift of capacity from Stansted, as supported by statistics provided by Ryanair on the number of aircraft based at Stansted. These aircraft were withdrawn from Gatwick for the 2011/12 winter traffic season.[220] Moreover, Ryanair told the CAA that winter growth on other routes did not need to be delivered through aircraft grounded at Stansted, and that this growth was in fact delivered mainly through new aircraft deliveries, with Ryanair's fleet growing from 133 units in 2007 to 294 by the end of 2012. Some additional winter growth was delivered through frequency reductions on other routes and with existing aircraft which were not grounded.[221] The CAA therefore does not place particular weight on press releases as evidence of Ryanair's actual substitution decisions, in contrast with evidence of actual behaviour.

5.24 The withdrawal of one based low cost carrier aircraft, efficiently utilised, could result in the removal of approximately 400,000 passengers per annum for Ryanair. For easyJet, the withdrawal of one low cost carrier on a "back and forth" pattern would result in the removal of 6 daily movements; equating to 350,000 passengers per annum.[222]

5.25 For example **[✂]**[223] **[✂]**[224] Evidence concerning the airports' response to these actions is mixed. Stansted has said that it is important for it to retain a

[218] Source: Ryanair
[219] Source: Ryanair
[220] Source: Ryanair
[221] Source: Ryanair
[222] Source: RBB Economics report commissioned by Ryanair (page 13) November 2012 http://www.caa.co.uk/docs/5/rbb%20stansted%20final%20non-confidential%20version%2029%20Nov%2011.pdf and Frontier Economics Report, commissioned by easyJet (page 18) http://www.caa.co.uk/docs/5/rpt-easyJet%20Competition%20Assessment%20Final%20Report_Abridged.pdf
[223] Source: [✂]
[224] Source: [✂]

critical mass of aircraft at the airport.[225] According to a May 2012 strategy document, the airport has recognised that one of its challenges is to address the increase in 'competitive tension' as a result of **[✂].** The document however also records an expectation of "re-negotiations with **[✂]** to deliver significant growth **[✂].** [226]

5.26 Having considered the various ways in which airlines might, in principle, be able to switch away from Stansted, including the analysis undertaken by Frontier Economics, the CAA considers that the evidence suggests that the strongest disciplinary action that an airline can undertake is to relocate its based aircraft. While the switching that has occurred to date appears not to have disciplined the airport operator's pricing of existing services to any significant degree, this may reflect the airport operator's views on a number of factors including (but not limited to) future economic conditions, the capacity available at (and the success of) other London airports and the level of switching that has occurred at Stansted to date. The CAA therefore considers that substitution of a sufficient number of based aircraft away from Stansted could significantly impact on its profitability and therefore could constrain the operator's behaviour.

Critical loss analysis

5.27 As discussed above, switching away based aircraft appears to be the most effective way for airlines to attempt to constrain STAL's behaviour. In light of this, we considered the necessary scale of switching and the likelihood of such switching materialising following a 10 per cent price increase.

5.28 Frontier Economics estimated on behalf of easyJet that, to make a 10 per cent price increase unprofitable, Stansted would have to lose between 1.1 million and 1.3 million passengers per year out of the 2011 total of 18 million. It estimated that this was equivalent to 29 daily ATMs[227], which means that to discipline the airport, easyJet would need to relocate 4 to 5 of aircraft current based at Stansted.[228] CAA analysis based on the same methodology, with a 10 per cent increase in aeronautical revenue per passenger, estimated that approximately 3 to 5 aircraft, representing between 1.3 and 1.5 million passengers per year, would amount to a "critical loss" of movements for Stansted, making the price increase unprofitable.

5.29 Using the underlying allocation model of the DfT's Aviation Forecast NAPALM methodology, Frontier Economics estimated how many passengers at Stansted would switch away from the airport in light of an increase of 10 per cent in the cost (equating to £0.66) of using the airport. The results

[225] Source: STAL
[226] Source: STAL
[227] Having estimated the passenger numbers required to respond to a price increase Frontier Economics convert this into the number of planes required to switch away from an airport. To derive the number of planes required to switch, Frontier Economics assumed that there is a uniform percentage reduction in passengers across Air Traffic Movements (ATMs).
[228] The analysis undertaken by Frontier Economics indicates that the elasticity required for passengers to switch so that there is no additional profit at Stansted airport is 6.7.

show that an estimated 690,000 passengers would switch away from Stansted in such a scenario, which is equivalent to approximately 2 aircraft. When modelling capacity constraints, by restricting substitution to Heathrow and London City airport, the estimated loss in passengers falls to 610,000. As the estimated actual loss in passengers is smaller than the critical loss, Frontier suggested that Stansted might be able to increase its prices profitably by 10 per cent[229].

5.30 These estimates are also consistent with Thomson Airways' estimate of the required magnitude of aircraft switching to constrain an airport. **[✂]**[230]

5.31 However, there are a number of factors linked to the NAPALM[231] model that affect the way that the results should be interpreted. While the CAA outlined a number of these in the Initial Views[232], the key factors worth noting are[233]:

- The report's analysis of airline switching restricts any switching to the London airports. This appears to be a reasonable restriction given the importance of operating from London for easyJet, as well many other carriers at Stansted including Ryanair. However, this analysis does not allow for substitution to Southend airport, as it pre-dates easyJet's operations at the airport.
- The analysis of passenger switching restricts passengers' choices. In particular, the model does not allow passengers to exit the market following a price rise (i.e. to decide not to travel), and only allows them to switch or fly from their current airport. In addition, the model does not seem to allow for route substitution; for example, a passenger flying to Paris Charles de Gaulle airport can only switch to another flight to the same destination airport.
- The NAPALM model treats flights by LCCs, charter airlines, and full service carriers as not being substitutable from the point of view of passengers, which limits the scope for substitution in the model.
- The modelling is a static analysis of the change in passenger numbers over one year, taking the existing route networks at UK airports as given. This allows estimation of short-run reaction from the price increase, although omits longer-term implications. However, these dynamic reactions are taken into account in the overall assessment of the degree of Stansted's market power, through the analysis of passenger switching (see below).

[229] Source: Frontier Economics - Market Power Assessment: Stansted and Gatwick Airport http://www.caa.co.uk/docs/5/rpt-easyJet%20Competition%20Assessment%20Final%20Report_Abridged.pdf (accessed January 2013)
[230] Source: Thomson Airways
[231] The National Air Passenger Allocation Model is a fully-estimated multinomial choice model that is used to convert unconstrained forecasts of air passenger demand into forecasts of passenger demand by airport.
[232] CAA, Stansted Market Power Assessment – Initial Views, February 2012, paragraphs 3.59-3.60 and 3.89 http://www.caa.co.uk/docs/5/StanstedMarketPowerAssessment.pdf (accessed January 2013)
[233] It should be noted that these factors are examples of the types of limitations that are typically experienced when the complexity of markets are simplified to allow a tractable model to be constructed.

5.32 The limitations of the NAPALM model suggest that the level of passengers actually switching may be higher than the estimated level, which is influenced by the use of an estimated elasticity in the model as well as other modelling restrictions. Nonetheless, the CAA considers the available evidence highlights the difficulties of disciplining the airport operator in this way given existing capacity constraints. The impact of capacity constraints are considered below.

Switching costs and ability of Stansted airlines to switch in general

5.33 Having considered the different switching strategies that might be available to passenger airlines, as well as the likely scale of switching required to constrain the airport, this section examines the switching costs facing Stansted's airlines to establish the underlying reasons why airline substitution may be insufficient to constrain the airport.

5.34 The categories of switching costs potentially faced by an airline were described in detail in the Competition Commission's 2009 report. They are summarised below:

- *Cost of physical relocation*: these are one-off costs incurred when re-basing aircraft, which could include relocating flight crew if the airport to which the aircraft is rebased is a considerable distance from the current airport. There may also be ground staff redundancy or recruitment expenses. If an aircraft is being relocated to an airport where the airline has existing operations, these costs may well be smaller than if it were opening a new base, in which case some additional start-up expenses might be incurred.
- *Long-term commitments*: an airline might have a multi-year contract with an airport where the charges it pays are linked to the volume of passengers it carriers. An airline could also have long-term arrangements for maintenance facilities at the airport. Full or partial switching of aircraft or services could well break these agreements, and the benefits of these agreements would need to be considered against the offer at an airport to which the airline may switch.
- *Loss of economies of scale*: switching away one or more aircraft from a base could result in the loss of economies of scale at that particular airport as the size of the airline's operations is reduced. However, this switching cost might be offset by the creation of economies of scale at the airport to which the aircraft is (are) being relocated, or may not be significant if the aircraft switching occurs between two or more sizeable bases.
- *Market effects*: these include transitory costs of switching aircraft to substitute airports. Marketing costs can be incurred for new routes, and the lower yields in the first year(s) of a route's operation as the yields reach maturity. These costs could be offset to an extent by the airport to which the aircraft is (are) relocated offering discounts (or direct

marketing support) to new airlines or for the operation of new routes. In addition, these costs may be smaller if the aircraft and routes are moved to airports that are proximate to the original airport, and whose catchment area(s) overlap with it. However, there may be longer-term market effects resulting in lower yields, even on mature routes, which could occur from operating routes from airports whose location is less attractive or where the airline faces more direct competition.

- *Network effects*: network effects can occur at an airport where the number of airlines or routes offered increases the number of passengers choosing to fly from the airport, which in turn can make the airport more attractive to other airlines. Switching away from an airport, in particular to a smaller airport, might result in the airline losing the benefits of these network effects. However, the strength of these effects varies on a case-by-case basis. Given the concentration of passenger traffic at Stansted in a smaller number of airlines, it appears that the loss of any network effects between airlines would be unlikely to constitute an important switching cost for airlines at Stansted.
- *Capacity constraints*: capacity constraints at other airports that are seen as substitutable by an airport's incumbent airlines can reduce the threat and likelihood of airline switching as airlines might be less able to relocate aircraft in a profitable way and on a sufficient scale to constrain the airport. These capacity constraints can occur, for example, from a lack of suitable runway slots, aircraft parking stands capacity, and/or terminal capacity.
- *Sunk costs*: these are irrecoverable costs resulting from an airline's investment in infrastructure and facilities at an airport, either through purchase or leasing. Where the assets are owned by the airline, the initial investment costs might be to an extent recoverable through the sale of the assets, thereby reducing the size of the sunk costs.

5.35 The different types of switching costs outlined above are likely to affect airlines operating to and from Stansted differently according to their business model and the nature of their operations.

5.36 As set out in section 3, the passenger airlines at Stansted are predominantly LCCs. The infrastructure and service level requirements of these airlines will tend to be below those of a FSC.[234] For example, LCCs will typically not require facilities for transferring passengers and baggage between flights, or to facilitate the carrying of bellyhold cargo, or facilities targeted at premium passengers, such as business lounges. In addition, the airlines at Stansted typically make relatively limited investments in facilities at the airport, particularly when compared to the investments made by FSCs and network carriers. Indeed, both Ryanair and easyJet stress the flexible nature of their

[234] Source: CAA, Stansted Market Power Assessment – Initial Views, February 2012, paragraphs 24 http://www.caa.co.uk/docs/5/StanstedMarketPowerAssessment.pdf (accessed January 2013)

operations.[235, 236] Ryanair and easyJet currently also operate at a number of much smaller airports than Stansted, which highlights that its minimum requirements are relatively low and below the level of infrastructure available at Stansted (with its long runway and cargo facilities)[237].

5.37 Passenger airlines at Stansted can be split into three main groups: based LCCs, for which most of their operations at the airport are from, based scheduled airlines, inbound LCCs, and charter airlines. We have therefore examined the switching costs and ability of each of these different passenger airlines to switch.

Based short-haul LCCs

5.38 Ryanair and easyJet are the two largest airlines at Stansted and the two main based scheduled airlines operating from the airport, carrying approximately 90 per cent of Stansted's airport traffic.[238]

5.39 Ryanair has indicated that it has very little tangible investments at Stansted and has not undertaken significant capital investment that could be considered a switching cost. It has, however, indicated that it has previously estimated that the capital cost associated with a move from Stansted to Gatwick would be approximately £10 to £12 million.[239]

5.40 Generally, switching costs facing based low cost carriers at Stansted tend to be sunk costs of marketing services and offering promotional fares. In addition, the market effects of switching away a route could be significant due to the potential of another airline replacing the switched service, diminishing the credibility of an airline's threat to switch, as it would not then have a significant effect on the airport.

5.41 Ryanair has told the CAA that the largest sunk switching cost it would face is associated with the expenditure it has incurred through marketing and promotional fares offered on more than 100 routes at Stansted over the past two decades. Ryanair considers that these costs are substantial and that this prevents it from withdrawing a significant part of traffic on a year-round basis.[240] Other switching costs the airline has indicated that it would incur include loss of yield (relative to a mature route) from opening a new route[241],

[235] See, for example, interview with Michael O'Leary, retrieved from http://www.anna.aero/2012/01/25/ryanair-ceo-michael-oleary-the-award-winning-interview/
[236] "easyJet has built flexibility into its fleet planning arrangements such that it can increase or decrease capacity deployed, subject to the opportunities available and prevailing economic conditions. The Company also has flexibility to move aircraft between routes and markets to improve ROCE", easyJet Annual Report (page 11), 2011. http://corporate.easyjet.com/~/media/Files/E/Easyjet-Plc-V2/pdf/investors/result-center-investor/annual-report-2011.pdf
[237] Ryanair currently operates from 160 airports, with 47 bases, easyJet currently operates from 123 airports, with 19 bases.
[238] Please see Section 3 for more details.
[239] Source: Competition Commission, BAA airports market investigation, March 2009, Volume 2, Appendix 3.1, footnote 2. http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/545_3_1.pdf
[240] Source : Ryanair
[241] Source: Ryanair

redundancy costs, the loss of efficiency of engineering facilities and economies of scale.[242]

5.42 Frontier Economics reports that **[✂]** faces **[✂]** per passenger in additional marketing costs in the first year of operating a new route.

[✂][243]
[✂][244]
[✂][245]

5.43 **[✂]**

5.44 The difference between these costs appears to be considerable, with the one-off switching costs being greater than the cost of remaining at the airport. While these are estimates, and might therefore vary on a case-by-case basis, they appear to provide an indication of the potential switching costs faced by easyJet and the airline's switching reaction in practice. They show that the cost of switching away from Stansted in light of such a small but substantial non-transitory increase in price exceeds the cost of remaining at the airport, suggesting that it is unlikely that easyJet would relocate marginal aircraft in response. Similarly, additional evidence provided by easyJet shows that marketing costs for switching three aircraft from Stansted to Southend would be up to **[✂]**.[246]

5.45 **[✂]** said that it would need to take into account the likelihood and extent to which other airlines would replace their operations in a scenario where they switch away based aircraft. Airline backfill for Stansted's (or any other airport's) passenger base could render an airline's threat to switch non-credible.[247] There are two separate aspects to this which may constrain airline switching: first, it is a reason why the airport operator may not be constrained by an airline exiting a route as another airline would be likely to take its place; second, airline backfill may reduce the profitability to the airline of exiting the route and operating it from another airport. If either or both scenarios materialise, this would limit the airline's ability to constrain the airport operator.

5.46 Overall, the evidence the CAA has received suggests that, compared to full service airlines with typically more significant capital investments at an airport, the based scheduled airlines at Stansted would face relatively low switching costs if they were to switch away aircraft from the airport. However, the additional marketing costs per passenger and the risk of airline backfill

[242] Source: [✂]
[243] This leads to an estimated additional net present value per passenger cost of £1.60 over four years.
[244] Having cross-checked the assumptions with regard to the period required for a route to reach maturity with data on contribution per block hour over time and route-specific revenue projections, the assumptions appear to be reasonable and robust.
[245] Source: Frontier Economics - Market Power Assessment: Stansted and Gatwick Airport, http://www.caa.co.uk/docs/5/rpt-easyJet%20Competition%20Assessment%20Final%20Report_Abridged.pdf (accessed January 2013), page 27.
[246] Source: [✂]
[247] Source: [✂]

appear to be sufficiently high to constrain these airlines' ability to switch away in the short-run. Nevertheless, the absence of significant investment in infrastructure at Stansted by these airlines means that they retain flexibility in the longer term to response to a price increase by switching away marginal aircraft and services from Stansted.

Inbound scheduled carriers

5.47 In recent years, Stansted has lost a number of inbound airlines that have switched to Gatwick. Together these airlines accounted for approximately 4 per cent of passengers at Stansted in 2011, having declined from approximately 6 per cent in 2007.

5.48 The CAA asked three of these airlines about the costs and practical aspects of switching away from Stansted.

- Air Asia X indicated that it did not encounter significant costs – beyond the termination of catering, groundhandling and hotel contracts – in switching from Stansted to Gatwick, largely because it did not have any aircraft based at the airport.[248]
- Air Berlin indicated that, apart from obtaining suitable slots, changing airports would entail some new investment at the new airport as well as costs associated with ticketing. However, it noted that as it uses a handling agent and a ticketing agent these costs are relatively small.[249]
- Wizz indicated that it would not face many switching costs in moving its current operations from Luton, due in large part to its crew being based in Central and Eastern Europe. However, it noted that it would face some one-off marketing costs to rebuild part of its passenger base after a move to another airport.[250]

5.49 In addition, the scope for airline backfill was raised as an additional market effect which can form an important element of a switching cost. For example, Wizz has indicated that any decision to switch from Luton would be influenced by its view of the potential consequences on its profitability, of other airlines potentially taking their place on the routes or frequencies that Wizz would have exited.[251] Overall, inbound airlines to London airports do not appear to face significant physical switching costs but there may be other commercial considerations that deter them from switching.

Charter airlines

5.50 Thomas Cook and Thomson Airways are charter airlines, with one[252] and two[253] aircraft based at the airport respectively, that operate at Stansted throughout the year. In addition, Monarch operates charter flights during the

[248] Source: Air Asia X (Air Asia X subsequently ceased operations to the UK, due in large to macroeconomic conditions).
[249] Source: Air Berlin
[250] Source: Wizz Air
[251] Source: Wizz Air
[252] Source: Thomas Cook
[253] Source: Thomson Airways

winter traffic seasons on a smaller scale than Thomas Cook and Thomson Airways.

5.51 Thomas Cook said that, other than the cost associated with operating new slots, there would be staff redundancy and recruitment costs involved in moving airports.[254] As a result, some financial and reputational costs would be incurred. Thomson Airways said that typical switching costs would include crew relocation, labour/union issues, and selling and buying office space.[255]

5.52 On the whole, charter airlines with one or two based aircraft are unlikely to face considerable switching costs due to the small size of their operation at Stansted and consequent lack of significant infrastructure investment at the airport, though these costs would be lower for inbound charter airlines.

Strategic constraints on switching

5.53 In addition to the "traditional" switching costs tied to operations at the airport, some Stansted airlines may face strategic (commercial) switching costs from switching between London airports, or to other non-London airports in the UK or in continental Europe. Indeed, STAL has argued that it faces competitive constraints for LCC business from continental European airports, and that these airlines have considerable flexibility to switch between these airports.[256] This is an issue that the CAA did not explore in the Initial Views but is an issue that the CAA's subsequent analysis suggests is a relatively important factor in an airline's decision to switch.

Based low cost carriers

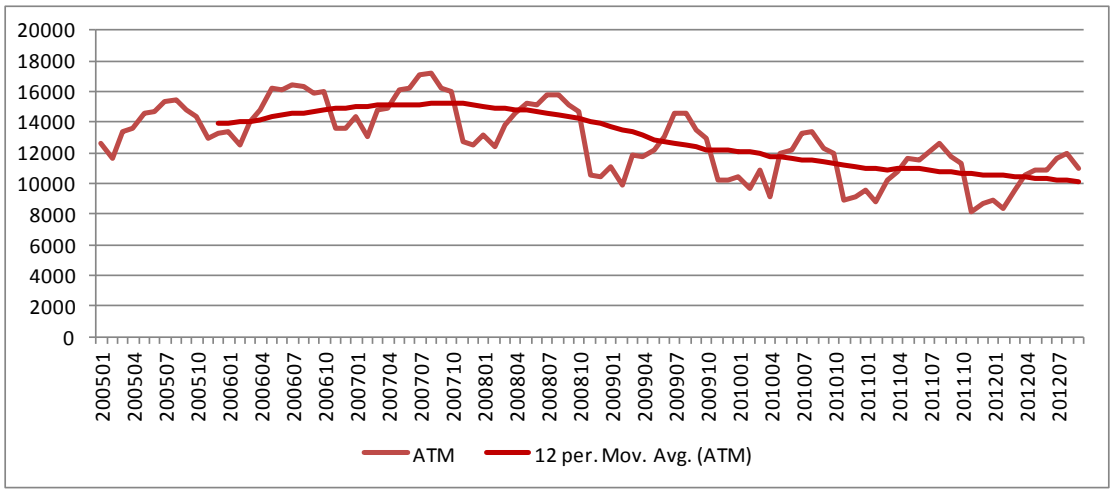
5.54 In principle, given the breadth of their networks, Ryanair and easyJet should be able to switch marginal aircraft or routes to a range of airports across the UK and the rest of Europe.

5.55 However, while both Ryanair and easyJet have moved aircraft between their respective bases, they have both indicated that operating from London is central to their business model. For example, Ryanair has told the CAA that its network could not function without a significant London presence[257] as London is "the main centre of commerce in Europe, a major tourism destination, as well as the largest agglomeration in Europe, London is of significant importance to any airline network".[258] The airline has also indicated that a London connection is a "must have" for most of the 170 airports from which it operates.[259] Ryanair also indicated that it was unable to materially reduce frequencies to/from Stansted from its current levels (to reduce its overall use of the airport without closing down routes), having already reduced frequencies over the past few years, as this would make its

[254] Source: Thomas Cook
[255] Source: Thomson
[256] Source: STAL
[257] Source: Ryanair
[258] Source: Ryanair
[259] Source: Ryanair

routes **[✂]**. This is illustrated by the fact that the number of ATMs has stabilised in 2012, as shown in Figure 5.2.

Figure 5.2: Monthly ATMs at Stansted over time 2005-2012



Source: CAA Airport Statistics

5.56 In a report commissioned by Ryanair, RBB set out reasons why a strong presence in London is important to the airline:

- a strong presence in London affects the brand value of an airline;
- the thickness of demand in London allows a large number of routes to be operated from the same base, which results in efficient aircraft utilisation;
- new routes can be launched with lower risk, in regard to profitability, from London airports rather than from non-London airports; and
- significant sunk costs in marketing its London bases. There is a significant option value to a London presence associated with the ability to operate from London in the future.[260]

5.57 Similarly, easyJet states that **[✂]**.[261] Indeed, many of the top 100 European routes in terms of passengers carried connect to London, though in the case of easyJet a substantial number of these routes are likely to be flown to Gatwick. Further, in terms of total European capacity, London is the leading network point, followed by Paris.[262, 263]

5.58 In addition, STAL says in its Information Memorandum that London has always been a key destination for both Ryanair and easyJet, and that it

[260] Source: RBB Economics commissioned by Ryanair (page 16), November 2012 http://www.caa.co.uk/docs/5/rbb%20stansted%20final%20non-confidential%20version%2029%20Nov%2011.pdf
[261] Source: easyJet
[262] Source: easyJet
[263] As discussed in paragraph 5.34, we do not consider that network effects are likely to be a significant switching cost for airlines at Stansted. While easyJet may find network effects at another London airport, it is likely that airlines see London as an important network point due to the attractiveness of the area in terms of economic activity and catchment area.

anticipates that the airport will continue to represent an important part of both airlines' traffic schedules in the long term.[264]

5.59 Based on this evidence, it appears likely that Stansted's based LCCs would consider switching to another substitutable London airport before considering relocating aircraft away from the London airports. While competition with more distant airports is important when airlines are starting new services and are able to put these at a number of different airports, rivalry with more distant airports is likely to be less relevant when prices for existing services are being renegotiated. Indeed, the CC has previously stated that, while non-neighbouring airports do exert a degree of competitive constraint on each other, the constraint is considered to be weaker than that from neighbouring airports.[265]

5.60 Considering its options to switch to another London airport, Ryanair has told the CAA that the "three London airports that are suitable for Ryanair's operations" are Stansted, Luton and Gatwick[266]. Ryanair also told the CAA that *"other London airports are only partially substitutable for Stansted, because each airport 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."*[267]

5.61 **[✂]**[268]
[✂] [269]

5.62 Regarding the possibility of relocating aircraft and services to airports in continental Europe, Ryanair has indicated that, although it could theoretically operate a base at Stansted with as few as 5 to 10 aircraft[270], a connection to London is seen as a "must have" by most of Ryanair's 170 airports and moving a route out of Stansted to a continental European airport would result in a reduction in schedule quality at Stansted; that this would be equivalent to exiting the market and airlines do not therefore move aircraft from developed routes lightly.[271] On the basis of evidence provided by Ryanair, the CAA has calculated that it has reduced:

- the number of based aircraft during the Summer traffic season by approximately 5 per cent from summer 2007; and
- its Winter based capacity by over 35 per cent between 2006 and 2012.[272] However, it noted that this reduction was achieved through the

[264] Source: STAL
[265] Source: Competition Commission, BAA airports market investigation, "Consideration of possible material changes of circumstances" 19 July 2011. http://www.competition-commission.org.uk/our-work/baa-airports
[266] Source :Ryanair
[267] Source: Ryanair
[268] Source: easyJet
[269] Source: easyJet
[270] Source: Ryanair
[271] Source: [✂]
[272] Source: Ryanair

grounding of aircraft at Stansted rather than their re-allocation to other bases.[273]

5.63 In addition, the CAA has calculated that it has reduced its overall capacity at Stansted by over 20 per cent over the period between 2007 and 2011, but also increased the number of routes it operates by 14 per cent over the same period.[274]

5.64 In a report commissioned by Ryanair, RBB noted that:

- Ryanair had not switched aircraft from Stansted and deployed them on continental European routes **[✂]** , instead choosing to ground them (see examples paragraph 5.92);
- there would appear to be additional costs to switching routes from Stansted, among which is the argument that there may be no additional passenger demand on these routes as a result of switching aircraft to expand capacity.[275] Indeed, Ryanair said that it can "to a limited extent, mitigate its losses at Stansted by moving aircraft and developing bases in Europe, such action is no substitute for serving the key market around London and South East England."[276]; and
- Ryanair would be unable to serve the vast majority of its Stansted demand base from a regional airport, unless the change in relative airport charges alone were sufficient to affect the profitability of serving another route with an unrelated demand base, as serving these passengers would be more profitable than at Stansted.[277]

5.65 Despite recording a number of reservations with the RBB report in the Initial Views, the CAA has re-considered several arguments put forward in the report, as detailed above.

5.66 **[✂]**[278]
[✂][279]

5.67 The CC said in its Q5 price control review of Stansted that there could be profitable routes available at continental European airports to which Stansted airlines could switch if charges at Stansted increased, although it noted that this was only likely to be a constraint in the short run as in the long run an airline could buy or lease more aircraft to take advantage of profitable opportunities available to them. Indeed, when considering switching an

[273] Source: Ryanair
[274] Source: CAA Airport Statistics
[275] Source: RBB Economics commissioned by Ryanair, November 2011 http://www.caa.co.uk/docs/5/rbb%20stansted%20final%20non-confidential%20version%2029%20Nov%2011.pdf
[276] Source: Ryanair response to the Competition Commission's 30 March 2011 Provisional consideration of possible material changes of circumstances. http://www.competition-commission.org.uk/our-work/baa-airports/evidence
[277] Source: RBB Economics commissioned by Ryanair November 2011 p.15 http://www.caa.co.uk/docs/5/rbb%20stansted%20final%20non-confidential%20version%2029%20Nov%2011.pdf
[278] Source: [✂]
[279] Source: [✂]

existing aircraft, the profitability of a route in continental Europe would need to be at least at the level of the route which would be removed from Stansted in order to serve it, for the airline to consider relocating the aircraft. In contrast, if an airline's fleet numbers were such that it had spare aircraft (either currently or forthcoming), the perceived profitability of the new route would need to be at least positive, that is the profit threshold for advantage to be taken of the opportunity would be lower.

5.68 Investor presentations from Ryanair and easyJet for the full year results in 2012 show that both airlines have recently acquired additional aircraft: Ryanair quote 25 new aircraft in 2012[280] while easyJet forecast an increase from 210 to 217 in 2013. This suggests that both of Stansted's based LCCs might well have scope for taking advantage of profitable opportunities at airports in continental Europe which obviates the need to switch away aircraft from Stansted (or indeed another airport).

5.69 Overall, it appears that the strategic constraints facing Ryanair and easyJet in switching between London airports are quite small, and that switching between these airports is more influenced by "traditional" switching costs. However, these airlines appear to face considerable strategic switching costs to relocate aircraft away from the London airports to other UK or continental European airports due to the importance of London to their respective networks. Indeed, their growing fleets may allow them to take advantage of profitable opportunities without switching away aircraft from Stansted (or another airport).These strategic constraints are, however, not influenced by a lack of capacity, as our analysis of the largest bases of Stansted's based airlines shows there is sufficient capacity to enable aircraft relocation to European airports.

5.70 Looking forward, STAL expects that southern European airports will gradually become less attractive options in light of reductions in their governments' incentives for airlines to operate at these airports.[281]

Inbound scheduled airlines

5.71 Based on evidence from Wizz and Air Berlin[282], airlines operating scheduled inbound services into Stansted appear to regard Stansted, Southend, Luton and possibly Gatwick as comparable options when seeking to operate flights into London, although individual views on substitutability differ by airline. This suggests that the strategic constraints are very small for inbound airlines seeking to switch between London airports. In fact, none of the inbound scheduled airlines the CAA talked to identified strategic barriers to switching between London and other UK and European airports.

[280] Source: Ryanair http://www.ryanair.com/doc/investor/present/quarter4_2012.pdf (slide 9) and http://corporate.easyjet.com/~/media/Files/E/Easyjet-Plc-V2/pdf/investors/results-centre/2012/2012-full-year-results-pres.pdf (slide 18).
[281] Source: STAL
[282] Source: Wizz Air and Air Berlin

Charters

5.72 Charter airlines tend to regard each airport individually on a case-by-case basis, rather than looking at a route as a city-pair, seeking to serve the core catchment in each case. Thomas Cook has said that, while Stansted's catchment for their passenger base is small and local, it is possible for it to offer based services from Stansted. However, Luton cannot sustain one based aircraft and overall Gatwick is the "default airport for holiday flights"[283]. Similarly, Thomson Airways said that Stansted serves East Anglia as a catchment, though operationally it competes with Luton, although the CAA notes that this does not necessarily mean that the airline considers the two catchment areas to be substitutable. However, again Gatwick is seen as the main airport for holiday flights.[284] Overall, charter airlines appear to face strategic constraints when switching between London airports due to their focus on serving each airport's local catchment.

5.73 Charter airlines operating from Stansted are based in the UK and only fly inbound to non-UK airports. While they would be unlikely to relocate aircraft to airports outside of the UK, as this would require the opening of an overseas base(s), UK charter airlines potentially have the scope to switch aircraft to other UK airports. For example, Thomson Airways has said that Birmingham is operationally, though not commercially, substitutable with Stansted. However, in each case, it is likely that based charter operators would consider switching away their operations from Stansted only if there was another local core catchment that it could capture, as their business model focuses on serving the local core catchment of each airport from which they offer flights. This may differ for inbound charter airlines. However, given the small size of their operations at Stansted, it appears unlikely that strategic constraints would be sufficient to constrain charter airlines from switching.

Summary

5.74 Overall, the evidence suggests that strategic constraints can be an important factor in an airline's decision to switch away marginal aircraft from one airport to another, whether considering switching between Stansted and another London or UK airport, or an airport in continental Europe. This means that, while switching costs may be relatively low, the strategic constraints facing airlines at Stansted can in many cases reduce their flexibility when considering airports to which to switch aircraft. This is particularly the case for Ryanair and easyJet, who have based aircraft at Stansted and for whom operating from London is central to their network strategy. In addition, charter airlines may also to a lesser extent face strategic constraints in switching away from Stansted due to their business model targeting an airport's local core catchment area. By contrast, inbound scheduled airlines are unlikely to face considerable strategic constraints in their decisions to switch away from Stansted.

[283] Source: Thomas Cook
[284] Source: Thomson Airways

5.75 The Initial Views indicated that the CAA considered that both Ryanair and easyJet have the ability to switch volumes away from the airport. While the CAA still considers that there is some scope to move some aircraft away from the airport, based on material that has been submitted following the publication of the Initial Views, the CAA no longer considers that the available evidence supports this view and the CAA now considers the actual scope for switching is more limited than it originally thought in large part due to the strategic constraints faced by many of Stansted's airlines. In addition, the CAA considers that an airline's particular circumstances will determine the scope of any potential movement away from the airport and it is therefore necessary to be cautious about making across the board assumptions that switching is possible.

Capacity constraints

5.76 Capacity constraints across actual and potential substitute airports can affect the ability of airlines to switch services between them. Analysing the extent of capacity constraints across London airports can be informative as to the scope for potential airline substitution to and from Stansted, and consequently the extent to which airlines might be able to constrain the airport operator's behaviour. In Annex 4, airport capacity has been analysed separately according to its main components: terminal, and aircraft parking stand, and runway slot capacity.

5.77 Slot utilisation at each of the airports that airlines consider in the market as Stansted is higher during the Summer traffic season than during the Winter traffic season, though the utilisation pattern remains similar.

5.78 To allow efficient aircraft utilisation, airlines with based aircraft require early morning departure slots, as this allows a sufficiently early departure to serve passenger demand and allow the aircraft to perform four to six daily rotations. As a result, for based airlines flying short-haul routes to consider switching to another London airport, it is particularly important that there is sufficient capacity[285] at an alternative airport to meet both morning and evening peak requirements.[286] In addition, due to the typical "back and forth" pattern of based aircraft, there also needs to be sufficient capacity available outside of this period.

<u>Stansted</u>

5.79 STAL says that, in annual terms, it is operating at 50 per cent of capacity, with the extent of spare capacity varying according to different traffic seasons, weeks, day and times of day. In particular, STAL says that during the early morning departure peak, the airport's busiest time of day, there were typically 20 departure slots in the summer 2012 traffic season. Further,

[285] In terms of terminal, aircraft parking stand and runway slot capacity.
[286] In particular, an alternative airport would need to be able to accommodate the first rotation of all necessary aircraft during the early morning departure peak period (which is approximately between 0600 and 0759 BST), and during the evening peak arrival period as the aircraft return to base.

the available capacity at the airport during this time of day is greater than at Luton or London City airports.[287]

5.80 The CAA's analysis of capacity constraints at Stansted confirms that there remains on average approximately 20 early morning departure slots in the summer 2012 traffic season[288]. There also remains a considerable amount of departure and arrival slot capacity across the rest of the day. Generally, slot utilisation is higher during the summer season than during the winter traffic season, though the utilisation pattern remains similar. In addition, there are currently no binding aircraft parking stand capacity constraints. Further, in addition to the existing spare capacity at Stansted, the airport operator has a number of capacity expansion plans – linked to taxiway, terminal and stand capacity - plans which would need to be implemented when passenger traffic reaches (depending on the project) 25, 30 or 35mppa.[289]

5.81 The availability of departure slot capacity is likely to provide the airport operator with an incentive to attract additional traffic from incumbent or new airlines, through offering discounts for new routes. However, while this may be the case, this is unlikely to affect the ability of the largest incumbent airlines to discipline STAL, for two reasons. First, due to the significant existing volume of traffic and route maturity that Stansted's largest airlines operate from the airport, the marginal benefit of opening an additional route is unlikely to be sufficient to impact switching decisions by these airlines. Second, the ability of incumbent airlines to constrain the airport operator, and consequently the degree of market power held by STAL, is determined by the ability of airlines to switch away aircraft and movements currently being operated from the airport, and crucially the availability of spare capacity at substitute airports. This is considered below.

Luton

5.82 Luton airport's type of airline business is similar to Stansted, with LCCs constituting most of Luton's airline business[290]. However, Luton also has a number of airlines operating long-haul services. In their presentation to the CAA board, STAL argued that the percentage of unallocated capacity at Stansted in the peak week was broadly similar to that at Manchester and Luton[291], although in internal minutes of a meeting with **[✂]**, STAL noted the lack of overnight aircraft parking capacity at Luton[292].

5.83 The availability of departure slots during the early morning peak and the off-peak periods at Luton suggests that based low cost, other based and inbound carriers might have scope to move marginal aircraft or services from Stansted to Luton. Indeed, Frontier Economics estimated that there were

[287] Source: STAL
[288] Stansted has also submitted movement data showing the number of departures during the early morning peak has fallen over time since 2007. As CAA Airport Statistics use the same data, our findings are consistent.
[289] Source: STAL
[290] See Annex 4 for more details.
[291] Source: STAL
[292] Source: STAL

enough spare slots at Luton to enable easyJet to switch some aircraft from Stansted.[293]

5.84 However, limited aircraft parking stand capacity at the Luton means that few additional aircraft can be based at the airport, as well as potentially leading to taxiway congestion if inbound early morning arrivals were to arrive off-schedule[294,295].

5.85 The Luton's current Masterplan does however outline plans to expand the number of aircraft stands and increase peak movement rate from 34 to 40 movements per hour by 2031, with a forecast increase from 9.5mppa in 2011/12 to 12.1mppa by 2019. The actualisation of these plans could, in the long term, increase the number of based aircraft that could switch from Stansted. Projects to expand terminal capacity have also been put forward.[296]

Gatwick

5.86 Gatwick airport has a comparatively more varied airline customer base than Stansted and Luton, with it having a greater proportion of long-haul services. Slot utilisation is high throughout the day in the summer traffic season, and there appears to be very little available departure slot capacity during the early morning period to accommodate additional based aircraft for either scheduled or charter services from LCCs. In relation to this, Ryanair has told the CAA that neither Gatwick nor Luton have sufficient early morning capacity to allow for an efficient use of Ryanair's based aircraft.[297] However, there is more capacity available during the mid-morning and mid-afternoon periods, which could give scope for switching to airlines operating based or inbound services at Stansted during the off-peak period. In addition, there appears to be currently sufficient aircraft parking stand capacity to accommodate additional based aircraft, as well as sufficient terminal capacity.

5.87 The airport's capacity expansion plans are likely only to increase available capacity at the margins, as Gatwick is not currently permitted to build a second runway. This additional capacity, likely to be the only increase until 2025, could increase scope for switching from Stansted, although it would seem that this principally depends on the scope for increasing declared departure capacity during the early morning peak for the Summer traffic

[293] Source: Frontier Economics – Market Power Assessment: Stansted and Gatwick Airport, page17-19 http://www.caa.co.uk/docs/5/rpt-easyJet%20Competition%20Assessment%20Final%20Report_Abridged.pdf (accessed January 2013)

[294] Source: Leigh Fisher report for London Luton Airport Operations Limited, May 2012, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/2707/dft-2012-22-capacity-analysis.pdf (accessed January 2013)

[295] Although Luton has a comparatively shorter runway (2160m) than Stansted (3048m), this is unlikely to affect switching by Stansted's low cost carriers operating short-haul services with narrow-bodied aircraft.

[296] Source: LLAO Masterplan, September 2012, http://www.london-luton.co.uk/en/content/8/1171/Masterplan.html (accessed January 2013)

[297] Source: Ryanair

seasons, and the extent to which this capacity expansion simply allows for underlying demand growth to be accommodated.

Southend

5.88 Following the start of easyJet operations at the airport in April 2012, easyJet passengers have constituted 90 per cent of Southend's traffic, followed by approximately 9 per cent of passengers being transported by Aer Arann[298]. Southend expects traffic to reach between 600,000 and 700,000 passengers in 2012 and 2 million passengers by 2020. While the airport could technically handle more passengers, there is currently a movement cap in place which restricts the total number of flights. However, although the airport capacity is not currently impacted by movement limits, it is an airport of limited size and overall capacity.[299] In April 2012, easyJet relocated three aircraft previously based at Stansted to the airport and began operations there[300]. However, due to its runway being much shorter (1739m TORA) than that of Stansted's (3048m TORA), Ryanair's aircraft are unable to operate from the airport[301], which means that it is not a viable substitute for Stansted's largest airline in terms of both movements and passengers. This could also limit the scope for other Stansted airlines to relocate aircraft to the airport, as they might face similar operational difficulties.

5.89 Overall, although Stansted has a considerable degree of spare capacity during the early morning peak, which should give it the incentive to attract new traffic, this is unlikely to have a material bearing on incumbent airlines' ability to constrain the airport operator. The capacity constraints during the early morning peak at Luton and Gatwick suggests that there is limited scope for the relocation of aircraft to these airports[302]. While Southend has significant spare capacity during the relevant times of day, its insufficient runway length makes it technically impossible for Ryanair to relocate Stansted aircraft to that airport.

Natural experiment

5.90 When assessing the likely airline switching reaction to a price increase at Stansted, examining the experience of Ryanair and easyJet in 2007 when a number of long-term contracts between Stansted and its various airlines expired and the majority of the airport's airlines faced significant price increase, has merit. In particular, examining the evidence on the airlines' response to this change can help illustrate what disciplinary action the airlines can take in response to an increase in prices. However, we note that the period when discounts were removed was around the time the financial

[298] These shares are constructed using passenger data at the airport between April and September 2012.
[299] Source: Southend Airport (The current growth targets are to process 2million passengers by 2020)
[300] Source: CAA airport statistics.
[301] Source: http://www.caa.co.uk/docs/5/MOLearytoIO25112011.pdf (paragraph 5)
Source: Southend Airport
[302] It is also worth noting that in marketing material to both short-haul and long-haul airlines, STAL has repeatedly sold itself as having the "only new capacity in the UK South East". This is consistent with its view on capacity constraints. Source: STAL

crisis started and consequently the airlines would have been facing both the price increase and a negative demand shock. As such, the responses may reflect these particular circumstances.

Ryanair

5.91 While there are numerous issues that influence profitability, following the 2007 price increase at Stansted, Ryanair's profitability per passenger at Stansted fell from **[✂]** in 2007/08 to **[✂]** in 2008/09. Ryanair has also indicated that following the price increase in 2007, and in 2008, that it absorbed much of these price increases. [303] By contrast, during the same period, the profitability of the airport operator (measured in EBITDA) continued to grow, albeit at a slower rate, between 2007 and 2008.[304]

5.92 In addition to absorbing the price increase, the frequency of many routes at Stansted were cut, and a considerable number of aircraft were grounded during the Winter traffic season. One reason the airline provided for these groundings is that its winter season aircraft groundings at Stansted in the past few years have always affected fewer aircraft than Ryanair's network-wide winter groundings, and therefore any winter growth in other markets did not need to be delivered through aircraft grounded at Stansted. In fact, any such winter growth has been delivered mainly through new aircraft deliveries (Ryanair's fleet expanded from 133 units in April 2007 to 294 units by April 2012), while some of such growth was delivered through frequency reductions on other routes and existing (not-grounded) aircraft.[305]

5.93 **[✂]**.[306] This evidence suggests that the airline had begun to pass through the price increase at Stansted to passengers via its airfares and reduce the frequencies on certain routes at the airport. Over the same time period, it is visible that STAL's profitability started falling significantly, in line with the fall in passengers at the airport, as shown in Figure 5.3 (below).

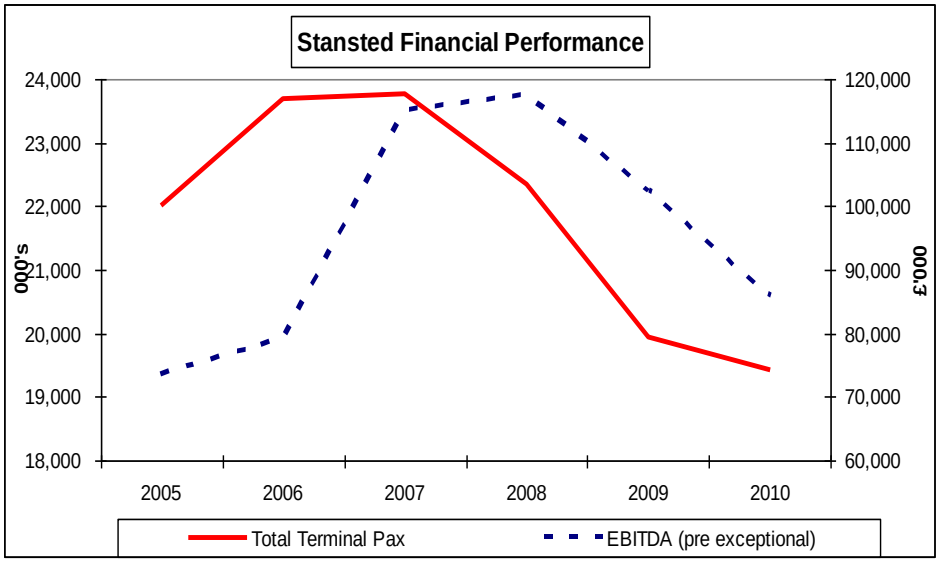
5.94 According to STAL's commercial strategy documents, one of the main drivers of the reduction in passenger numbers was the reduction in Ryanair passenger volumes. The airport operator says that "from April 2007, BAA decided not to extend the discount that Ryanair had from published tariffs) to support the business case for the second runway. From 2008, Ryanair focused the growth in other countries in Europe and started to decrease the volume in Stansted."[307] In the Information Memorandum, STAL also cites the expansion of low cost carriers in Southern Europe and the worsening macroeconomic environment as contributory factors to the fall in traffic since 2007[308].

5.95 The price increase in 2007 and the fall in passenger numbers coincided with the worsening of macroeconomic conditions, with the overall effect being a

[303] Source: Ryanair
[304] Source: STAL
[305] Source: Ryanair
[306] Source: Ryanair
[307] Source: STAL
[308] Source: STAL

decrease in STAL's profits. As a result, it is unclear whether the price rise itself was profitable for the airport, as it appears to be offset to an extent by the exogenous contemporaneous factors affecting market conditions.

Figure 5.3: Stansted profitability and passenger numbers



Source: STAL

5.96 Ryanair and STAL disagree as to the long-term consequence for passengers of the higher prices. Ryanair argues that these higher prices, which reduce airline profits, will in the longer term lead to "less investment by airlines in capacity, and less choice and higher prices for airline customers."[309] In contrast, STAL sees that the services at the airport are settling back to a new, sustainable equilibrium level reflecting the maturity of the industry.[310]

5.97 In considering these two opposing arguments, the CAA observes that:

- Traffic at Stansted continued to grow up until 2007, when prices were increased, although the growth rate of passenger numbers declined from between 12 and 18 per cent per annum between 2001 and 2004 to 8 and 5 per cent respectively in 2005 and 2006, followed by zero per cent growth in 2007, and subsequent decreases.
- Meanwhile, passenger growth for LCCs has continued across the other London airports, such as Luton, Gatwick and Southend, while Ryanair's passenger numbers have been broadly stable at its other UK airports,[311] In addition, **[✂]**.[312] However,**[✂]**."[313]
- STAL's comments in the Information Memorandum[314] indicate an expectation that **[✂]** at Stansted would **[✂]**.

[309] Source: Ryanair
[310] Source: STAL
[311] It should be noted that traffic also declined at regional airports during the recession.
[312] Source: STAL
[313] Source: easyJet
[314] Source: STAL

5.98 These observations appear to weaken the argument put forward by STAL.

5.99 Following the price increase, Ryanair and STAL have been unable to negotiate any discounts successfully. STAL has argued that the initial discounts given to Ryanair consisted of a "breakthrough deal", to help them establish themselves and grow from their initial volumes.[315] **[✂]**.[316] **[✂]**[317,318] Ryanair has not allocated any new growth to Stansted, instead focusing on other airports across its network and reducing its winter operations at Stansted.[319] However, it is unclear whether the airline has done so in response to the price increase, in response to economic conditions, or a reflection of the maturity of Stansted as a base in Ryanair's network. The latter would mean that the potential options for expansion are not as profitable at the margin as other options across its network **[✂]**.[320]

<u>easyJet</u>

5.100 easyJet did not decrease its services at Stansted following the increase in prices in 2007. It also did not immediately switch marginal aircraft away from Stansted to facilitate the contemporaneous and subsequent growth of its operations at Gatwick airport. **[✂]**.[321]

5.101 **[✂]**.[322]**[✂]**

5.102 **[✂]**[323]

5.103 The reactions of Ryanair and easyJet to the price increase at Stansted in 2007 (which coincided with the start of the recession) suggest that at that time their operations suffered a serious negative impact. After what appears to be a short-term strategy of cost absorption, driven primarily by competition between airlines (and possibly the impact of the recession), both airlines sought slightly different approaches to return to sustainable operations, although one common approach was to try and negotiate marketing support and/or discounts with the airport operator using the threat of switching of based aircraft. While **[✂]**, an outcome that the CAA would have expected to see in a competitive environment. As a result Ryanair and easyJet have reduced their operations at the airport and have relocated several based aircraft, with the former telling the CAA that it was forced to do in light of the doubling of airport charges. This contributed to the significant decline of passenger numbers seen at the airport. In the meantime, the airport has continued to charge Ryanair the full regulated price. Overall, passenger numbers at Stansted have fallen from approximately 24mppa in 2007 to approximately 18mppa in 2012, which also includes the effects from the

[315] Source: STAL
[316] Source: STAL
[317] Source: STAL
[318] An analysis of negotiations between Stansted and airlines can be found in paragraph 6.70.
[319] Source: CAA Airports Statistics
[320] Source: STAL
[321] Source: STAL
[322] Source: STAL
[323] Source: easyJet

worsening underlying macroeconomic conditions during that period. However, this does not appear to have significantly constrained STAL's pricing behaviour.

Countervailing buyer power

5.104 Airlines may be able to constrain an airport operator's pricing power by leveraging the importance of its operations to the airport during negotiations. As stated in OFT guidance,[324] this countervailing buyer power is "most commonly found in industries where buyers and suppliers negotiate, in which case buyer power can be thought of as the degree of bargaining strength in negotiations." This guidance further states that "size is not sufficient for buyer power. Buyer power requires the buyer to have choice." This means that, to have a degree of buyer power, an airline would typically need to be a significant proportion of a particular airport operator's business and have a number of substitute airports to which it could credibly switch in response to the airport's behaviour.

5.105 As set outlined in section 3 Ryanair (68 per cent) and easyJet (22 per cent) account for around 90 per cent of Stansted's passengers. A comparative table for UK airlines at Heathrow, Gatwick and Stansted is available in paragraph 3.96 of the Initial Views. While these market shares (individually and together) may, at first glance, suggest that these airlines would have significant countervailing power, there are a number issues associated with relying on market shares as an indicator of market power (see section 4). However, the CAA uses this section to explore some of the specific characteristics of Stansted's two major airlines. In doing this, the CAA recognises that the level of countervailing power that an airline may have will be influenced by its ability to switch away from the airport.

5.106 STAL states in its Information Memorandum that London has always been a key destination for both Ryanair and easyJet, and that it anticipates that Stansted will continue to represent an important part of both airlines' traffic schedules in the long term.[325] Further, the airport operator sees a key opportunity in capturing additional traffic from LCCs as they pull back from Southern Europe and relocate capacity where there are the strongest yields, as well as benefiting more generally from an improving economic outlook.[326,327]

Ryanair

5.107 Table 5.1 shows that between 2003 and 2011 the number of passengers flown to and from Stansted by Ryanair had become an increasingly important proportion of Stansted's total passengers, reaching 68 per cent in 2011. Over the same period, passengers by Ryanair flown to and from Stansted had become a progressively smaller proportion of the airline's total passengers,

[324] Source: OFT Assessment of market power guideline (OFT415).
[325] Source: STAL
[326] Source: STAL
[327] Source: STAL

falling significantly from 58 to 17 per cent. Although Ryanair reduced its traffic at the airport from 2007, CAA airport statistics show that Ryanair's passenger traffic appears to have stabilised in 2012. The airport says that this was due to no year-round routes being cancelled and load factors being maintained at broadly similar levels. The airport also noted that Ryanair had launched a number of new routes in 2012.[328]

Table 5.1: Ryanair's share of Stansted and Stansted's share of Ryanair's passengers over time[329]

	2003	**2006**	**2011**
STN pax as a proportion of Ryanair's total passengers	58%	40%	17%
Ryanair as a proportion of STN's passengers	60%	63%	68%

Source: Ryanair

5.108 The size of Ryanair's operation at Stansted fulfils the first requirement for the existence of buyer power. However, evidence regarding the airline's ability to credibly threaten to switch away from Stansted is less clear cut.

5.109 Ryanair told the CAA that its sunk costs at Stansted (in establishing more than 100 routes at the airport) undermine its ability to make a credible threat of a disciplining response.[330] In addition, Ryanair has noted that Stansted is the "only access point to/from London capable of accommodating Ryanair's substantial demand for airport capacity in this area." It also added that other London airports do not have excess capacity for Ryanair to move their operations to and that other airports in the UK are not acceptable alternatives to passengers seeking access to/from London[331] or do not have the appropriate infrastructure.[332] Further, the airline says that capacity constraints at Gatwick and Luton meant that its small operations at these airports could not be supplemented by switching marginal aircraft away from Stansted, as this may result in the loss of economies of scale.

5.110 For example, following the 2007 price increase, Ryanair says that it did not receive offers from Gatwick or Luton specifically as a result of the airline's public comments regarding the price increase at Stansted because these airports could not accommodate Ryanair's overnight aircraft[333]. Further, Ryanair said that it would now not be able to reduce route frequencies beyond its current level without ceasing certain routes, as this would make schedules unattractive to passengers.[334] STAL's internal documents from

[328] Source: STAL
[329] Source: Ryanair
[330] Source: Ryanair
[331] Source: Ryanair
[332] For example, Ryanair would not be able to relocate to Southend as the declared runway length is too short for its current aircraft to operate out of the airport.
[333] Source: Ryanair
[334] Source : Ryanair

2010 suggest that it is aware of **[✂]** apparently limited scope for switching away from Stansted to another London airport, given the capacity constraints at London airports.[335]However, Ryanair said that it has previously decided to move some capacity from Stansted because of "BAA's refusal to offer competitive terms."[336]

5.111 STAL acknowledge that opening positions in negotiations are extreme: while it recognises that the **[✂]** it offers have not been what has been sought by Ryanair, **[✂]**.[337] However, it is notable that Ryanair is the party that repeatedly attempted to return to negotiations with STAL, although this does not necessarily mean that these attempts were not repeatedly extreme positions. With regard to its future airline strategy, STAL said in a February 2010 internal document that:

[✂][338]

5.112 While both parties may begin negotiations from extreme positions – with the result being that no successful negotiations have been concluded between Ryanair and STAL since 2008 – STAL's apparent indifference in losing some of Ryanair's traffic contrasts starkly with Ryanair's continually attempts to negotiate. Overall, it appears that Ryanair's countervailing buyer power towards Stansted is more limited than its share of overall Stansted traffic would suggest, and that the airport operator is likely to hold the stronger negotiating position in particular in relation to existing traffic.[339]

easyJet

5.113 easyJet is the second largest airline at Stansted in terms of annual passengers carried, and its share of the airport's passengers has remained relatively constant over the past decade, as 5.2 shows.

Table 5.2: easyJet passengers as a proportion of Stansted's passengers over time

	2003	**2006**	**2011**
easyJet passengers as a proportion of STN's passengers	23%	20%	22%

Source: CAA Airport Statistics

[335] Source: STAL
[336] Source: Ryanair [✂]
[337] Source: STAL
[338] Source: STAL
[339] Based on economic theory, it might be in principle possible for Ryanair to begin operations at Southend airport by leasing aircraft capable of operating from the airport. However, there are a number of operational reasons why this is not likely, such as; leasing these aircraft would break fleet uniformity possibly leading to additional costs to train crew; and Ryanair's business model is based on operating the most efficient aircraft to minimise costs. From a switching perspective, in order to constrain Stansted, Ryanair would also need to redeploy its existing aircraft at the airport elsewhere, as the leased aircraft at Southend would in effect constitute new growth allocated at another airport. Overall, this would probably prove a costly exercise whose costs would make such a move potentially less profitable less remaining at Southend.

5.114 Unlike Ryanair, easyJet has significant operations at several London airports; Gatwick, Luton and Southend **[✂]**.[340]

5.115 **[✂]**

5.116 According to evidence submitted to the CAA, we consider that STAL saw **[✂]**, but STAL has also said that it sees **[✂]** as an attempt to constrain STAL's pricing. This is consistent with the Monitoring Trustee's account of Stansted's view in 2011, which said that "Stansted management did perceive some additional risk to the operational success of Stansted as a result of easyJet's agreement with Southend airport and a potential threat to easyJet growth, although commercially given the capacity restrictions at Southend it was not considered a significant or long-term risk."[341] We further note that the ability of easyJet to potentially constrain the airport operator will be enhanced should the expected development of Southend airport proceed.[342]

5.117 On balance, in contrast to Ryanair, the CAA considers that the evidence suggests that easyJet currently has a degree of countervailing buyer power against Stansted and that this will continue. **[✂]**.

Entry and expansion by other airports

5.118 Competitive constraints can also arise from entry and/or expansion of airports in Stansted's market. The impact of this form of competitive constraint will be limited by the magnitude of barriers to airport entry and expansion. These factors are considered below.

Barriers to entry and expansion

5.119 The Guidelines note that barriers to entry in airport markets are particularly high and that expansion of existing airports is more likely to represent a competitive constraint on existing airports than the threat of entry by an entirely new airport.[343] New airports can sometimes enter the market, but the investment and lead times involved in new entry are likely to significantly limit the impact of this form of competitive constraint.[344]

5.120 Expansion and/or entry by existing aerodromes, and/or the threat thereof, may represent a source of competitive constraint. However, as with de novo entry, the cost and timescales involved in expanding to accommodate sufficient switching may still be too great to constrain STAL's prices in the short to medium term.

[340] Source: easyJet
[341] Source: Competition Commission, 2011 Material Change in Circumstances report Paragraphs137-139.
[342] Source: Southend Airport
[343] The Guidelines are available on the CAA's website: http://www.caa.co.uk/docs/5/Final%20Competition%20Assessment%20Guidelines%20-%20FINAL.pdf
[344] For example, Robin Hood Doncaster Sheffield airport opened in April 2005, and London City Airport opened in 1988.

Evidence of actual entry or expansion

5.121 One way to understand the nature of barriers to entry and expansion is to consider the history of entry and expansion in the market. As outlined in the Initial Views document[345] there is very limited evidence of significant entry or expansion in Stansted's market. However, there are two recent examples of expansion in the form of Southend and the recent announcement of Luton's intention to increase capacity.

5.122 easyJet opened based operations at Southend airport in April 2012, **[✂]**. It is possible that other airlines may also begin operating from Southend airport, however any operations would be limited by Southend's runway specifications, which notably are not suitable for Ryanair's aircraft. Although Southend airport constitutes entry on a relatively small scale, the airport currently has plans to expand to handle 2 million passengers by 2020.[346]

5.123 In addition, Luton airport's Masterplan sets out a plan to increase capacity at the airport from 10.3mppa in 2013 to 18mppa by 2030, including a forecast increase in traffic up to 12.1mppa by 2019.[347]

5.124 In summary, while relatively small scale expansion is possible, the timescale required to achieve adequate expansion to accommodate sufficient switching is too long to constrain prices in the short term, but there is some potential for expansion projects that act to constrain pricing in the medium term at least (as illustrated by the Southend airport example).

Overall assessment of factors capable of counteracting STAL's market power

5.125 On balance the CAA considers that the evidence suggests that there is some scope for airlines to counteract STAL's market power, although this varies on a case-by-case basis and that larger market share does not automatically translate to stronger market power. In particular, the CAA considers that the evidence suggests that:

- Ryanair's countervailing buyer power towards STAL is limited, and that the airport operator is likely to hold the stronger negotiating position for the foreseeable future, in part exacerbated by the airline's inability to switch to Southend airport; and
- easyJet has a degree of countervailing buyer power against STAL and this will continue going forward. In particular, the CAA considers that the evidence suggests that easyJet is well positioned to leverage the three aircraft that are currently based at Southend airport and potentially move further aircraft there once further development of the airport occurs.

5.126 More broadly, the CAA considers that expansion of the market is possible, the timescale required to achieve adequate expansion to accommodate

[345] See CAA, Stansted Market Power Assessment - Initial Views, February 2012 paragraphs 3.144-3.151. http://www.caa.co.uk/docs/5/StanstedMarketPowerAssessment.pdf
[346] Source: Southend minutes
[347] For more information see, http://www.london-luton.co.uk/en/content/8/1171/Masterplan.html

sufficient switching is too long to constrain STAL's prices in the short term, although there is some potential for such future development to constrain STAL's pricing in the medium term. The CAA also notes that the Davies Commission is due to report in 2015 its findings on airport expansion, but significant capacity expansion is not expected until 2025.

Demand forecasts and implications for capacity constraints

5.127 The way in which capacity constraints at London airports are expected to evolve in the short to medium term has implications for the level of market power of STAL. To this end the CAA has examined a range of forecasts and estimates that have been produced to inform our view on capacity constraints going forward.

5.128 In its presentation to the CAA Board in October 2012, STAL provided traffic forecasts estimating an increase from **[✂]**, with an additional **[✂]**,from discount-driven growth, resulting in a total forecast of **[✂]**.[348] The airport operator adds that this would be supported by an investment programme focused on the renewal and replacement of assets averaging **[✂]**.[349]

5.129 It is worth noting that the Stansted ACC and Stansted said in a letter to the CAA on 25 September 2012 that there had been no agreement on Stansted's traffic forecasts between the SACC and the airport operator, due to several underlying issues with the modelling and related assumptions.[350] However, in summarising the mid-term review of the Constructive Engagement process in letter to the SACC and Stansted, the CAA said that the airlines "agreed to use the airport's traffic forecasts as the basis for further CE discussions. Whilst not accepting the forecast *per se* for Q6, they broadly accept the macro-economic assumptions on which it is based"[351].

5.130 Based on statements made in its strategy documents, STAL appears to consider that the level of its spare capacity relative to Luton and Gatwick, including some capacity during peak hours, is one of its "key medium-term strengths", particularly given the expected tightening of capacity constraints across the South East"[352]. For example, the strategy document it produced in January 2012 was based on an expectation that STAL could capture London area traffic in the medium term due to growing capacity constraints. In addition to traffic recovery from improving macroeconomic conditions, "flat real" charges and discount-led growth, and increasing relative charges at Heathrow and Gatwick, STAL says in its October 2012 Information Memorandum that Stansted is expected to benefit from the growing capacity constraints at other London airports, in particular at Heathrow and Gatwick. Indeed, the traffic forecasts in the Information Memorandum provided by

[348] A forecast was presented by the Daily Telegraph: http://www.telegraph.co.uk/finance/newsbysector/transport/9608307/Stansted-airport-owner-admits-it-could-be-run-for-5m-less.html
[349] Source: STAL.
[350] Source: Stansted ACC
[351] Source: CAA response to Stansted ACC and STAL: http://www.caa.co.uk/docs/5/20121002%20STNv4.pdf
[352] Source: STAL

Stansted suggest that passenger growth begins to benefit from overspill from Heathrow and Gatwick from **[✂]**, increasing from **[✂]** to **[✂]** by 2019.[353]

5.131 STAL also referred to estimates prepared by **[✂]**[354], which forecast that by 2017, **[✂]** additional passengers would overspill from Heathrow and Gatwick to Stansted. However, it considered that assuming the capacity constraints in existence at Luton, this figure could be as high as **[✂]**. In its business plan, it included "conservative" estimates of **[✂]** passengers by 2016, which were revised **[✂]** by 2019 in the October 2012 Information Memorandum.[355] It is worth noting that part of the discrepancy between forecasts made in 2012 and previous estimates stems from the fact that BAA centrally produced forecasts for the airport until 2012, as well as due to an updated view of economic growth and the impact on demand at the London airports. Following the change in the way that Stansted is managed, making it more independent from Heathrow, the airport operator produced its own forecasts.[356] The forecasts were revised **[✂]** for the company's **[✂]** strategy document but nevertheless forecast that **[✂]** million passengers would travel through Stansted by 2017.

5.132 By contrast in June 2012, **[✂]** produced a series of long-term traffic forecasts for Stansted in the context the Q6 regulatory process. With a range of very low to very high case scenarios, **[✂]** estimated that Stansted, with currently **[✂]** may vary from **[✂]** mppa to **[✂]** mppa in 2019, with a central case estimated of **[✂]** mppa in 2019. The CAA notes that these forecasts are more conservative than those used by STAL for its own strategic planning (forecasts which themselves had been described by Stansted as "conservative") and that they were produced as part of the regulatory process.

5.133 As such, the **[✂]** forecasts could be one of the key inputs from which regulated per passenger charges will be derived and the CAA notes that lower forecasts would result in higher regulated prices. Given this context and the fact that these forecasts have not yet been subject to sufficient regulatory scrutiny, the CAA is minded to give more weight to STAL's figures in their strategy document at this stage. The Information Memorandum for the sale of Stansted forecasts that passenger traffic will reach **[✂]**.[357]

5.134 Frontier Economics used DfT's 2011 traffic forecasts showing that the capacity situation at the London airports will tighten by 2019.[358] Although there is expected to be slot capacity at Luton and Stansted through most of the day, the morning capacity is projected to be constrained until about 0800.

[353] Source: STAL
[354] STAL has stated that it did not commission and does not endorse **[✂]**.
[355] Source: STAL
[356] Source: STAL
[357] A forecast was presented by the Daily Telegraph http://www.telegraph.co.uk/finance/newsbysector/transport/9608307/Stansted-airport-owner-admits-it-could-be-run-for-5m-less.html
[358] Source: Frontier Economics – Market Power Assessment: Stansted and Gatwick Airport, http://www.caa.co.uk/docs/5/rpt-easyJet%20Competition%20Assessment%20Final%20Report_Abridged.pdf (accessed January 2013)

This could reduce the feasibility of rebasing aircraft to other London airports because of the loss of operational flexibility implied by having to delay the first departure until after 0800.

5.135 By 2019, the forecasts show that Gatwick airport would be capacity constrained for most of the day, so aircraft from Stansted could only be switched to Luton. There is generally sufficient capacity to switch four to five departures from Stansted to Luton, although limited overnight aircraft parking stand capacity is likely to limit airlines' ability to do so as Stansted airlines typically require the ability to operate early morning departures in order to maximise aircraft utilisation. The analysis of arrival slot availability provides the same conclusions for these airports.

5.136 Frontier Economics says that underlying this analysis is the assumption that capacity stays unchanged over the period and the distribution of slot demand throughout the day also remains the same. This appears to be a reasonable assumption for the short term, but it is possible that slot demand at Stansted may change, increasing during the current off-peak periods, in light of any long-haul services that could begin from the airport. There is also additional uncertainty regarding the airport operator's future strategy, due to the forthcoming change in ownership of the airport.

5.137 Frontier Economics contrasts the DfT's 2011 forecasts with those produced by various interested parties for the Q5 price cap decision, finding that the former are below the 2008 forecasts. This, as Frontier Economics also states, underline the considerable uncertainty in forecasting future passenger numbers. Frontier Economics notes that the change in demand projections illustrates that demand and therefore slot availability in 2019 may be considerably higher (or lower) than forecast today. Indeed, if economic conditions improve at a greater rate this would serve to exacerbate the effect of capacity constraints by the end of Q6 in 2019.[359]

5.138 Using Frontier Economics's forecasts, it can be seen that even with conservative traffic growth estimates that Stansted will be likely to benefit from the resulting increasing binding capacity constraints at other London airports. Further, the DfT's NAPALM forecasting model suggests that, as capacity constraints tighten, Stansted will benefit from a material degree of overspill in passenger traffic from Heathrow and Gatwick not before 2014. Forecasts provided by STAL suggest that passenger growth begins to benefit from overspill from Heathrow and Gatwick from **[✂]**, increasing from **[✂]**in 2017 to **[✂]** by 2019 for a total of **[✂]**.[360][361]

[359] It follows, of course, that if economic conditions worsen considerably then the effect of passenger demand growth on capacity constraints during Q6 could be well below the 2011 forecasts. However, this seems an unlikely scenario.
[360] Source: STAL
[361] A forecast was presented by the Daily Telegraph
http://www.telegraph.co.uk/finance/newsbysector/transport/9608307/Stansted-airport-owner-admits-it-could-be-run-for-5m-less.html

5.139 The CAA is minded to conclude that, in the next five years, the tightening of capacity constraints at Heathrow and Gatwick will result in an increase in the degree of market power at the London airports that have spare capacity. Given its overall size, range of facilities and level of spare capacity, we would anticipate that STAL would be a beneficiary of these trends, which are subject to a recovering economy.

5.140 The Initial Views discussed the potential emergence of regional airports as stronger alternatives to Stansted over the longer term as the capacity constraints were unlikely to ease over time. However, having reviewed the evidence along with information submitted subsequent to the publication of the Initial Views, the importance of London to most of Stansted's airline traffic is likely to mean that these regional airports would not become viable alternatives to London airports due to strategic constraints facing airlines[362].

5.141 The Initial Views also considered that the tightening capacity constraints might lead to infrastructure development at other London and regional airports which could erode the market position of Stansted. While other London airports, such as Gatwick and Luton, have developed plans to expand capacity, these are unlikely either to constitute sufficiently large increases or be completed in sufficient time as to create significant additional constraints on Stansted. In addition, although Southend airport entered the market in 2012, and easyJet has relocated aircraft away from Stansted to the airport, the airport is limited in size and consequently in its ability to constrain Stansted.

Passengers' ability to switch and implications

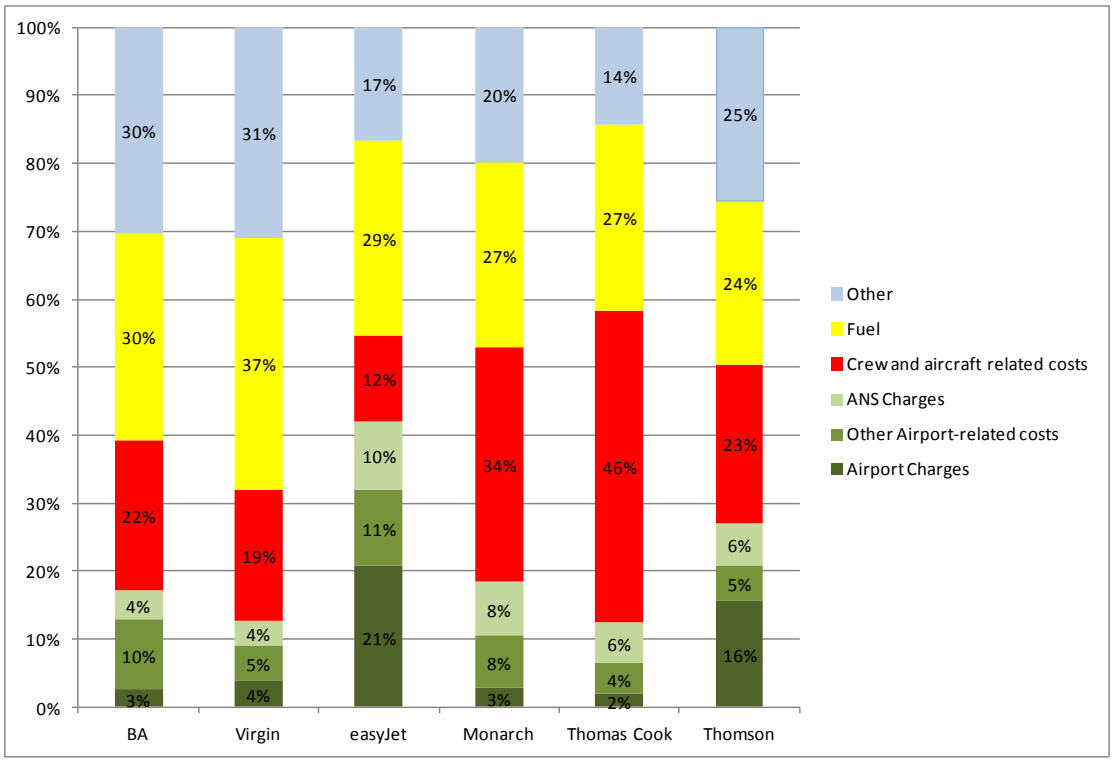
5.142 This section has so far analysed the required scale and the ability of airlines at Stansted to constrain the airport operator's pricing behaviour by switching away in various ways.[363] Additional constraints can occur dynamically through the subsequent reaction of marginal passengers currently choosing to fly from Stansted in response to the changes in the airline offer at the airport, in terms of price, the number of routes and service frequency and timings.

5.143 Due to the importance of airport charges as part of their operating costs, the airlines currently operating from Stansted, of which LCCs constitute the significant majority, are likely to be highly sensitive to increase in prices by the airport operator.[364] The proportion of airport charges and other

[362] We note nevertheless that regional airports will also benefit from the spill of passenger demand due to the capacity constraints at Heathrow and Gatwick. However, given the strategic importance of London to airlines based at Stansted, regional airports would not necessarily become viable substitutes for their current operations.
[363] The reasons for analysing passenger switching in a derived demand context rather than a two-sided market context can be found in paragraph 4.6.
[364] This is consistent with the Initial Views, paragraph 2.70. CAA, Stansted Market Power Assessment – Initial Views, February 2012 http://www.caa.co.uk/docs/5/StanstedMarketPowerAssessment.pdf

constituents of operating costs are shown for Stansted's main UK airlines in figure 4.4.[365]

Figure 5.4: Cost breakdown for various airlines



Source: CAA airline account information, latest available financial years[366]

5.144 While several airlines have said that they will absorb the increased costs resulting from a rise in airport charges in the short run, leaving their services unchanged, they will pass through the cost to passengers in the longer term. Once airlines have reacted through changes in their operations at the airport, marginal passengers might in turn react to the change in airline offer by deciding to fly from another airport, which would result in an additional loss of revenue for the airport operator in the form of lower commercial returns.

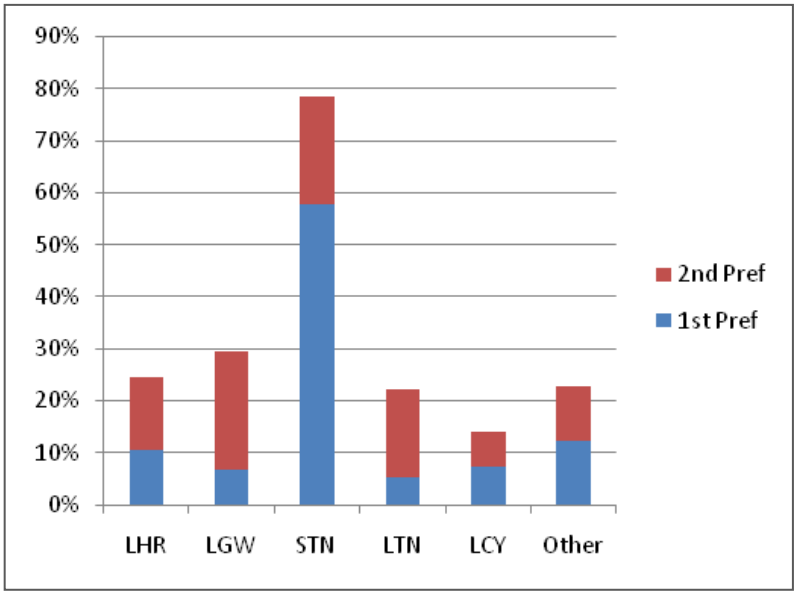
[365] The CAA collects financial information for UK airlines. This is available of the CAA website: http://www.caa.co.uk/default.aspx?catid=80&pagetype=88&sglid=13&fld=2010_2011

[366] Figures taken from Table 6 of the 2009/10 airline accounts published regularly on the CAA's website: http://www.caa.co.uk/default.aspx?catid=80&pagetype=88&pageid=13&sglid=13. Airport-related costs for the purpose of this figure include the following line items: 22, 24, 25, 27. This is likely to include also costs for services that fall outside the services relevant for this assessment, for example for ground handling services. Costs charged for relevant services provided by airport operators are therefore likely to constitute a lower share.

Potential drivers of passenger marginality

5.145 There are several potential drivers of passenger marginality[367]. According to evidence obtained from the CAA Passenger Survey, nearly 60 per cent of Stansted passengers stated the airport as their first preference for the flight they were about to take, even if the flight were available from another airport. This leaves approximately 40 per cent of passengers for whom Stansted was not stated as their first choice airport.

Figure 5.5: First and second preference airports for Stansted short-haul passengers

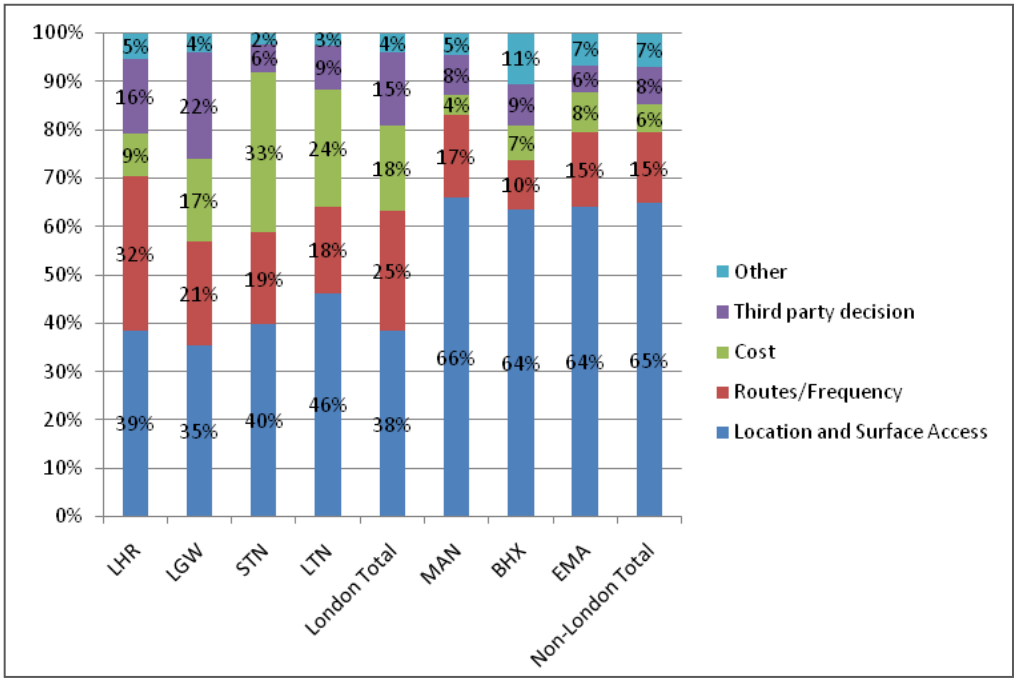


Source: CAA analysis of CAA Passenger Survey data – supplementary stated preference question

5.146 Relating this to the stated reason why passengers chose to fly from Stansted, location and surface access (40 per cent) was the most common reason, followed by cost (33 per cent) and availability of particular routes and/or their frequency (19 per cent). While a significant proportion of passengers chose Stansted due to its location, the importance of cost to a third of the airport's surveyed passengers suggests that they could be sensitive to a fare increase resulting from airlines passing through increased airport charges in the longer term[368].

[367] These aspects of passenger preferences are also considered in the context of market definition. Please see paragraph 4.93.
[368] For further details on these CAA Passenger Survey results, please see the CAA's working paper on Passenges' airport preferences. http://www.caa.co.uk/docs/5/Passenger%20survey%20results%20-%20FINAL.pdf (accessed January 2013)

Figure 5.6: Reasons for airport choice (one answer per passenger)



Source: CAA analysis of CAA Passenger Survey data (January to July 2011 provisional)

5.147 For such cost-sensitive passengers to be able to switch, they would probably need to originate from a district in a catchment area overlap between a number of the London airports, and be able to fly to the same destination from another London airport. Catchment area analysis shows that 47 per cent of Stansted's passengers originated from an area where Stansted's catchment area overlapped with that of Heathrow, Gatwick, and Luton, while only 11 per cent of passengers originated from the airport's unique catchment area[369]. This suggests that a significant number of Stansted's passengers could travel from at least one other London airport.

5.148 Table 5.3 shows the level of city pair overlaps for short-haul flights in the London area. It shows that 60 per cent of routes available at Stansted are also available at other London airports. Stansted has the lowest proportion of overlaps, reflecting the fact that it also serves the highest number of short-haul destinations (provided predominantly by Ryanair), including to a number of relatively small destination airports.

[369] The catchment area analysis has focused on the four largest London airports: Heathrow, Gatwick, Luton and Stansted. For more details, please see the CAA's working paper on Catchment area analysis http://www.caa.co.uk/docs/5/Catchment%20area%20analysis%20working%20paper%20-%20FINAL.pdf (accessed January 2013)

Table 5.3: Number of short-haul and domestic route overlaps between LON airports, 2010

	Cities Served	Overlaps	% overlap	LHR	LGW	STN	LTN	LCY
LHR	64	55	86%		47	33	28	16
LGW	121	92	76%			65	48	21
STN	131	79	60%				42	16
LTN	69	59	86%					13
LCY	26	24	92%					

Source: CAA airport statistics

5.149 60 per cent is still a significant proportion and if we weight this by passenger numbers on these routes, we see that 74 per cent of passengers could fly to the same destination from another London airport. This suggests that, in principle, there could be significant passenger reaction to a change in the airline offering at Stansted resulting from a passed through increase in airport charges.

5.150 Using the evidence outlined in this section the CAA has estimated that the number of marginal passengers that might actually have the ability to switch airports is quite low, with it representing approximately 10 per cent of passengers that fly from Stansted.[370] Based on total passenger numbers for 2011/12, this proportion represents approximately 1.8 million passengers. While the CAA recognises that this estimate is derived in a somewhat rudimentary manner, it nonetheless provides some context as to the size of this potential constraint. This shows that while passengers at Stansted may be quite sensitive to price, the actual level of passenger switching that may result from an increase in airport charges is unlikely to have a significant disciplinary effect on the airport operator. However, it is important to note that this number of marginal passengers is not a robust estimate to be compared against the critical loss of passengers required to make a 10 per cent price increase unprofitable. As this figure is constructed on the basis of passenger survey data obtained through questions not directly focused on a 10 per cent increase in airport charges, it is unlikely that all of these passengers would switch away following the price increase as this figure is likely to overestimate passenger switching. Nevertheless, the small size of the number serves as evidence that the actual size of switching is likely to be relatively small and of insufficient magnitude to impose a significant constraint on STAL by itself. The following section discusses a range of long-run elasticity estimates for passengers in light of an increase in airport charges.

[370] This estimate is derived by multiplying together the percentage of passengers that are price sensitive (33 per cent), the number of passengers in districts where Stansted's catchment overlaps with at least one other of the three major London airports and whose route is available at one or more other London airport (40 per cent) and the percentage of passengers that could fly to their preferred destination at another airport (74 per cent).

Estimated passenger elasticities

5.151 A series of estimates of the airport price elasticity of demand were produced by various parties and can be used as an indication of the likely scale of passenger switching over the longer term, that is, over the course of the forthcoming quinquennium.

5.152 The CAA NAPALM and **[✂]** estimates capture passenger reactions over at least a five-year period. Table 5.4 summarises the results described above and the key factors or assumptions affecting each piece of analysis. The Stansted price elasticity of demand of passengers to an increase in airport charges is likely to be subject to a degree of uncertainty, with the various results showing that it can range from 0.26 to 0.6[371]. Despite this variability, the elasticity is relatively low, which might be expected due to the relatively small magnitude of a 10 per cent increase in airport charges relative to the overall airfare that on which the passenger's purchase decision is based. Indeed, the CAA NAPALM runs are based on a £1 increase to the passenger in the cost of using Stansted, which represents a fully price increase of £1 in airport charges to the airline. Evidence from airlines tells us that this cost is likely to be passed through to the passenger in the airfare in the long run. The resulting low elasticity suggests that there could well be limited passenger switching in the long-run in response to a small but substantial increase in airport charges. This is therefore unlikely to have a sufficiently significant constraining effect on the airport operator.

Table 5.4: Range of elasticity estimates

	Airport Elasticity	**One-line comment**
CAA NAPALM run (increase in 2014)	~ 0.6 to 0.5	Passenger-led switching of passengers (and routes)
[✂]	~ 0.26	Time-series approach confirmed with simpler passenger allocation model results
[✂]	**[✂]**	**[✂]**

Source: CAA

5.153 Using the upper bound estimated elasticity of 0.6, for a £1 increase (approximately 15 per cent) in airport charges, this would mean that approximately 1.62 million passengers would switch away from the airport. Though this number is not directly comparable to the critical loss estimates discussed above, as the latter are based on price increase of 10 per cent, it is likely that this passenger estimate falls below the critical loss threshold for a 15 per cent increase, which reinforces the suggestion that passenger switching is likely to be insufficient to constrain STAL's behaviour.

5.154 Each of the models used is an imperfect representation of reality and each make different assumptions that affect the results in one direction or the

[371] This is the absolute values for the range of airport charge own-price elasticity of demand estimates. The values are negative, indicating that air transport from Stansted is a normal good and a substitute rather than a complement for other goods and services.

other. In reality many factors will affect the relevant/true Stansted airport charge elasticity of demand.

5.155 Due to the nature of modelling, it is important to consider the limitations of each of these estimates. First, the NAPALM model used by the CAA (as well as by Frontier Economics) has a number of limitations, key among which are the following.

- The model treats passengers travelling in full service scheduled, charter and LCCs separately. As a result, given the very high proportion of low cost traffic at Stansted, the demand that is displaced from Stansted cannot go directly to Heathrow, as there are no low cost services there. It will have to go to low cost services at Luton and Gatwick. There is also an effect of increasing route specialisation over time whereby the airports in the model retain their existing routes. We believe that this artificial separation may weaken the extent of substitution reported by the model, depending on whether there are enough alternative services at Gatwick and Luton.
- The model does not predict much growth at Southend airport in response to a price increase in Stansted. We think this is because there is no significant traffic at Southend airport in the base year and the airport never gets critical mass to become established. The recent entry of easyJet in Southend suggests that the potential competitive constraint posed by Southend to Stansted is downplayed by these forecasts.

5.156 As a result, it is likely that the estimated range of -0.5 to -0.6 could be a slightly conservative estimate of the actual elasticity of passengers to airport charges.

5.157 Regarding the estimates provided by York Aviation, it was not possible, on the basis of the information provided, to fully assess the validity of the methods employed. As a result, the CAA would add a large range of uncertainty to the elasticities calculated on this basis. Finally, an important caveat to the Frontier Economics 2007 work is that the data employed were solely easyJet booking data, which means that the resulting elasticity estimate, though consistent with the CAA's NAPALM estimate, might not be representative elasticity of passengers flying with all airlines at Stansted.

5.158 In spite of the different shortcomings of the various models, it can be seen that the range of elasticities produced are within a similar range. Therefore, in light of the relatively small estimated number of potentially marginal passengers at Stansted and the relatively low estimated range of long-run airport elasticities, we are minded to conclude that passenger switching in light of an increase in airport charges is unlikely to constrain significantly STAL's behaviour.

Ability of cargo-only airlines to discipline the airport operator through switching or the threat of switching

5.159 Air cargo, consisting of freight and mail, generally provides the fastest method of transporting goods over long distances. In this way, air cargo plays an important role in supporting UK businesses, in particular those engaged in high value sectors of the economy, by enabling them to compete in the UK, Europe, the USA, and the rest of the world and also unbundle their supply chain. In comparison to other modes of transport, shipment by air offers the benefits of speed and reliability, compared to the lower cost but slower options of sea or road shipment. Further, rail shipment involves additional costs of loading and unloading at each end of the road network[372].

5.160 The majority of Stansted's cargo-only carriers have long-standing operations at Stansted. For example, **[✂]**[373] and Royal Mail in 2003[374], while **[✂]**.[375]. As discussed in the context of market definition, see paragraph 4.136, cargo carriers at Stansted have emphasised the importance of basing cargo-only operations at a London airport, in order to ensure a service of sufficient quality to London and the south east of England. Indeed, Stansted has been described as essential to **[✂]** business, due to the importance of timely access to the London area[376]. Regulatory, legislative and infrastructural limitations at other London airports, as discussed in paragraph 4.157, mean that Stansted appears to be the only suitable airport from which to operate for most cargo-only flights.

5.161 This section considers both the switching costs and strategic constraints that are likely to be faced by the different types of cargo-only carrier at Stansted.

Integrators

5.162 Generally, integrators could face a number of costs regarding the physical relocation of their operations. **[✂]**[377]. **[✂]**.[378]**[✂]**.[379] We consider that this is likely to apply to all the integrators at Stansted. **[✂]**.[380]**[✂]**[381],**[✂]**.

5.163 Several cargo-only carriers operate a hub system of short- and long-haul flights at Stansted, which means that any switching decisions would concern the relocation of their entire operations away from the airport. **[✂]**.[382]**[✂]**.

5.164 **[✂]**.**[✂]**.**[✂]**[383].**[✂]**.[384].**[✂]**[385].**[✂]**[386]**,[✂]**.[387] Similarly, in light of a 10 per cent increase, **[✂]**[388]

[372] For more details on air cargo, please see the report "Air Freight: Economic and Environmental Drivers and Impacts" by Steer Davies Gleave for the DfT in March 2010. http://webarchive.nationalarchives.gov.uk/20120606174609/http:/www.dft.gov.uk/publications/air-freight-eonomic-and-environmental-drivers/
[373] Source: **[✂]**
[374] Source: Royal Mail
[375] Source: **[✂]**
[376] Source: **[✂]**
[377] Source: **[✂]**
[378] Source: **[✂]**
[379] Source: **[✂]**
[380] Source: **[✂]**,**[✂]**
[381] Source: **[✂]**
[382] Source: **[✂]**

5.165 Given the competitiveness of the industry, the CAA considers that this is likely at least in the short-run **[✂]**. The CAA considers that the prospects of reducing the number of flights would seem to be clearly contingent of the volume of cargo they need to transport. Whilst relocating aircraft movements might be in principle feasible – particularly for integrators not operating a hub at Stansted – the CAA considers it likely that the current restrictions at the other London airports would limit the scope for this type of switching. In addition, as integrators control every step of the shipment process, it is likely that they would face relocation costs. In addition, the CAA notes that certain integrators work with passenger airlines at both Heathrow and Gatwick, for example FedEx works with approximately 45 airlines at Heathrow and 2 at Gatwick, which is likely to be in order to take advantage of the wide range of destinations to which integrators can ship cargo without incurring the flying costs to destinations where demand is likely to be insufficient to sustain a freighter service. It appears to the CAA that the routes operated by integrators with their own freighter aircraft tend to be those to their main hubs and their other thick routes, for example in the USA or in Europe. To constrain Stansted by re-routing volume, the CAA considers that there would need to be sufficient bellyhold capacity to be able to re-route a significant volume of cargo on a regular basis, which is not necessarily the case. Overall, the CAA considers that integrators would be unlikely to be able to effectively constrain STAL by switching away at the margin.

Freight forwarders/general cargo

5.166 Freight forwarders will generally purchase capacity from passenger or cargo-only airlines; however the forwarders will also purchase integrator capacity or in some cases whole aircraft on an ACMI basis[389]. Indeed, BA World Cargo's operation at Stansted involves leasing of freighter aircraft on an ACMI basis.[390] Freight forwarders do not usually operate their own aircraft nor, typically, will they run their own trucking network, preferring instead to outsource haulage to a third party.[391] BA World Cargo, the second largest cargo carrier at Stansted, has told the CAA that Stansted's proximity to the forwarding community at Heathrow is of central importance to allow the operation of freighter aircraft from London, given the constraints on operating from other London airports.[392]

5.167 The location of cargo-only flights by freight forwarders appears also in part to be dictated by the location of companies offering the ACMI leasing of

[383] Source: **[✂]**
[384] Source: **[✂]**
[385] Source: **[✂]**
[386] Source: **[✂]**
[387] Source: **[✂]**
[388] Source: **[✂]**
[389] ACMI: Aircraft, Crew, Maintenance, Insurance.
[390] Source: BAWC
[391] For a more detailed description of their business model, please see the DfT report March 2010 Air Freight: Economic and Environmental drivers and impact.
[392] Source: BAWC

particular types of freighter aircraft. For example, BAWC leases three B747-8Fs on an ACMI basis from Global Supply Systems, which is based at Stansted.[393] In addition, DHL has previously chartered additional aircraft from a third party based at Stansted.[394] It follows that there could be a significant cost involved in breaking – in some cases long-term – leases for these aircraft. There also appears to be a limited supply of suitable aircraft at other London airports. Indeed, BAWC has told the CAA that GSS is the only supplier from which it could lease B747-8Fs aircraft, on which it relies for fleet uniformity across its network.[395] This suggests that relocating marginal aircraft would generally not be practical, in part due to the crew contracted on an ACMI basis being based at Stansted. There could also be cost duplication in sub-contracting cargo handlers at other airports, as well as additional road transport resources.

5.168 In addition, freight forwarders sub-contract cargo-handling services to specialist cargo handling agencies, such as Servisair or Swissport. A decision by a freight forwarder to move its current operations would probably also be subject to the costs of terminating contracts with its current cargo handling agencies, as well as the costs of establishing new contracts at another airport. Further, the CAA considers that relocating operations away from Stansted to another airport would be likely to entail the costs of reconfiguring their road transports networks, into which the airport is incorporated. However, the scope for switching to a substitutable London airport is very limited.

5.169 At the margin, it may be possible for freight forwarders to purchase additional bellyhold capacity on passenger airlines, or capacity on integrators or freight forwarders at other London airports, in order to reduce the volumes processed at Stansted to constrain the airport. However, the CAA considers that the ability to do so would be contingent on the availability of spare capacity on such operations on a regular and reliable basis. BA World Cargo said that it operates freighter services from Stansted where bellyhold capacity on passenger aircraft is insufficient or the destination is not served by BA's (or possibly other) passenger flights.[396] This suggests that there may only be limited scope to switch away cargo onto other flights. [397]

5.170 It is also worth noting that freight forwarders are unlikely to be able to easily re-route oversized cargo to bellyhold capacity, and dangerous or specialist goods are subject to legal restrictions regarding which carriers are permitted to carry them. In addition, the CAA has seen evidence suggesting that trucking cargo by road to air transport from other airports outside of the

[393] Source: BAWC
[394] Source: DHL
[395] Source: BAWC
[396] Source: BAWC
[397] It is also worth noting that cargo carriers may be able to buy capacity on integrators or passenger airlines at other airports. For example, BAWC buys capacity on DHL's A300s operating short-haul services to and from Luton. However, buying capacity on such flights would be viable for air cargo with long-haul destinations, and would depend on the availability (if any) of capacity on integrator flights to the appropriate destination.

London area, such as East Midlands Airport which is the other principal cargo-only airport in the UK, is likely to increase the total transport time to such a degree that it would not be possible to meet certain express cargo delivery times. As a result, if in some cases East Midlands Airport could impose a constraint, the extent is unlikely to be considerable. Overall, there would appear to be only limited scope for freight forwarders to constrain the airport operator.

Domestic air mail

5.171 The principal domestic air mail services at Stansted are operated by charter cargo-only airlines that are contracted to Royal Mail for particular services set out in its tender documents. It is likely that the decision to operate from Stansted, as opposed to another London airport, is in part due to the fact that charter cargo-only airlines are mostly based at Stansted. Indeed, one of the contracted airlines, **[✂]**[398], although our analysis suggests that this might not be the case, as set out in paragraph 4.147. Royal Mail added that the night flight restrictions at Luton are the principal restriction that prevents it from operating from the airport. In addition, Royal Mail has had a "Unit" based at Stansted since 2003, which consists of a leased warehouse to process the mail, which is then passed on to the handling agency to load the aircraft.

5.172 While the physical switching costs for domestic air mail services might appear to be relatively small at Stansted, the TDRs and night flight restrictions at other London airports provide the most important barrier to switching, given that Royal Mail would need to operate from another London airport.

5.173 Further, at the margin, the CAA considers that Royal Mail appears unable to re-route its air mail via other carriers because the transport of its air mail is subject to a volume tender contract with particular carriers, as discussed above. Overall, it appears unlikely that Royal Mail would be able to effectively constrain STAL.

Discounts

5.174 Evidence of negotiations regarding price between the airport operator and its cargo-only carriers could be informative as to how important the airport considers their business to be to its profits. Evidence submitted by STAL shows **[✂]**.[399] Further, BA World Cargo said that it considers it unlikely that it would be able to obtain a discount in the future, due to the previous discount scheme having been agreed in the context of falling cargo volumes during the recession and it having not been repeated.[400] Overall, evidence suggests that STAL is not facing significant pricing pressure with regard to cargo-only carriers and users.

Airport behaviour

[398] Source: **[✂]**
[399] Source: STAL
[400] Source: BAWC

5.175 In general, the evidence suggests to the CAA that cargo carriers at Stansted consider the airport operator to have a significant position in the market, principally due to the cargo carriers' inability to move to another London airport, or indeed another airport in the UK to provide their existing services. **[✂]**.[401] FedEx added that STAL's significant position is due to the capacity constraints and infrastructure limitations at other London airports, as well as good road links; space away from the passenger terminals; a flexible slot regime; a reasonable set of policies on noise and night flights. However, FedEx also argues that the airport is clearly competing on the quality of its offering, and not relying on any power it arguably has. FedEx added that airport competitiveness in regard to cargo needs to be a key focus at Stansted and where possible other London airports. Finally, it added that UK exporters cannot compete properly in global markets unless UK airports give them cost-effective access to European and global markets.[402]

5.176 On this basis, the CAA consider that STAL – as currently the sole London airport suitable for most cargo-only carriers – would clearly have an incentive to maintain its infrastructure at a sufficient quality level because a failure to do so could result in the carriers exiting the market, as it becomes uneconomic to serve the London area and south east of England, given the current constraints on operating from the other London airports and the general competitiveness of the air cargo carrier industry. Their full or partial exit could also have a broader impact on the economic activity in the region, as businesses in the London and south east region requiring a high speed and reliable delivery network could suffer a considerable competitive disadvantage. However, and perhaps more importantly, the price regulation to which STAL's aeronautical charges are subject is likely to be preventing any abusive behaviour, as the tariff aeronautical charges are currently at the price cap.

Forward look

5.177 From the foregoing analysis, it is evident that the significant market position of STAL is directly influenced by regulatory and infrastructural issues in the south east of England. Indeed, TDRs, in combination with historical BAA policy, have had a distortive effect on the distribution of cargo-only carriers, resulting in their concentration at Stansted. However, the range of hours to which TDRs are applied is a function of the capacity constraints facing Heathrow and Gatwick airports at particular hours of the day, which are reviewed before the start of each traffic season. Given the prospect of tightening capacity constraints at the London airports over the medium term, with little sign of capacity expansion beyond incremental growth in capacity until 2025, it would seem that the range of peak hours stipulated in the TDRs are likely to increase rather than decrease, which would mean that scope for new cargo-only movements at Heathrow and Gatwick airports could become even smaller.

[401] Source: **[✂]**
[402] Source: FedEx

5.178 In addition, the relatively short runway length and night flight restrictions at Luton airport means that Stansted's cargo-only airlines do not see Luton airport as a viable substitute for movements by fully-laden wide-bodied aircraft[403]. As there are no current plans to expand the runway length at Luton airport, it is unlikely that the airport would become a viable substitute for integrators or freight forwarders utilising wide-bodied freight aircraft. Further, several cargo carriers have told the CAA that Luton could only become substitutable for Stansted if the night flight restrictions were relaxed. However, developments on night flight and noise restrictions at the London airports suggest that there will be ongoing gradual tightening of the restrictions over the medium to long term.

Conclusion

5.179 Overall, the CAA is minded to conclude that STAL holds significant market power over cargo-only airlines. The CAA will however further consider whether the ability of downstream customers to switch from cargo-only carriers operating from Stansted to bellyhold carriers operating from other London airports could indirectly constrain the behaviour of STAL. The CAA considers that the consistent evidence suggests that cargo-only carriers at Stansted face severe strategic constraints in moving away from Stansted, due to their business need to operate from a London airport to serve London and the south east of England and the restrictions which mean that Stansted is currently the only viable airport from which they can run their current operations. Evidence suggests that STAL is not facing considerable pricing pressure from other airports, although the current price cap regulation is likely to be restricting the airport operator's scope for exerting its significant market power through pricing. However, it is likely to have an incentive to maintain infrastructure of a sufficient quality in order to retain their business. Given the trend towards tightening night flight restrictions and TDRs, and low likelihood of significant new airport capacity until at least 2019, it seems unlikely that STAL's position of substantial market power towards cargo-only carriers would lessen over the medium term.

Minded to conclusions on potential competitive constraints

5.180 In this section, the CAA has considered the extent to which Stansted airlines are able to switch services out of Stansted. In principle, the airport operator's ability to exploit market power could be constrained by the switching behaviour of airlines, passengers or both.

[403] Wide-bodied aircraft are generally preferred to narrow-bodied aircraft by cargo-only carriers due to their greater cargo capacity.

Switching costs and strategic constraints

5.181 The CAA considered the various ways in which an airline can try to discipline an airport operator: allocation of new volume growth to other airports; decreasing the frequency of existing services; grounding based aircraft or reducing their use; and moving based aircraft to other bases or opening a base at another airport.

5.182 The CAA's evidence suggests that, while other types of switching would only have a limited impact, the relocation of marginal aircraft is likely to be the strongest disciplinary action that an airline can undertake in attempting to constrain STAL's ability to increase prices profitably. According to critical loss estimates, it appears that a loss of between 3 and 5 based aircraft – representing approximately 1.5 million passengers – would be required to make a 10 per cent price increase unprofitable.

5.183 Regarding the switching costs faced by Stansted's airlines, the evidence suggests that switching costs faced by Stansted's airlines are relatively low, even for short-haul LCCs with aircraft 'based' at Stansted. However, Ryanair and easyJet, together carrying 90 per cent of passengers at Stansted, face significant strategic constraints in switching away from London airports. This is because of the central strategic importance of London in their networks, which considerably reduces their ability to relocate aircraft to non-London airports in the UK and to continental Europe. In addition, the business model of charter airlines is focused on serving the core catchment of an airport, which means that switching away from Stansted would only be considered if there was another local core catchment that it could capture. By contrast, inbound short-haul LCCs at Stansted have not identified such strategic barriers to switching away from London airports. However, these carriers constitute only a small proportion of the airport's traffic.

Capacity constraints

5.184 While strategic constraints are likely to restrict based airline (and charter) substitution away to non-London airports, capacity constraints in addition appear to limit the scope for switching between London airports. To allow efficient utilisation of based aircraft, airlines with based aircraft require early morning departure slots, as this allows a sufficiently early departure to serve passenger demand and allow the aircraft to perform four to six daily rotations. As a result, for based airlines flying short-haul routes to consider switching to another London airport, it is particularly important that there is sufficient capacity[404] at the alternative airports to meet both morning and evening peak requirements.[405] In addition, due to the typical "back and forth" pattern of based aircraft, there also needs to be sufficient capacity available at the same airport outside of this period.

[404] In terms of terminal, aircraft parking stand and runway slot capacity.
[405] In particular, an alternative airport would need to be able to accommodate the first rotation of all necessary aircraft during the early morning departure peak period (which is approximately between 0600 and 0759 BST), and during the evening peak arrival period as the aircraft return to base.

5.185 Although Stansted has a considerable degree of spare capacity during the early morning peak, which would give the operator the incentive to attract new traffic, this is not likely to be a relevant consideration for incumbent airlines' ability to constrain the airport operator. However, the capacity constraints during the early morning peak at Luton and Gatwick airports suggests that there is limited scope for the relocation of aircraft to these airports. While Southend airport has significant spare capacity during the relevant times of day, its relatively short runway makes it technically impossible for Ryanair to relocate Stansted aircrafts to that airport.

Natural experiment

5.186 The reactions of Ryanair and easyJet to the price increase at Stansted in 2007 (which coincided with the start of the recession) suggest that at that time their operations suffered a serious negative impact. After what appears to be a short-term strategy of cost absorption, driven primarily by competition between airlines (and possibly the impact of the recession), both airlines sought slightly different approaches to return to sustainable operations, **[✂]**.

5.187 **[✂]**. Overall, the passenger numbers at Stansted have fallen from approximately 24mppa in 2007 to approximately 18mppa in 2012, which also includes a number of airlines ceasing operations and the effects from the worsening underlying macroeconomic conditions during that period. However, this does not appear to have significantly constrained STAL's pricing behaviour.

Countervailing buyer power

5.188 In response to a price increase, it is conceivable that certain airlines could be able to exert some countervailing buyer power. Ryanair (68 per cent) and easyJet (22 per cent) account for around 90 per cent of Stansted's passengers. However, while the size of Ryanair's operation, and to a lesser extent that of easyJet, at Stansted fulfils the first requirement for the existence of buyer power, evidence regarding their ability to credibly threaten to switch away from Stansted is less clear cut.

5.189 In the case of Ryanair, it is notable that while both parties may begin negotiations from extreme positions – with the result being that no successful negotiations have been concluded between Ryanair and STAL since 2008 – we noted STAL's apparent indifference in losing some of Ryanair's traffic. Overall, it appears that Ryanair's countervailing buyer power towards STAL is more limited than its share of overall Stansted traffic would suggest, and that the airport operator is likely to hold the stronger negotiating position in relation particularly to existing traffic.

5.190 Unlike Ryanair, easyJet has significant operations at several other London airports; Gatwick, Luton and Southend. On balance, the CAA considers that the evidence suggests that easyJet currently has a degree of countervailing buyer power against STAL and that this will continue. In particular, the CAA considers that the evidence suggests that easyjet may be well positioned to

leverage the three aircrafts that are currently based at Southend airport and potentially move further aircraft there once further development of the airport occurs.

Passengers' ability to switch and implications

5.191 In addition to constraints from airline switching, an additional constraint can occur dynamically through the subsequent reaction of marginal passengers currently choosing to fly from Stansted to the changes in the airline offering at the airport, in terms of price, the number of routes and service frequency and timings.

5.192 Using the evidence outlined in this section the CAA has estimated that the number of marginal passengers that have the ability to switch airports is quite low, with it representing approximately 10 per cent of passengers that fly from Stansted.[406] Based on total passenger numbers for 2011/12, this proportion represents approximately 1.8 million passengers. While the CAA recognises that this estimate is derived in a somewhat rudimentary manner it nonetheless provides some context as to the size of this potential constraint. This shows that while passengers at Stansted may be quite sensitive to price, the actual level of passenger switching that may result from an increase in airport charges is unlikely to have a significant disciplinary effect on the airport operator. A range of estimates of the long-run passenger airport charge elasticity of demand supports this.

5.193 Therefore, in light of the relatively small estimated number of potentially marginal passengers at Stansted and the relatively low estimated range of long-run airport elasticities, the CAA is minded to conclude that passenger switching in light of an increase in airport charges is unlikely significantly to constrain STAL's behaviour, although the CAA recognises that it may have a small additional disciplinary effect, if combined with airline switching.

Demand forecasts and implications for capacity constraints

5.194 The way in which capacity constraints at London airports are expected to evolve in the short to medium term has implications for the level of market power of STAL. To this end, we have examined a range of forecasts and estimates that have been produced to inform our view on capacity constraints going forward.

5.195 Based on the analysis of a range of demand forecasts from different parties, the CAA is minded to conclude that, in the next five years, the tightening of capacity constraints at Heathrow and Gatwick airports will result in an increase in the degree of market power at the London airports that have spare capacity. Given its overall size, range of facilities and level of spare capacity, the CAA anticipates that STAL would be a significant beneficiary of

[406] This estimates is derived by multiplying together the percentage of passengers that are price sensitive (33 per cent), the number of passengers in districts where Stansted's catchment overlaps with at least one other of the three major London airports and whose route is available at one or more other London airport (40per cent), and the percentage of passengers that could fly to their preferred destination at another airport (74 per cent).

these trends, which are subject to a recovering economy. STAL itself appears to have such an expectation.

Ability of cargo-only airlines to discipline the airport through switching or the threat of switching

5.196 In defining the market for services to cargo-only carriers at Stansted, we considered that the market is no wider than Stansted. The majority of Stansted's cargo-only carriers have long-standing operations at Stansted, have emphasised the importance of basing operations at a London airport, in order to ensure a service of sufficient quality to London and the south east of England. Further, regulatory and legislative restrictions at other London airports, such as TDRs and night flight limits, mean that Stansted appears to be the only suitable airport from which to operate for this purpose.

5.197 Overall, the CAA is minded to conclude that STAL holds substantial market power over cargo-only airlines. The CAA will, however, further consider whether the ability of downstream customers to switch from cargo-only carriers operating from Stansted to bellyhold carriers operating from other London airports could indirectly constrain the behaviour of STAL. The CAA considers that the consistent evidence suggests that cargo-only carriers at Stansted face severe strategic constraints in moving away from Stansted, due to their business need to operate from a London airport to serve London and the south east of England and the restrictions which mean that Stansted is currently the only viable airport from which they can run their current operations. Evidence suggests that STAL is not facing considerable pricing pressure from other airport operators. However, it is likely to have an incentive to maintain infrastructure of a sufficient quality in order to retain their business. Given the trend towards tightening night flight restrictions and TDRs, and the low likelihood of significant new airport capacity until at least 2025, it seems unlikely that STAL's position of substantial market power towards cargo-only carriers would lessen over the medium term.

6. Indicators of market power

Introduction

6.1 This chapter considers a range of indicators of market power:

- market shares;
- profitability measures and efficiency;
- quality of service;
- competitive pricing level; and
- engagement with airlines and potential price discrimination.

6.2 Where appropriate, this section draws upon the airport's own perception of its current and future market position, as reflected in its internal papers.

6.3 In interpreting evidence relating to the behaviour or performance of Stansted the CAA recognises that the airport is subject to economic regulation and that consequently its behaviour is likely to be constrained to a certain extent. However, we note the Office of Fair Trading's (OFT) view that "it is feasible that regulation of the average price or profit level across several markets supplied by an undertaking may still allow for the undertaking profitably to sustain prices above competitive levels in one (or more) of these markets and/or engage in exclusionary behaviour of various kinds." [407]

6.4 Empirical methods for assessing the behaviour, performance and profitability of airports were described in a CAA working paper, available on our website.[408] We draw upon this paper where appropriate.

Market shares

6.5 The Guidelines indicate that evidence on the market structure and market shares is commonly used in competition assessments and that the CAA would expect to undertake such analysis.[409]

6.6 However, the Guidelines also noted that:

- Difficulties in defining the market precisely might limit the reliance that could be placed on any given measure of market shares as an indicator of market power.
- There are aspects of airport markets that may reduce the reliability of market shares as an indicator of market power. In particular, the differentiated nature of airports both in terms of their facilities and services but also in terms of their location and the differing degrees of

[407] OFT, Assessment of market power, Understanding competition law, 2004, p. 26.
[408] This working paper is available at:
http://www.caa.co.uk/docs/78/ERG_Working_paper_Performance_and_Behaviour-26-11-10_FINAL.pdf.
[409] The Guidelines are available at:
http://www.caa.co.uk/docs/5/Final%20Competition%20Assessment%20Guidelines%20-%20FINAL.pdf.

their interdependent demand can reduce the reliability of market shares as an indicator of market power.[410]

6.7 In its 2009 decision, the CC recognised the limitations of market share calculations in the context of the supply of airport services. Specifically, the CC noted:

- the importance of geographical location for airport competition means that there is a continuum of substitution possibilities depending on distance and other airport characteristic; and
- any market definition beyond a single airport is, to an extent, arbitrary and assessment of market shares is unlikely to be a useful tool in itself for measuring airport market power.[411]

6.8 In the case of London airports, there are additional reasons why market shares may not be a reliable measure of the level of market power of airports, including:

- Long term capacity constraints at Heathrow airport and to a lesser extent at Gatwick airport. As stated by the OFT in its guidance, where competitors are unable to increase output substantially because of capacity constraints, "the undertaking would be in a stronger position to increase prices above competitive levels than an otherwise identical undertaking with a similar market share operating in a market where its competitors were not close to full capacity".[412]
- Common ownership of the three largest airports (Heathrow, Gatwick and Stansted) for a considerable period of time under BAA. For example, BAA might not have operated or marketed its airports as substitutes for one another. Instead, it may have marketed its airports as complementary to one another to prevent growth at one airport cannibalizing growth at another. While the sale of Gatwick airport may have reduced this concern, Stansted and Heathrow airports have remained within the BAA portfolio, and it is only recently that BAA agreed to dispose of Stansted.
- The level of substitutability of airports for different airlines, which can be influenced by (amongst other issues) infrastructure requirements, capacity constraints, strategic reasons and costs. For example, Ryanair is currently unable to switch its operations to Southend airport as the runway is too short for the type of aircraft it has chosen to operate.
- The London Air Traffic Distribution Rules (TDR) that came into effect in 1991. Under the Airports Act, the Secretary of State for Transport has the power to make such rules, which distribute traffic between airports

[410] CAA, Guidance on the assessment of airport market power, April 2011, paragraphs 4.5 – 4.7.
[411] CC 2009, BAA airports market investigation, A report on the supply of airport services by BAA in the UK, p. 36.
[412] OFT, Assessment of market power, Understanding competition law, paragraph 4.4.

in a 'system'.[413] In 2009, the CC noted that BAA considered that the original purpose of the TDRs was to ensure priority was given in peak hour slots to passenger services at Heathrow and Gatwick.[414]

6.9 Notwithstanding these concerns, the CAA has calculated market shares for Stansted by reference to the market definition that we adopted based on the evidence available to us (see section 4).

6.10 In the first instance the CAA has looked at market shares for two different markets for short haul travel, short haul being defined as travel to Europe.[415,416] The evidence suggests, including evidence derived from discussions with stakeholders, that Heathrow airport is not a substitute for Stansted but that Gatwick airport may be (even if only on an asymmetrical basis). The first market examined is Market 1, which is comprised of Stansted, Luton and Southend airports, while the second market (Market 2) is comprised of Market 1 plus Gatwick airport.

6.11 Table 6.1 suggests that in Market 1, Stansted has:

- A strong market presence, with the airport holding, on average, 70 per cent of the short haul passenger market over 2000-2011. In 2011, the airport had 66 per cent of the passenger market (the same level it had in 2000), down from the 74 per cent peak reached in 2004. This compares with Luton airport, which had 34 per cent of the passenger market in 2011, with an average of 30 per cent of the market over 2000-2011.[417]
- A strong, albeit declining market presence when measured by Air Traffic Movements (ATM). Specifically, the table shows that the

[413] Article 19 of Regulation (EC) 1008/2008 gives member states the power to put in place TDRs, provided they do not discriminate on grounds of nationality.
[414] CC 2009, The London Air Traffic Distribution Rules, available at: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/545_6_2.pdf, p. A6(2)-1.
[415] The CAA has not outlined a third potential market for long haul services. While the CAA recognises that Stansted has the capability to compete with Heathrow and Gatwick for such services, it notes that Stansted currently has a negligible market share of this particular market and the CAA's analysis has correspondingly focussed on the more relevant short haul markets (see section 3 for information on market definition). The CAA also notes that there are different types of carriers – based and in-bound – and although these carriers may face different switching costs, due to differences in their respective business models, it does not necessarily affect the way in which the relevant market for passenger airlines is defined (see section 4).
[416] The market shares that the CAA has outlined in Table 6.1 include short haul, full service carrier connecting flights. The CAA has also considered the situation where these flights are excluded from the market. Under this particular scenario, Stansted's overall market shares are slightly larger while Gatwick's is relatively smaller, however in 2011 the outcomes are broadly similar to those seen where these flights have not been excluded from the analysis.
[417] It has been held by the courts that a market share of 50 per cent could be considered to be very large so that, in the absence of exceptional circumstances pointing the other way, an undertaking with such a market share will be presumed dominant (see *AKZO v Commission*: Case C-62/86 [1991] ECR I-3359, [1993] 5 CMLR 215). In the case of lower market shares, undertakings with market shares below 40 per cent may be considered to be in a dominant position if other factors (such as high entry barriers) provide strong evidence of dominance (see OFT Guidelines *Assessment of Market Power,* paragraph 2.12). Undertakings with market shares of no more than 25 per cent are not likely to be dominant (see EU Commission *Staff Working Paper on the application of Article 82 EC to exclusionary abuses*, paragraph 31).

airport's market share declined from 72 per cent to 65 per cent over 2000-2011, with Luton airport's share showing a corresponding increase from 28 per cent to 35 per cent.

6.12 Table 6.1 also suggests that in Market 2:

- Stansted has a strong market presence, with the airport holding, on average, 37 per cent of the short haul passenger market over 2000-2011.
- This compares with the average of 16 per cent achieved by Luton airport and 47 per cent achieved by Gatwick airport over this period.
- It also shows that in 2011 Stansted had 33 per cent of the relevant passenger market, higher than 17 per cent share achieved by Luton airport but lower than the 51 per cent share achieved by Gatwick airport.

Table 6.1: Market shares (selected years 2000–2011)

	2000	**2002**	**2004**	**2006**	**2008**	**2010**	**2011**
MARKET 1							
Passenger share							
Stansted	66%	71%	74%	71%	69%	69%	66%
Luton	34%	29%	26%	28%	31%	31%	34%
Southend	0%	0%	0%	0%	0%	0%	0%
ATMS							
Stansted	72%	73%	73%	70%	67%	67%	65%
Luton	28%	27%	27%	30%	33%	33%	35%
Southend	0%	0%	0%	0%	0%	0%	1%
MARKET 2							
Passenger share							
Stansted	31%	36%	41%	41%	38%	35%	33%
Luton	16%	15%	15%	16%	17%	16%	17%
Southend	0%	0%	0%	0%	0%	0%	0%
Gatwick	54%	49%	45%	43%	45%	48%	51%
ATMS							
Stansted	34%	36%	39%	38%	36%	33%	30%
Luton	13%	14%	14%	17%	17%	16%	16%
Southend	0%	0%	0%	0%	0%	0%	0%
Gatwick	52%	50%	47%	45%	47%	51%	53%

Source: CAA
Note: Columns may not add up to 100% due to rounding.

6.13 When measured by ATMs, Stansted appears to have a relatively strong, albeit declining market presence. Specifically, the table shows that the airport's market shares declined from 34 per cent to 30 per cent over the period 2000–2011. This compares with the average of 15 per cent achieved by Luton and the 49 per cent achieved by Gatwick airport. It also shows that in 2011 Stansted had 30 per cent of Market 2's passenger market, higher

than the 16 per cent share achieved by Luton airport but lower than the 53 per cent share achieved by Gatwick airport.

Assessment of market shares

6.14 Table 6.1 suggests that in Market 1 (irrespective of whether it is measured by passenger numbers or ATMs), Stansted's share of the market would support a rebuttable assumption of dominance. It also suggests that in Market 2 (irrespective of whether it is measured by passenger numbers or ATMs) Stansted would have the second largest presence in the market and would have a large share of the market, albeit not at a level that would be sufficient to support a rebuttable assumption of dominance.

6.15 In observing these figures, there are a number of reasons to consider market shares may not be a reliable measure of the level of market power of airports and these results must accordingly be read with that qualification in mind.

Profitability measures and efficiency

6.16 The CAA's *Empirical methods for assessing behaviour, performance and profitability of airports* (Empirical methods) working paper stated that analysis of the financial performance of regulated airports is unlikely to provide particularly strong evidence about an airport's market position.[418] This was particularly true if the airport operator chose to set their prices at, or near to, the allowed price cap, as economic regulation is designed to prevent airport operators from earning excessive returns.[419]

6.17 Ryanair has argued that "BAA overhead has been allocated on an arbitrary basis to a given airport to increase artificially operating expenditure numbers to conceal the real profit generated by that airport".[420] It further argued that "overinvestment was a way of exploiting Stansted's market power". It also noted that efficiency of service provision is the real indicator of market power[421] and that return on capital employed (ROCE) might not be an appropriate measure of profitability.[422]

6.18 The CAA recognises the issues associated with profitability measures, which is why we explore other possible indicators of market power, including efficiency and pricing. Nevertheless, given the airport is regulated there are difficulties in interpreting these measures. In particular, it may be difficult to establish to what extent improvements in efficiency and service quality are driven by economic regulation or by competitive constraints. For this reason, the CAA assesses these issues in the section that sets out its views on Test C (chapter 8).

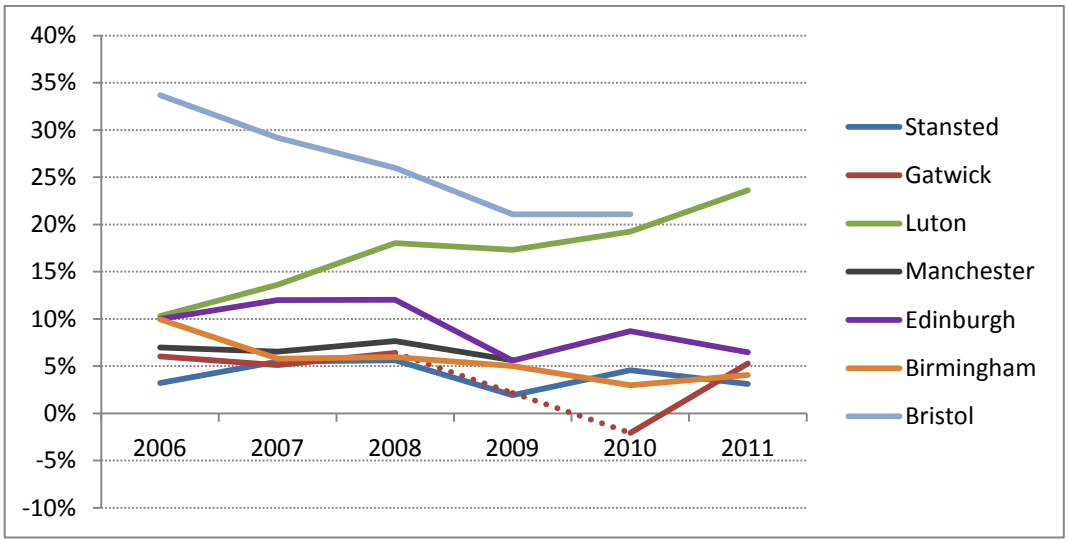
[418] This document is available at: http://www.caa.co.uk/docs/78/ERG_Working_paper_Performance_and_Behaviour-26-11-10_FINAL.pdf.
[419] CAA, Empirical methods for assessing behaviour, performance and profitability of airports, Paragraph 4.3.
[420] Source: Ryanair
[421] Source: Ryanair
[422] Source: Ryanair

Current profitability

6.19 While recognising the limitations of profitability analysis in the context of regulated airports, we have examined a number of indicators of profitability at Stansted and at a number of other UK airports.[423] The airports selected for this analysis reflected the CAA's judgment, informed by an examination of a number of key financial indicators.

6.20 The analysis below suggests that Stansted's ROCE from 2006 to 2011 has been consistently at the lower end of the spectrum of UK airports that the CAA has examined, with a low of 1.9 per cent, a high of 5.6 per cent and an average of 4 per cent. This data is reflected in Figure 6.1.

Figure 6.1: ROCE analysis



Sources: Financial statements Stansted, Gatwick, Luton, Manchester, Edinburgh, Birmingham and Bristol (various years), and CRI Airport Statistics.

6.21 The CAA has also examined (and calculated where necessary), a number of financial metrics, including EBITDA margin, EBITDA per passenger, operating margin, and revenue per passenger for Stansted and 14 other UK airports. This information suggests Stansted's performance across the profitability benchmarks has been mixed, but in general its recent performance has been in line with other UK airports.

6.22 Commenting on the historical financial performance of the airport shown in Figure 5.3 (see section 5), BAA noted that on 1 April 2007, all airline discounts were removed and this created the strong EBITDA performance shown albeit at the cost of significant volume loss.[424]

6.23 The increase in EBITDA that Stansted achieved was maintained for two years before declining, with the continued decline in passengers being the main contributor (with corresponding declines in retail and car parking

[423] For a discussion of the various measures of profitability, see the CAA, Empirical Methods working paper, paragraphs 4.1– 4.19.
[424] Source: BAA

revenue).[425] However, notwithstanding the decline in passenger numbers, the airport's EBITDA in 2010 was still higher than that achieved in 2006, i.e. before the price increase.

6.24 In its February 2010 strategy document, BAA noted that "in 2009 Stansted achieved an outstanding performance against budget, beating the EBITDA target despite 1.5 million less passengers".[426]

6.25 The CAA notes that Stansted has achieved this financial performance notwithstanding that concern with some of its employment costs have been identified[427]. This suggests that in the event that these issues were addressed there may be scope for the airport to improve its performance.

Assessment of profitability

6.26 Taking into account the material submitted by STAL, other stakeholder views and the CAA's own analysis, it does not consider there is evidence of persistent and excessive returns being achieved at Stansted. It does not consider that this outcome is surprising given that the airport is subject to price cap regulation.

6.27 This finding on the overall profitability of the airport is consistent with the CC's 2011 study into possible material changes of circumstances of BAA, which found that the airport's 'financial results were healthy when compared with other, non-BAA airports', notwithstanding a decline in passenger numbers in recent years.[428]

Future profitability

6.28 In its submission to the CC on the Material Change of Circumstances, BAA stated that "there has been a significant fall in the level of Stansted's profitability and there is considerable uncertainty at the current time around the airport's future prospects".[429]

6.29 The CAA considered a number of strategy documents from Stansted that detail its view on its prospects, including its profitability. One of these documents states that the airport's objective is to "achieve deregulation with no price cap" and that point to point long-haul spill to Stansted from the London system will help achieve its base case strategic scenario. Specifically, STAL noted that:

[425] Source: BAA
[426] Source: STAL
[427] In particular, in 2009 the CC identified that some employment costs at the airport were a concern. More recently Steer Davies Gleave (SDG) – a consultant engaged to assist us with our analysis – identified similar concerns at the airport. The SDG report is available at: http://www.caa.co.uk/docs/5/SDGStanstedReport.pdf (accessed December 2012)
[428] CC, BAA Market investigation, Consideration of possible material changes of circumstances, 2011, paragraph 245.
[429] In particular, BAA noted that Stansted's passenger traffic fell from 23.8 mppa in 2007 to 19.9 mppa in 2009 and the current moving annual total (MAT) was 18.7 mppa. It also noted that it considered that the principal reason for the large fall in passenger numbers was the withdrawal of significant seat capacity from Stansted by Ryanair and easyJet since 2007. This information is available at: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/baa_submission_on_mcc_non_confidential_version.pdf, p. 20 (accessed December 2012).

"Our objective is to achieve deregulation with no price cap but retain commitments in terms of service and investment levels. That will be a significant value lever for the long term given that this will allow recovery of part of the return in the future (when utilisation is higher) that we have not been able to capture during the present recession."[430]

"We expect that traffic will grow **[✂]** per cent from 2012 to reach **[✂]** million in **[✂].** The EBITDA will grow **[✂]** per cent pa from £ **[✂]**million in 2012 to **[✂]** million in **[✂]**."[431]

6.30 As part of a May 2012 strategy document Stansted also noted that it expects as part of its base case scenario that EBITDA to grow from **[✂]** million in 2012 to £ **[✂]** million in 2017, with traffic growing from 17.1 million in 2012 to **[✂]** million in **[✂]**.[432]

6.31 STAL's projections for the period 2012–2017, which were also outlined in the May 2012 strategy document, also suggest that STAL is expecting strong growth in EBITDA per passenger, increase in tariffs in 2012 and an increase in passenger numbers.

6.32 The CAA considers that STAL's ability to increase its prices and passenger numbers concurrently reflects its view that it will be able to capture the expected spill (including for long-haul) from the other, increasingly constrained London airports, due to improving economic conditions (see section 4). The projections also assume that there will be improvement in net retail income per passenger from improved economic conditions and improved duty-free spend from long haul passengers, as well as a slight reduction on operating costs per passenger.[433]

6.33 Going forward, the CAA also notes that STAL is expecting relatively robust employment cost growth over the next few years[434], notwithstanding the current economic climate and growth in some employment costs having previously been identified as an area of concern. While growth in employment costs may be justified, particularly if productivity offsets are being made, there is evidence to suggest that some employment costs within the airport are already above benchmark.[435] This may indicate that the airport operator is not expecting competitive pressures to constrain such costs.

[430] Source: STAL
[431] Source: STAL
[432] Source: STAL
[433] In October 2012, the airport also released an Information Memorandum which contained updated financial projections. These projections suggested that the airport's profitability over its forecast period, which ended in 2019, would continue post 2017. Source: STAL
[434] Source: STAL
[435] In particular, the study found that in terms of cash and total reward that the employment costs at Stansted were, in general, higher than the general market. Source: Incomes Data Services – a non confidential version of this report will be available on the CAA's website. Importantly, this evidence builds on the 2009 CC finding that there was a 'peace premium' associated with some employment costs at the airport.

Efficiency

6.34 The Empirical Methods working paper outlined approaches to the assessment of efficiency and stated that, in principle, the analysis of relative cost efficiency might provide useful evidence to identify whether an airport is performing in a way that might be expected in a well-functioning market. It also stated that care must be taken to understand the underlying causes of any identified inefficiency, and whether there is evidence to suggest that relatively poor performance is transitory or can be explained by factors that do not relate to market power, for example the effect of regulatory incentives.[436]

6.35 The CAA has nevertheless examined evidence relating to efficiency at the airport and considers there are reasons to consider that the airport operator may have been slow at addressing inefficiencies.[437] The CAA has seen no evidence that competitive constraints have driven the efficiency initiatives that it has pursued. In contrast, there is some evidence that the airport operator has been responding to some regulatory initiatives in this area. A recent consultancy study commissioned by the CAA identified several efficiency opportunities for the airport operator in relation to its operational costs such as security. The issue of efficiency is considered in more detail in chapter 9 on Test C.

Service quality

6.36 The CAA recognises that economic regulation can complicate the relationship between the level of service provided and the degree of market power held by an airport operator. In particular, the CAA notes that the level of service quality of designated airports might be an outcome of regulation rather than of market power or competitive pressures, which can reduce the degree to which any analysis of service quality might provide a reliable indicator of market power. The CAA notes that in the case of Stansted, regulation of service quality under the SQR regime was introduced by the CAA in 2009, in response to a public interest finding[438] made by the CC.

[436] CAA, '*Empirical methods for assessing behaviour, performance and profitability of airports*', p. 13.
[437] In 2008 and 2009 the CC identified a number of areas where there was scope for efficiency improvements, including with respect to employment costs, standards and procedures for baggage delivery and staff rostering – an issue that had previously been identified in 2006. More recently (2012), SDG identified a number of areas, including rostering, where improvements could be made. The airport has indicated that it has looked to implement initiatives to drive down absenteeism and implement rostering changes to increase security efficiency and flow.

6.37 Having considered evidence from a range of sources, including through passenger surveys and direct measurement[439], and evidence from stakeholders, the CAA considers that there is a lack of evidence of whether competitive pressures have led to improvements in this area. However, there is evidence to suggest that the introduction of the service quality rebate (SQR) regime that forms part of the price control at Stansted has resulted in an improvement in the quality at the airport.

Competitive price level

6.38 The Guidelines stated that it is important to understand, at a minimum, whether there is evidence that the prevailing and historical price levels are reasonably close to or significantly above or below the competitive level. This is consistent with OFT guidance that "depending on other available evidence, it might, for example, be reasonable to infer that an undertaking possesses market power from evidence that it has set prices consistently above an appropriate measure of costs".[440]

6.39 The CAA further noted that the potential for prices to vary over time may limit the ability to determine the competitive price level with a significant degree of accuracy and that it expected to analyse this long-term average price level using measures of long-run, forward-looking, cost such as depreciated replacement or incremental cost. It also considered that given the difficulties involved in establishing a competitive price level, it might not always be possible to derive an accurate measure, but where sufficient and robust evidence was available to determine a reasonable estimate, the CAA expects to take full account of it.

6.40 This section considers a number of possible measures of the competitive price:

- the regulated price;
- LRIC; and
- price benchmarking.

The regulated price

6.41 In March 2009, the CAA concluded that the price caps set out in Table 6.2 (below) would fall within the range of price caps that could be reasonably recommended by a regulatory authority applying a 'building block' methodology.

[439] The working paper on empirical methods discussed the two main methods by which service quality could be measured: through passenger surveys and direct measurement. It identified the various surveys that are carried out at airports, in particular: ACI's Airport Service Quality Ranking (the ASQ survey); BAA's own passenger surveys called the Quality of Service Monitor (QSM) and surveys carried out by the CAA. It is however important to note that the surveys that the CAA undertakes are not designed to collect information about service quality, although the CAA did add a question on passenger satisfaction with the airport experience in May 2012.
[440] OFT, Assessment of market power, Understanding competition law, 2004, paragraph 6.5.

Table 6.2: CAA's proposed Stansted Q5 price control

Proposed price cap £/passenger	2009/10	2010/11	2011/12	2012/13	2013/14
2009/10 prices	6.53	6.53	6.63	6.74	6.85
Increase in price cap: retail price inflation plus X per cent		RPI + 0 per cent	RPI + 1.63 per cent	RPI + 1.63 per cent	RPI + 1.63 per cent

Source: CAA

6.42 There was a dual rationale for the CAA arriving at the profile set out above; that it is the product of both the 'building block' analysis that had been carried out by the CC and the CAA's assessment that the resulting price control profile was consistent with the development of more effective competition between airport operators over time.[441]

6.43 As stated in the Guidelines, in principle, regulated prices might be above, below or approximately equal to the competitive level. The regulated price might be a reasonable proxy for the competitive price level and we understand that some competition authorities have treated the regulated price as a reasonable proxy for the competitive price for the purposes of assessing complaints of excessive pricing.[442] However, the CAA also recognises that the price a regulator sets for an airport is a reflection of the objectives, process and effectiveness of the regulatory regime under which it operates and that it may vary from the competitive price for significant periods of time. There are therefore reasons to believe that the regulated price may not represent the competitive price for Stansted, including the following.

- Statutory duties that have the effect of encouraging over-investment at an airport. For example, Section 39 of the Airports Act places an obligation on the CAA in performing its economic regulatory duty for airport operators to (amongst other obligations) 'encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports'.[443]
- The scope for the misalignment of proposed capex and current market requirements, due to the long term and 'lumpy' nature of the capex. For example, Stansted was designed and built to cater for a mix of aircraft,

[441] In reaching a view on the appropriate price level, the CAA placed some weight on the LRIC estimate of £7 per passenger and took into account the prices paid by Ryanair and easyJet across the airports that they used and the average aeronautical revenue per passenger across a range of UK airports. The CAA also took the competitive price into account when deciding on the profiling of the price cap during the price control so that the price cap increased during Q5 and was closer to the competitive price at the end of the control period, although the CAA, at the time considered that the LRIC estimate would still be above the price cap in 2013/14.
[442] Michele Giannino, Enforcement of excessive price competition provisions in the airport sector: An overview, June 2012.
[443] CC 2009, BAA airports market investigation, A report on the supply of airport services by BAA in the UK, p. 131.

yet, in general, it is only catering to short-haul, LCC aircraft. Similarly, STAL commenced a project, consistent with Government policy at that time, to develop a second runway (SG2) to ensure sufficient capacity going forward. While this long term project has been abandoned, these costs are being recovered through current users of the airport.

- Difference in the valuation of assets, which will affect the calculation of the competitive price. For example, the value an airport operator places on its assets will be affected by the companies' asset capitalisation and valuation policies. In addition, the value of assets can be affected by the company's depreciation policy and the useful economic lives over which assets are depreciated. As such, an airport operator that depreciates its assets more quickly will have a lower value of capital employed than an airport operator that depreciates its assets over a longer period.
- The potential for opex inefficiencies which a regulator may be only partially able to mitigate due to insufficient information and/or the implementation of insufficiently strong incentives to address an issue. For example, issues with the security rostering at Stansted were identified several years ago, this issue remains alive today.
- The bias towards increased use of capital created by RAB-based price regulation may have the undesirable effect of encouraging inefficient investment. It may also provide incentives for strategic behaviour by the airport operator to inflate the size of the RAB and may discourage the application of charging structures that make efficient use of capital. While the CAA is aware of these concerns, these issues nonetheless lead to a number of general criticisms of RAB-based price cap regimes.[444]
- Common ownership of airports which can result in less favourable regulatory outcomes if efficient capacity expansion at one airport impacts passenger numbers, airline performance and airport performance at another. In addition, common ownership can impinge on the incentive under the RPI approach for an airport to outperform the forecasts used in the price determination so far as passenger numbers are concerned. This is because such outperformance at one airport would, to some extent, come at the expense of the others.[445]

6.44 STAL has suggested that its regulated price may not be a reasonable proxy for the competitive price level. In discussions with the CAA, STAL has noted that its current offers to new airlines tend to be **[✂]**.[446]

[444] These concerns were set out in paragraph 6.18 of the CC's 2009 report.
[445] These concerns were set out in paragraph 6.62 of the CC's 2009 report.
[446] Source: STAL

6.45 Airlines have expressed some concerns with the regulatory approach adopted by the CAA, and the resulting price. Ryanair has noted that the current regulatory approach has allowed STAL to 'inflate its RAB' and inflate its opex with 'intra group cost transfers and Heathrow cost transfers'.[447] It has also indicated that the presence of intra-group costs demonstrates that STAL's claim that it is a 'stand-alone' airport is unjustified.[448,449]

Long-run average incremental costs LRAIC

6.46 Price caps based on long-run average incremental costs (LRAIC) have been used by some regulators in a number of cases. The primary conceptual benefit of this approach is that it proxies the long-term average price that might emerge from a "competitive" market.[450]

6.47 In the Initial Views we outlined that the LRAIC was one way by which the competitive price could be assessed. However, the CAA noted that while the calculation of LRAIC is relatively straight forward in methodological terms, any estimate is highly sensitive to the assumptions that are used. The CAA also outlined the analysis that had been undertaken with respect to Gatwick airport and noted that in the context of Stansted, where the cost of expansion might be expected to be somewhat different to that of Gatwick airport, it was difficult to place much reliance on these estimates.[451]

6.48 There are a number of drawbacks to a LRAIC approach:

- 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; and
- 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

[447] Source: Ryanair
[448] Source: Ryanair
[449] Issues associated with Constructive Engagement are not explored in detail within this document and will be addressed, if required, as part of any future regulatory determination.
[450] CAA, Review of Price Regulation at Heathrow, Gatwick and Stansted airports ("Q6"), Policy update, p. 56.
[451] CAA, Initial Views, p. 74.

produce significant price volatility.[452] Indeed, the Guidelines[453], 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.[454]

6.49 Connected to the third point above, the fluctuation of a price around the competitive price as a result of 'lumpy' investments assumes that the development of new airport capacity is largely driven by market forces. Evidence suggests that this is not the case for airports in the South East, where the decision to develop significant new capacity is largely driven by government policy.[455] The CAA notes that government policy in this respect changed in 2010 and is currently not expected to be settled until 2015. Under such circumstances, pricing above the competitive level is unlikely to result in significant new airport capacity being brought forward.

6.50 In addition, based on previous engagements with stakeholders, it has been suggested that the accuracy of a LRAIC can be adversely affected by the history of ownership and regulation of the London airports. In particular, it has been argued that the current specification of the airports was set by BAA (as the common owner of Heathrow, Gatwick and Stansted), which means that the estimates of the incremental costs at the airport are higher than the costs of expanding an efficient airport. While it is difficult to assess the strength of this argument, it is true that the current airport configuration may not reflect that which would result from a well-functioning airport market – albeit that it is not clear whether this would increase or reduce the incremental costs.[456]

6.51 easyJet has also highlighted that there are 'practical problems' with using a LRIC based approach to setting a price cap which means that it does not see any real alternative to the use of a RAB based approach to setting prices.[457]

6.52 Looking to address the conflicting views on the merits of using LRAIC to help inform our minded to decision, the CAA engaged Europe Economics (EE) to (amongst other factors):

- estimate a LRAIC for Stansted; and
- identify the advantage and disadvantages of using a LRAIC based approach to inform estimates of the competitive price for Stansted (and to set price caps).[458, 459]

[452] CAA, Review of Price Regulation at Heathrow, Gatwick and Stansted airports ("Q6"), Policy update, p. 57.
[453] See Paragraph 3.17 of the Guidelines.
[454] In principle, short-run prices in a well-functioning airport market would be expected to fluctuate around a long-term average, depending on the level of spare capacity available in the market: when capacity tightens, prices could be expected to increase with the resulting high prices triggering the development of new capacity by competing airports and subsequent fall in prices. Under such circumstances, pricing above the competitive price for a period of time might be considered a normal feature of a well functioning market.
[455] For a description of this, see paragraphs 96–174 of Volume 2: Appendices of the CC's 2009 BAA report.
[456] CAA, Gatwick - Market Power Assessments Non-confidential Version, Initial Views – February 2012, p. 71.
[457] Source: easyJet

6.53 EE examined four[460] increments for Stansted and considered that the most appropriate increment to use for LRAIC was complete airport replacement. Using this increment, EE determined that the LRAIC for Stansted was £6.30 per passenger.[461]

6.54 EE indicated that estimating the LRAIC was one way of assessing price in a normally competitive market. However, it also identified a number of practical disadvantages of using this approach, including:

- difficulties in determining the appropriate increment to use – as noted above, EE considered that the most credible increment would be the replacement of an airport (rather than, for example, a small amount of incremental capex or a new runway). However, it noted that since Stansted was a relatively new airport, these problems may be less severe;
- greater uncertainty (and loss of accuracy) due to the need to make a judgement as to the efficient levels and types of investment required rather than using historic values that were spent; and
- the potential for greater uncertainty of remuneration of investment. For example, a historic cost-based RAB system would offer greater certainty since once an investment cost has been approved for inclusion in the RAB it would be part of the calculation for future price limits.

6.55 EE's analysis also identified that any model that is used to estimate LRAIC would be sensitive to the inputs and the assumptions that underpin it. In particular, EE's sensitivity analysis indicated that changed to the inputs and assumptions could lead to quite significant changes in a LRAIC estimate. More fundamentally, EE questioned the relevance of an estimate of the competitive price obtained through LRAIC given the level of government involvement in planning of airport capacity, particularly in the south east of England.[462]

[458] EE was engaged to review the various approaches taken to calculate LRAIC and examine these issues as they applied to Stansted and Gatwick airports.
[459] A non-confidential version of EE's report is available on the CAA's website.
[460] Five increments were examined if you consider that two scenarios were considered under one of the increments examined.
[461] The other increments EE examined were based on SG1 plans SG2 plans and the airport's current capex plans.
[462] Europe Economics, Advice on the application of long run incremental cost estimates for Gatwick and Stansted.

Price benchmarking

6.56 An alternative way of estimating the level of the competitive price is to consider evidence on pricing at comparable airports. As airports are relatively differentiated, there are 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.

6.57 The CAA considered the suitability of comparing Stansted's prices to the prices published in the ATRS Airport Benchmarking Report 2011, which surveys 156 airports worldwide, including 45 airports in Europe. Because these prices are based on published tariffs rather than actual prices paid the CAA concluded that they were unlikely to provide a suitable benchmark for Stansted.[463]

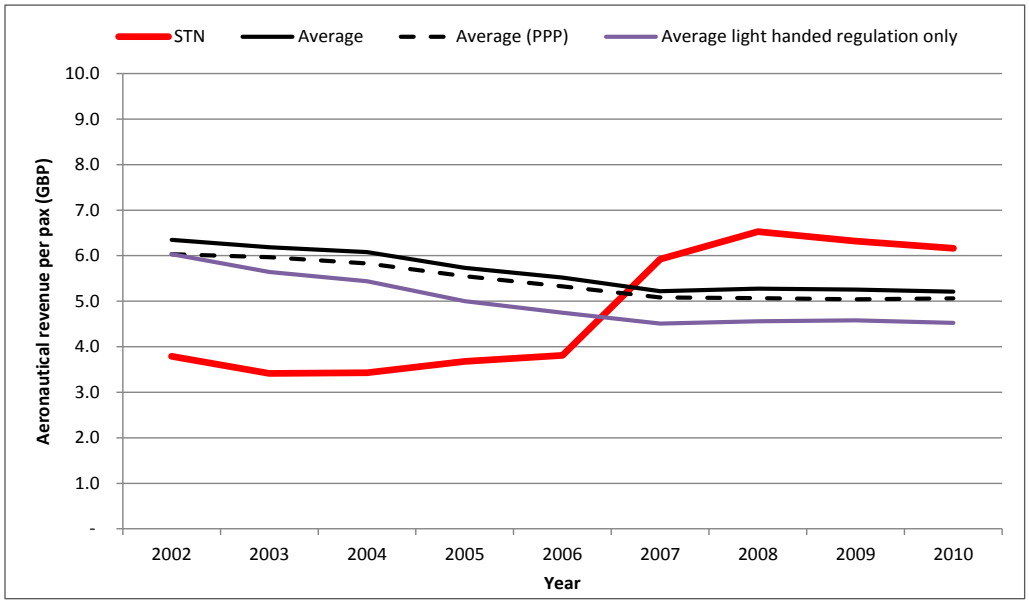
6.58 The CAA commissioned Leigh Fisher to undertake work on benchmarking airport charges at Heathrow, Gatwick and Stansted, against suitable comparator airports, which where possible, were operating in a competitive market. This work can therefore help inform the discussion of the competitive price at Stansted. Leigh Fisher'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.

6.59 Leigh Fisher's analysis shows, as illustrated by Figure 6.2, that Stansted's aeronautical revenue per passenger is approximately £1 above the average of comparable airports and about £1.5 above the subset of airport operators that are subject to lighter regulation[464] Leigh Fisher estimated that the margin of error of the analysis was +/- 10-15 per cent (equivalent to £0.60 - £0.90).

[463] In the Initial Views the CAA noted that this indicator was more relevant when the relevant comparator were considered to be large international airports. The CAA also indicated that given the heterogeneity of airports that the use of this tool would not provide conclusive results but could be used to provide an indicator of whether or not Stansted's charges were significantly above or below those of other airports. Source: CAA, Initial Views, p. 76.

[464] The analysis also shows that Stansted's aeronautical revenue per passenger were below the average of comparable airports over the period 2002 to 2007.

Figure 6:2: STAL's aeronautical revenue per passenger compared to the basket average



Source: Leigh Fisher

6.60 Leigh Fisher also undertook comparisons of total revenues and aeronautical tariffs. Based on the analysis undertaken, tariffs do not appear to be very informative of the competitive price of airports due to the widespread discounts available to published tariffs, particularly for airport operators that compete with STAL. Total revenues per passenger at Stansted are broadly comparable to that of the comparator set. This may be informative given that charges at Stansted are regulated on a single till, however the substitutability between aeronautical and non aeronautical charges may be limited (for example there is likely to be little substitution between retail income and landing charges).

6.61 In a competitive environment, airport operators will have an incentive to maximise non aeronautical revenues as this will allow them to maximise the overall revenues and profits of the airport. In a RAB based framework, the airport operator will also have a strong incentive to outperform regulatory non aeronautical revenue assumptions during the control period. However, these incentives may be muted compared to a competitive environment as the regulator will remove any outperformance at the end of the control period and thus reduce incentives for outperformance in the latter years of a control period. In addition, the regulated company might have an incentive to underperform towards the end of the control period on non aeronautical revenues, as this would maximise the scope for outperformance and reducing the pressure placed on management in the following price control period. Given these potential distortions to incentives under regulation, the CAA considers that comparing aeronautical revenues at Stansted with other airport operators is more informative as both regulated and non regulated airports have similar incentives to maximise aeronautical revenues.

6.62 Overall this analysis appears to indicate that STAL's aeronautical charges are likely to be above the level of comparator airport operators. Given the margin of error it is difficult to be definitive about how much STAL is pricing above the competitive level.

6.63 The CAA cross-checked the validity of these results by examining the actual prices charged by Luton airport[465] to its main airlines under long term contract,[466] including current prices charged and the price path over the course of those contracts.[467] The CAA found that these prices were considerably lower than the prices currently charged by STAL. The CAA notes that these prices were negotiated at a time when Stansted and Luton airports had substantial spare capacity and STAL was subject to a much stronger competitive constraint from Luton airport.[468]

6.64 Ryanair also provided the CAA with information on its airport charges over its 15 largest bases, which includes Stansted, for the five-year period commencing 2007. This information shows that:

- Stansted is one of the most expensive airports that Ryanair uses, with it being either the most expensive or within the top three most expensive bases over the five years commencing in 2007.[469]
- on average, over the five year period commencing in 2007, the per passenger charge incurred by Ryanair at Stansted was **[✂]**;
- the increase in charges per passenger at Stansted over this five-year period was the highest of the 15 airports considered. For example, in 2007, the charges Ryanair experienced at Stansted were (31 per cent) lower than those at **[✂]** but by 2011 this situation had reversed, with **[✂]** charges being (44 per cent) lower than Stansted's charges.[470]

6.65 Similarly, easyJet provided us information on the costs of operating at various airports within the UK and internationally. This information highlighted that STAL's costs per pax **[✂]** place it approximately in the middle of the top 30 airports that easyJet use both in the UK and overseas – this is below the costs it incurs at Gatwick airport **[✂]** but **[✂]** the costs it incurs at Luton airport **[✂]** and **[✂]** than the costs at Southend airport **[✂]**.[471]

6.66 The CAA notes that in the Initial Views it indicated that the costs that easyJet incurred at Stansted were in the region of the average level of airport charges

[465] Source: Luton Airport
[466] The Guidelines state that: "the CAA considers that the terms of long-term contracts may provide useful information regarding an airport's long-term pricing."
[467] The CAA considers Luton is a close substitute as it is in the relevant market for Stansted (see market definition in section 4). **[✂]**
[468] CC 2008 report on Stansted, p 139, paragraph 67.
[469] The costs that the CAA examined were expressed in a Pound sterling and Euros and the CAA converted the Euros into Pound Sterling using a PPP exchange rate derived from Eurostat data. The CAA did, however, consider a number of approaches to converting these charges and all of these approaches generated similar outcomes.
[470] Edinburgh Airport has been selected as a comparator as this is an airport that STAL has indicated it is increasingly competing against (Source: STAL). However, the CAA considers this to be a relatively weak constraint (see section 4).
[471] **[✂]**

across easyJet's network, and similar (albeit slightly lower) than a number of airports serving major European cities, such **[✂]**.[472] However, evidence from easyJet, including correspondence on a long term pricing agreement also suggests that the airline considers a reasonable price for Stansted would be lower at around **[✂]** per departing passenger (inclusive of all charges).[473,474]

Assessment of the competitive price level

6.67 The CAA notes that STAL has been pricing at or close to the regulatory cap for over five years. This suggests that the airport operator may increase its prices should price cap regulation be removed and we note that the airport operator has indicated that one of its objectives is to 'achieve deregulation with no price cap but retain commitments in terms of service and investment levels. That will be a significant value lever for the long term given that this will allow recovery of part of the return in the future (when utilisation is higher) that we have not been able to capture during the present recession'.[475] The CAA also notes that the airport operator considers that its offers to 'new' airlines tend not to be at what the airport operator considers is the competitive price and that it is trying to get to all its airlines to what it perceives to be the competitive prices over time.

6.68 Based on the additional analysis that the CAA has undertaken since the Initial Views, it considers that the evidence, including the price benchmarking exercise by Leigh Fisher, suggests that STAL is pricing above the competitive level. In addition, the evidence suggests that free from any regulation STAL could seek to increase prices (further) above the competitive level.

6.69 Given the distortions arising from government policy on airport's incentives to invest in new capacity, the CAA considers that a price that is higher than the competitive price may persist for a significant period of time and therefore could be indicative of SMP.

[472] CAA, Initial Views, Confidential Version.
[473] Source: easyJet
[474] Source: easyJet. **[✂]**.
[475] Source: STAL

Engagement with the airlines and price discrimination

6.70 STAL informed us that it puts significant effort in engaging with airlines to compete for new business and that in pursuing new business it is a standalone business, albeit one that receives some assistance from BAA.[476] It noted, for example, that it has identified a number of airlines that it is actively pursuing and that it will often develop comprehensive proposals (at some cost) to present to those airlines.[477]

6.71 The airport operator provided us with numerous examples of the offers it has made to airlines to demonstrate its approach to engagement and this evidence suggests that it has offered some aggressive discounts on its published charges to try and win new business. While each offer is unique, discounts appear closely linked to growth in passenger numbers and tend to last **[✂]**, with discounts **[✂]**. **[✂]**.[478] **[✂]**.[479]

6.72 In addition to discounts to its published charges, the airport operator has also indicated that it can provide a range of other incentives to airlines that are considering operating at Stansted, including:

- offering an airline **[✂]**;
- **[✂]** at no cost to the airline; and
- **[✂]**.[480]

6.73 The airport operator has however indicated that despite generous offers being made it has not been able to attract new airlines and that its current mix of airlines may be contributing to the difficulties that it has.[481]

6.74 In respect of the airlines currently operating at the airport, STAL has also provided us evidence on its negotiations with these airlines. This material was supported by other material from the airlines themselves. In general, the offers made by the airport operator involve discounts on incremental traffic, tend to be for **[✂]** in duration and are conditional on specific growth targets being met.[482] The level of discounts to the published charges varies from airline to airline and can be accompanied with **[✂]** various branding initiatives. Some **[✂]** can also be offered. The particulars of some of these offers, in particular the offers the airport has made to Ryanair and easyJet, are discussed below.

6.75 A number of stakeholders have suggested that BAA's ownership of the airport may have influenced STAL's approach to negotiations and that its approach reflected broader BAA airport portfolio considerations.[483]

[476] STAL noted that it had been able to determine its own strategy since at least 2005 and there has been little external control except with respect to the SG2 proposals and some marginal support from the centralised aviation team.
[477] Source: STAL
[478] Source: STAL: **[✂]**
[479] **[✂]**
[480] Source: STAL
[481] Source: STAL
[482] Source: **[✂]**
[483] Stakeholders who expressed this view included Southend Airport and Gatwick Airport.

Specifically, it has been suggested that limitations have been placed on what airlines STAL could pursue and that there were 'other' reasons why it may act less than competitively.

6.76 The CAA's analysis of the evidence suggests that while STAL is making a number of approaches to new airlines, it has maintained its relationship with Heathrow and that it is this relationship that appears to be an important factor in determining what Heathrow airlines are pursued by STAL. The existence of STAL's relationship with Heathrow has been acknowledged by STAL and it has indicated that it has worked closely with Heathrow to identify carriers who do not necessarily fit with the Heathrow profile, although it suggested this was at the margin.[484] One example of the airport's few 'wins' (albeit short lived), is Air Asia X and this airline established itself at Stansted as a result of the support from the BAA centralised aviation team, who had directed traffic deemed unsuitable for Heathrow to it.[485]

6.77 Some airlines have noted that STAL has had a uni-lateral approach to negotiation. For example, Thomson Airways noted that, of the airports from which it operates, STAL and GAL are less likely to be willing to negotiate[486]. Similarly, Air Berlin indicated that STAL had not been very active in negotiating with them, although Wizz noted that STAL were active in trying to attract them away from Luton airport.[487] The CAA notes that STAL's approach to negotiations appears to be somewhat different to that seen at neighbouring airports, where evidence suggests more evenly balanced negotiations.[488]

6.78 STAL's strategy documents (and the information memorandum), suggest that the airport operator considers that changing economic conditions and the resultant 'spill' of traffic from Heathrow and Gatwick airports will contribute to its growth in the future.

6.79 The willingness of the airport operator to offer discounts on its published tariffs to airlines currently at the airport also appears limited, with any potential being conditional on conditions determined largely by the airport operator. This approach is reflected, in part, by evidence from STAL internal papers that indicated that "STAL has been pricing to the cap since 2007/08" and that it "negotiates specific commercial deals based on delivering significant growth, strategic fit and commitment to the airport."[489] The CAA notes that, STAL has indicated that it has not given any discounts to **[✂]** since 2008 as mutually acceptable commercial arrangements have not been able to be reached and that discounts to other airlines have been **[✂]**.[490] Indeed, with two exceptions, the evidence received by the CAA shows that

[484] Source: BAA
[485] Source: STAL
[486] Source: Thomson Airways
[487] Source: Air Berlin and Wizz Air
[488] In particular, evidence from airlines **[✂]** and to a lesser extent **[✂]** and our discussions with other airports **[✂]** suggest that this is the case.
[489] Source: STAL
[490] Source: STAL

discounts granted by STAL to airlines has been in the form of **[✂]** or new airline entry at the airport.

6.80 The position that STAL sets the tone for its negotiations is to a lesser extent supported by evidence on STAL's negotiations with Ryanair. The airport operator has, for example, **[✂]**. In particular, in February 2010, the airport operator indicated that under *Ryanair's LCC* model **[✂]**.[491,492] The airport operator has indicated that it is looking to increase the diversity of the airlines operating at the airport and the continued strong presence of Ryanair is acting as a deterrent to this – a view a number of other stakeholders agreed with.[493] The airport operator has also suggested that Ryanair has limited choice as to where it can operate out of if it wishes to service the London market. For example, it has noted that against a background of constrained capacity, which is unlikely to be resolved in the short term, that volume threats by Ryanair will **[✂]**.[494]

6.81 Ryanair also provided us evidence on its proposals to STAL, its expectations and reasons why it considered that an agreement with the airport operator had not been reached (with its main concern being pricing). This evidence also suggests that the airline has been relatively pro-active in looking to secure an agreement with the airport operator.

6.82 The Ryanair evidence also highlights that notwithstanding the airline threatening to grow at other airports (UK and Europe airports – a position that has featured in some subsequent correspondence between the two parties) at the expense of growth at Stansted, no deal was reached.[495]

6.83 STAL has however also provided the CAA with evidence that suggests that it tried to reach an agreement with Ryanair but that the airline's approach to its negotiations has not helped to make an agreement possible. For example, there is evidence that suggests the airport operator had almost reached an agreement with the airline but then Ryanair's approach to the negotiations changed quite dramatically, with Ryanair reverting to an earlier position, which resulted in a deal not being made. The airport operator also noted:

- Ryanair may have given an impression that the airport operator refused to make a deal but the reality is that Ryanair couldn't deliver the conditions necessary to make any deal work;
- while it offers incentives to airlines to support costs of starting new routes, airlines can develop high levels of dependency on these discounts;
- it cannot surrender revenues to profitable airlines (such as Ryanair);

[491] Source: STAL
[492] Source: STAL **[✂]**
[493] Stakeholders who indicated that the strong presence of Ryanair at the airport was an influencing factor in deciding whether to relocate there include **[✂]**, Wizz Air, Air Berlin and to a lesser extent Thomas Cook.
[494] Source: STAL
[495] Source: Ryanair

- the incentives that it offers need to make sense and that growth must be greater than costs.[496]

6.84 Evidence regarding STAL's negotiations with easyJet, the second largest airline at the airport, appears to show that these were less difficult than those with Ryanair. While the airline has indicated that discounts have been available, evidence from easyJet also suggests that **[✂]**[497] Based on recent discussions with STAL, the CAA also understood that the airport operator may have been relatively unconcerned with the movement of these aircraft away from the airport as it was 'not really that relevant in competition terms as it is one of 200 airports in Europe', and that it was an opportunity and an easyJet experiment that may not succeed.[498] However, the CAA has also seen other evidence that suggests that the airport operator considers that competitive tensions at the airport have increased in the past few years, including by increased capacity at Southend, and that it has entered into re-negotiations with easyJet (unsuccessfully) to deliver growth at Stansted following the movement of some of easyJet's planes to Southend.

6.85 The CAA considers that STAL's approach may suggest a (second degree) price discrimination strategy.[499] While price discrimination in competitive markets, such as cinemas or airlines, may increase consumer welfare, it can also lead to super-normal profits – and potentially abusive pricing – where firms have a considerable degree of market power.[500] STAL's behaviour of **[✂]** discounts for **[✂]** also suggests that the airport operator is again involved in (second degree) price discrimination towards its airlines in the form of **[✂]** discounts. These discounts appear to be targeted on a case-by-case basis, as each airline tends to face different costs in setting up routes which in turn each have different costs. In addition, **[✂]**.

6.86 More generally, evidence on pricing and negotiations suggest that STAL is able to undertake other (third degree) price discrimination.[501]

Assessment of negotiations and price discrimination

6.87 The CAA considers that the evidence suggests that STAL largely sets the terms that an airline will receive and that the scope for negotiation is relatively limited, an approach that appears to be different from its

[496] Source: STAL
[497] Source: easyJet
[498] Source: STAL
[499] Second degree price discrimination is when the firm has some knowledge of its consumers' distribution of preferences and offers different versions of its product according to the variation in their willingness to pay, leading consumers to self-select their consumption.
[500] The potential for STAL to price discriminate to earn super normal profit in the long run is only possible provided three general necessary conditions are met: (1) the firm has a degree of market power; (2) its consumers must be heterogeneous; and (3) no resale of the product or service must be possible between its different consumers.
[501] Third degree price discrimination occurs when a firm uses information about their consumers to price discriminate. For example, the airport's conditions of use show that it charges a higher tariff landing charge for the summer traffic seasons (the peak), when airline demand is greater, than for the Winter traffic seasons (off-peak). There is also variation in per passenger charges according to whether the destination is domestic, the Irish Republic, or another international destination until the current financial year where a uniform charge was levied.

neighbouring airports. The CAA also considers that the evidence suggests that the airport operator has adopted a deliberate strategy that aims to decrease the presence of some airlines at the airport in an attempt to improve the appeal of the airport to other airlines.

6.88 The CAA also considers that there is evidence that suggests that the airport operator can use price discrimination strategies towards its airlines. While price discrimination can occur in both competitive and less competitive markets, when the CAA considers that the airport operator can use price discrimination in conjunction with other evidence that shows the absence of negotiated long-term deals, that the airport operator is pricing to the cap and the absence of reasonable commercial negotiation between the airport operator and its airlines, this suggests that the airport operator may have the ability to set its charges higher than what would occur in a competitive environment.

Minded to conclusion on indicators of market power

6.89 While the individual indicators of market power may each suggest slightly different outcomes, when considered as a whole, we consider that, on the balance of probability, they suggest the airport operator has market power. In addition, the indicators suggest that it is more likely than not that the airport operator will have relatively more market power going forward, not least due to improving economic conditions and tightening capacity across the London airports.

6.90 In coming to this view the CAA recognises that relatively more weight can be given to some indicators compared to others. For example, at first glance the market share analysis suggests that Stansted has a strong market presence, however, this has to be considered in light of the limitations of market share analysis. Similarly, as Stansted is a regulated airport its financial performance, which we consider is broadly comparable to other UK airports (albeit on the low side), is unlikely to provide particularly strong evidence about the airport operator's market power. The same can be said for service quality and efficiency.

6.91 Indicators which the CAA considers may carry relatively more weight include price and the airport operator's approach to its negotiations. With respect to price, the CAA considers that notwithstanding some heavily discounted prices being offered in some negotiations, the evidence suggests that the prices at Stansted may be above the prices charged by other comparator airports and may be above that which would occur in a competitive environment. In addition, the airport operator's approach to its negotiations appears, in general, to be relatively one sided, with its strategic aims underpinning many of its discussions.

7. Summary of Test A

Introduction

7.1 The decision that the CAA is required to reach under Test A is whether the relevant operator has or is likely to acquire SMP in a market for one or more airport operation services. This section summarises the CAA's findings having considered the available evidence and analysis (both internally carried out and externally commissioned). Overall, the CAA presently considers that the evidence points to it being minded to conclude that STAL has SMP in one relevant market and is likely to acquire SMP in another one. The CAA invites comments on this view, as detailed in our Introduction.

Market definition

7.2 A necessary preliminary step is to identify the economic market or markets STAL is in. This provides the framework for analysing competitive constraints, whether they come from within or outside the market. The defined market forms the basis for the calculation of market shares. The CAA's current view is that STAL operates in two distinct markets[502], combining the product and geographic dimensions of market definition.[503]

- core aeronautical services[504] for LCCs and charter airlines covering a geographic market that includes at least Stansted, Luton, Southend and possibly Gatwick airports. We refer to this market as the Stansted short-haul market.
- core cargo aeronautical services[505] provided to cargo-only airlines at Stansted.[506] We refer to this as the Stansted cargo market.

7.3 This market definition is based on the combination of the views of airlines and airport operators on the substitutability of other airports for Stansted; evidence on switching behaviour; and the analysis of passenger preferences and behaviour. For example, airlines tend to view Stansted as having a core 60 minute passenger catchment. The CAA's own research suggests that 80 per cent of Stansted passengers are drawn from a catchment travel time of

[502] The CAA identified a third market: core aeronautical services for long-haul carriers and associated traffic. This market includes Heathrow and Gatwick. We note that STAL has the potential to operate in this market, given the nature of its facilities, but has to date failed to get a foothold within it. The CAA has seen no evidence to suggest that this may change in the short term.
[503] Note that at this stage, the CAA has not defined the markets for non-aeronautical services.
[504] These activities include facilitating the use of runway and taxi-ways, aerodrome ATC, aircraft parking, ramp handling services, fuel and oil handling, and aircraft maintenance, as well as the minimum activities required for the processing of passengers at the airport, the provision of a terminal and the facilities for check-in, baggage handling, security screening and the transit of passengers to and from the aircraft.
[505] These activities include facilitating the use of runway and taxi-ways, aerodrome ATC, aircraft parking, ramp handling services, fuel and oil handling, and aircraft maintenance, as well as the minimum activities required for the processing of cargo at the airport.

up to 90 minutes. The CAA also notes that the available evidence on price elasticities of demand (PEDs) for Stansted are in the range of 0.2-0.6. The CAA considers that taken in the round, this evidence suggests a relatively narrow geographical market.

7.4 The CAA also recognises that certain passengers' choice set, taking account of surface travel time and route overlaps, may include flights operating from Stansted and Heathrow and that this may develop in the future. For the purpose of present market definition, however, the CAA has attached more weight to the views and behaviours of airlines (particularly when supported by internal documents) than to catchment area analysis, to reflect the fact that they are the direct customers of the airports and could be expected to have a strong incentive to internalise their customers' switching behaviour. The CAA has also taken account of the fact that catchment area analysis does not itself provide direct evidence of passengers' propensity to switch in response to a price increase. It is also possible that, following the divestment of Stansted and the adoption of different management practices by the new owner of the airport, more airlines (and more passengers) may start to view Heathrow and Stansted as substitutes, particularly if STAL actively markets itself and attracts airlines from Heathrow airport in the future. However, there is considerable uncertainty as to the speed and extent to which such developments may take place. For these reasons, the CAA is minded to conclude that Heathrow airport is not in the same market as Stansted. The CAA has, however, considered the competitive interactions between the two airports as part of our analysis of airline and passenger switching.

7.5 In its Initial Views document the CAA questioned whether Stansted should be considered as part of a European wide market. However, upon reflection and further discussions with stakeholders, the CAA now considers that the market should not be defined as European wide because the competitive constraints posed by airline switching (or threat of switching) to European airports from UK airports including Stansted appears to be relatively weak and the CAA has found little evidence of actual switching of established airline capacity from London airports to European airports. Where there has been such switching, the evidence suggests that it has not constrained STAL's behaviour.

Strength of competitive constraints on the airport operator's behaviour

7.6 After defining the relevant market the CAA needs to reach a judgement on whether there are sufficiently strong competitive constraints (from within and outside the relevant markets) such that STAL cannot profitably raise its charges above what might be considered the competitive price.

Airlines' and passengers' ability to switch

7.7 In principle, the airport operator's ability to exploit market power could be constrained by the switching behaviour of airlines, passengers or both. The

CAA has first considered whether different categories of airlines were constrained in their ability to switch, then examined passengers' ability to switch.

7.8 Starting with the ability of airlines to constrain STAL's behaviour through switching, the CAA considered the switching costs they face and other factors (in particular strategic and capacity constraints) affecting their ability to switch; the scale of switching required to constrain STAL's behaviour; and actual behaviour following the significant price increase that was implemented in 2007.

7.9 The evidence the CAA has seen suggests that switching costs faced by Stansted's airlines are relatively low, even for LCCs with aircraft 'based' at Stansted. Airlines including LCCs have significantly reduced their movements at Stansted over the past few years (c.191,522 ATMs in 2007 to 136,899 in 2012). Some airlines channelled capacity growth to other airports in Europe. The response of STAL to the actual withdrawal of capacity or threat of switching by both easyJet and Ryanair however appears to have been muted. Evidence tends to suggest that this may have been for strategic reasons, the airport operator trading short-term losses for potential long-term gains.

7.10 In order to constrain the airport operator from profitably raising prices above the competitive level in the planning period for Q6, the CAA's critical loss analysis suggests that airlines would need to withdraw a significant further amount of capacity - equivalent to Ryanair removing 2 to 4 of its based aircraft (across the year) out of its current total[507] of 39. This can be achieved mainly by switching based aircraft to other airports or grounding based aircraft. The availability of spare capacity at peak time[508] is key to the business of LCCs (particularly early morning departures). In practice, however, LCCs with based aircraft at Stansted (especially Ryanair, less so easyJet) appear constrained in their ability to switch significantly more based aircraft. This is because switching them away from serving London is limited by the strategic importance to their business models of needing access to London; while capacity constraints at other London airports mean they do not have the option to switch away from Stansted and still serve London. STAL recognises[509] that it is the only airport in London currently capable of accommodating new daily services at peak hours.

7.11 With regards to passenger switching, although there are significant overlaps between passenger catchment areas in the London system, which would suggest that passengers have significant choice, their sensitivity to increases in airport charges (as opposed in increases in airfares) is relatively low and taking into account the availability of equivalent flights at other airports, we are of the view that only a relatively low proportion of passengers would in

[507] The average for January 2012 is 25
[508] Peak at Stansted is made up of four waves of arrivals and departures throughout the day.
[509] **[✂]**

practice be prepared to switch to another airport in response to a rise in the charges levied by Stansted on airlines. This may imply that not enough passengers would choose to switch to another airport in order to constrain airport operator pricing.

Indicators of market power

7.12 Stansted has a 66 per cent share of the relevant passenger market excluding Gatwick airport and 30 per cent including Gatwick airport. The first of these two measures would support a rebuttable presumption of dominance, while the second would be below the level that normally supports such a presumption. There are, however, a number of reasons to consider market shares may not be a reliable measure of the level of market power of airports and these results must be read within that context.

7.13 The CAA considers that STAL's profitability, pricing behaviour and efficiency records are relevant to this assessment. Whilst recognising there is some uncertainty and judgement in how to interpret the evidence, it would appear that there is doubt whether competitive constraints are strong enough to discipline STAL's pricing behaviour because of its existing based airlines needing access to the morning peak to be able to utilise fully their aircraft throughout the day with a number of 'turns' (e.g. Ryanair).

7.14 STAL is broadly pricing to its regulated price cap and has been doing so since 2007/08 (with a small under-recovery). In 2007, as contracts with Ryanair and easyJet came to an end, "*BAA decided not to extend the discount that Ryanair had from published tariffs to support the business case for the second runway*[510]". The airport operator consequently started to charge its largest customer, Ryanair, the full regulated price. The CAA cannot conclude that STAL is making excessive profits (but the CAA would not expect it to, under the current regulatory regime): its performance across the profitability benchmarks has been mixed, but in general its recent performance has been in line with other UK airports. The unwinding in 2007 of the large discounts that had been negotiated in 2001 was profitable for STAL for some time. However, the increase in profitability was eroded with subsequent traffic reductions. This reduction in profitability could be a response to the price increase and/or a consequence of economic pressures that bear on many other UK airports, particularly ones serving LCCs, and the reduction is in line with trends at such airports.

7.15 STAL has offered significant discounts to attract new airlines or new traffic in off peak periods but these pricing initiatives have not generally been taken up by the airlines. Several reasons have been suggested for this including the (large) presence of Ryanair. The airport operator has not to date offered significant discounts to existing airlines despite the decline in overall traffic. Several reasons have been suggested for this including its market power

[510] Source: STAL

over these airlines especially those needing to be based at Stansted to use the morning peak and then fully utilise the aircraft throughout the day.

7.16 There is some uncertainty over what should constitute a competitive price benchmark for STAL. Much turns on the peer group chosen and other factors. The CAA's preliminary benchmarking in February 2012 suggested that STAL's pricing might be more or less in line with benchmarks, but there were weaknesses in the methodology adopted. The CAA commissioned an independent benchmarking study that shows that STAL's prices are likely to be above the level of comparator airports. Although caution should be used in the interpretation of such benchmarking given the inevitable difficulties of obtaining like for like comparisons, the CAA considers that the methodology adopted in this study is reasonable.

7.17 The CAA has seen no evidence that competitive constraints have driven significant efficiency initiatives that Stansted has pursued. In contrast, there is evidence that the airport operator has been responding to the regulatory initiatives in this area.

7.18 In interpreting the evidence provided the CAA is mindful of the unique circumstances within which STAL and its airlines have been conducting business in the past three years: the combination of a deep recession and the uncertainty linked to the forced sale of Stansted may have artificially distorted the incentives and behaviours of both the airport operator and its airlines. The CAA is also mindful of the distortions of STAL's behaviour that may have been due to its joint ownership with Heathrow airport, and have seen evidence that this may have dulled its incentives to market itself aggressively despite having considerable spare capacity at certain times of the day.

Future competitive constraints

7.19 The CAA has seen some evidence from internal company documents that STAL may be trading off a short-term decline of profitability for long-term gains: in developing its plans, the airport operator took account of Ryanair's limited ability to move based aircraft out of Stansted and the airport operator appeared confident that the airline would eventually start to grow at the airport again. The CAA has seen evidence of concerns about the challenges posed by the strong presence of Ryanair at the airport, including its deterrent effect on potential new airlines[511], while STAL has stated that it is conscious of **[✂]**[512] With regards to easyJet's move of three aircraft to Southend airport, STAL saw this as a tactical decision and expected that easyJet would eventually return to Stansted, having been unsuccessful at Southend airport.

7.20 To the extent that it is currently subject to a constraint from the threat of switching of marginal aircraft to European airports, STAL's Information Memorandum notes:

[511] Source: Wizz Air
[512] Source STAL

"A key opportunity for Stansted over the next few years will be to capture additional traffic as LCCs pull back from markets in Southern Europe in response to enforced cut-backs in the level of government incentives". [513]

The CAA considers that this is evidence that STAL anticipates that the competitive constraints on it from this source will weaken.

Conclusions on minded to assessment of Test A

7.21 The most likely source of any substantial market power possessed by STAL would appear to stem from the inherent attractiveness of the London market and its strategic importance to airlines in general and easyJet and Ryanair in particular, combined with capacity constraints in the London system, which reduce the number and size of available alternatives. This is especially the case for LCCs that are based at Stansted and require access to the morning peak to be able to fully utilise their aircraft throughout the day (e.g. Ryanair).

7.22 The indicators of Stansted's present market power show a mixed picture. Market shares support a presumption of dominance if the market excludes Gatwick airport; but this is not the case if Gatwick airport is included. With the limitations of using market share analysis other indicators have been assessed. There is no evidence of excessive profits, which would be expected of a regulated airport. Also, the presence of regulation complicates the conclusions that can be drawn from looking at efficiency and service quality. The CAA has taken into account that STAL is pricing to its regulatory price cap and there are indications that these prices are at, or above, what might be considered a competitive level.

7.23 Taken in the round, the CAA considers that STAL has a level of market power at present that *may* be substantial in relation to the provision of core aeronautical services to LCCs.

7.24 There are reasons, however, to believe that over 2014-2019 capacity constraints will tighten further to result in a 'spill' of traffic from other London airports to Stansted, which may further weaken competitive constraints on STAL. STAL's recent internal strategy documents forecast Stansted traffic will grow to **[✂]** mppa by **[✂]**. STAL's Information Memorandum for its sale process suggests that traffic will reach **[✂]** mppa by **[✂]** and **[✂]**[514] mppa by **[✂]** (compared to 23.8 mppa at the 2007 peak).

7.25 STAL itself expects significant improvements in profitability driven at least partly by capacity constraints at Heathrow and Gatwick airports leading to significant passenger growth and increased aeronautical revenue per passenger. STAL also sees future deregulation as "*a significant lever for the long term that will allow recovery of part of the return in the future (when*

[513] Source : STAL
[514] A forecast was presented in the Daily Telegraph: http://www.telegraph.co.uk/finance/newsbysector/transport/9608307/Stansted-airport-owner-admits-it-could-be-run-for-5m-less.html.

utilisation is higher)..."[515] Given the absence of government support for new runway capacity in the south east and the lead-time for the development of such capacity if and when such support is given, it appears likely that STAL's position of substantial market power based on these capacity constraints may be sustained for some time.

7.26 The CAA acknowledges that the development of competition among London airports is still in its early stages with the relatively recent transfer of Stansted and Gatwick airports to their new owners. The legacy of joint ownership of these airports and Heathrow has had an influence on the extent of current rivalry among the main London airports in terms of how they are perceived by passengers, existing patterns of use and consequently the willingness of passenger and airlines to switch. It remains to be seen how the market will develop over future years and how it will fulfil the potential for competition that the Competition Commission saw when it recommended the sale of Stansted and Gatwick.

7.27 The CAA is presently minded to conclude that in relation to the provision of core aeronautical services to LCCs, STAL holds a degree of market power, which may currently be substantial, and is likely to become substantial in the course of Q6.

7.28 In relation to cargo services, the CAA has received consistent and credible evidence from STAL's customers that access to London is essential to their operation and that they have no ability to switch to other airports. The CAA is therefore minded to conclude that STAL currently has substantial market power in the Stansted cargo market. The CAA will, however, further consider whether the ability of downstream customers to switch from cargo-only carriers operating from Stansted to bellyhold carriers operating from other London airports could indirectly constrain the behaviour of STAL.

7.29 The CAA recognises there is a degree of uncertainty in its analysis of Stansted. Looking over the planning period for Q6, changes might be brought about by new ownership once the airport is sold. Also there are uncertainties over the future evolution of economic growth, and hence passenger traffic, in the UK and London region. These factors could impact the analysis of competitive constraints. Moreover, the airline market is dynamic and passenger preferences could change over time, hence the market definition could evolve.

7.30 The CAA is using this consultation to invite views on its 'minded to' assessment. It particularly invites stakeholders to provide any further evidence they consider relevant to the CAA's final decision and their views on the relative weight the CAA should attribute to various pieces of evidence.

[515] Source: STAL

SECOND PART: TEST B

8. Test B: The application of competition legislation to airport operators with substantial market power

8.1 In this section the CAA sets out its general approach to the application of Test B to operators of airports with substantial market power (SMP) and then give its view on whether, in relation to STAL, Test B is met. The three tests within the market power test set out in the proposed CA Act are cumulative therefore the CAA only anticipates examining the further airport-specific arguments around Test B if the relevant operator has met Test A.

About Test B

8.2 Section 6(4) of the CA Act 2012 describes Test B:

"that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that substantial market power".

8.3 Section 6(8) of the CA Act goes on to say:

"For the purposes of test B conduct may, in particular, amount to an abuse of substantial market power if it is conduct described in section 18(2)(a) to (d) of the Competition Act 1998" (CA98).

8.4 Section 6(9) of the CA Act says: In test B "competition law" means -

a. Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU);

b. Part 1 of the Competition Act 1998; and

c. Part 4 of the Enterprise Act 2002 (market investigations).

8.5 Section 18(2)(a) to (d) CA98 lists four behaviours that amount to an abuse of a dominant market position, these are more commonly referred to as the Chapter II prohibitions:

a. directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;

b. limiting production, markets or technical development to the prejudice of consumers;

c. applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

d. making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts.

8.6 The CAA's focus in applying Test B is, in line with its duties under section 1 of the CA Act, on what will further the interests of passengers and cargo owners and also on what, where appropriate, will promote competition in the provision of airport operation services.

8.7 Test B is written in terms of behaviour that amounts to an "abuse of substantial market power"; and it is explicitly set out that this will in particular include abusive conduct as defined by CA98 which prohibits behaviour that amounts to an "abuse of a dominant position." The concept of abuse of substantial market power would therefore seem in principle to have a potentially wider scope than abuse as defined in section18 (2) of CA98. The CAA's approach to such conduct under regulatory powers and via the deployment of competition powers is different and Test B ensures that conscious consideration is given to what will be the better approach to avoiding the detriment to users that can come from such anti-competitive conduct.

8.8 In the context of STAL, this will involve looking at what mechanism will better address the risks that flow from the CAA's findings under Test A. The CAA currently considers that in relation to the provision of core aeronautical services to LCCs, STAL holds a degree of market power, which may currently be substantial, and is likely to become substantial in the course of Q6.[516] The CAA also considers that (subject to further examination of some aspects) the airport operator currently has substantial market power in the Stansted cargo market.

8.9 As set out above, Test B focuses attention on the ability of competition law to act as a general constraint on the commercial conduct of airport operators and in particular to discipline against the risk of behaviour that would amount to abusive conduct. The CAA is therefore required to evaluate the efficacy of these constraints on the commercial behaviour of airports so as to reach a view on whether further incremental regulation is required to mitigate the risks of the abuse of a dominant position.

8.10 Competition law already applies fully to all airport operators within the UK and even in the event of regulation continuing or being introduced by an operator at an airport deemed to have passed Test A, the airport operator will still be subject to it. Neither UK nor EC competition law prohibits market power or dominance – it is the abuse of dominance that is prohibited. Competition law has established the principle that where a dominant party exists in a market, the competitive structure of that market is already impaired.[517] Competition law cannot be expected to prevent all possible abuses of market power just as sectoral regulation cannot mitigate all the risks posed by a dominant operator. The assumption underpinning Test B is that there may be cases where, given the risks of harm or damage, the application of existing competition law and the enforcement tools that support

[516] Paragraph 7.22-7.24
[517] Case 85/76, *Hoffman-La Roche & Co AG v Commission* [1979] ECR 461.

it after an abuse has taken place can be judged to be adequate to offset the risks posed.

8.11 The fact that an undertaking enjoys a dominant position, and therefore has the power potentially to behave independently of competitors and customers does not have the inevitable consequence that its practices are necessarily abusive or even that its practices are likely to be abusive. This is seen across the economy where there are a number of undertakings that may be regarded as having a dominant position but are not subject to any form of *ex ante* regulation.

8.12 Similarly not all exploitation of market power is necessarily problematic. Taking advantage of a temporary situation of market power is considered part of the incentive mechanism of a well functioning, dynamic economy. High prices and high profits often signal scarcity, and can play an important role in rewarding previous investment, guiding future investment, incentivising entry and efficiently matching demand to available supply in the short term. Only when the adjustment process (by which the development of additional or alternative services tends to erode the high prices/profits) is blocked or severely impeded in some way or other, such that exploitative behaviour can be sustained in the longer term, are the economic effects likely to be adverse.

Other regulation of airport operators

8.13 In broad terms, Test B invites a comparison of the situation with a licence to the situation without a licence. Competition law is not the only set of rules that would apply in either event. Additional sectoral regulation exists in the form of the Groundhandling Directive (GHD)[518] implemented in the UK as the Airports (Groundhandling) Regulations 1997 and the Airport Charges Directive (ACD)[519] (implemented as the Airport Charges Regulations 2011).

8.14 In general terms, the CAA does not consider that these provisions are relevant to Test B. This is because the test focuses solely on the effectiveness of competition law compared to a licence; these regulations are not part of competition law as defined by the CA Act.

8.15 However, these regulations do contain provisions that might address some aspects of behaviour amounting to abuse of a position of substantial market power, even though they do not per se prohibit it. The CAA will therefore give appropriate consideration to their role in the regulatory framework with regards to Test C when weighing the costs and benefits of the application of economic regulation under a licence issued by the CAA.

[518] Directive 96/67/EC Groundhandling
[519] Directive 2009/12/EC Airport Charges

Previous considerations of Test B

8.16 As summarised in the Q6 Policy Update[520] sole reliance on general competition law has attractions as it brings airport regulation into line with the level of economic regulation applied to the vast majority of companies in the wider economy. However, for an airport operator that has substantial market power reliance solely on competition law may be sub-optimal for users.

8.17 It is therefore important, given the CAA's duties under section1 of the CA Act, to consider where there are features of the operation of airports that may significantly impair the ability of competition law to remedy any issue for airport operators deemed to have substantial market power.

How the CAA will assess Test B

8.18 In applying Test B, the CAA considers that it should seek to answer the following question:

- Whether applying the legal tests required by competition law to the situations that might arise based on our assessment of market power in a given case, will ensure that the identified risk to the interest of users of airport operational services is addressed in a timely and comprehensive manner.

8.19 This may in particular require the CAA to consider whether there is a risk of conduct that competition law may not suitably address.

8.20 It is important to be aware of the risk of over-intervention. This might arise in particular because of temporary market power. As noted in paragraph 8.12, in the CAA's view, temporary market power is unlikely to act in the long run against the interests of airport users, unless associated with other signs of market mal-function.

The aims of *ex ante* regulation vs. the aims of *ex post*

8.21 Before considering the application of competition law it is worthwhile considering the aims of competition law in comparison with the aims of regulation as these are generally quite different. Competition law is set in place to protect competition within markets and it is often referred to as ex-post in nature: that is, action is taken after anti-competitive conduct and the consequent harm to competition has occurred. On the other hand regulation is put in place to open up markets to allow for the development of competition and hence it is often referred to as ex ante, as action is taken before the event to mitigate the impacts of substantial market power on competition. In this sense ex ante regulation could be considered to be holding the fort until competition arrives. Even in the case where competition is unlikely to arrive,

[520] CAA (2012) '*Review of Price Regulation at Heathrow, Gatwick and Stansted Airports ("Q6"): Policy Update'*, May 2012 available online URL: http://www.caa.co.uk/docs/5/Q6PolicyUpdate. pdf

regulation should as far as possible mimic the conditions a firm would face in an effectively competitive market. The difference between the two has been highlighted by Ofcom in its consideration of the sufficiency of competition law within the telecoms markets:

"Ex-post competition law is [. . .] unlikely within itself to bring about effective competition, as it prohibits the abuse of dominance rather than the holding of a dominant position. In contrast, ex-ante regulation is normally needed to promote actively the development of competition. Ex-ante regulation attempts to reduce the level of market power in a market, thereby encouraging effective competition to become established".[521]

8.22 This quote highlights that in the face of substantial market power there needs to be consideration of the likelihood of the development of competition within the markets in which the dominant firm operates. In instances where competition is unlikely to arrive over the medium term, regulation is better suited to aiding its development as it can curtail the risks of abusive behaviour before the behaviour emerges.

8.23 There are a number of markets where it is judged that competition may never arrive. In a number of markets, especially network industries, there has been a level of unbundling of services, where sections of the pipeline that can be competitive are separated from those that cannot. This usually leaves the provision of the network as the monopoly bottleneck where the assumption is that competition will never develop and regulations will be needed in perpetuity.

8.24 In a limited number of cases competition law can act ex ante where it is judged that there is likely to be a threat of irreparable damage to competition. Action can be taken before the cases are concluded through interim measures. The key point here is that the competition law mechanism is only likely to be triggered where a complaint has been raised and the behaviour is such that competition is likely to be irreparably foreclosed prior to a resolution of the main investigation[522]. Competition law can also have a forward looking impact where it sets a valuable precedent. Taking a single case within a particular industry where a breach of competition law has taken place may be sufficient to deter similar behaviour in the future. Indeed in its 'Competition prioritisation framework' (2006) the OFT states precedent as one of its considerations for taking a case forward.

8.25 Alternatively, where the relevant competition authority has reasonable grounds to suspect that there are market features which may prevent, restrict or distort competition, but where the authority does not believe there is evidence sufficient to establish a breach under CA98, or where it considers that action under CA98 has been or is likely to be ineffective to deal with the

[521] Ofcom (2012) Business Connectivity Market Review: Review of the retail leased lines, wholesale symmetric broadband origination and wholesale trunk segments markets, Annex 6: Regulatory Framework.
[522] In its reforms the Department for Business, Innovation and Skills is seeking to lower the threshold for which interim relief can be applied.

adverse effect on competition identified the authority may refer a market to the CC under sections 131 and 133 of the Enterprise Act 2002. Rather than examining the conduct of a single firm in a market, market investigation references focus upon the functioning of a market as a whole looking at features such as non-collusive oligopolies or the effect of regulations or Government policies.

8.26 However, there are situations where intervention using either form of competition law may not be effective. For example:

- a situation of emerging SMP may not satisfy the test of dominance at the time an assessment under the CA98, Article 102 of the TFEU is carried out. There may however be legitimate concerns that there is a risk of abuse of dominance in future. A market investigation under Part IV of the Enterprise Act 2002 is not designed to address conduct-based concerns rather it is designed to focus on remedying features of a market that have adverse effects on competition. Where an airport operator is likely to acquire SMP, ex ante regulation to place proportionate safeguards in place before irreparable damage to efficient competitors and consumers occurs may be the more effective option;
- it is possible that the abusive conduct will not fit neatly into the formal tests developed by competition law; for example, disputes about access to facilities would, under competition law, have to be tackled by applying the legal tests relating to the "essential facilities" doctrine and would usually produce a ruling based on the effect on access for a particular complainant. By contrast the development of a regulatory safeguard may be a greater aid in opening the market. This was, for example, the approach of the European Commission in seeking to open up the market for airport groundhandling services via the regulatory mechanisms in the GHD;
- intervention after the event will not compensate the competitors or customers of a dominant operator for the loss/prevention of competitive advantage or may not offer remedies that are well suited to the problems that have arise in the market. An infringement decision under CA98, Article 102 of the TFEU would not necessarily lead to an across the board remedy aimed at the sector as a whole. Any remedy would focus on a narrow range of affected parties. Remedies that are wider in scope might be achieved via a market investigation but as noted market investigations can only target features of a market rather than the behaviour of an individual firm.

8.27 In 2007, a market reference was made by the OFT in relation to the supply of airport services by BAA in the UK. In its decision, published in March 2009, the CC commented[523]:

"Even under separate ownership [for Heathrow, Gatwick and Stansted airports], 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".

8.28 This highlights that even after the application of a significant competition remedy[524] there can still be concerns over the future behaviour of firms that are considered to have substantial market power. It also points out that for some undertakings, the competitive conditions may be such that it is never appropriate to rely solely on competition powers. This is more apparent in markets where there are significant network externalities such that two or more suppliers would likely be less efficient than a single supplier of the product or service.

8.29 The discussion above suggests that, where the CAA considers that a firm has substantial market power and competition is unlikely to develop over the medium term, the CAA should seek to impose regulation as competition law on its own may be inefficient. Where the CAA considers that a firm has substantial market power but is facing nascent competition, regulation should continue to be applied to aid the development of that competition. In both of these cases the CAA would be seeking to foster the development of competition and to protect users.

8.30 As a result of its examination to date of market power in relation to Stansted, the CAA is minded to consider that STAL's market power is likely to become substantial over the coming years. The likelihood of sufficient competition to discipline the airport operator developing over the medium term therefore appears to be limited. In this context some form of *ex ante* regulation is likely to prove beneficial in aiding the development of competition within the markets where STAL holds or is likely to acquire a position of substantial market power under Test A.

[523] Competition Commission (2009) BAA airports market investigation: A report on the supply of airport services by BAA in the UK.
[524] It should be noted that the remedy imposed by the CC on BAA as a result of its market investigation findings could not have been achieved through regulatory powers under the Airports Act 1986 or the CA Act. Remedies such as those applied are only available to the CC and the powers given to it under the Enterprise Act 2002.

The application of competition law to airport operators

8.31 The ability of competition law to deter prohibited conduct has been developed through case law where the general prohibitions have been applied to individual commercial circumstances triggering penalties.

8.32 The two main concerns of competition law as it applies to the conduct of dominant parties (the focus of Test B) are exclusionary and exploitative abuses. Exclusionary behaviour can be concerned with both horizontal issues such as predatory pricing and vertical issues such as margin squeeze.

8.33 Exploitative practices consist mainly of the charging of excessive prices to customers (although in principle they could also concern the provision of suboptimal quality of service or product). Competition authorities have found such cases to be problematic both in principle and in practice. This is explored in more detail below.

8.34 There are a number of precedents for the direct application of competition law to airport operators which is examined briefly below. It is also possible, where appropriate, to read across from differing industries facing similar issues. In a UK context, with concurrent powers available to a number of sectoral regulators, there has been the application of competition law in other regulated sectors[525]. As such, there is a body of precedent to provide guidance on behaviours within this area.

8.35 As noted above there are a range of cases that have been taken under community law against airport operators.[526] It is of note that where exclusionary behaviour has been considered in relation to airport operators, the airport operators in question have had an interest within the downstream market. Each of the cases were concerned with exclusionary practices and the airport authority had put in place a range of discounts from the tariff price the impact of which was to provide a competitive advantage to domestic carriers. As such, the three cases are typified by a strong single market imperative on the part of the competition authority to tackle situations where the operator of the domestic (generally state owned) airport was pricing to protect the domestic (generally state owned) airlines.

8.36 In all of the cases the airports authorities had clear reasoning for the EC application of the discriminatory pricing. However the CC considered that the justifications provided were not objective or not related to the charges levied. In each of the cases, the Commission considered that the airport operator had breached community competition law by applying dissimilar conditions to similar transactions. Given the significant discounts available to based carriers in the Brussels airport case the decision stated:

"While most of the abuses committed by undertakings in a dominant position are designed to maximize their profits or strengthen their dominance, Article

[525] For example, see Office of the Rail Regulator infringement decision in respect of English, Welsh and Scottish Railway.
[526] Commission decision 95/364/EC, Commission decision 1999/199/EC, Commission decision 1999/198/EC.

86 also applies to cases in which an undertaking in a dominant position discriminates against its partners for reasons other than its own interest. This may involve, for example, giving preference to another undertaking from the same State or to an undertaking which is pursuing the same general policy." [527]

8.37 The quotation crystallises that even without a downstream presence airports that favour a particular airline or group of airlines can in principle face sanction under the competition law regime[528]. This point is highly relevant to the UK context it is now the rule rather than the exception that airport operators have little presence within the downstream markets which they serve. Generally they are neither closely allied with airlines nor do they participate significantly in groundhandling activities.

8.38 Where there is downstream presence, the application of competition law can restrain the leveraging of power in the upstream market. For example, a breach of CA98 was contended against an airport operator in Purple Parking v Heathrow Airport Limited (HAL)[529] in the context of private commercial litigation. The allegation was based on an abuse of dominance by HAL in the downstream market for 'meet and greet' valet parking. The court found that HAL had abused its dominant position in the market for the provision of airport facilities at Heathrow airport to the advantage of its subsidiary Heathrow Valet Parking, by seeking to exclude competitors from the use of the Terminal 1 and 3 forecourts.

"In taking the steps that it took, HAL was relying on the situation that it had produced in byelaws with the force of the criminal law. Because of the position which HAL occupies at Heathrow it is in a position to control access through byelaws and not merely through the enforcement of proprietary rights. In my view that makes no difference. That is merely the control mechanism, and its position as the maker of byelaws merely gives it another method of control, and not a special method of control which is exempt from the effects of competition law. " [530]

8.39 With regards to exclusionary behaviours of the type discussed above, the case law suggests that they could be tackled adequately by competition law alone. However, the CAA would have to consider whether an investigation, which would typically be prompted by the concerns of a particular complainant would produce a solution was sufficiently comprehensive and also that it would be a swift enough process to ensure irreparable harm to competition in the market did not occur. It may also be appropriate to look to licensing under the CA Act where there are concerns around issues such as cross-subsidisation supporting exclusionary behaviour and the optimum solution would be one which would allow the underlying accounting to be examined. This may be better achieved by an appropriately focused form of

[527] Commission Decision 95/364/EC paragraph 17.
[528] See also Commission decision 98/513/EC; T-128/98 and C-82/01 Commission decision 98/190/EC.
[529] Purple Parking & Anor v Heathrow Airport Limited [2011] EWHC 987 (Ch).
[530] Purple Parking & Anor v Heathrow Airport Limited [2011] EWHC 987 (Ch) para 240.

ongoing information requirements delivered via a licence so as to tackle any underlying asymmetry of information.

Exploitative behaviour

8.40 Exploitative behaviour can take many forms. Relevant abuses within airport operations are likely to include abuses in relation to price, service quality and quality of the product (i.e. under investment in facilities). This section explores these abuses in turn.

Excessive pricing

8.41 It is generally recognised that excessive pricing cases are amongst the most complex and difficult competition law cases to pursue. This is reflected in the low number of court judgments in this particular area. In United Brands[531], the lead case, the Court of Justice recognised that "charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied would be such an abuse".

8.42 The court proposed a two limb test; it should be shown that i) the price cost margin is excessive and ii) the price imposed is either unfair in itself or when compared to competing products. However the decision did not provide bounds above which prices would be deemed excessive. This test has formed the framework in the assessment of excessive pricing in the cases that have followed.

8.43 The United Brands case highlights the key issue of determining the appropriate price against which to measure whether there is excessive pricing above that level. There are a number of issues that affect the accurate measurement of the appropriate price. [532]

- A key challenge is that firms normally record their costs in a format designed for financial presentation rather than economic evaluation. When assessing prices from an economic perspectivethe CAA is concerned with the marginal costs of production, which is not needed for standard accounting purposes. Therefore cost data from firms may need to undergo some form of transformation.
- Where a firm supplies a number of products over a number of areas, such as an airport, there is an issue of cost allocation and cost recovery. There is no correct methodology for the allocation of common and sunk costs within a business. Based on two differing sets of clear and objective criteria the costs of a firm may look significantly different. For example airport costs derived from the perspective of passenger use may look different from those derived from the perspective of airline use but may both be based on a rational allocation.

[531] United Brand v the Commission, Case 27/76. The finding of abuse was not upheld on appeal for lack of evidence establishing excessive pricing against the legal test the court had articulated.
[532] Lyons B (2007), The Paradox of the Exclusions of Exploitative Abuses, in: Swedish Competition Authority (ed), The Pros and Cons of High Prices, pp 65-87 url:

- Finally, few products are charged on a basic unit cost. Costs are often dependent on volume or have multiple components. This is especially an issue at airports given the bundle of goods that are purchased by airlines. The nature of costs at an airport is such that there is a high fixed cost of provision therefore on a unit basis costs can decrease at a significant rate as volume rises.
- A further challenge is that competition law investigations into conduct necessarily focus on a point in time or at least a fixed period. Making a robust assessment of cost information in this context can be difficult as it may not always be possible to gain robust information on past events.

8.44 In such a context a licence based regulatory solution can allow measures to address asymmetry of information. This includes but is not limited to the provision of information and accounts conditions.

8.45 Another key issue that was raised in the United Brands case is that of total economic value. This can take in such matters as brand appeal based on attributes such as the reputation of the airport as a hub or as a holiday, business or low cost carrier airport. Similarly, an airport being situated by a major city provides additional value in terms of access for the airlines' target market. These components add up to the economic value of the service rather than the basic accounting value of the immediate costs of provision. Finding a credible value for these can prove difficult in practice.[533]

8.46 Another issue for the consideration of excessive pricing is the role of high prices in the competitive process. As noted above, high prices can be part of the mechanism of a well functioning market where they encourage entry by equally (or more) efficient competitors and are eventually competed away. A core question is whether it is likely that, given the particular market dynamics, the high prices are likely to drive entry. Therefore an assessment of price over an appropriate time period rather than a simple consideration of the spot price is important. Further, prices play a role in rewarding investment and innovation, either of which can be damaged if the dominant firm considers it cannot gain the appropriate compensation. The market setting therefore plays an important and variable role in the assessment of excessive pricing. This can mean looking beyond whether a price represents a covering of costs plus a reasonable rate of return to taking proper account of the wider market context.[534]

8.47 Finally an issue that has been cited with regards to excessive pricing has been the reluctance by competition authorities to prescribe clear upper limits for market prices. This stems in part from the lack of specialised knowledge of specific industries and in setting what would effectively be a form of price control. This has traditionally been viewed as a rather different activity from

[533] See Scandlines SverigeAB v Port of Helsingborg Commission Decision of 23 July 2004 [2006] 4 CMLR 1224, paragraphs 241-242.
[534] AtTheRaces v British Horseracing Board [2007] EWCA Civ 38, [2007] UKCLR 309. In the original hearing at the High Court excessive pricing was upheld, however it was quashed in the Court of Appeal.

competition enforcement.[535] Given that the CAA will have concurrent powers as well as its responsibilities as the sector regulator the CAA does not see this as a critical factor in assessing the merits of competition law in the context of Test B. Assuming that where appropriate, the CAA would be able to regulate prices if such a remedy was required.

8.48 However, it will be important to consider whether the flexibility of a licensing regime may be better adapted to address the full sectoral implications of pricing issues or whether the imposition of fines and/or directions aimed at pricing conduct or price-focused market investigation remedies are sufficient.

8.49 It is of note that there have been some infringement decisions with regards to excessive pricing.[536] This highlights that competition law enforcement based on excessive pricing can be the appropriate prism through which to tackle some types of commercial behaviour. However the precedent value may be limited as the cases contain quite specific circumstances which negated a number of the difficulties associated with the United Brands tests. The CAA is minded to consider that the evidential threshold for a finding of infringement based on excessive pricing limits the ability of competition law to discipline this behaviour. Given the nascent development of this area the uncertainties associated with this type of investigation are high. As competition law develops in this area through both domestic and European case law the CAA will adjust its approach accordingly.

Exploitative quality abuses

8.50 Service quality performance has been a concern at airports where the operator is considered to have SMP. The CC has on a number of occasions found that airports have acted against the public interest. For example in its recommendations for Q5 at Stansted the CC found:

"[Security queue] performance has been sufficiently poor to merit a public interest finding and that new standards for security queue performance should be imposed... [Further service quality] performance overall has been declining...We have concluded that targets based on measures of customer satisfaction... should be included in the SQR regime[537]".

8.51 To the CAA's knowledge no competition law cases have been pursued on the basis of an exploitative abuse arising from service quality or product quality. Therefore, where there are concerns about abuse arising from service quality the CAA would be breaking new ground as a concurrent competition law enforcement authority in deploying competition law tools in the event that such a possible abuse was identified.

[535] OCED (2011), Excessive Prices, Background paper for Working Party No.2 on Competition and Regulation, url:http://ssrn.com/abstract-1946779
[536] Case 2001/893/EC; Napp Pharmaceuticals Holdings Limited and subsidiaries – OFT CA98/2/2001 decision upheld at appeal CAT/1001/1/1/01, and more recently case brought by the Italian Competition Authority against Roman and Milan airports.
[537] Competition Commission (2008) Stansted Airport Limited: Q5 price control review, Appendix N, 23rd October.

8.52 As discussed above, there are a number of challenges associated with the measurement of excessive pricing. The decided cases shed light on the difficulties of finding an appropriate measure for this type of exploitative conduct. The assessment of quality abuses is likely to be more difficult. For such cases not only are there issues with assessing price present but additional challenges are likely to arise as quality or the perception of quality is subjective in nature, fluctuating with both the price charged and income of those in receipt of the service. As discussed below, there are also issues with regards to quality of product in terms of limiting capacity resulting from the operating environment.

Summary

8.53 The discussion above seeks to highlight that there are issues with regards exploitative abuses resulting from the burden of proof necessary and the application of a legal test with poorly defined benchmarks of economic value and an assessment of what is considered to be unfair.

8.54 The CAA has also considered that there are a number of issues of particular relevance at airports, such as catchment area, associated brand, lack of downstream presence, and network externalities that may make an evaluation of economic value particularly difficult.

8.55 The CAA has reviewed the level of pricing at Stansted as part of its assessment of Test A. The CAA notes that STAL has historically not priced up to its regulatory price cap but has done so in the last few years. The analysis from Test A suggest that STAL may currently be pricing at a supra competitive level

8.56 That said, the CAA does not consider these aspects of competition law to be a barrier to deregulation as it clearly is an available tool. However where an airport operator is deemed to have substantial market power, the application of some form of regulation may prove to be incrementally beneficial.

Government intervention

8.57 In all major infrastructure projects within the UK, whether it is roads, railways, ports, electricity or communications networks, Government usually plays some role in either funding or planning. Airports are not an exception to this rule. The development of capacity at an airport is affected by a number of issues including planning laws and restriction from national and local government. A clear example of planning restrictions has been in place at Gatwick airport since 1979 and will run until 2019 forbidding the development of a second runway. [538]

8.58 Capacity issues are particularly acute in the south east. At least as far back as 2003[539] there was a case for significant expansion of airport capacity in

[538] See url: http://www.ukaccs.info/gatwick/profile.htm
[539] DfT (2003) The Future of Air Transport, white paper, December.

the region with the proposed development of two runways, the first one being at Stansted. However despite the fact that BAA had developed planning proposals in response to the policies set out in 2003 a moratorium on airport expansion was put in place following the election of a new Government in 2010.[540] Considering a material change to circumstances in relation to the sale of Stansted in 2011 the CC concluded on the Government's policy that:

"The change in government policy since 2009 has reduced the likelihood of the introduction of a new runway in south-east England within the next 30 years. As a result, government policy is also likely at least to delay the competitive benefits to be expected from a new runway, and as a result, there is a reduced likelihood than there was at the time of the 2009 report that those benefits will accrue during the next 30 years."[541]

8.59 The CC's comments highlight the detrimental impact that imposed capacity constraints can have in the development of competition. This is consistent with the view taken by the CAA of the impact of Government policy in the south east. The CAA considers that it will slow the process of competition developing and interfere with the normal price signals expected within a competitive market. In an unregulated market at an airport facing these constraints it would be expected that prices rise at these airports to better match demand with available supply. The moratorium extends the period for which rents could be extracted. It is unlikely that these price rises would be in the interests of passengers or cargo users as although they provide the signal for additional capacity the market would not be able to react and provide the additional capacity.

8.60 More generally, the CAA considers that the high level of Government involvement with planning in the airports sector is likely to effectively mask the market signals that would usually dictate the development of capacity as demand grows. In an unregulated environment capacity constrained airport operators would have a significant incentive to raise prices, extracting additional rents resulting from the artificial restriction in supply. Further when restraints are lifted, absent regulation, an airport operator with substantial market power would face limited incentive to provide additional capacity as this would erode the rents available. Where there is sufficient excess capacity to allow for growth within an airport market it is likely that these issues are likely to lessen.

8.61 In the CAA's considerations of Test B careful consideration of the capacity situation at the airport in question and the market in which the operator operates will need to be reviewed. Consideration will be needed of the likelihood of constraints coming into force over the medium term and the risks that this may result in incentives to abuse its position. The situation may be one where SMP may build up as a product of diminishing capacity in the

[540] Cabinet Office (2010), The Coalition: Our Programme for Government, May.
[541] Competition Commission (2011), Consideration of possible material changers of circumstances, BAA Market Investigation, 19th July, paragraph 116.

market. Action under CA98, Article 102 can only be initiated once the legal test of dominance can be met and evidence of abuse of that dominance can be obtained. This may take time and the risk is that the competitive structure of the market will deteriorate further in the meantime to the detriment of users of air traffic services and competition in the market. Therefore, where an airport operator is operating in a capacity constrained market and this is likely continue, we should consider carefully whether regulatory safeguards can be put aside in favour of competition law controls.

Application of Test B to STAL

8.62 The CAA in its minded to decision on Test A has concluded that STAL has market power with regards to the Standsted short-haul market[542]. It is also the CAA's consideration that this is likely to persist at least across the medium term.[543]

8.63 The position is strengthened by Government policy towards airport capacity in the south east and the spill over effects from the London system. Indeed STAL considers it will see significant passenger growth to 2017 through overspill effects from the other London airports.[544]

8.64 Additionally the CAA has reviewed the prices charged at Stansted and notes that it currently charges at the regulatory price cap. Further assessment of the price level suggests that it may be currently above the competitive price.[545]

8.65 This is suggestive that the risk of STAL being in a position to engage in exploitative behaviour is high. Given the issues highlighted with the enactment of exploitative pricing cases and the size of the operation at Stansted the potential harm to the passenger from any such abuse is likely to be significant. As noted above, if regulation under the CA Act is not imposed, concerns about the excessive pricing will need to be addressed either by way of an investigation under the CA98, Article 102 or by a market investigation under Part IV of the Enterprise Act 2002.

8.66 An infringement decision and the imposition of remedies based on a abuse of dominant position in the form of excessive pricing will require that there be actual and not potential dominance on the part of STAL and further that this dominance has been deployed to impose prices which are excessive by reference to the United Brands test as developed in the case law. Potential or emerging dominance will not be sufficient to base a finding of infringement. In addition, the components of pricing at airports are complex. Identifying the relevant period of infringement and gathering the evidence of excessive pricing over that period is necessarily a formalistic exercise working towards a finding of infringing conduct over a fixed time frame. This can take time, not

[542] Paragraph 7.22
[543] Paragraph 7.24
[544] Paragraph 7.24
[545] Paragraph 7.16

least because of the considerable amount of evidence that may be needed about the market, during which excessive prices may persist to detriment of users and to effective competition.

8.67 The remedy would also normally be a financial penalty and/or directions possibly combined with action for follow-on damages by affected airport users. However, this may not fully offset the advantage gained by the course of conduct. Constructing directions aimed at remedying excessive pricing would also require extensive further work to formulate an appropriate mechanism for control and oversight of pricing.

8.68 The alternative of a market investigation would allow CAA to examine features of the market which adversely affect competition but if the key enabling feature is reducing capacity, the remedies available at the conclusion of a market investigation Reference to the CC are likely to offer limited scope to address that market feature.

8.69 To the extent that STAL's market power may also put it in a position to reduce or fail to improve service quality, the same considerations would apply. The outcome of an infringement decision under CA98/Article 102 would be bounded by the remedies available: namely, a fine on the airport operator and/or directions issued by the CAA, and possibly follow on damages claims. A fine may not be an effective incentive to improve service quality and imposing a direction would face the same challenges as described above in relation to excessive pricing.

8.70 It is of note that STAL is going through a period of change following the implementation of the remedies following the CC market investigation into BAA airports. As stated above, there is a clear expectation from the CC remedies that competition at Stansted will intensify in the future, although the current Government moratorium on airport expansion may lengthen the time horizon over which the benefits of competition are likely to accrue. In this context the maintenance of some form of regulation may prove beneficial in supporting the development of competition within the markets in which STAL provides services.

8.71 On balance the CAA is minded to consider that there is a risk of potential exploitative behaviour over the short to medium term resulting from STAL's market power. For the reasons set out above, therefore it is likely that the provision of some form of regulation under the CA Act would provide a more effective safeguard against the risk that the operator of Stansted would abuse a position of substantial market power than competition law. Such regulation would in the CAA's view be better adapted to protect the interests of passengers and cargo customers by mitigating the effects of STAL's SMP. It would potentially allow a number of safeguard such as ongoing monitoring of prices and quality to be put in place with a view to maintaining effective competition as the market and the wider economic context develops over the short to medium term.

THIRD PART: TEST C

9. Test C

Purpose

9.1 This chapter sets out the CAA's assessment of Test C of the market power test. As set out in the CA Act:

"Test C is that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects"[546]

9.2 The relevant operator is "the person who is the operator of the airport area at the time the test is applied."[547]

9.3 Users of air transport services are defined in the CA Act as passengers, or those with a right in cargo and includes future users of such services.[548]

Approach

9.4 The application of Test C necessarily follows the assessment carried out under: Test A, whether the relevant operator has, or is likely to acquire substantial market power (SMP); and the application of Test B, whether or not competition law does provides sufficient protection against the risk that the relevant operator may abuse that SMP. It therefore follows that Test C will not fall to be considered unless both Test A and Test B are met.

9.5 The assessment of Test C considers whether the incremental benefits of regulatory requirements set out in a licence are likely to outweigh the adverse effects. The CA Act states that a licence may include:

"such conditions as the CAA considers necessary or expedient having regard to the risk that the holder of the licence may engage in conduct that amounts to an abuse of substantial market power in a market for airport operation services (or for services that include airport operation services)", and

"such other conditions as the CAA considers necessary or expedient having regard to the CAA's duties under section 1". [549]

9.6 Section 1 sets out the CAA's general duty to further the interests of users[550] of air transport services and to do so, where appropriate by promoting competition.

9.7 The assessment of Test C therefore considers the incremental benefits and costs of regulation by way of a licence on an airport operator which seeks via

[546] Civil Aviation Act, Section 6 (3)
[547] Civil Aviation Act, Section 6 (2)
[548] Civil Aviation Act, Section 69 (1) and (2)
[549] Civil Aviation Act Section 18 (1)
[550] Users in this instance are passengers and those with an interest in cargo and include future users. In this document where it refers to passengers it also encompasses those with an interest in cargo and future users.

appropriate conditions to mitigate the risk of the abuse of SMP. In general the abuse of SMP can arise in many areas, but for the purposes of Test C, this assessment focuses on the areas most commonly addressed by economic regulation in assessing the likely impact of such regulation at Stansted:

- price;
- efficiency (which impacts on future prices);
- service quality, in terms of the range and level of services; and
- investment, which in capital intensive industries such as aviation, can impact on future levels of service quality.

9.8 The assessment also considers whether users may benefit from other additional licence requirements that are not directly related to market power but that the CAA may consider necessary to fulfil its duties under Section 1, for example on operational resilience.[551]

9.9 Against the potential benefits the assessment has considered the adverse effects of licence regulation in terms of:

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

9.10 Where relevant adverse effects are discussed with potential benefits (for example in terms of investment incentives).

9.11 Test C considers whether licence regulation as a whole has net benefits. Consequently the impacts of licence regulation have been assessed in aggregate rather than assessing the impact of individual measures.

9.12 The impact (i.e. the benefits and adverse effects) of licence regulation will depend on the form of regulation. Different forms of regulation will address possible abuses of SMP differently and will have different potential adverse effects. However the purpose of Test C is to ensure that the CAA satisfies itself that there is a form of licence regulation that has net benefits compared to no licence regulation. It is not to specify exactly the form of licence regulation is most appropriate.[552] This assessment therefore does not require the CAA to set out in detail how individual forms of regulation might operate

[551] See section 18 of the CA Act.
[552] The CAA will set out its decision on the most appropriate form of regulation at each airport operator subject to licence regulation in January 2014.

but rather to consider whether key forms of licence regulation that might be applicable to STAL may have net benefits and so be able to reach a view on whether some form of regulation may have net benefits. Based on the Q6 policy update, the following forms of regulation have been considered[553]:

- flexible or enhanced RAB-based price caps – where the current RAB approach is amended to increase flexibility for example through a flexible capex programme or a different duration to five years;
- long run average incremental cost (LRAIC) price caps – where a price cap is established based on the average unit cost of additional output over the long run when all costs are assumed to be variable;
- pegging price caps to tariffs at comparator airports – where the price cap is pegged to a level (and/or changes) in the charges of an index of comparator airports;
- price cap based on some other basis such as constant in real or nominal terms or based on voluntary undertakings from the airport on the future price path which is incorporated into a licence; and
- price monitoring – where the price is monitored ex-post, with regulatory discretion on when to intervene (where airport prices or performance could harm user interests) or triggered by pricing or quality meeting certain thresholds requiring a detailed review by the regulator.

9.13 Where price caps are included in the form of licence regulation, the CAA has considered whether there would be any incremental impact[554] if these price caps were based on a default settlement, where the price cap is based on a minimum level of service with airlines able to purchase a higher level of service quality as required. The Q6 policy update includes further details on these forms of regulation and the CAA's initial assessment of these options against its statutory duties. The CAA has subsequently undertaken further work on alternative forms of regulation, in particular consultancy studies into comparator price benchmarks, LRAIC and price monitoring. This work together with the further analysis of market power, has provided further insight into the likely impact of different forms of regulation in relation to Stansted.

9.14 Where possible the assessment has sought to quantify the impact of licence-based regulation. This is easier for some impacts, such as the CAA's direct costs of RAB-based regulation, than others, such as the impact of future alternative forms of regulation where there are practical difficulties in defining the precise impacts given that they are not currently in place. The assessment also has to take into account the incremental benefits and adverse effects of licence regulation over and above other forms of regulation

[553] Further details on these forms of regulation are contained in the Q6 Policy Update, CAA, May 2012. This document can be accessed at: http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf
[554] i.e. the incremental impact above the method for setting the price cap such as RAB or LRAIC.

that currently exist, most notably the Airport Charges Regulations 2011 (ACR) and Airports (Groundhandling) Regulations 1997 (AGR).

Structure of this chapter

9.15 This chapter is structured as follows:

- a summary of the CAA's initial views on Test C;
- an assessment of whether the ACR and AGR provides sufficient protection against the risk of abuse of SMP by the operator of Stansted;
- an assessment of the impact of licence regulation on:
  - price,
  - efficiency,
  - service quality,
  - investment,
  - other potential benefits of licence regulation,
  - direct costs, and
  - other adverse effects.
- an overall assessment of whether the benefits of licence regulation are likely to outweigh the adverse effects.

9.16 Where appropriate the assessment draws on the previous assessments on de-designation of Stansted airport undertaken by the CAA in 2007[555] and DfT in 2008 [ref xx] as these considered many of the same issues raised by Test C. However it is important to emphasise that this assessment takes place under different legislation and under different circumstances.

9.17 The assessment focuses on the potential impact on passengers, but also, where relevant considers the impact on cargo, in particular in the consideration of excessive prices.

The CAA's initial views on Test C

9.18 The CAA's initial views on Test C were set out in the Q6 policy update document[556] and are set out in the box below.

[555] De-designation of Manchester and Stansted airports for price control regulation: The CAA's advice to the Secretary of State, July 2007. This document can be accessed at: http://www.caa.co.uk/docs/5/ergdocs/de-designation_advice.pdf

[556] Paragraphs 4.20 to 4.23 of Q6 Policy Update, CAA, May 2012. This document can be accessed at: http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf

Box: CAA's initial views on Test C – May 2012

The CAA acknowledged that it was difficult to reach a firm conclusion on Test C in the absence of a clear package of measures developed for regulating each of the airports. However, the CAA considered that the Bill (and its licensing regime) would significantly help to improve the situation compared to current legislation because it would:

- enable key passenger priorities to be addressed, e.g. operational resilience;
- allow regulation to be more tailored to the circumstances of the airport and avoids the 'one size fits all' 5-year price cap approach under the current AA86;
- allow more proportionate forms of regulation, such as price monitoring, and regulation to be time limited and more flexible;
- reduce potential investment distortions, for example by allowing a rolling capex programme and 'at risk' projects;
- allow variation in duration, with no need to necessarily follow a five-year price cap; and
- enable a review of issues within the price control period, and not just once every five years.

Compared to the context for the CAA's unsuccessful de-designation request for Stansted in 2007, the CAA considered that the potential distortion and costs of regulation may be lower now given that airlines at Stansted are not being asked to fund the significant costs of a new runway and terminal through a Regulatory Asset Base (RAB).

Given its initial views on Test A, and exploratory views on Tests B and C, the CAA does not currently consider that any of the airports ought to be removed from economic regulation before April 2014. The CAA will, however continue to keep the situation under review and engage with stakeholders on the issues.

The CAA's initial view is that there is a strong case for continued economic regulation at Heathrow and to a less extent at Gatwick for a time beyond April 2014. Given the relatively weaker market position of Stansted compared to the other two airports, the CAA's initial view is that if it confirms that Stansted has substantial market power, there is a reasonable prospect that some form of economic regulation beyond April 2014 will be required, although the CAA recognises the need to ensure that continuing regulation creates more benefits than costs and this will influence the choice of regulatory approach.

Airport Charges Regulations

9.19 All three of the currently designated airports will remain subject to the ACR regardless of whether they are removed from the licensing regime under the CA Act[557,558]. The ACR came into effect in November 2011 and transposed into UK law Directive 2009/12/EC of the European Parliament and of the Council of 11th March 2009 on airport charges. The ACR provide airlines (but

[557] The airport charges directive can be found at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:070:0011:0016:EN:PDF
[558] The airport charges regulations can be found at: http://www.legislation.gov.uk/uksi/2011/2491/pdfs/uksi_20112491_en.pdf

not directly passengers) with a number of protections, which include the following requirements:[559]

- airport operators must consult annually with airlines on airport charges and service quality[560];
- airport operators have to provide airlines with information about the overall cost structure and revenues relevant to charges[561];
- four months' notice of changes to the system or level of airport charges or to the quality of service associated with an airport charge[562];
- airport charges must not discriminate between airlines except on relevant, objective, and transparent criteria[563], which can include cost and the quality and scope of services[564]; and
- airport operators must consult airlines on major infrastructure projects.[565]

9.20 If an airline considers that an airport operator has breached one of these requirements, it can take action in the Courts to recover loss or damage, or complain to the CAA. If the CAA receives such a complaint it must investigate and can impose a compliance order on the airport operator and order any damage or loss be remedied.

9.21 There are, however, a number reasons for considering that the ACR may not provide sufficient protection for passenger and cargo users of Stansted airport,, which may currently have SMP and is likely to have SMP in the future:

- *The ACR does not require charges to be cost reflective*. The ACR requires that where charges are varied across users, such modulation is based on transparent criteria. The criteria can include costs and quality of service but there is no requirement for the criteria to include these issues. Furthermore the ACR do not seek to control the overall level of charges, just the differentiation of charges across users[566]. Consequently the ACR is unlikely to provide sufficient protection against the risk of excessive prices[567] for STAL given the degree of

[559] The Regulations apply to airports with over 5m annual passengers. Heathrow, Gatwick and Stansted are all subject to the Regulations.
[560] Article 6 (1) of the directive, regulation 8 (1) of the regulations
[561] Article 7 (1) of the directive, regulation 8 (2) of the regulations
[562] Article 6 (2) of the directive, regulation 9 (1) of the regulations
[563] Article 3 of the directive, regulation 14 (3) of the regulations
[564] Article 10 (1) of the directive, regulation 14 (4) of the regulations
[565] Article 8 of the directive, regulation 27 of the regulations
[566] Paragraph 3.10 of the CAA's emerging thinking on ACD implementation states that licence regulation is able provide additional protection against anti-competitive behaviour above that provided by the ACD. It is also worth noting that DfT did not take the opportunity afforded by the ACD to allow the CAA to adjudicate on disputes in airport charges as the CAA has the opportunity to "examine.whether such airports are subject to effective competition" and whether they should be subject to licence regulation, although the CAA does have power to assess complaints on whether airports are complying with the ACD.
[567] The ACR includes provisions for overall cost transparency, however there is no requirement for charges to be based on a single (or dual) till basis, or the appropriate level of profitability.

market power that the airport operator has now and is likely to have in the future;

- *The ACR is likely to provide limited incentives for the airport operator to be efficient*. Recital (1) of the [preamble] to the directive (but not the ACR) states that airports should endeavour to operate on a cost efficient basis. The mechanism for how this should be achieved is not discussed. One way incentives to be efficient might increase is through the requirement for increased cost transparency[568]. Under the ACR the airport operator is required to provide details of the overall cost structure and details of costs associated with different airport charges. This information, however, is unlikely to be sufficiently detailed to allow airlines to robustly challenge the efficiency of airport costs to gain sufficient assurance where an airport operator has/is likely to have SMP, like STAL. Consequently the ACR is likely to provide only limited incentives for STAL to be efficient[569].
- *The ACR is likely to provide limited incentives to provide an efficient level of service quality where an airport operator has/is likely to have SMP, like STAL.* The ACR requires the airport operator to consult on the level of charges and, where appropriate, service quality. It also allows the airport operator and airlines to negotiate levels of service quality[570]. However where an airport operator holds SMP these negotiations may not approximate those that would be conducted in a competitive market and so the level of service quality and charges may not be efficient.
- *The ACR may provide some incentives to invest.* The ACR requires an airport operator to consult on investment. However there is no requirement on an airport operator to undertake an efficient level of investment. Consequently where an airport operator has/is likely to have SMP, like STAL, it may undertake investment inefficiently (as the costs can be passed on to users) or delay the required investment, reducing future service quality.

9.22 The degree to which the ACR provides adequate protection to airlines will, to some extent, depend on the degree of market power found in relation to the airport. The CAA's assessment of Test A was 'minded to' conclude that, in relation to passenger traffic, STAL has market power that may be substantial now and is likely to have SMP in the future as capacity constraints in the south east tighten. While STAL is likely to have less market power than that in relation to Gatwick and Heathrow[571], it is likely to be sufficient for it to raise prices above the competitive level and/or reduce service quality to airlines

[568] Article 7 of the ACD and Article 8 of the ACR.
[569] See paragraph 5.9 of CAA emerging thinking on ACD implementation, CAA, December 2010. This document can be accessed at:
http://www.caa.co.uk/docs/5/ergdocs/20101207ACDEmergingThinking.pdf
[570] Article 9 of the directive and Article 12 of the regulations
[571] This statement is based on the CAA's initial views on market power at Gatwick and Heathrow published in January and February 2012.

over the course of the next five years. For cargo traffic, the CAA was 'minded to' conclude that STAL had SMP. Consequently there may be a need for additional regulation, over and above the ACR, to provide adequate protection for both passengers and cargo owners. This would be consistent with our primary duty under the CA Act to further the interests of users of air transport services. The following sections discuss the potential additional regulatory controls and whether the benefits of these controls are likely to outweigh their adverse effects.

Airports (Groundhandling) Regulations

9.23 The Airports (Groundhandling) Regulations, 1997, (AGR) transpose the European groundhandling directive into UK law. Groundhandling covers a multitude of activities including check-in, handling baggage, cargo and mail, re-fuelling aircraft, and transporting passengers and crew to aircraft.

9.24 Under the AGR, airport operators with more than 2 million annual passengers cannot restrict the numbers of self handling airlines or third-party groundhandlers that operate at the airport without a determination from the CAA. There are currently no restrictions on the number of handlers in the UK

9.25 Where handlers use aircraft facilities, such as check-in desks, baggage belts and fuel hydrant systems, the airport operator must set its charges according to relevant, objective, transparent and non-discriminatory criteria. The CAA can investigate alleged breaches of the AGR.

9.26 While the AGR provides some protections to users of groundhandling facilities, the protections to the users of Stansted airport, where the airport operator may have SMP now and is likely to have SMP in the future, are likely to be limited. For example there is no requirement in the AGR for charges to be cost based[572] and therefore the protection against the risk of abuse where an airport operator has SMP may be limited, although in practice case law has tended to focus on the cost reflectivity of charges. Furthermore groundhandling facilities are only a small part of overall airport operation services and so the additional protection is likely to be required where an airport operator has SMP.

Impact of licence regulation

Excessive prices

9.27 Licence regulation may be a good way to limit excessive prices through price caps or price monitoring. Price caps can limit excessive prices by placing a limit on the level of prices during a control period. However there is a risk that the price cap is either set too high or too low. The CAA has previously stated that the risk that the price cap is set too high could to some extent be

[572] Reg 16, Airports (Groundhandling) Regulations, 1997.

mitigated by the presence of competition law[573], although the limitations highlighted under Test B still apply. If the price cap is set too low then this could affect the prices of the airport's competitors, reducing their operators' incentive to invest or ability to make adequate returns. This may affect the development of the market over time, potentially to the detriment of consumers. It may also adversely affect airline locational decisions. The drawbacks of price caps highlighted above do not apply to price monitoring which can limit excessive prices by encouraging more moderated price increases through, for example greater transparency and/or the threat of more prescriptive regulation. However price monitoring requires some level of self control from the airport operator and so is likely to be most appropriate where the risks of abuse are more moderated.

9.28 As part of the 2007 assessment of the potential de-designation of Stansted airport the CAA considered

"whether designation ...would, taking account of the risks [of abuse of SMP] and its detrimental effects were it to materialise, deliver additional benefits (i.e. over competition law) which exceed the costs and potential adverse effects of such designation (i.e. the incremental benefits are positive)".

9.29 This is similar in structure to Test C and so the CAA's consideration at the time may provide some useful insights for the current assessment under Test C. There are, however, some important caveats, as highlighted in the CAA's Initial Views on Test C. Firstly the de-designation assessment considered designation under the Airports Act. The form of regulation available under designation was more prescriptive than under the CA Act with a requirement for price cap conditions to be set for a five year period[574, 575]. Secondly circumstances have changed since 2007, with new evidence on market power, pricing, efficiency and the service quality performance of the airport. Third, based on the balance of evidence, the DfT decided against de-designation of Stansted, despite the CAA's recommendations. Consequently while it will be informative to consider the key issues raised by the CAA in 2007, it will also be important to consider the views of the DfT, the CC (in its Q5 review of Stansted) and how circumstances have changed since that time, when making a decision on whether Test C is met.

9.30 In 2007 the CAA stated that the benefits of a price cap at Stansted were limited as:

- STAL was already pricing underneath the price cap, with the CAA suggesting that the airport operator was setting prices in relation to

[573] This is based on a CAA statement from 2007. In practice the presence of a high price control could make the case against excessive prices more difficult to make as competition authorities may be more reticent to find against an airport that was charging in accordance with a regulatory settlement. The potential for a competition law claim of excessive pricing to mitigate a high price may therefore be very low.
[574] Sections 40 (3), (4) and (5), Airports Act (1986). This document can be accessed at: http://www.legislation.gov.uk/ukpga/1986/31/contents
[575] Cargo traffic is subject to separate public interest conditions which prevent charges from being greater than the equivalent passenger aircraft.

what the market could bear rather than the maximum allowed under the cap;

- while acknowledging that the airport operator may have increasing pricing power in the future, the CAA considered that future regulatory price caps may not bite as, for example long run costs were above current airport charges or a high price control may be set to avoid distorting competition;
- users would still have the potential to challenge excessive prices by reference to competition law; and
- there was a significant risk of distorting competition by setting prices too low.

9.31 In 2008 DfT, after considering the CAA's analysis, the representations from stakeholders and undertaking its own analysis, stated that a price cap could provide benefits of between £55m and £350m. The lower end of this range, equivalent to £0.5 per passenger, was informed by responses to the DfT's consultation. The higher end of this range, equivalent to £3 to £4 per passenger, was informed by DfT internal analysis on the extent to which the airport operator might be able to increase prices in the future. The DfT also considered the impact of setting price caps too high or too low. The DfT stated that if price caps were set too high then a RAB-based price cap might have costs resulting from distortions to investment incentives. Nevertheless the DfT considered that even a high price cap may have benefits by limiting the degree to which prices could be increased. In addition the DfT considered that while a low price cap may distort airport investment decisions, there may also be benefits to consumers from lower prices.

9.32 The CC found in its 2008 price cap recommendations to the CAA, that there were relatively weak competitive constraints on STAL and that charges could be increased further above their current level and a price cap similar to existing prices at the time, was likely to constrain prices over the course of Q5[576].

9.33 The current regulatory framework sets a cap on airport charges per passenger based on the published charges. Charges on non passenger traffic are limited to be no more than those for the equivalent passenger aircraft. Discounts that were included in the published airport charges, for example for growth traffic, are included in price cap calculations. However discounts that are negotiated between individual airlines and the airport operator are not. STAL started pricing at the cap, but excluding the recovery of any previous discounts, from 2007/08[577]. Since 2009/10 STAL has been pricing fully at the cap (any over recovery in one year is automatically paid

[576] See paragraphs 3.12 of Stansted Airport Ltd, Q5 price control review, Competition Commission, October 2008. This document can be accessed at: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2008/fulltext/539.pdf

[577] This followed a commitment from the airport operator to the airlines not to recover previous discounts given in Q4, see paragraph 3.12 of Competition Commission (October 2008).

back the following year). The small difference between the actual revenue yield and the yield based on published charges indicates that the impact of any bilateral airline deals is small in comparison to overall charges. In 2011/12 this difference was only 3 per cent.[578] Further details on the operation of the price cap are given in section 6 of Test A.

9.34 As STAL is pricing at the cap there is a reasonable expectation that if licence regulation was removed then charges would rise. There are a number of ways to identify the potential impact of a price rise.

- Based on the airport charge benchmarking analysis under Test A it was estimated that the price cap could be around £1 per passenger more than the charge at comparator airports. This could be taken as one estimate of what STAL may charge users above the competitive price level.
- In 2008 DfT estimated, based on its own internal modelling, that prices at Stansted could increase by £3 to £4 per passenger above the average yield at the time of around £6.30 per passenger[579]. The CAA has not repeated this analysis, however average yields are currently £6.70 per passenger, and while traffic at Stansted has fallen since 2008, it is expected to return to those levels by the end of Q6[580]. Consequently this estimate might better apply towards the latter half of Q6.
- An alternative approach, and one used by the CC in the Stansted Q5 assessment[581], is to consider the net benefit to STAL if it managed to perfectly price discriminate, i.e. it increased prices so that it captured all of the profits from captive airlines. Test A indicated that Ryanair was the most captive of the airlines at Stansted. The CAA has therefore calculated the impact of assuming that STAL increases prices so that it can capture all Ryanair profits. Over the last five years Ryanair's profits have averaged around [✂]. Ryanair's profits over the last two years have been [✂].[✂]. In practice it is unlikely to be possible for STAL to perfectly price discriminate and Ryanair may find more profitable uses for its aircraft than simply grounding them. Alternatively Ryanair may be willing to take a loss on some operations to avoid the costs of grounding aircraft, where the company may still need to bear leasing/depreciation costs. Consequently this assessment should be treated with some caution.

[578] This is based on a comparison of the per passenger airport charges from passenger flights in the regulatory accounts with those in the revenue statement for 2011/12.
[579] This is based on an actual aeronautical yield per passenger of £5.55 per passenger taken from the regulatory accounts from 2007/08 uplifted to 2011/12 prices.
[580] In 2007/08 Stansted handled 23.6mppa. The Stansted airport sale information memorandum has forecasts of [✂]A forecast was presented by the Daily Telegraph:
http://www.telegraph.co.uk/finance/newsbysector/transport/9608307/Stansted-airport-owner-admits-it-could-be-run-for-5m-less.html.
STAL regards these forecasts as reasonable or the most likely view of the future
[581] See paragraphs 83 and 84 of Appendix B, Competition Commission (October 2008).

9.35 Based on the above, this gives a potential range of airport charges of **[✂]** per passenger above the competitive level.[582] An additional charge in this range, using an airport charge elasticity of -0.4 and taking into account the impact on operating expenditure and commercial revenues, could lead to an increase in airport profits of between £50m and **[✂]** over the next control period (net present values 2011/12 prices)[583]. The degree to which prices at Stansted might be expected to be above the competitive level will depend on the degree of competitive pressure and countervailing buyer power to which the airport operator is subject. For the reasons set out in Test A, the CAA expects the degree of competitive pressure on STAL to decline over the Q6 period. Consequently, while we might expect the potential scope for STAL to increase charges above the competitive level to increase during Q6. A charge increase of £1 represents around 15 per cent of current average airport charge yields of £6.7 per passenger[584]. It therefore appears likely that the airport operator could be able to profitably increase prices significantly (by over 10 per cent) over the competitive level if licence regulation was removed. Furthermore our analysis suggests that it may even be doing so at the current time.

9.36 The above analysis has indicated that in the absence of licence regulation, STAL may be able to profitably increase prices above the competitive level. The following discusses the potential impact of different forms of licence regulation on excessive prices.

- A RAB-based price cap could provide some protection to consumers. However the CAA indicated in the Q6 policy update that, due to the recent reduction in traffic, a RAB-based price cap could be 40 per cent higher in real terms at the end of Q6 compared to Q5[585]. These numbers are indicative and should not be regarded as a signal of future price caps[586]. Airlines at Stansted consider such price increases are

[582] The [✂]estimate is based on a competitive price of £1 below the price cap and further potential price increases of [✂] above the price cap [✂]
[583] The range is based on an opex elasticity of 0.3 from the CC Q5 review and 0.5 from the mid Q review from SDG. This assumes a discount rate of 7.1 per cent the Stansted Q5 cost of capital.
[584] Source Stansted regulatory accounts 2011/12
[585] Paragraph 5.61 Q6 policy update, CAA, May 2012. This document can be accessed at: http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf. In addition SDG estimated that, based on the current level of RAB based building blocks, a price cap would be 45 per cent higher now than when set in Q5 (see page 49, Mid Q review of opex and investment consultation, SDG, May 2012, this document can be accessed at: http://www.caa.co.uk/docs/5/SDGStanstedReport.pdf. Based on different traffic growth and building block assumptions the airport has produced both much higher and much lower forecasts of the price cap increase under a RAB approach for Q6.
At the CAA's request, these estimates used the CAA's weighted average cost of capital for Q5 of 7.1 per cent per year. STAL consider that their actual cost of capital is substantially higher than this and therefore the estimates do not represent STAL's view of the appropriate RAB-based price caps in Q6. In the Baseline Business Plan STAL stated that they had strong concerns with the use of a RAB-based approach where an airport faced competition and there was a high degree of uncertainty around the forecasts for key inputs. In such situations STAL considered that there would be insufficient confidence in the inputs to adopt them as a reliable basis for setting five-year price caps. Hence, STAL's view was that the RAB-based approach would not be well suited to the degree of uncertainty that would be prevalent at Stansted in the period to the end of Q6.
[586] It should be emphasised that the level of a RAB based price caps will depend on the individual building blocks and different assumptions could lead to significant change in the potential level of the cap.

unlikely to be viable. Ryanair has raised concerns about the valuation methodology of the RAB for example the inclusion of certain costs in the RAB in preparation of a second runway (such as houses). Under a RAB approach it is possible that price caps could be higher than considered viable by airlines, for example if the RAB included assets that are not used (for example second runway costs) or valued by current airlines given their business model.

- A price cap set through an alternative means may provide better protection to users, for example, EE's estimates of LRAIC are below the existing price cap, although it should be acknowledged that these estimates are subject to considerable uncertainty. The Leigh Fisher work on price comparators found that the average price of comparators is below the current price cap.
- Price monitoring may also provide adequate protection, although this would depend on whether the airport felt sufficient pressure to moderate price increases from the monitoring itself, any countervailing competitive pressure or buyer power, threat of re-regulation, or any conditions including within price monitoring, for example enhanced transparency.
- Voluntary undertakings which might be included in a licence could also provide reasonable protection if they include a price commitment at a reasonable level.

9.37 The above analysis shows that absent some form of licence regulation there is a significant risk that STAL may be able to raise prices above the competitive level. A number of different forms of regulation may be able to provide adequate protection to users if suitably developed, for example price monitoring or a price cap set through price comparators or LRAIC-based approach. Even a RAB-based price cap could be better than no licence regulation as this may provide a backstop against excessive prices, although the degree of protection would depend on the level of the price cap itself[587].

9.38 One of the key concerns in the earlier CAA analysis, and to some extent the DfT analysis, is the risk that the CAA may set the price cap too low, distorting competitive and investment decisions at other airports. The CAA considers that, compared to 2007, it has more information on where the competitive price sits. The uncertainty over the future price path at Stansted has not stopped Luton from advancing investment decisions and the airport is due to put forward a planning application to increase capacity from 10 to 18 million passengers a year, although much of the additional capacity is unlikely to

[587] Paragraph 5.61 of Q6 policy Update stated that a RAB-based price cap could be 40 per cent higher in real terms by the end of Q6. STAL produced lower estimates of the potential real price increase in its Baseline Business Plan. Consequently the level of protection provided by a RAB based price cap will be particularly dependent on the level of individual building blocks.

come on stream until after Q6.[588] Nevertheless the CAA will still need to take care if setting price caps to avoid potential distortions.

9.39 The CAA will also need to take care in setting price caps to ensure that an efficient business can finance its activities. This is likely to be a particular issue for market led price caps such as LRAIC and pegging to comparators as there may be no direct link between the price cap and the current costs of the airport operation.[589] However to the extent that there is such a risk, it is likely to be substantially outweighed by the benefits of setting some form of price control or monitoring through a licence.

9.40 In 2007 the CAA argued that it might set a high price cap to avoid distorting competition and allow users to challenge excessive prices, even if the charges were below any price cap. Given the greater knowledge the CAA now has of the competitive price level, the likelihood that competitive pressure will decrease rather than increase over Q6, and the difficulties users may have of making a case on excessive charges if the airport operator was pricing within its regulatory cap, the CAA is unlikely to consider this approach to be appropriate for STAL in Q6.

9.41 STAL has suggested that the current price cap regulatory system introduces rigidity into the charges regime[590]. In particular STAL cite the example of whether winter parking should be included in regulated airport charges. STAL suggest that this would not have been an issue in an unregulated environment. STAL also suggest that price cap adjustment k and s factors introduced complexity as well as whether the same charges should be paid by cargo and passenger aircraft.

9.42 The CAA acknowledges that the regulatory system necessarily imposes some rigidity although does not consider that this would be significantly reduced if the airport operator was deregulated, due for example to the likely presence of long term bilateral contracts. The inclusion of k and s factors in the regime reduces the risks to the airport operator and consequently, while this increases complexity, they reduce overall costs. Consequently k and s factors only need to be included in the regime if this continues to be the regime and are not an intrinsic part of licence regulation. The regulatory requirement that dedicated cargo aircraft pay charges that are no higher than the equivalent passenger aircraft follows the CAA Q4 decision[591]. As the CAA is 'minded to' conclude that STAL has SMP over cargo, in the Stansted cargo market the CAA considers that this provision provides some protection to

[588] See http://www.bbc.co.uk/news/uk-england-beds-bucks-herts-19622284. Luton airport masterplan gives the timing of the additional capacity: http://www.london-luton.co.uk/en/content/8/1171/Masterplan.html
[589] This could be addressed by using a hybrid RAB and LRAIC approach
[590] Source: STAL
[591] See paragraphs14.79 to 14.81 of the Heathrow, Gatwick, Stansted and Manchester Airports' Price Caps, 2003-2008, CAA Preliminary Proposals - Consultation paper, CAA, November 2001. This document can be accessed at: http://www.caa.co.uk/docs/5/ergdocs/preliminaryproposals.pdf

cargo traffic from excessive charges, while minimising potential regulatory distortions.[592]

Inefficiency

9.43 Licence regulation can be an effective way of promoting operating and capital expenditure efficiency. The strength of efficiency incentives will depend on the type of licence regulation. Licence regulation can also create adverse effects in particular through the distortion of incentives between opex and capex efficiency. In judging the impact of existing regulatory incentives it is important to consider what would happen in the absence of licence regulation and the degree to which efficiency performance has been driven by regulation rather than competitive pressure.

9.44 In 2007 the CAA found that[593]:

- STAL outperformed the settlement in the early years of the control period in both operating and capital expenditure;
- this was more likely to be driven by competitive pressures rather than regulatory incentives as the outperformance took place in a period when the price cap was not biting;
- competitive pressures were likely to continue in the future, which was expected to be supported by pressure from the new owners of BAA/Stansted to generate an equity return; and
- price regulation was therefore unlikely to have significant benefits.

9.45 DfT's 2008 assessment did not assess the impact of regulation on efficiency.

9.46 The CAA commissioned consultants Steer Davies Gleave (SDG) to undertake a mid Q5 review of operating expenditure and investment consultation.[594] SDG's review used a variety of methods to assess STAL's performance, including both top down and bottom up cross airport benchmarking and bottom-up analysis of individual cost areas.[595,596] In the review of opex, SDG found that:

- taking into account the fall in passenger numbers, STAL had outperformed the regulatory settlement[597];

[592] Due to concerns over differential discounts to cargo aircraft, this was supplemented by a CC recommendation that charges for aircraft in the highest weight-band (>250mt) at least the same level of off-peak discount on landing charges as that offered in the next lower weight-band (50mt–250mt). See paragraph 29 (c) of Stansted Q5 price control, Competition Commission, October 2008. This document can be accessed at: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2008/fulltext/539.pdf

[593] See pages 160 and 161 of CAA (July 2007).

[594] Review of operating expenditure and investment consultation (Annex D): Mid-term Q5, SDG, May 2012. This document can be accessed at: http://www.caa.co.uk/docs/5/SDGStanstedReport.pdf

[595] Care was taken to ensure the choice of suitable comparator airports to Stansted

[596] The use of a variety of approaches to assess efficiency addresses a number of concerns with individual methods identified on pages 14 to 16 of Empirical methods for assessing behaviour, performance and profitability of airports, CAA, June 2011. This document can be accessed at: http://www.caa.co.uk/docs/5/Performance&BehaviourWP.pdf

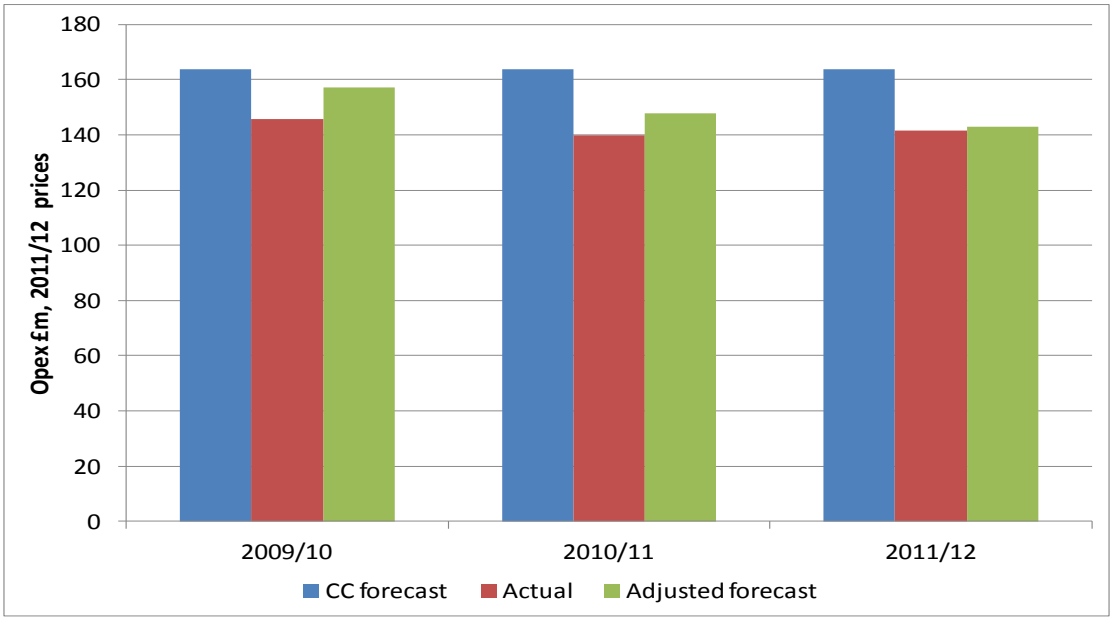
[597] See page 7 of SDG (May 2012).

- nevertheless substantial scope for efficiency remained[598]:
  - improvements in rosters could reduce security costs by 10 per cent, with potential for further improvements from processing rates;
  - average staff costs are higher than other airport benchmarks;
  - high utility costs, due to electricity hedging and a change in the allocation of electricity distribution asset costs away from Gatwick and to Stansted; and
  - high intra-group charges, which might be reduced through a change in ownership.[599]

9.47 Subsequent to the SDG analysis, the CAA commissioned consultants IDS to assess STAL's unit employment costs. This found that, depending on job category, airport staff were paid between 60 per cent greater and 9 per cent less than the general market cash rate and between 79 per cent and 9 per cent greater than the market on a total reward (including pensions).[600] IDS also found evidence of grade shift.

9.48 The CAA has repeated SDG's analysis of the performance against the regulatory settlement and included the most recent year. The analysis, shown in Figure 9.1 shows that STAL is still outperforming the regulatory settlement, although the differences are now relatively small.

Figure 9.1: Comparison of actual and forecast opex in Q5



Source: Competition Commission Stansted Q5 final report, Stansted regulatory accounts, CAA calculations

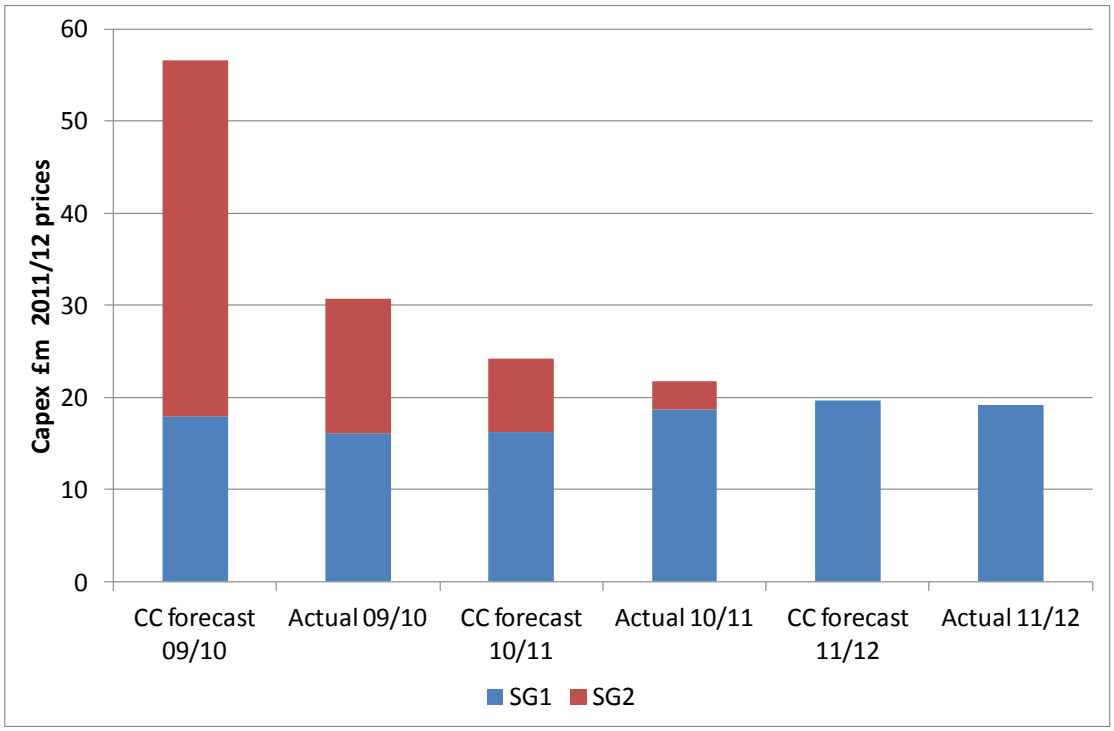
[598] See for example page 75 of SDG (May 2012).
[599] The information memorandum states could be reduced by [✂] through the sale. Although STAL considers that there would be one off capex and/or transitional costs to achieve this saving.
[600] STAL considers that the benchmarks in the IDS study do not take proper account of the local and regional employment market in which Stansted operates.

Note: CC forecast opex is adjusted by an opex elasticity of 0.5 based on the work undertaken by SDG[601]

9.49 An assessment of capex efficiency is more difficult as the actual schemes taken forwards by STAL during the control period have changed from those envisaged at the time of the price control. For example both projects that were extensively discussed in the run up to Q5: baggage refurbishment and Code F passenger, have not been progressed during Q5, with the capex allowance spent on other projects.[602]

9.50 Figure 9.2 shows actual and forecast capex for the first three years of Q5. This is split between spending on the existing runway (SG1) and the proposed second runway (SG2). This shows that SG1 spend is in line with forecasts (£54m compared to £53.9m forecast). BAA withdrew the planning application for the second runway in May 2010, following the withdrawal of political support.[603]

Figure 9.2: Comparison of actual and forecast capex in Q5



Source: CC Stansted Q5 final report, Stansted regulatory accounts, CAA calculations

9.51 The impact of regulation on efficiency is difficult to judge. Under a RAB-based price cap the regulated company has strong incentives to outperform the settlement particularly in the early years of the control period, as it can keep the gains for longer. These incentives will diminish over the control period.

9.52 A RAB-based price cap will also provide incentives for efficiency by including efficiency assumptions within the individual building block calculations. In Q5 the CC reduced the original BAA opex projections by 2 to 9 per cent over

[601] See page 57 SDG (May 2012).
[602] See page 75 SDG (May 2012).
[603] See http://news.bbc.co.uk/1/hi/business/8701433.stm

Q5[604], although it could be argued that some of this reduction could reflect the removal of regulatory gaming by BAA (i.e. that they would bid high knowing that the regulator would later reduce costs).

9.53 On capex the CC identified savings of 10 to 16 per cent, equivalent to £25 to £40 million on BAA's original Stansted Generation 1 capital expenditure programme over Q5[605]. These savings fell to 5.6 to 7 per cent following agreement between the airlines and the airport on a significant reduction in the scope of the capex programme.[606] The impact of the RAB-based framework on the efficient delivery of capex is more difficult to judge. CAA was clear in its Q5 decision that there should be no presumption that a RAB-based framework would apply in the future in relation to Stansted[607] and hence the airport operator could not be certain that capex spend would necessarily be remunerated in future control periods. This may have sharpened the airport operator's incentive for efficient delivery.

9.54 STAL suggested that a RAB approach which resets prices every 5 years distorts incentives where in a competitive environment price corrections may happen over a longer period of time. STAL also noted that there was generally pressure from the business to be efficient regardless of the regulatory settlement[608].

9.55 The Empirical Methods[609] states that in principle the analysis of relative cost efficiency might provide useful evidence to identify whether an airport operator is performing in a way that might be expected in a well functioning market. However care must be taken to understand the underlying causes of any identified inefficiency, and whether there is evidence to suggest that relatively poor performance is transitory or can be explained by factors that do not relate to market power. The Empirical Methods also recognise that operating efficiency may not be created by competitive pressure but could be the result of regulatory incentives.

9.56 There appears to be some evidence to suggest that regulatory involvement has had a beneficial impact, with the airport operator outperforming the regulatory settlement earlier in the control period, when the gains are greatest, with outperformance reducing over the control period, as the potential gains reduce. Nevertheless the SDG analysis suggests that there is scope for further improvement in operating efficiency. During 2012, STAL have introduced a series of measures to improve operating efficiency,

[604] See Table 3 of Annex H of Competition Commission (October 2008). The range depends on the traffic and capex forecast assumptions.
[605] See paragraph 8.97 of Competition Commission (October 2008).
[606] See paragraph 8.102 of Competition Commission (October 2008). This is equivalent to around £5m per year on the revised scope.
[607] Paragraph 18, Stansted Q5 decision, CAA, March 2009. This document can be accessed at: http://www.caa.co.uk/docs/5/ergdocs/20090313StanstedPriceControl.pdf
[608] Teleconference between Tim Hawkins (STAL) and Tim Griffiths (CAA), 16 August 2012.
[609] See paragraph 3.20, Empirical Methods for assessing behaviour, performance and profitability of airports, CAA, June 2011. This document can be accessed at: http://www.caa.co.uk/docs/5/Performance&BehaviourWP.pdf

particularly of security.[610] We do not have evidence to suggest that competition has driven improved efficiency. It therefore appears unlikely that the removal of licence regulation would lead to an improvement in efficiency. Given the reduction in competitive pressure forecast during Q6, the incremental benefits of licence regulation on efficiency are likely to increase.

9.57 In general it appears that a variety of forms of licence regulation could provide incentives for efficiency.[611]

- a RAB approach provides incentives to outperform the regulatory settlement, and a flexible RAB approach with core and development capex may improve incentives for the planning and efficiency of capex;
- LRAIC based price caps should provide incentives for efficiency as the price cap would be delinked from expenditure, although the power of these incentives would depend on the accuracy of the long term forecasts and the level of the price caps;
- comparator based price caps should provide incentives for efficiency as prices would be delinked from expenditure but the strength of incentives would be dependent on the suitability of comparators and the level of the price cap;
- other forms of price caps such as constant real or nominal prices or voluntary undertakings on prices (which are incorporated into a licence) are likely to similarly provide incentives for efficiency as the link between expenditure and prices would be removed but again the strength of incentives would depend on the level of the cap;
- price monitoring should also provide incentives for efficiency as prices would be delinked from expenditure, with the strength of incentives dependent on the strength of competitive pressure and the perceived impact of any threat of greater regulation should prices move out of line with expectations.

9.58 Based on this analysis the CAA is 'minded to' conclude that, for airport operators such as STAL, which may have SMP and is likely to have SMP during Q6, some form of licence regulation would create greater efficiency incentives for the airport than relying solely on competitive pressures.

Range and level of service quality that passengers require

9.59 Licence regulation can address service quality issues although it could also impose risks. These risks centre around setting the wrong set of service quality requirements for example if the elements of service quality measured and associated financial incentives do not match passengers' priorities or there is a focus on attributes that can be easily measured. There is also a risk that licence regulation can fix service quality requirements at a particular

[610] Source: STAL
[611] This analysis is based on the initial appraisal of alternative forms of regulation set out in Annex 1 of the Q6 Policy Update, CAA, May 2012. This document can be accessed at: http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf

level during a control period when circumstances and requirements may change.

9.60 In 2007 CAA did not consider that regulation would provide service quality benefits as[612]:

- in Q4 the CC did not impose public interest conditions on STAL (unlike Heathrow and Gatwick) as it felt the airport operator was subject to sufficient competitive pressure;
- the problems with security queuing at the time were to some extent caused by the increased Government security requirements in August 2006 and may have been exacerbated by high capacity utilisation, the business models of LCCs (which avoid early check-ins) and the knock-on effects on tight schedules of LCCs;
- users have tended to focus on avoiding gold plating rather than pushing for higher service quality standards; and
- *ex-ante* regulation through its incentives for efficiency may lead to lower rather than higher service quality.

9.61 In 2008 DfT considered that the abuse of SMP could lead to lower service quality and estimated that this could be equivalent to up to 10% of revenue, or around £55m.

9.62 In its Q5 review, the CC found that weaknesses in STAL's security queue performance in 2003, 2005 and 2006 operated against the public interest. The CC also reviewed STAL's performance against wider service quality using QSM and ASQ survey information[613]. Due to the airport operator's perceived failure in service quality, the CC imposed public interest conditions which resulted in the current service quality rebate (SQR) scheme.[614]

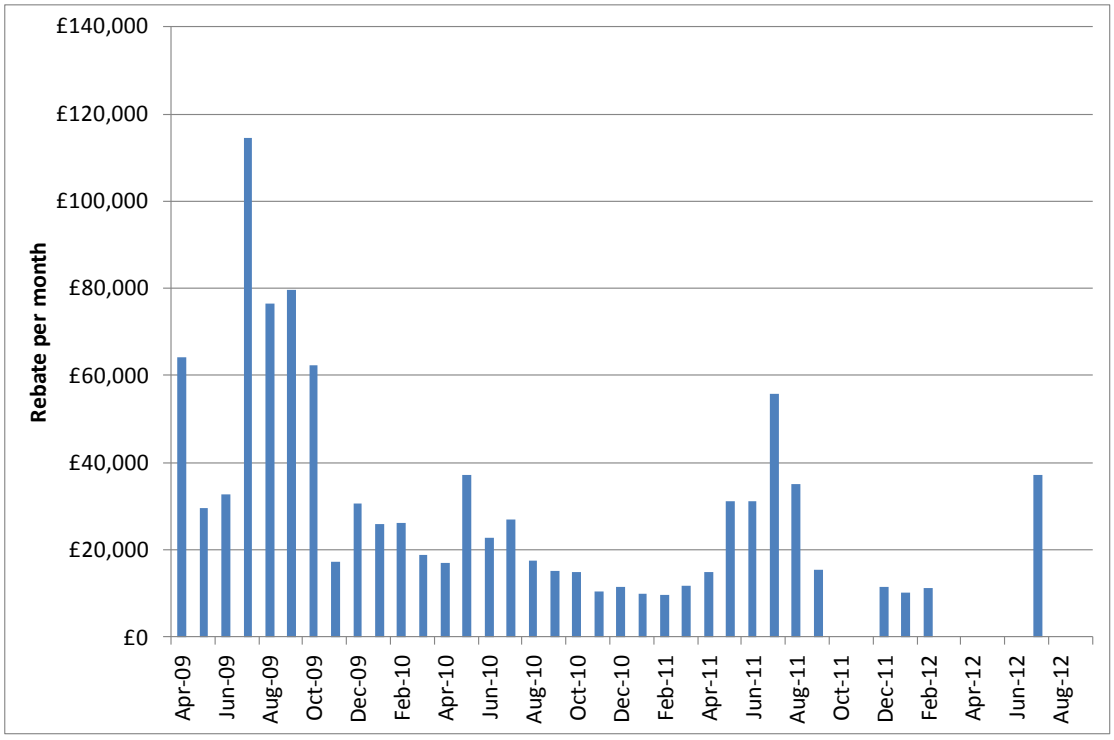
9.63 In line with the Empirical Methods guidelines[615], the CAA has considered STAL's performance against both direct objective measurement, using the SQR scheme, and qualitative assessment through passenger satisfaction surveys such as the ASQ and QSM.

9.64 The current SQR scheme, which was agreed between the airport operator and airlines, includes 16 measures of service quality, with the 7 per cent of revenue at risk focused on the key areas of concern, central search and outbound baggage. Unlike Heathrow and Gatwick bonuses are not available for high performance.[616] In general STAL's performance against the SQR

[612] See paragraphs 10.221 to 10.27 of CAA (July 2007).
[613] QSM is the Quality of Service Monitor which is customer satisfaction survey data collected by BAA. ASQ is an international customer satisfaction survey overseen by the Airports Council International which enables the benchmarking of STAL's performance with other airports.
[614] See paragraphs 13.25 to 13.38 of Competition Commission (October 2008).
[615] See page 23, Empirical methods for assessing behaviour, performance and profitability of airports. This document can be accessed at: http://www.caa.co.uk/docs/5/Performance&BehaviourWP.pdf
[616] Further details of the SQR regime can be found in CAA (March 2009).

scheme has been improving throughout Q5 and few rebates have been paid in the last year.[617]

Figure 9.3: Stansted airport performance against the SQR scheme

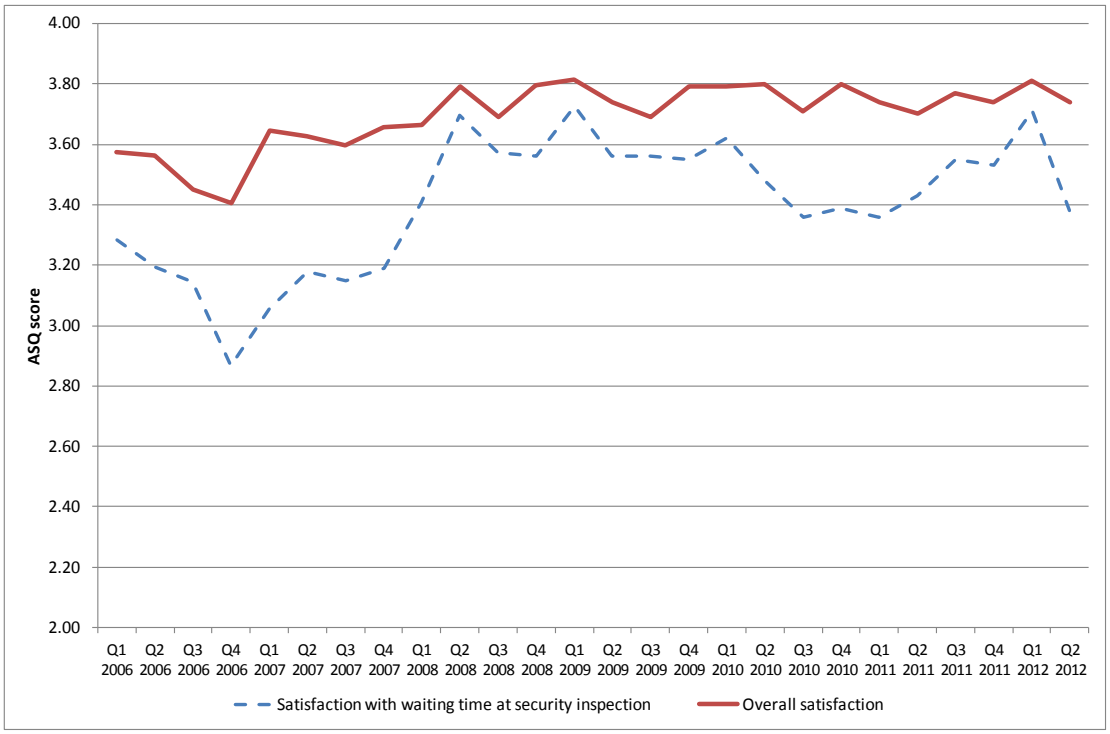


Source: STAL

9.65 In terms of ASQ customer satisfaction scores, STAL's service quality performance appears to have improved somewhat since the start of 2008 as shown in Figure 9.4.

[617] There have been some specific areas of the SQR regime that have suffered from repeated failures earlier in the regime such as jetties and departure lounge seat availability.

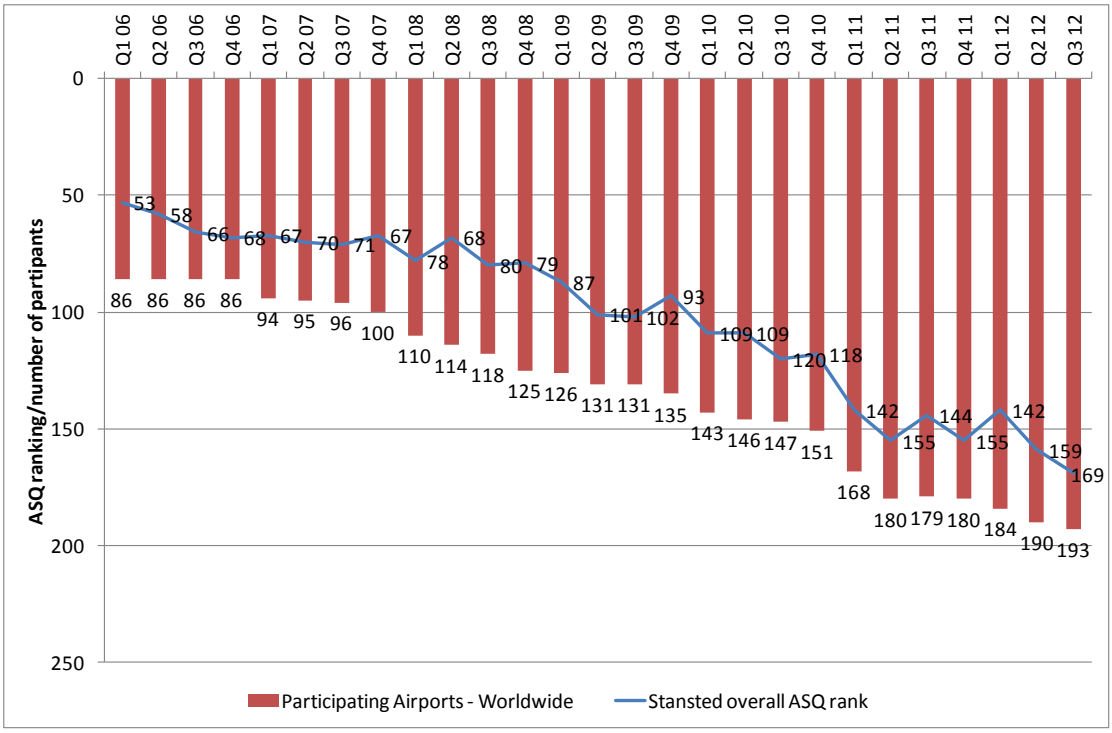
Figure 9.4: ASQ survey scores for Stansted airport



Source: STAL's ASQ survey

9.66 The airport's ASQ ranking out of all airports in the survey has improved little over the period, averaging 61 out of 86 in 2006 and 157 out of 189 in 2012, see Figure 9.5. STAL's view is that the inclusion of a large number of additional airports has distorted the sample. In particular that the self selecting nature of the airports included in ASQ will have biased the sample towards airports with a higher than average level of service, and those airports below the average will be less likely to pay to be included. The CAA agrees that the rankings should be treated with some caution and greater weight should be attached to the airport's own ASQ scores which have broadly improved over the period.

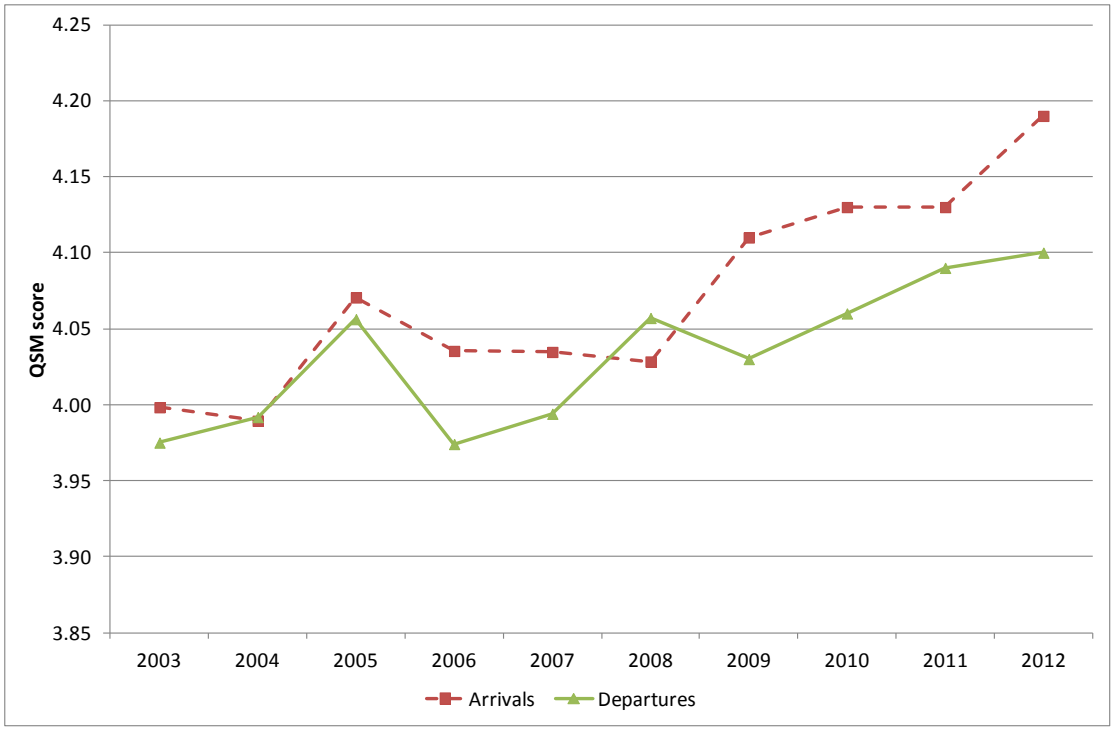
Figure 9.5: Stansted overall ASQ ranking



Source: STAL

9.67 The airport's QSM scores also appear to have improved over the period, see Figure 9.6, and show a similar pattern to the scores under the SQR scheme and ASQ survey.

Figure 9.6: QSM scores



Source: STAL

9.68 The indications of STAL's improved service quality performance appear to coincide with the greater regulatory scrutiny since the start of the Q5 review and the introduction of the SQR scheme in quarter 2 2009. While the CAA cannot be certain that this improved service quality performance reflects the impact of regulation, the CAA does not have evidence to suggest that competition has been driving the improved performance, particularly given the poor performance of STAL during the majority of Q4. The earlier concern of the CAA, that regulation could reduce service quality by providing strong efficiency incentives, does not appear to have arisen.

9.69 The airlines consider that the existing SQR scheme has worked quite well and do not envisage significant changes for Q6.[618] The airport operator itself does not envisage that there would be a step change in the regime if the airport operator were to be deregulated.[619]

9.70 The main concern with the existing SQR scheme cited by the airport operator is that the regime is too rigid as it is fixed for a five year control period and cannot be easily changed to take account of different circumstances and priorities.[620] Given that neither the airport operator nor airlines envisage step changes in the SQR scheme going forwards and that changes to the scheme can be agreed by the airport operator and airlines or amended by the CAA, any rigidity is unlikely to lead to significant passenger detriment and the main

[618] Source: Stansted ACC
[619] Source: STAL
[620] Source STAL

cost is likely to be the time taken to make changes. Even under a competitive environment the airport operator would need to agree changes in service quality standards and so some rigidity is likely to remain.

9.71 It has also been argued that regulation, in particular the service quality rebate scheme, enforces a one size fits all approach, which might not reflect the needs of different users. This could be the case as service quality standards are set uniformly across the airport offering to users. Given the homogenous nature of airlines at Stansted, Ryanair and easyJet accounting for 90 per cent of Stansted passengers, it appears unlikely that there would be a significant difference in the needs of users across the airport. Furthermore given the default nature of the price cap, airlines can always agree and pay for some items of higher service quality, for example lounges. Distortions arising from regulation in this area therefore do not appear to be significant.

9.72 The level of service quality at Stansted does not appear to be misaligned with passenger preferences. As the CAA has previously stated that it considers the interests of passengers and airlines are broadly aligned as regards the provision of airport operation services[621], and consequently if passengers were dissatisfied with the level of service quality received this would feed through into airlines' opinions. The airlines appear content with existing service quality at Stansted. Furthermore the CAA has provisionally found that over 85 per cent of passengers rated the overall experience of Stansted airport terminal as good or excellent, with only 2 per cent rating it as poor or extremely poor[622]. The SQR scheme does not therefore appear to be distorting outcomes to those that are not in passengers' interests.

9.73 A SQR scheme of the type in place at Stansted could be included in any of the forms of licence regulation that are envisaged for the airport operator be that a form of price cap or price monitoring. Furthermore a default contract could allow different levels of service quality to be agreed across airlines, if operationally feasible, although given the generally homogenous nature of airlines at Stansted it is unlikely that there would be major differences in airline requirements. Given the apparent success of the SQR scheme there is a chance that, absent licence regulation, the scheme would be maintained. This will to some extent depend on the relative market power of the airport operator and the countervailing competitive pressure and countervailing buyer power of the airlines. Given the increase in market power of STAL forecast over Q6, it is by no means certain that such a scheme would continue across the whole of Q6 absent licence regulation.

9.74 In summary the existing regulatory regime at Stansted appears to have provided benefits in terms of service quality which could be maintained under different forms of licence regulation. It appears that the costs of licence regulation in terms of rigidity and misalignment with passenger priorities are likely to be relatively small and might be minimised by the involvement of

[621] In the context of airport operation services.
[622] CAA departing passenger survey, Quarter 3 2012, raw unweighted provisional data.

airlines and passenger representatives in the development of regulation. If regulation was removed there is a risk, given the past performance of STAL, that service quality could reduce, resulting in detriment to the airport's passengers.

Investment incentives

9.75 Licence regulation can provide incentives to investment, for example by ensuring investment can be recouped, but it can also distort investment incentives by encouraging too much or too little investment.

9.76 In 2007 the CAA stated that:

- RAB-based regulation provides an incentive to invest by providing comfort to the regulated company that efficient and economic investment can be recouped, however it could distort incentives and could, in certain circumstances, lead to too much investment too soon which could give rise to a major cost to consumers, and distort the incentives of users;
- a market based price cap would not provide strong incentives to invest as the regulatory commitment that efficient and economic investment could be recouped would no longer apply;
- competition would be a spur to investment, as there would be strong incentives to enter into long term contracts which could allow better tailoring to customer requirements;
- regulation can also affect investment incentives across airports as competing airport operators will need to respond and compete with any new investment, irrespective of whether the new investment was efficient; and
- under investment could be protected through competition law, as proposed investments were incremental rather than lumpy and actual airport investment could be compared to relatively well-developed investment plans for the expansion of the airport.

9.77 In 2008 DfT stated that:

- RAB-based regulation could distort new investment incentives, although the impact of distortions from regulation was difficult to separate from other factors affecting investment decisions such as the planning process;
- the cost of regulation is likely to be greatest where an airport operator does not possess market power; and
- given the scale of investment being considered at Stansted and the options available to the CAA to address the distortions to incentives through different approaches to price regulation, the impact of the distortions to incentives are unlikely to outweigh the beneficial effects of regulation.

9.78 Other regulators (and previously the CAA) have stated that RAB-based regulation distorts investment incentives.[623] For example it can lead to too much investment where the allowed cost of capital exceeds the company's cost of capital.

9.79 In Q5 these distortions do not appear to have been great. It could be argued that RAB-based incentives to invest were one of the reasons why STAL was supportive of a second runway in Q4. However it should be acknowledged that a second runway was Government policy at the time, and STAL withdrew the application when that policy changed.[624] As discussed earlier STAL has invested in line with allowed SG1 expenditure and has not invested the capex allowance for SG2 following the change in policy. STAL's initial capex proposals for Q6 were relatively modest at between £100m to £207m (Q6 total 2011/12 prices) depending on forecast traffic growth[625]. Following further internal work STAL refined these proposals and is now proposing a capex spend of £139m (2012/13 prices).[626] The vast majority of this expenditure is related to renewals at around £20m per year. It does not appear from these proposals that the existing regulatory framework is causing capex bias at Stansted in the current control period (albeit acknowledging that the framework is not wholly RAB-based).[627]

9.80 STAL has suggested a number of biases from the current regulatory approach, for example[628]:

- it has prevented investment for new customers as this would be opposed by current customers;
- it requires capex levels to be set up to 7 years in advance and it is difficult to predict investment this far in advance; and
- the consultation process introduces rigidity into the process.

9.81 The CAA has considered each of STAL's concerns and whether they would necessary apply to all types of licence regulation. In terms of a bias against investment for new customers. It is acknowledged that under a RAB-based framework in particular, airlines are likely to oppose new investment that would accommodate potential competitors, in particular as they will initially be facing higher charges to pay for the investment. However the current regulatory framework does not require the airport operator to agree investment plans with users but to consult with them and reach agreement

[623] See paragraph 5.8 of CAA (May 2012) and for other regulators views see for example Section 6.6.3 of Future Price Limits – A consultation on the Framework, Ofwat, November 2011. This document can be accessed at: http://www.ofwat.gov.uk/consultations/pap_con201111fpl.pdf?download=Download#
[624] Stansted withdrew the application in 2010 following the election of the coalition government that had ruled out new runways at Heathrow, Gatwick and Stansted during the lifetime of the current parliament – see coalition policy statement: http://www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/documents/digitalasset/dg_187876.pdf.
[625] Source STAL
[626] Stansted Airport, 2012 Capital Investment Plan: Airline consultation, October 2012.
[627] STAL agree that there has not been capex bias at the airport as the airport has not made the regulatory return for some time
[628] Source: STAL

where possible.[629] STAL is also able to propose investment plans to the CAA as part of the periodic review, where the CAA will need to take into account its new duty to current and future users.

9.82 The current regulatory framework requires a capex allowance to be set up to 7 years in advance. STAL has suggested that this causes them to do more detailed planning earlier in the process, than would otherwise be the case.[630] While this may be the case, even though the capex allowance is set in advance, capex schemes can change[631], and there have been a number of changes to the Q5 schemes made by STAL. Regardless of the changes to the mix of projects during the control period, airport operators, including STAL, have tended to keep to this expenditure allowance during the control period. In part to address the concern over early detailed planning, the CAA has proposed a core and development approach to capex over the next control period, where core projects would be fixed but development projects would be progressed during the control period, with development expenditure either included in the original price cap or adjusting the price cap during the control period as it is incurred. This should go some way to addressing STAL's concerns in this area.

9.83 The airport's consultation requirements are set out in Annex D of the CAA's Q5 decision. These requirements followed an earlier CC public interest finding that in Q4 information provided by STAL was frequently too insufficient and untimely to enable effective consultation.[632] The rigidity included in the current regime is a direct consequence of this finding. Given the past performance of STAL, and where STAL has substantial market power, it is likely that some form of regulation in this area would be required to protect the interests of passengers and those with rights in cargo. It is important to note that even if licence regulation was removed, the ACR still has a requirement for an airport operator to consult with users over capex schemes, although the requirements of this consultation are less onerous than those set out in Annex D.

9.84 The above discussion focuses on the impact of the current, partially RAB-based approach, on investment incentives. Compared to a RAB approach, market based approaches such as price caps based on LRAIC or comparators, or price monitoring are likely to be a different impact on investment compared to a RAB approach. In general market based approaches are likely to lead to weaker investment incentives than a RAB approach, in particular as they remove the link between investment and future returns as prices are based on a market proxy rather than costs. This could discourage investment that was economic and efficient. This could in part be addressed by including a service quality regime within a market based approach, which could be used to drive necessary investment, or

[629] Paragraphs 44 and 45 of Annex D of CAA (March 2009)
[630] Source: STAL
[631] Paragraph 36 of Annex D of CAA (March 2009)
[632] Paragraph 13.14 of Competition Commission (October 2008)

require a minimum level of investment in line with airport masterplan requirements.

9.85 In summary licence based regulation could distort investment incentives, with a RAB potentially leading to too much investment and market based approaches leading to too little investment. The current regulatory framework does not appear to have resulted in too much investment in the current quinquennium and there is the potential to strengthen investment incentives under market based regimes by putting in place additional regulatory requirements. It should be possible to address other concerns with licence regulation such as fixing investment too far in advance and disincentivising investment for new customers. Nevertheless licence regulation will necessarily lead to some costs in terms of rigidity particularly in terms of investment consultation, which appear to be required address potential primary duty concerns.

Other potential benefits of licence regulation

9.86 A licence can also be used to provide additional benefits. For example the CA Act allows the CAA to include other conditions that it considers necessary and expedient so as to further the interests of users of airport operation services, that is passengers or those with rights in cargo.[633] One of the key areas where licence conditions might be in the passenger interests is operational resilience.

Operational Resilience

9.87 A licence can be used to compel or incentivise the airport operator to adopt certain behaviours regarding the needs of the end users (passengers and cargo owners) that, as a monopoly provider without a direct contractual relationship with the end user, it otherwise might not consider necessary.

9.88 One example of this is requiring the airport operator to ensure operational resilience, especially in times of disruption. A licence condition could require the airport operator to have adequate plans in place to deal with disruption and to keep the end user informed at such times.

9.89 Recent events have suggested that such a licence condition could be beneficial to passengers. The consequences of severe disruption due to snow in January and December 2010, as well as severe disruption due to the Icelandic ash cloud, highlighted the lack of adequate emergency planning at many airports. A number of reports[634] looked at operational aspects of winter

[633] Furthering the interests of users can include, where appropriate, acting to promote competition
[634] The Quarmby report Oct & Dec 2010 (http://transportwinterresilience.independent.gov.uk/), the Transport Select Committee report May 2011. (http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtran/794/79402.htm) the Begg report on Heathrow, March 2011. (http://www.baa.com/static/BAA_Airports/Downloads/PDF/BeggReport220311_BAA.pdf) CAA's reports (http://www.caa.co.uk/docs/5/CAA%20review%20of%20snow%20disruption%20-%20Final%20Report%20-%20WEB%20VERSION%20_2_.pdf) and (http://www.caa.co.uk/docs/5/CAA%20Issues%20facing%20passengers%20during%20the%20snow%20disruption%20FINAL.pdf).

resilience and the impacts on passengers and made a number of recommendations. In response to these, the Government tasked a subgroup of the South East Airports Taskforce (SEAT, set up in June 2010) to propose ways in which the operational performance of Heathrow, Gatwick and Stansted could be improved within the constraints of the current capacity caps.

9.90 In May 2011, the SEAT subgroup made a number of recommendations on punctuality, delay and resilience[635] including the need to develop performance charters setting out operational plans and including cross-industry co-ordination and controls to manage and minimise disruption. The three airport operators have taken this forward but progress has not been as fast as had been hoped, partly due to questions about accountability and enforceability.

9.91 A licence condition could be useful in situations where there is no agreement between the stakeholders to facilitate greater progress. This could be by making the airport operators accountable more directly to the end users and more accountable to its customers, thus incentivising a greater willingness, or even requiring them, to take their customers' needs into account as well as encouraging them to use the levers at their disposal to encourage and co-ordinate the relevant stakeholders to greater effect.

9.92 There is a risk that a licence condition could create perverse incentives, by limiting the ability of the licence holder to negotiate effectively or by adversely altering the balance of risks that have already been agreed between the various parties. However, in situations where there is stalemate, a licence may have benefits by changing this balance. A licence condition may also impose costs from developing the associated resilience plans but these are likely to be relatively small and be outweighed by the efficiency savings and reputational benefits from managing emergencies more effectively.

9.93 Clearly there is a benefit to the users of air transport services by protecting their interests in terms of improved resilience however such protections must not be too onerous for the airport operator. In particular as requirements that are too onerous will be too expensive, which is not in the end users' interests. Before imposing licence conditions the CAA will also need to consider its duty not to impose unnecessary regulatory burdens on the airport operator, and that regulation should be proportionate and should only target those areas where action is needed.

9.94 In summary, there are benefits to passengers and cargo owners of having good operational resilience plans for times of disruption and there could be a role for a licence condition to facilitate this.

[635] http://assets.dft.gov.uk/publications/south-east-airports-taskforce-report/south-east-airports-taskforce-sub-group-report.pdf

Direct costs

CAA direct costs

9.95 Licence regulation will undoubtedly have costs. These costs can include indirect costs, such as the impacts on incentives set out above, and direct costs, such as the CAA's costs and the time and expenditure of management and regulation staff at regulated airports and their airlines.

9.96 In 2007 the CAA estimated the CAA's and CC costs for the Q4 review (covering all three designated airports) was around £3m and acknowledged that there would be additional costs of the airport and airlines.

9.97 The CAA's annual charges for economic regulation at Stansted are around £0.5 million per year, with additional costs of around £0.5m per year during the periodic review.[636] In addition there are likely to be the costs of any appeals to the Competition Appeal Tribunal and the CC. The extent and cost of these appeals are unknown. The direct costs at Stansted compare to an annual charge for Luton, which is unregulated, of less than £0.1 million per year[637]. Based on this the additional CAA costs are likely to be around £1m per year on average during a five year control period. As RAB-based regulation is resource intensive some of the alternative forms of regulation may be cheaper, for example there will not be a requirement to estimate individual building blocks and the expensive consultancy that this entails. However a LRAIC approach is likely to be resource intensive as it requires the calculation of forward looking or modern replacement costs. Even a price monitoring regime could require some regulatory involvement from an annual review of costs and performance, with these costs are likely to be in excess of £0.2m per year.[638]

Airport and airline direct costs

9.98 In addition to this there will be the cost of management and regulation staff at the airport and airlines as well as the direct costs of compliance with regulatory measures such as the introduction of automated security queue measurement. It is difficult to estimate these costs but these could be £2m to £4m per year, and possibly significantly greater.[639]

Overall direct costs

9.98 Overall the direct costs of regulation of the existing regime are likely to lie somewhere between £3m and £5m per year. It might be possible to reduce

[636] This is based on around 9 million arriving passengers at Stansted and a charge of 4.75 pence for designated airports and 4.99 pence per arriving passenger for the Q6 review for Stansted. Source: CAA charges 2013/14 consultation document. This document can be accessed at: http://www.caa.co.uk/docs/1352/CAACharges1314ConsultationDocWebFinal.pdf
[637] Source: CAA charges 2013/14 consultation document. This document can be accessed at: http://www.caa.co.uk/docs/1352/CAACharges1314ConsultationDocWebFinal.pdf
[638] This is based on three staff with a cost of around £80,000 per year. Average staff costs are taken from note 3 of the financial statements in the CAA Annual report and accounts 2012. This document can be accessed at: http://www.caa.co.uk/docs/2474/CAA_AR2012.pdf
[639] This is a CAA calculation based on a HAL estimated cost of more £10m per year factored down to take account of the size of the airport and size of the regulation team

these by £1m or more through alternative forms of regulation. The main costs however are likely to be indirect, in terms of any potential distortions to incentives.

Other adverse effects

9.99 The discussion above has highlighted a number of potential adverse effects from regulation, including:

- the price cap could be set too low, distorting competition and investment decisions at other airports;
- the increased rigidity of a regulatory system in particular in relation to consultation requirements and changes in charges and service quality;
- the distortions to incentives on opex, non aeronautical revenue and investment;
- the disincentive to invest for new customers;
- the requirement for capex plans to be set too far in advance.

9.100 These adverse effects could result from RAB-based regulation, but as discussed above could also occur with other forms of regulation. Two further potential adverse effects from licence regulation are: the crowding out of a more commercial approach and management distraction.

Crowding out of a more commercial approach

9.101 One of the key areas where licence regulation could create distortions is through crowding out of a more commercial approach. In the absence of regulation airport operators and airlines would have an incentive to enter into bilateral contracts or deals. These deals could vary in terms of the duration, scope and service requirements depending on the needs of individual users and characteristics. Bilateral contracts can also provide benefits to airport operators from traffic and growth commitments and the utilisation of new facilities. Such bilateral contracts characterise much of the competitive airport sector in the UK. The desirability of such deals has been recognised by the CC[640]. The CAA has also recognised the potential benefits of bilateral contracts and the airport operator's commitments at Gatwick.[641]

"In the right circumstances, bilateral contracts and airport commitments could be capable of providing protection that is at least as good as what regulation can provide, while also allowing more diversity and flexibility of provision than regulation easily allows. At its best, such a system could be better than regulation, and therefore be in the interests of passengers".

9.102 A regulatory settlement can crowd out such contracts as both the airport operator and airlines will want to know what the potential settlement is before agreeing to any deal. This is why the CAA has been keen to encourage

[640] Paragraph 5.16, Competition Commission (March 2009).
[641] Gatwick Airport Mid Constructive Engagement (CE) Review, CAA, October 20112. This document can be accessed at: http://www.caa.co.uk/docs/5/121005LGWKCJSG.pdf

commercial agreements where possible, for example on the extension of the Heathrow and Gatwick price controls[642] and by encouraging a similar arrangement for Stansted (which did not reach agreement). The current regulatory settlement has not been a block on STAL reaching a commercial bilateral contract with some airlines, although this is not the case with its largest airline Ryanair. The reasons for this are uncertain but the evidence suggests that this is more likely to reflect concerns over the market power of the airport operator rather than the regulatory settlement per se. Indeed it is important to recognise that in some circumstances bilateral contracts may not be good for passengers; for example where the contract would not have been signed but for the airport exercising its SMP. That is why when discussing bilateral contracts and airport commitments at Gatwick the CAA stated that

"if a commitment/contract regime were to be a main reason why a price control would not be put in place (when it otherwise would be), that regime would also need to be fair to airlines. This means the overall deal would have to be reasonable compared to a potential regulatory settlement, and that non-discrimination was observed".

9.103 Consequently while a regulatory settlement can create distortions by discouraging bilateral contracts from being agreed, it does not stop such agreements and, in cases where the airport operator has SMP, like STAL, it can prevent the airport operator from abusing its market power in such agreements.

Management distraction

9.104 Regulation could distort incentives by distracting management by focusing the regulated company more on maximising the value from a regulatory settlement rather than focusing on improved efficiency or service quality. For STAL these issues are compounded by the distractions created by the potential sale of Stansted. The scale of regulatory distractions could be reduced through more flexible forms of regulation, For example:

- a more flexible RAB-based approach could involve more airport operator and airline engagement for example on capex plans, reducing the scope for regulatory distraction;
- a market led price cap, could focus discussions on the level of the price cap rather than on individual RAB-based building blocks; and
- price monitoring, could focus the airport into behaving competitively rather than trying to outperform a regulatory settlement.

Summary

[642] The extension of the Gatwick Q5 price control was itself partially to allow the airport to reach commercial agreements with its airlines.

9.105 In summary, the CAA considers that given the provisional findings of SMP in Test A, the ACR and AGR are unlikely to provide sufficient protection to passengers and additional licence based controls are likely to be required.

9.106 The benefits and adverse effects of licence regulation, to some extent, depend on the form of regulation. For example RAB-based regulation is well understood and a good way to ensure that prices are cost based, while providing incentives for outperformance. However, for STAL, a RAB approach may provide less protection from higher prices than other forms of regulation, be more costly to implement and create greater distortions to incentives. Other more market based forms of price regulation (such as LRAIC or airport comparators), if practicable, might provide a better method of controlling prices at STAL, while still maintaining incentives for efficiency, although issues around the detail of the calculations would need to be resolved and care would be needed to ensure that the airport operator could finance its activities. Price monitoring or voluntary undertakings may provide a method of controlling prices, however much would depend on the perceived threat of regulation and the scale of countervailing competitive pressure or buyer power and how this is expected to change over time.

9.107 It is not necessary in assessing whether Test C is met to define precisely the type of regulation that would apply, rather that the benefits of some form of licence based regulation are likely to outweigh the costs. Our analysis demonstrates that, for STAL, the likely forms of licence regulation in general would provide benefits by offering the scope to limit the risk and extent of excessive prices, by encouraging efficiency, improving service quality and providing other benefits in terms of operational resilience. Licence regulation does also have adverse effects for example in terms of direct costs of management and regulation staff and consultancy associated with the periodic review. It can also distort incentives and introduce rigidity and commonality into processes, discourage bilateral contracts that may be in the passenger's interests and distract management. Test A found that STAL may have SMP and is likely to have SMP during 2014-19. Given the risks such market power could impose, the potential benefits of licence regulation at STAL are likely to outweigh the adverse effects. The CAA is therefore 'minded to' conclude that Test C is met and that some form of licence regulation should apply to STAL. The CAA will ensure that a licence is proportionate to the specifics of STAL and any conclusions under the market power assessment. The CAA will make proposals on the form of regulation that would apply at STAL as part of its Q6 initial proposals, published in April 2013.