



Civil Aviation Authority

Heathrow, Gatwick and Stansted – market power assessments

Summary of the CAA's initial views – January 2012

(page left intentionally blank)

Airport market power: the CAA's initial views

1. High levels of market power can allow airports to raise prices, deliver inadequate levels of service quality and scale back on investment. This can harm consumers, including by limiting the ability of airlines to offer choice and value to passengers.
2. Where airports enjoy high levels of market power, it can be appropriate for the CAA to apply economic regulation, so as to improve outcomes for passengers, cargo shippers and airlines. This regulation currently takes the form of a cap on the prices charged by the airport and a series of financial incentives and other obligations to encourage efficient operation, appropriate service quality and efficient investment.
3. Most UK airports are not subject to this form of economic regulation. Airports are only subject to this regulation if they have (or are likely to have) 'Substantial Market Power' and if economic regulation is likely to improve outcomes. Further, when airports are subject to such economic regulation, it can take a number of forms, and be tailored to the extent and nature of market power.
4. The CAA is committed to ensuring that its regulation of airports promotes choice and value for consumers, whilst also meeting the better regulation principles. In order to deliver on this commitment, during 2011 the CAA embarked upon a project to understand the extent and nature of market power held by the airports that are currently 'designated' for price control regulation: Heathrow, Gatwick and Stansted. This work also addresses the Competition Commission'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.¹
5. This work will inform the CAA's views on whether these three airports should continue to be subject to economic regulation, including whether – under the proposed reforms set out in the Civil Aviation Bill (2012) – these airports should be required to hold an economic licence. The work will also allow the CAA to work with stakeholders in developing future regulation of these airports that protects consumers. A summary of the background to this work is in an annex to this paper.
6. We would like to thank those stakeholders who have engaged with the CAA during 2011, and invested time and money in providing evidence and analysis.

The CAA's initial views on market power

7. The CAA's final decisions on the future regulation of Heathrow, Gatwick and Stansted will be made in late 2013/early 2014. Alongside this process the CAA will develop the economic licences that will apply to those airports that will remain subject to economic regulation after that date. There is, therefore, some time before the CAA needs to reach a definitive view on the extent and

¹ Competition Commission, 'BAA Airports Market Investigation – Final Report', March 2009, paragraph 10.339.

nature of the market power at these airports, during which further analysis can be undertaken and additional evidence – including from more recent market trends – can be considered.

8. However, it is important that we provide sufficient clarity now about the extent and nature of the market power we think Heathrow, Gatwick and Stansted enjoy, for two reasons:
 - first, to set out our initial views, and the supporting evidence, to allow all stakeholders to offer views and additional evidence; and
 - second, to provide sufficient clarity to support stakeholder discussions on the appropriate form of regulation to be applied at the three airports.
9. During the process leading up to the Q6 price control decision the CAA will be refining its analysis, incorporating additional evidence, and thereby enabling it to reach conclusions on the market power of Heathrow, Gatwick and Stansted.
10. The CAA's approach to assessing market power has been set out in detail in its *Guidance on the Assessment of Airport Market Power*.² In general terms, assessing the degree of market power involves the evaluation of two main issues. First, the degree to which passengers, cargo shippers, and airlines can reduce their use of the airport if they do not consider the price-service offering to be reasonable. This ability of customers to go elsewhere, or to switch (some or all of) their business away from the airport, is likely to depend on a number of factors, which a competition assessment seeks to explore in a structured manner. Second, we need to consider whether the extent of likely switching away from the airport will be sufficient to discipline that airport's pricing, service quality, and investment decisions.
11. We set out below the high-level findings of our work to date to understand the market power held by Heathrow, Gatwick and Stansted. These views are based on the evidence currently available to the CAA. As noted above, we expect that additional evidence will become available before the CAA takes a firm view on the position of each airport. Reflecting this, there are a number of issues that have been left open and, whilst the CAA has sought to highlight where each airport might sit on the market power spectrum, it has not reached a definitive view on each airport at this stage.

The extent and nature of Heathrow's market power

12. Heathrow is the UK's only major hub airport, and focuses on the provision of services to airlines that have based their networks at the airport, and airlines that fly into the airport from a different hub. Both of these airline business models rely to some degree on the ability of passengers to connect between services at Heathrow.
13. These airlines have particular requirements from the airport to: support operations, including the ability to offer premium services to passengers;

² CAA, 'Guidance on the Assessment of Airport Market Power', April 2011, available at <http://www.caa.co.uk/docs/5/Final%20Competition%20Assessment%20Guidelines%20-%20FINAL.pdf>.

connect passengers and their baggage between aircraft; and process cargo carried in the hold of passenger flights.

14. This means that the number of airports with which Heathrow competes for the majority of its airline business is relatively limited. This is particularly the case for airlines based at the airport, who face higher costs to relocate their business to alternative airports due to the adverse impact of such switching on the quality of the networks available at Heathrow. These airlines appear to only have the choice of operating at Heathrow or, for some services, at Gatwick. It is also likely that many of the airlines operating into Heathrow from other hubs place particular weight on the size of the airport's catchment, the ability to transfer passengers, and the yields that can be earned from operating at the airport, which may only be available at a relatively small number of other airports.
15. When attracting passengers, Heathrow operates in two different markets. First, for passengers travelling on direct services, Heathrow appears to be competing over a relatively broad geographic area, extending to include the South East and Greater London regions, and extending towards the west and north, particularly when attracting passengers to long-haul services. Consequently, there are very significant overlaps in the airport's catchment area with Gatwick, Stansted and Luton (amongst other smaller airports), although many passengers appear to have a strong preference for using services at Heathrow. Second, for passengers connecting through the airport, Heathrow is competing in a market with the major hub airports in Europe, but also faces competition from hubs located further afield.
16. The airport, therefore, operates in broad markets to attract passengers, but in a much narrower market when competing for its main airlines. When the passenger-facing and airline-facing aspects of competition are combined, it suggests that the airport has a particularly strong market position in respect of those network airlines based at the airport, which then supports the airport's strong position in long-haul. This means that, whilst passengers might in principle be willing to use an alternative airport, the airlines are unlikely to reduce significantly their use of the airport in response to an increase in prices.
17. Overall, the available evidence all points towards Heathrow enjoying a very strong market position, which amounts to Substantial Market Power (SMP).
18. Looking forward, the CAA has not identified any factors that would indicate that this market position will substantially change over time. Heathrow is facing increased rivalry from Gatwick – and potentially from Stansted – but the impact of this competition appears likely to be offset by the market strength that comes with the hub operations at the airport, in particular when combined with capacity constraints and growing demand to use Heathrow.

The extent and nature of Gatwick's market power

19. Gatwick provides services to a range of different airlines, including point-to-point short-haul, charter and long-haul operators, some of whom benefit from passengers who connect between services.

20. The way in which the airport competes for airline business is likely to vary across these market segments. In some market segments, notably for long-haul carriers based at the airport, Gatwick appears likely to compete with Heathrow for airlines, with the competitive pressure from Heathrow being limited by the capacity constraints that exist at that airport.
21. The airport is also a major base for easyJet and a number of other point-to-point short-haul airlines operating independently of connecting traffic. The airport is a significant base for some of these airlines, who argue that the airport delivers a level of profitability that is difficult to replicate elsewhere. However, these short-haul point-to-point airlines are generally very flexible in their operations, and are likely to face lower costs to reduce their use of any given airport. When competing for the most flexible (i.e. most marginal) airline services, the airport is likely to compete with other airports not only in Greater London and the South East of England but with other UK and potentially European airports. However, Gatwick offers airlines access to a large and prosperous catchment, which will not be available at all airports in this market. Further, in this market segment, the competitive pressure from Heathrow is limited as short-haul point-to-point airlines are unlikely to see Heathrow as a viable alternative to operating at Gatwick.
22. Gatwick appears to attract passengers primarily from the Greater London area and the rest of the South East (about 80% of its surface passengers). It also attracts passengers from the East of England and the South West, particularly when attracting passengers to long-haul services. Consequently, there are significant overlaps in the airport's catchment area with Heathrow, Stansted and Luton (and some other smaller airports).
23. The airport, therefore, operates in a number of markets to attract airlines (in part, due to the range of airline business models at the airport), some of which are relatively broad. However, it operates in a narrower market when competing for passengers. This passenger market appears to be focused on the South East region, where the airport has a relatively high share of traffic (44% of passengers from this region use Gatwick) and evidence suggests a degree of reluctance by passengers to use some other airports.
24. Further, when we consider how passenger-facing and airline-facing aspects interact, it suggests that the airport might have a particularly strong market position in some market segments. For example, it has a relatively strong market position when competing for point-to-point (no frills and charter) services serving passengers in the South East of England, where there is competition from Luton and Stansted for airlines, and competition from Heathrow for passengers.
25. Indeed, there is evidence to suggest that some airlines and passengers do not view Stansted airport as a particularly close alternative to operating at Gatwick, albeit that both airports have significant catchment overlaps. There are a number of possible explanations for this. The main reason cited by airlines is the inability to realise the same level of yields at Stansted as at Gatwick; with some regarding the two airports operating in distinct catchments. Joint ownership of Stansted and Heathrow by BAA may have

reduced Stansted's efforts to differentiate its service offering and to adopt innovative and aggressive strategies to raise passenger awareness of the airport and its relative strengths. Alternatively, the apparent unwillingness of passengers currently using Gatwick to travel to Stansted might reflect relative weaknesses in the surface access options offered to passengers, such as the congestion and cost associated with travelling to Stansted from South London, Kent and Sussex.

26. Further, a number of airlines stressed the higher yields earned at Gatwick, explaining that the reduction in yield experienced when switching away from Gatwick contributed to the airport's market position. Linked to this, Gatwick argued that the current price controls keep its prices at the airport artificially low, inflate airlines' route profitability, and increase the apparent market power of the airport. In order to assess this argument, it is necessary to take a view on whether the current price cap keeps prices significantly below the level that would be seen in a competitive market. Whilst Gatwick presented evidence that supports their view, it was not sufficiently compelling to allow the CAA to conclude that this was the case (but equally, this is an issue that would need to be looked at again in the context of any revised price caps that were to apply at Gatwick beyond April 2014).
27. Set against this, the airport argued that its conduct since its sale by BAA was consistent with that of a competing airport, with improved service quality, greater efficiency and more competition to attract airlines to the airport.
28. It is certainly the case that the airport's conduct has changed and that – in a number of important ways – has delivered real improvements to airlines and passengers. Whilst not agreeing with every example of improvements, airlines generally accepted that these changes had been positive overall.
29. However, this is not sufficient to find that Gatwick no longer holds any SMP:
 - First, whilst some of this evidence supports the view that the airport is competing for passengers and for airlines more than it once did, the airport might still have sufficient market power to require economic regulation.
 - Second, it could also be argued that any change in conduct was driven by the change of owner attempting to maximise the return on its investment, rather than being driven by a step-change in the level of competition faced by the airport.
 - Third, there is mixed evidence on the extent to which there has been a significant change in the airport's incentive to compete for airline business. In particular, whilst the airport emphasises its successes in attracting a number of airlines to the airport, including a mix of short and long-haul operators, the previous owner successfully attracted growth from easyJet, and a number of other carriers, and a number of incumbent airlines based at the airport have stressed that they have not been offered the discounts available to some new carriers. There is, therefore, mixed evidence as to whether recent trends represent a clear break from the past.

30. To the extent that ownership changes have affected the degree of competition faced by Gatwick, there is still a lack of sufficient evidence to support a clear, unambiguous decision on the airport's market power. The airport has been in separate ownership from Heathrow and Stansted for only a little more than two years, limiting the amount of information available about the airport's conduct.
31. Looking forward, the CAA's view on the market power at Gatwick will likely depend upon the following:
- Additional evidence on the switching costs faced by airlines at Gatwick, including the extent to which yields might fall when moving services away from the airport.
 - Whether there is evidence that the competitive pressure from Stansted represents a significant constraint on Gatwick's conduct; and
 - The emerging evidence on the extent to which other UK airports can attract passengers and airlines away from Gatwick.

We would hope to be able to work with airlines and the airport to obtain better information to reach a firmer view on all of these factors.

32. Overall, therefore, we see Gatwick as having some market segments where its market position is relatively strong, whilst there is also credible evidence that in others there are significant competitive constraints. Reflecting this, the airport does not appear to enjoy a level of market power similar to that at Heathrow – there is certainly a degree of competitive pressure at the airport. However, on the basis of the evidence currently available, there are some areas in which Gatwick appears to still hold SMP. Whilst the sale of Stansted might inject additional competition into the South East airport market, growing demand and the constraints on airport expansion suggest that this position of SMP might sustain over time.

The nature and extent of Stansted's market power

33. Stansted focuses on serving point-to-point airlines, and currently focuses on short-haul services to European destinations. Looking ahead, the airport appears most likely to be capable of attracting further point-to-point operators, including long-haul services operating into London from other (distant) hubs. Reflecting this, when competing to attract and retain airlines, the airport competes with a very broad range of other airports, and can be viewed as operating in a European market for airline services, albeit that the airport offers airlines access to a large and prosperous catchment, which will not be available at all airports in this market.
34. The airport attracts a broad range of passengers, including those travelling for leisure, business or to visit friends and relatives. Evidence from the past use of the airport and from survey responses, suggests that the airport competes for passengers against airports in the South East and East Anglia, and may also face some competitive pressure from airports in the Midlands.
35. The airport, therefore, operates in both a broad market to attract airlines, and a broad market to attract passengers. Stansted's share of either of these

markets is not particularly large, although when Heathrow is taken into account (reflecting the common ownership of Heathrow and Stansted by BAA), its market position is more significant. It also appears that the airport operates in a broad market when competing for cargo flights.

36. Set against this, airlines operating at Stansted have emphasised the importance of operating from the airport, and that the efficient operation of short-haul, no frills services requires airlines to use capacity early in the morning. The relative shortage of peak capacity at Stansted and at alternative airports could, therefore, allow the airport to raise prices above the level that might prevail in a competitive market. Indeed, airlines at Stansted have made clear that they consider that recent trends in the airport's pricing reflect exploitative behaviour.
37. At this stage, the supply of capacity at peak times is the most likely source of any position of substantial market power at the airport, albeit that we remain concerned that BAA's ownership of Heathrow and Stansted could be reducing the ability of the airport to raise its profile and adopt aggressive strategies to attract passengers and airlines to the airport.
38. There is, however, a lack of clarity about the ability of airlines to reduce their use at peak times, and the evidence on pricing at these times. First, peak capacity appears important to the airlines at Stansted, as it supports the efficient use of their aircraft, making them reluctant to reduce their use of peak capacity. This, however, needs to be set against the apparent flexibility of their business models, which might enable switching to alternative airports. Second, we have seen evidence that supports the view that Stansted's prices, whilst higher than a number of airports across Europe, appear comparable to those serving major conurbations.
39. Looking forward, the CAA's view on the market power at Stansted will likely depend upon the following:
 - The evidence available on the barriers to airlines reducing their use of Stansted at peak times, including the impact on airline yields; and
 - Whether, and to whom, the airport is sold by BAA.
40. Whilst the second of these factors is outside of the control of the CAA, we would hope to be able to work with airlines and the airport to obtain better information to reach a firm view on the former.
41. Overall, therefore, we see Stansted as enjoying the least market power of the three airports being assessed and, whilst the evidence is currently not sufficiently clear to reach a definitive view, it appears that any position of substantial market power arises from the relative bargaining positions of the airport and airlines during a relatively narrow peak period. The relative strength of these positions might change over time and be affected by the potential ownership changes at the airport, as well as the balance between demand and available capacity.

Implications for economic regulation and Q6

42. The balance of evidence currently available suggests that there is a reasonable prospect that Heathrow, Gatwick and Stansted airports will possess substantial market power beyond the expiry of the current price control arrangements in April 2014, and that all three airports would meet the first criterion for continued price-control regulation (i.e. designation under the Airports Act, or licensing under the proposed Civil Aviation Bill). It does not appear appropriate to consider, at this time, whether the airports meet the conditions for continued designation.
43. The CAA will be discussing with stakeholders how the three airports should be regulated going forward, which will include discussions on the costs and benefits of different regulatory approaches, and the role that competition law might play in mitigating the risk of abuse of airport market power. If the Bill passes into law, the CAA will assess whether each of these airports require an economic licence in late 2013/early 2014, and this work, together with the results of the airport market power assessments, will inform the CAA's decision as to which airports require economic licences and the licence conditions that should be applied.
44. The CAA's emerging views on market power, based on the balance of current evidence, means that there remains a significant risk that absent some form of safeguard from April 2014 the degree and nature of market power possessed by the airports may result in adverse outcomes (compared to what might be expected in a well-functioning market) for the users of airport services, including present and future passengers, cargo shippers and airlines. Potential areas where these adverse outcomes might manifest include service quality, investment decisions, consultation, innovation and prices charged.
45. However, at present the strength of market power varies across the airports, as do the market segments over which each airport's market power is concentrated:
 - At Heathrow, there is consistent evidence to support the view that the airport enjoys a very high degree of market power, over a large proportion of the passengers, cargo shippers and airlines using the airport.
 - At Gatwick, whilst there remains a degree of uncertainty over the airport's position, the balance of evidence suggests that the airport may be able to raise prices or reduce service quality – particularly to some market segments – were economic regulation to be removed.
 - At Stansted, the current focus is on the balance of bargaining power at peak times, where the airport might be able to raise prices and/or reduce service quality offered to passengers and airlines.
46. The CAA will need to keep the situation under review in the lead up to reaching a final decision in late 2013/early 2014. In particular, we will also need to monitor closely how features of the market change over time, and

incorporate any additional evidence, including about the likely capacity-demand balance at the airports, airline switching costs and the impact of airline yields on these costs.

47. These emerging views on market power suggest there may be a need to safeguard users' interests from the risks of abuse of the airport's market power. Under the Government's proposed Civil Aviation Bill (2012), the CAA would have much more flexibility than at present to tailor the design of regulation in a proportionate way at each airport. This includes setting proportionate licence conditions as well as placing reliance on general competition law, rather than on airport licences, where this is most appropriate.
48. As part of Q6, the CAA will continue to consider the most proportionate response to remedying the risks of abuse of market power. Whilst licence conditions may be required in relation to prices, service quality, and ensuring airports interact fairly with their customers, the exact nature of these obligations and the balance between them could potentially be different at each airport. It may also be possible to find alternatives to the current regulatory approach to price controls that best mitigate the risks of abuse of market power highlighted above. This could involve enhancements to the current RAB-based³ approach (as are being discussed between Heathrow and airlines), or moves towards alternative approaches to calculating price caps, and greater use of negotiated settlements.
49. Whatever the regulatory approach – and, indeed, even if any of the airports were to be de-regulated – the airport operators need to discuss how the airports should develop and how airports and airlines can collaborate to deliver benefits to consumers. Such discussion and debate is a normal feature of customer-supplier relationships in a well-functioning market.
50. Reflecting this, there is a compelling case at all three airports for airport-airline discussions (referred to as Constructive Engagement) to start, and for the airports and airlines to support this process by sharing suitable information and views. It is relevant that, at this stage, that we cannot rule out the possibility that the CAA will need to establish price caps at all three airports (whether this be based on a RAB approach, a derivation/enhancement of this, or some alternative), which should be informed by the output of this Constructive Engagement.

Way Forward

51. The work to assess the market position of Heathrow, Gatwick and Stansted is one of the pieces of evidence that will inform the development of the Q6 regulatory settlement, including how the approach to regulation might adapt and evolve over time.
52. During February and March 2012, the CAA will be engaging with stakeholders on its initial views on market power and the implications for the

³ The current regulatory approach involves the calculation of a Regulatory Asset Base, which is used to calculate the allowed returns for the airport and the appropriate depreciation charge, both of which affect the overall price cap set at the airport.

design of the next price controls. This will be supported by the publication of the individual assessments that support the summary set out in this document.

53. The CAA will also be hosting a number of seminars, to take forward the work on price control design, in early March. The output of these seminars – and other discussions with stakeholders – will be brought together into a publication in April 2012, which will frame the debate on the development of regulation and, where appropriate, support the process of Constructive Engagement.
54. If you would like to register your interest in the seminars, please contact Barbara Perata-Smith, on 020 7453 6202 or Barbara.PerataSmith@caa.co.uk.
55. There will also be an opportunity to engage on the CAA's initial views on airport market power during 2012, which will also allow the CAA to work with stakeholders to narrow down those areas of uncertainty that currently exist. Stakeholders will also be able to submit further evidence – and comment on the CAA's initial views – during this period. At this stage, the CAA expects to publish its next substantive analysis of airport market power in late 2012/early 2013.

Annex: Background to the CAA's market power assessments

- 1.1 The CAA is currently carrying out assessments of the market power held by Heathrow, Gatwick and Stansted. These assessments will form part of the evidence base informing the approach to the upcoming regulatory reviews ("Q6") for these three airports.
- 1.2 In particular, the analysis will inform the CAA's work to apply price and service regulation for the purposes of price control under section 40 of the Airports Act 1986 ('AA86'),⁴ but will also be relevant should the CAA be required to take a decision on whether an airport should hold an economic licence under a proposed new regime of economic regulation of airports, or if it were required to provide advice to the Government on whether an airport should be 'designated' or 'de-designated'.
- 1.3 More generally, the results of the competition assessments could be relevant to any assessment of anti-competitive conduct, under the CAA's powers to investigate airport conduct and impose additional conditions on airports under section 41 of the AA86.⁵

Purpose of this document

- 1.4 This document sets the high-level findings of the CAA's work to date to understand the market power held by Heathrow, Gatwick and Stansted. These views are based on the evidence currently available to the CAA. We expect that additional evidence will become available before the CAA takes a firm view on the position of each airport. Reflecting this, there are a number of issues that have been left open and, whilst the CAA has sought to highlight where each airport might sit on the market power spectrum, it has not reached a definitive view on each airport at this stage.
- 1.5 We will shortly be publishing the detailed assessments of each airport, together with the supporting evidence and analysis.

Process going forward

- 1.6 The results of the competition assessments will inform the ongoing work to develop the economic regulation of Heathrow, Gatwick and Stansted airports. We have set out an indicative forward timetable for this process below.

⁴ The current designation criteria determined by Government are that: an airport has, or is likely to acquire, substantial market power; competition law may not be sufficient to address the risk that the airport would increase and sustain prices profitably above the competitive level or restrict output or quality below the competitive level; and the benefits of designation outweigh the costs.

⁵ Section 41 of the AA86 provides the CAA with the power to impose conditions on airports holding a permission to levy airport charges for the purpose of remedying or preventing a number of forms of conduct. In general terms, these forms of conduct reflect those that a dominant airport would, under UK and EC competition law, be prohibited from pursuing.

Date	Publication / Event
31 January 2012	Publication of summary findings on airport market power
Early February 2012	Publication of supporting analysis on airport market power
March 2012	Individual airport seminars on the market power findings and the implications for economic regulation of the airports Publication of Constructive Engagement mandates
April 2012	Publication of Q6 Policy Update document Publication of Gatwick and Stansted airport business plans Start of Constructive Engagement
December 2012	Constructive Engagement ends Publication of Constructive Engagement reports
January 2013	Publication of updated airport business plans, where appropriate
Late 2012/early 2013	Publication of updated assessment of airport competition
April 2013	Publication of CAA's Initial Price Control Proposals for Q6
September 2013	Publication of Final Proposals consultation
January 2014	Publication of Q6 decision

- 1.7 Throughout this period, we urge interested parties also to engage with the CAA in a range of ways, including through bilateral meetings, seminars and less formal conversations.

Consultation

- 1.8 We welcome stakeholders' views on the information presented in this paper, although we would anticipate that stakeholders will also want to comment on the CAA's findings, once the full suite of documents is published. There are two periods over which interested parties can engage with the CAA:
- Those wishing to share their initial views with the CAA should aim to submit any material to the CAA by 24 March 2012, so that these can inform the CAA's next Q6 price control publication, which is scheduled for April 2012.
 - Those wishing to engage on the detail of the competition assessments are invited to engage with the CAA during 2012, so that any additional evidence and analysis can be incorporated in an updated assessment of airport competition, scheduled for publication in late 2012/early 2013.

- 1.9 If you would like to discuss the contents of this paper, and the CAA's work on assessing airport competition, in the first instance please contact Alina Jardine Goad on 020 7453 6229 / alina.jardinegoad@caa.co.uk or Alexander Dünki on 020 7453 6212 / alexander.dunki@caa.co.uk. You can also contact Chris Hemsley on 020 7453 6237 / chris.hemsley@caa.co.uk.
- 1.10 If you would like to discuss the economic regulation of Heathrow, Gatwick and Stansted, including the Q6 work programme, please contact Richard Moriarty on 020 7453 6203 / richard.moriarty@caa.co.uk.