

# YOUR LONDON AIRPORT

## *Gatwick*

04 APRIL 2012

Mr Iain Osborne  
Group Director  
Regulatory Policy Group  
Civil Aviation Authority  
CAA House, 45-59 Kingsway  
London, WC2B 6TE

**Reference: Q5-050-LGW09**

Dear Iain

### **CAA's assessment of market power at Gatwick**

The CAA published on 24 February its Initial Views on its market power assessments at Gatwick, Heathrow and Stansted. In the attached submission we set out our initial response to those documents. We intend to supplement this with additional submissions over the coming months including on the issues of airline yields, the competitive price level and airport behaviours

In summary, Gatwick submits that the CAA's evidence and analysis fails, by a considerable margin, to establish that Gatwick is dominant (and therefore has SMP). Accordingly, the first step in the case for continued price cap regulation at Gatwick has not been satisfied and the CAA's consideration of regulatory options needs to fully embrace the possibility of removing ex ante regulation from Gatwick following Q5.

### **The CAA's evidence fails to establish that Gatwick is dominant or that it requires ongoing ex ante regulation**

The CAA sets out the key points supporting its initial view on Gatwick's market power in relation to four factors; these being market shares, airline switching, passenger switching and airport behaviours and performance. I deal with each of these briefly below. Further detail is set out in the accompanying submission.

#### Market shares

In terms of market shares, the CAA concludes that Gatwick might have a "particularly strong market position in the point to point (no frills and charter) services serving passengers in the South East of England as well as outbound holiday makers." However, we note that the CAA has not defined these market segments as being relevant economic markets for the purposes of the market power assessment. The more relevant market definition is that identified by the CAA for "the provision by airports of infrastructure and infrastructure services" separately for surface and connecting passengers. For the surface passenger market, the CAA defines the geographic scope as including the Greater London area and South East of England, possibly also extending to include some districts in the South West and the East of England. This market definition clearly includes Heathrow, Stansted and Luton airports and others. For the connecting passenger market

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it is broader still, including airports in other parts of the UK and the EU more widely. It is by reference to these markets that the CAA should be assessing Gatwick's market power.

The CAA shows that Gatwick's market share of passengers from Greater London, the South East and the East of England is less than 30% - substantially less than the share above which there is a rebuttable presumption of dominance. This compares to Heathrow's share of around 40% and Stansted's of under 20%. Moreover, these market shares do not reflect the competitive constraints that the CAA considers could emanate from airports outside the market as defined and as such the market shares underestimate the extent of constraints present.

Heathrow, Gatwick and Stansted are all competing in the same relevant economic market. Yet, the CAA is arguing that each airport is dominant. If the CAA is proposing that the airports are jointly dominant, it needs to substantiate this finding with evidence. If the CAA is proposing that each airport is individually dominant in the same market then the CAA needs to explain this position with regard to the relevant case law.

### Airline switching

The CAA argues that some airlines face switching costs in moving services away from Gatwick. This has been identified in relation to the sunk investment of full service carriers (FSCs) and as a consequence of lower yields available from other airports.

The CAA's analysis of airline switching costs based on sunk investments is very high level and lacks detail. As such, it is insufficient to reject and overturn previous views of the CAA and the CC that, despite the existence of switching costs for some airlines, a substantial level of competition could be expected between the London airports. It is also the case that even if some FSCs have sunk investments, it is only in the event that the airline ceases all operations (rather than, more likely, curtails them) at an airport that it will have to forego such sunk investments.

As noted by the CAA, the data on yields provided by airlines focuses on average, rather than marginal, yields. This makes this evidence irrelevant for assessing competitive constraints. For such analysis to be relevant, it must focus on yields associated with routes that would be most likely to switch in response to price changes, as it is such switching at the margin that imposes constraints on an operator's ability to increase prices.

### Passenger switching

The CAA finds that some passengers do not consider Stansted a particularly close alternative and that there is relatively less choice for long haul passengers compared to short haul passengers, citing that only about 40% of long haul routes at Gatwick are also served by Heathrow.

The manner in which the CAA assesses passenger switching is not appropriate. It is well established in competition analysis that the relevant constraint is the presence of significant numbers of marginal customers i.e. those that are most likely to switch in response to price changes.

A more appropriate interpretation of the evidence cited above is that for 40% of long haul routes there is a very close substitute for passengers and that a significant proportion of passengers

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considers Stansted and Gatwick to be close substitutes. Indeed, the CAA's survey demonstrates that not only do a significant number of passengers consider that they have a choice but they also exercise it. Unsurprisingly, therefore, the CAA itself acknowledges that the majority of Gatwick's customers are not "captive". This is inconsistent with any claim that Gatwick derives market power due to any preference by South East passengers to use Gatwick, whether in respect of point-to-point services or otherwise.

### Airport behaviour and performance

The CAA concludes that the evidence on Gatwick's conduct since change of ownership is "not sufficient to find that Gatwick no longer holds any SMP" and that there is "still a lack of sufficient evidence to support a clear, unambiguous decision on the airport's market power."

While it is clear that the airport's behaviour cannot in isolation provide the basis for a judgment on SMP (a test that the CAA's drafting implies is being applied), it is an important corroboration of the other evidence demonstrating that Gatwick does not have SMP.

The CAA's view that Gatwick's conduct since sale by BAA can be ignored or marginalised on the grounds that it may simply reflect a change of ownership rather than a response to competitive market conditions is a highly selective reading of the available evidence. It is also at variance with the CAA's previously expressed views. As we evidenced in our November 2011 submission, the change of behaviour at Gatwick is highly correlated with both the CC and the CAA's expectations of airport competition, as set out by these authorities at the time of the CC's airports market investigation. The CAA has provided no evidence that Gatwick's recent behaviours have not been driven by competition. It is also unclear why a change of management should be assessed to have such a profound effect on conduct, whereas it is entirely understandable that conduct would be affected by an increase in competition resulting from BAA break-up. Accordingly, the increase in competition is a priori the most likely explanation for the behaviours seen, and as such should be given weight by the CAA.

If the CAA is to conclude that there is dominance in spite of the evidenced behaviours, it must clearly set out what additional behaviours it would expect to observe in a market with effective competition. Moreover, and particularly relevant to the second and third of the tests under the Bill, the CAA has not presented any evidence of behaviours consistent with those of a dominant operator, nor of an operator that would seek to abuse any dominance it holds.

### **Areas of omission of the CAA**

The CAA omits fully to consider a number of areas relevant to its competition analysis and to give due consideration to the significant body of evidence submitted by Gatwick. These areas include:

- The competitive price level, where the CAA has not developed its own estimates of forward-looking costs nor has it provided an adequate analysis based on an appropriate set of comparators, despite dismissing the evidence from Gatwick. The CAA is also apparently not pursuing the possibility that airline yields at Gatwick (quoted as a switching cost) are potentially relevant to the competitive price level against which such switching should be assessed;

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- Its analysis of competitive constraints, which should be on the basis of substitution and switching at the margin;
- Not giving full consideration to the availability of capacity in the South East, where the CAA has failed to give consider the prospects of dynamic competition to deliver additional capacity. The CAA's analysis is also very much based on an incomplete view of current capacity, not what could reasonably be expected in the future.
- Not providing a forward look throughout the CAA's analysis. This is particularly important in the context of Gatwick where the CAA relies heavily on Gatwick's historic pattern of traffic (e.g. in respect of outbound holiday passengers). The CAA also fails to place due weight on the fact that Gatwick has only recently been placed under separate ownership from BAA (and in conditions of continued regulation), hence the market positioning and competitive interactions observed to date are not a reliable guide to what would be expected in a deregulated future. The analysis should seek to build on what has been observed to date, recognise experience from other (including airport) markets, and consider the full range of possible competitive interactions to reflect the likelihood that separately owned, deregulated airports will take a dynamic, innovative and unpredictable approach to their market positioning, including the provision of capacity.

### **The legal test being applied by the CAA**

The CAA in its market power assessment documents has not been clear as to what it considers to be the legal test it needs to satisfy to demonstrate SMP. However, at the CAA's Q6 Setting the Scene workshop for Gatwick on 13 October 2011, you clearly stated that, under the new regulatory framework, the onus would be on the CAA to make the case that an airport has SMP.

However, the CAA's current approach seems to be more equivocal in that dominance seems to be assumed (a fact borne out by the CAA not undertaking similar analysis of the level of market power held by Luton airport). It is not appropriate to proceed, as it appears the CAA intends to, as if the default conclusion is that Gatwick is dominant unless there is proof to the contrary. In particular, its current designation – deriving from entirely different circumstances – cannot be the starting point for the CAA's thinking

As we set out in our November submission, it is for the CAA to make the case that an airport is dominant and the CAA's test for continued regulation at Gatwick is whether Gatwick is, at a minimum, dominant in the meaning of EC competition law. A dominance finding is a major hurdle and is not met merely because an entity may have some degree of market power, or that it may potentially obtain dominance in the future.

### **The CAA is potentially prejudicing Gatwick's position**

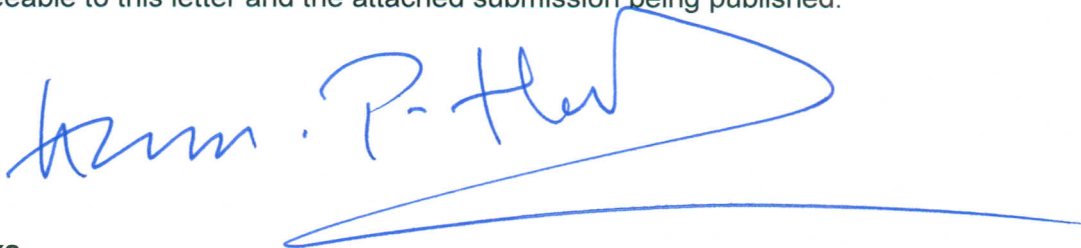
Gatwick is concerned that the CAA's Initial Views analysis, together with its consideration of future regulation, is potentially prejudicial to Gatwick, both in terms of the CAA's future conclusions on market power and our commercial position. This is for a number of reasons:

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- The CAA appears to have ignored important evidence and precedent. Its findings on Gatwick appear significantly at variance with the CC's analysis in the BAA market investigation and the CAA's own perspectives in recent years. We recognise that the CAA is not obliged to maintain its previous views when circumstances change. However, we would expect the CAA, in line with its own practice, and regulatory best practice more generally, to explain what has changed in the preceding period and why it takes differing views from any it has in the past, or from other relevant regulators.
- The CAA's position on whether market conduct since the sale of Gatwick indicates that competition is emerging seems to be substantially different from that of the Competition Appeal Tribunal's (CAT's) recent judgement.
- The CAA has not undertaken an assessment of the market power of Luton and is not considering imposing ex ante regulation on that airport. Luton is a key competitor to Gatwick and this discriminatory approach risks being detrimental to Gatwick's ability to compete effectively.
- The CAA does not provide in its document an adequate examination of the numerous points raised by Gatwick in its November submission, or substantive reasons for rejecting them. The CAA ignores much of the evidence presented by Gatwick and when the CAA does acknowledge our submission, it appears to only provide cursory comment. This compromises Gatwick's ability to properly respond to the CAA's new analysis.
- The magnitude of any market power held by Gatwick (as well as the behaviours demonstrated by it) is plainly germane to the proportionate approach to regulation encapsulated in Parts B and C of the Market Power Test proposed in the Civil Aviation Bill. The CAA is effectively treating its work on assessing competition as a sufficient precursor to regulatory design when the test clearly has three parts. By doing this the CAA appears to be substantially narrowing the options for future regulation, and indeed for future work on SMP, on the basis of an unconvincing analysis, which even the CAA acknowledges does not allow the CAA to come to a definitive finding on whether Gatwick has SMP. Tests B and C are crucial and will need to be carried out to a more rigorous degree than appeared to be evidenced by the initial appraisal in the CAA's slides presented at its recent workshops.

We are agreeable to this letter and the attached submission being published.



**Kyran Hanks**  
**Strategy and Regulation Director**  
T: 01293 503860  
E: [Kyran.Hanks@gatwickairport.com](mailto:Kyran.Hanks@gatwickairport.com)