

Virgin Atlantic Airways Response to CAA Consultation on Gatwick Market Power Assessment

26th July 2013

General View

This response provides Virgin Atlantic Airways (VAA) views on the CAA's 'Consultation on Gatwick Market Power Assessment' published May 2013.

Our continued position is that Gatwick Airport holds significant market power (SMP) and will continue to do so over the Q6 period, 2014 – 2019. This response builds on, rather than replicating, previous responses and evidence submitted.

Under Test A it is clear that the limited ability for airlines to switch away from the airport, also taking into consideration marginal switching, means that the airport is able to increase prices and act in an uncompetitive manner and not suffer a material loss in revenue. With this in mind we agree with the CAA's assessment that Test A has been met and that SMP is evident at the airport.

We also agree that Test B has been met as competition law alone as an ex-post measure will not be enough to prevent Gatwick Airport Limited (GAL) from abusing its market power in the relevant markets. Relying solely on competition law would be at the detriment to the users of air transport services. The retrospective nature of this form of remedy and lack of precedence in its application would result in a long, drawn out remedy process and inefficient means to address the problem.

Under Test C we acknowledge the price commitments that have been presented by GAL as an alternative to RAB based regulation at the airport. However, we currently have a number of reservations with the proposals and in particular would highlight the enforceability and the terms of Commitments. We question whether price commitments should be used as the counterfactual in this instance given our view that such Commitments would only work with a regulatory backstop. VAA would suggest that this is instead compared with alternative non-licence based approaches. Overall, we agree that Test C has been met and some form of licence should apply. In our view a RAB based approach is the most appropriate form of regulation at Gatwick.

We will in turn be commenting on Test A, Test B and Test C in greater detail. Coinciding with this we will also be responding separately to the proposed licence conditions under section 18 of the Civil Aviation Act 2012 in relation to price commitments.

Test A

VAA supports the CAA's overall view on Test A that Gatwick Airport has and will continue to hold significant market power (SMP) over the Q6 period, 2014 – 2019.

The competitive price at Gatwick

We note the CAA's conclusions that there is enough evidence to suggest that GAL's aeronautical charges are broadly competitive compared to comparator airports. GAL's view that the current cap is below the competitive price level illustrates that the airport believes it can sustain a higher, uncompetitive price level due to its market dominance. This is coupled with the inability for airport customers (both airlines and passengers) to switch away from the airport. Even at the margins this is unlikely to have an impact on the airport.

VAA notes the robust evidence that has been provided to the CAA on the ability for both airlines and passengers to switch away from the airport in relation to a price increase in supporting its conclusions.

Market definition

The CAA is currently 'minded to' consider that there are two market segments in which GAL operates for the provision of airport operation services to airlines and their passengers within the core area of Gatwick:

- Low Cost Carriers (LCC) and charters; and
- Full Service Carriers (FSC) and associated feeder airlines.

The services of each are broadly similar, however, it is noted that FSC and feeder airlines also require: bellyhold cargo processing facilities, premium passenger facilities and integrated transfer facilities for passengers and baggage between flights.

Given that VAA's operations are clearly definable within the FSC and associated feeder airlines market we accept this definition. However, we are aware that for certain airlines at Gatwick such market segmentation is not always as clearly definable.

We hold the view that regardless of the market definition being segmented as above or in an alternative or broader form, GAL would continue to maintain dominance. This is irrespective of the market share (however defined) being below the 40% threshold for dominance.

Although the geographic market may in theory include both Heathrow and Gatwick, in reality given the above constraints this market will be limited to just Gatwick during the Q6 period, 2014 – 2019.

Competitive constraints – FSCs and associated feeder traffic airlines

The CAA considers that allocating new airline growth to other airports or reducing frequencies of operations is unlikely to be an effective response to a ten per cent increase in airport charges at Gatwick and we would agree. Neither of these aspects is vigorous enough to appropriately constrain Gatwick's pricing level and therefore illustrates the airports market dominance.

The CAA also concludes that grounding aircraft and switching marginal based aircraft would not appear to be a realistic means of switching away in light of a ten per cent price increase. ✂

We have outlined the switching costs with relation to sunk investment at Gatwick and support the CAA's more detailed analysis of this concluding that airlines with operations based do tend to have greater infrastructure costs. We note GAL's comments that marginal switching could occur at the airport in relation to a price rise. ✂

We would also agree that there are network effects in action at Gatwick ✂. This is an important contributing factor and an added constraint on the ability for airlines to switch away from the airport.

Capacity constraints and barriers to airline entry and expansion is another key issue that needs to be addressed. Given that Heathrow is the only credible alternative for services, and is currently at maximum capacity (and unlikely to gain capacity prior to 2020) it remains that there is limited scope to move away from Gatwick to constrain prices. ✂

Competitive constraints – passenger switching

We note marginal switching should be evaluated when calculating whether passenger switching can act as a competitive constraint on airport pricing. We believe the CAA has now taken this fully into consideration in this consultation document and we would agree with the outcomes presented.

Switching by marginal passengers either in the short-run or the long run in response to an increase in airport charges is in our view highly unlikely to constrain GAL's behaviour in the way they would be able to in a competitive market.

Indicators of market power

VAA notes that the CAA has also taken into consideration GAL's engagement and service quality at the airport in this process.

We continue to hold the view that despite a change in behaviour since the change in ownership particularly in regards to service quality; we are not be able to directly attribute this solely to increased competition in the market.

Additionally, GAL's lack of engagement particularly in relation to discussions on Commitments and lack of information disclosure during the CE process further illustrates their market dominance. This is not the behaviour that would take place if operating in a competitive market.

Test B

VAA agrees with the CAA's conclusion reached under Test B that competition law alone will not be sufficient to prevent the risk of the airport abusing its market power in the relevant markets.

As the CAA has identified, the abuse could take the form of excessive pricing and/or unsatisfactory levels of service. Our view is that ex-post competition law would not provide a satisfactory or timely remedy.

Relying solely on competition law would not be sufficient in this circumstance where the airport has SMP and a high risk of abuse is evident. Furthermore, the retrospective nature of this form of remedy, and the relative limited available competition law precedent for exploitative abuses would result in a long, drawn out process and inefficient means to address the problem.

VAA's view is that ex-ante regulation has a number of advantages that outweigh competition law and that some form of licenced based regulation should be applicable at the airport.

We would also note that the CAA took the view that airlines were not deterred by complexity or expense in pursuing legal challenges in this area. Our view is that such challenges are expensive and time-consuming and should be seen as a last resort where other remedies have failed – or do not exist in the first place.

Test C

As set out in the Civil Aviation Act 2012 Test C looks at:

“for the users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects”

Bearing this in mind Test C does not require the CAA to define a regulatory approach that should be taken. However, we would question the CAA’s assessment that the appropriate counterfactual should be the Commitments proposed by GAL. As we have already highlighted, such Commitments are unfeasible without some form of licence backstop.

As a general overview on Commitments we have serious reservations with the proposals by GAL as they currently stand and will be providing a full response to the CAA’s current consultation on these. VAA has also provided evidence on this in previous submissions during the Q6 process.

There have been several versions of GAL’s Commitments, ranging from a 2012 version which covered only price, to a wider set of proposals in January with a price of RPI+4% and a recently updated version with a price of RPI+2.5%. It is possible that they could change again going forwards. Additionally, it is not possible to compare the Commitments as set out by the CAA as this involves the use of a licence, and therefore a RAB based approach should instead be compared with more general non-licence based approaches.

Enforcement: A licence will in our view provide a better method of enforcement than relying on Commitments alone or a non-licence based approach. A licence would also mean that quicker and more efficient resolutions could be reached where necessary than under a non-licence based approach.

Price: Under a non-licence based approach it is likely that prices would increase more than under a licence approach. GAL has made it clear that the current pricing level at the airport is currently under the competitive level and should be increased. This would be at the detriment to the passenger and it would be in excess of the CAA’s assessment and airlines view of a ‘fair price’.

Even if we were to look at GAL’s latest set of Commitments presented, the price put forward (the headline price of RPI +2.5% with a RPI +1.5% for a blended price) is still above what the CAA has deemed as fair, RPI +0%. It is anticipated that in the longer term the airport would aim to increase this headline price further.

Therefore a licence based approach is likely to deliver significant savings to the passenger resulting in reduced prices and increased number of services at the airport.

Inefficiency: Licence regulation is an effective way of encouraging both capital expenditure and operational efficiency. Price controls are specifically designed to drive out inefficiencies and deliver the benefits to the consumers through lower prices.

Despite a non-licence based approach in principle providing an incentive for efficiency in both capital expenditure and operations, in practice these efficiency savings would be retained by the airport and not passed to the passenger as would occur under a licence approach. Also efficiencies would be less inclined to be made by the airport operator under a non-licence based approach due to the ability to raise prices far above a level in the best interest for the passenger.

Service quality: Following a public interest finding by the Competition Commission a service quality regime at Gatwick was introduced, which in itself illustrates that service improvements are more likely under a licence based approach.

We would also agree with the CAA and their concerns regarding the service quality proposals being put forward by GAL under a Commitment's led approach.

Service quality is therefore likely to be better under a licence based approach.

Investment incentives: It is highly likely that under a non-licence based approach that we would see the level of investment in the airport fall. This is due to the fact that this would be the primary source of revenue for the airport and its shareholders and is likely that projects beneficial for the passenger would be overlooked.

Other potential benefits of licence regulation: Given that the airport has SMP our view is that a licence based approach will better constrain the airports market power by driving efficiencies, encouraging efficient and appropriate investment and setting the appropriate price level.

The benefit of the regulatory system has already resulted in GAL downwardly revising their proposed prices under Commitments and finding further efficiencies. This potential cost saving, should Commitments be taken further, should be viewed as a benefit to the passenger and benefit of a licenced based approach.

Direct costs: We would also query amount that is currently being put forward by GAL associated with its own costs of regulation of £8 million (with a further £1 million associated with the CAA). The majority of this expenditure is unnecessary and in our view is an overestimate of the actual spend on the regulatory process for GAL.

We would welcome a clearer break down of these costs and their justification, as we would be keen to see if further efficiencies can be made and ultimately reduce the cost for the passenger.

There will of course be some cost associated with a licence; however, the costs that would be borne under a non-licence based approach would ultimately be more costly as it a new process with a number of uncertainties.

Other potential distortive effects: We do not accept the view that a licence based approach at the airport would:

- Crowd out a more commercial approach and reduce incentives to achieve commercial arrangements. The airport already has the ability to enter into commercial arrangements and alter the structure of prices; and
- Distort investment and pricing as the regulatory controls should be able to replicate commercial market pressures and would have a benefit over non-licence based approach.

In our view the benefits of a licence would outweigh the adverse effects and would be in the best interest for the passenger. We have shared with the CAA our full views on the Commitments proposed by GAL in our response to the initial Q6 proposals. Our continued view is that a RAB based approach is the most appropriate form of regulation at Gatwick.

Overall we agree with the CAA that Test C is met and that some form of licence regulation should apply to GAL.