

CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports

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Introduction

This paper provides Gatwick Airport's initial response to the CAA's publication on 24 February of its Initial Views on its market power assessments of Gatwick, Heathrow and Stansted. This followed publication of a summary of these documents on 27 January. The CAA subsequently published annexes to the February documents on 13 March.

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 forthcoming regulatory review should proceed with a view to removing ex ante regulation from Gatwick following Q5.

This paper summarises Gatwick's initial high level comments on the CAA's analysis and findings.¹ Gatwick intends to follow up on various points of detail over the next few months, including on the issues of airline yields, the competitive price level and airport behaviours. However, Gatwick submits that the material we have already presented, together with the comments in this paper, are sufficient to show that the CAA has not established that Gatwick is dominant.

The paper is structured as follows:

- First, we explain why the CAA's reasoning and evidence falls well short of establishing that Gatwick is dominant, and that the minimum condition for regulation at Gatwick is therefore not met.
- Second, we discuss the legal test that the CAA needs to satisfy to enable an economic licence to be issued.
- Third, we discuss a range of concerns with the CAA's process, including its ignoring of evidence and precedent; further, we argue that even if the CAA were correct to conclude that Gatwick is dominant (which we contend it is not), it remains incumbent on the CAA to analyse whether it is appropriate to continue to regulate Gatwick.
- Fourth, we summarise our conclusions.

¹The observations here should not be taken as a comprehensive summary of the reasons why Gatwick has no market power. Gatwick provided extensive evidence and analysis in its initial submission to the CAA in November 2011: "Airport competition: Competing to grow and become London's airport of choice – An initial submission from Gatwick Airport to inform the CAA's review of airport competition", pages 20-96. For the most part the CAA, in contrast to its past practice, does not note the evidence submitted or provide the CAA's reasons for rejecting that evidence.

The CAA's evidence, even taken at face value, fails to establish that Gatwick is dominant or that it requires ongoing ex ante regulation

The CAA sets out the key points in support of its initial view on the degree of Gatwick's market power in paragraphs 3.207 to 3.224 of its document.² These are collated under the headings:

- Market shares;
- Airline switching;
- Passenger switching; and
- Airport behaviours and performance.

We summarise below the CAA's key points under these headings and provide our summary initial observations. In addition, we also provide some additional observations on areas where the CAA has ignored important aspects of competition between airports which should have been taken into account in its analysis.

Market shares

Gatwick's share of the market for the provision by airports of infrastructure and infrastructure services for surface passengers in the Greater London, East and South East of England market is less than 30%.³ As the CAA concedes, Gatwick does not have market shares that would justify a rebuttable presumption that Gatwick is dominant. In general, the CAA downplays the importance of market shares in its market power analysis and to the extent the CAA does take market shares into account, it does so in terms of market segments. For example:

- The CAA highlights that 44% of passengers from the South East planning region use Gatwick and that these passengers constitute 38% of Gatwick passengers.⁴ Combined with this, the CAA interprets other evidence on passenger preferences as suggesting that some of these passengers are reluctant to use other airports.
- The CAA acknowledges that airports are unable to price discriminate directly against passengers on the basis of where they originate from. However, it then goes on to imply that airports could price discriminate indirectly against South-East originating passengers through possible discrimination by airlines. This somewhat tenuous argument appears to be the foundation for suggesting that Gatwick has a strong position in respect of some South East passengers and that these geographic market segments should be considered separately.

² A major shortcoming of the CAA's analysis is the lack of clarity in linking the CAA's conclusions to the evidence and argument examined. It is unclear which aspects of the evidence are relied upon and to what extent. This materially compromises Gatwick's ability to respond properly to the case advanced against it.

³ Table 3, page 58

⁴ This compares with 25% of passengers from the Greater London area that use Gatwick, constituting 41% of Gatwick's passengers.

YOUR LONDON AIRPORT

Gatwick

- Overall, 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.”⁵

Gatwick agrees with the CAA that Gatwick does not have market shares in any reasonably defined market that would justify a rebuttable presumption of substantial market power. Indeed, Gatwick’s market share is well below the 40% level commonly accepted as the *minimum* condition for a dominance finding.⁶ This creates a strong presumption that Gatwick is not dominant and against this starting point, the onus is on the CAA to advance clear and compelling evidence as to why other factors point to Gatwick being dominant despite Gatwick’s low market share.

The CAA’s suggestion that Gatwick could be dominant in respect of particular market segments is wholly unpersuasive. Key weaknesses are:

- The CAA does not show that there is a relevant market for the segments that it relies upon. Indeed, it accepts that the segments where it finds shares above 40% are “somewhat narrower than the [market defined]”.⁷ Further, even if those segments did constitute relevant markets, showing that Gatwick has more than 40% is not sufficient to conclude that Gatwick is dominant in respect of them. It is well established in dominance appraisal that other considerations must be taken into account, many of which would point to a lack of dominance even if it were sensible to focus on individual segments, for example:
 - Other airports also account for a large shares of these segments (Heathrow is the market leader in long haul; Stansted and Luton have large point-to-point businesses);
 - In some segments, buyers are likely to be large and powerful (e.g. easyJet and BA at Gatwick);
 - Potential entry and expansion into some segments is a clear threat (e.g. Stansted in respect of long haul, Stansted/Luton/other airports in respect of point-to-point and outbound holiday makers).

Accordingly, even if it were legitimate to look at market segments where Gatwick has an important share, the CAA’s analysis fails to make any adequate case that Gatwick would have substantial market power in respect of them.

- While the CAA acknowledges that airports are unable to price discriminate directly against passengers on the basis of their geographic origin, its implication that airports could price discriminate indirectly against South-East originating passengers through discrimination by airlines is not supported by any evidence whatsoever. As far as Gatwick is aware, airlines do not price discriminate between passengers according to the area around London from which they originate and the CAA provides no evidence to support this notion. Further, even if airlines could price discriminate in this way, the CAA does not explain why they would or

⁵ Paragraph 3.211.

⁶ Case C-62/86 [1991] ECR I-3359, [1993] 5 CMLR 215 AKZO Nobel v Commission <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:6198600062:EN:NOT> and Case 27/76 [1978] ECR 207 UBC v Commission (United Brands) <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:61976J0027:EN:NOT>

⁷ CAA (Feb 2012) *Gatwick – Market Power Assessments Non-confidential Version: The CAA’s Initial Views* para 3.28: “... these segments are somewhat narrower than the markets described in Chapter 2”.

YOUR LONDON AIRPORT

Gatwick

how Gatwick would be able to exploit this. Accordingly, this argument appears to be purely speculative, falling well short of the evidential standard required for regulatory findings by the CAA.

- The CAA fails to explain why “outbound holiday makers” constitute a market segment that Gatwick can exploit. In particular, a significant proportion of surface passengers arrive at Gatwick by public transport and there is also a competitive market for car park provision, particularly in terms of long term car parking. In addition, leisure passengers generally and especially long haul, are more flexible in respect of which airports they fly from.

More generally, the CAA’s conclusion appears, on the basis of weak evidence, to be merely that Gatwick “might” have a strong market position in these segments. That is clearly inadequate to conclude that Gatwick *does* have a “strong market position” and still less a dominant one.

Airline switching costs and yields at Gatwick

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), for example in passenger lounges and maintenance facilities; and
- As a consequence of lower yields available from other airports, which creates an opportunity cost to airlines switching away from Gatwick.

The CAA acknowledges that its conclusion on this issue will be impacted by its view on how current prices relate to the competitive price level. However, the CAA concludes on this issue that Gatwick’s current charges are not significantly below the competitive price level. The CAA does so relying on information about charges at a set of airports against which it compares Gatwick’s airport charges and data obtained from easyJet and Ryanair about airport charges across their route portfolios, data which Gatwick has not had sight of.

In Gatwick’s view, the CAA’s analysis of how current prices relate to the competitive price level is superficial. No attempt is made to correlate level of charges with the quality of facilities or services or to reflect the differences attributable to geographic location or investment cycles. Given that the issue of what the competitive price level is at Gatwick is central to several key aspects of the SMP analysis, we consider that the CAA has much work to do on this area before it has a reliable evidence base for any conclusions that Gatwick has SMP

More specifically, in Gatwick’s view, 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, notwithstanding the existence of switching costs for some airlines, a substantial level of competition could be expected between the London airports.

Even though some FSCs may have sunk investments, it is only in the event that the airline ceases a large part of its operations at an airport that it will have to write-off such sunk investments. This is an extreme scenario, with a more likely scenario being the threat of substitution of a proportion of aircraft based at an airport or the ceasing of certain routes in response to a relative price change. In this more probable, less extreme, scenario the presence of sunk costs would not be such a barrier to switching. This is even more the case where an FSC is switching to an airport where it

YOUR LONDON AIRPORT

Gatwick

already has a presence. BA and Virgin, the major FSC airlines at Gatwick, already operate at Heathrow.⁸

It is also important to consider the airport's motivations. Gatwick could lose significant business if FSC airlines were to relocate or reduce their services – for example the Virgin services would be difficult to replace with services offering similar value to Gatwick. In this light we note that we have provided evidence to the CAA relating to the financial contribution from our leading airlines, including from non-aeronautical revenues. This highlights the value of these carriers to Gatwick.

Likewise, BA is well able to negotiate effectively with Gatwick given that the large scale of its operations at Heathrow make absorption of switched Gatwick services feasible as it has demonstrated amply in the past through switching services away from Gatwick. BA's potential acquisition of bmi increases the scope for it to make such switches to Heathrow which would be potentially very damaging to Gatwick. Accordingly, even if there are some sunk investments on airlines' part, that is not sufficient to negate the potential disciplining effect of airline switching or to show that Gatwick has a dominant position in respect of these airlines.

Moreover, the CAA's inference that many airlines might not regard Heathrow as a viable alternative for long haul services, or FSC services more generally, flies in the face of the facts: Heathrow has taken large numbers of services from Gatwick in recent years and could continue to do so. This has been demonstrated by the switching after Open Skies, which the CAA dismisses as being a response to a change in legal constraints rather than a response to price and service competition. However, regardless of the motivation, this example provides factual evidence that long-haul traffic can move from Gatwick to Heathrow, even if Heathrow is 'full'. This is further supported by the recent announcement that Delta is switching from Gatwick to Heathrow.

The fact that Heathrow faces capacity constraints overall does not prevent it from acquiring more long haul services (e.g. from Gatwick or through growth) facilitated, for example, by secondary trading of Heathrow slots, airline mergers, or simply normal traffic churn. In addition, it is also the case that there is significant spare capacity for passengers at Heathrow as flights are not operated to capacity and there is scope for increasing the average size of aircraft. Moreover, even though the CAA considers that Heathrow may not be an active competitor for charter or LCC airlines, FSCs operating from Heathrow still carry many point-to-point passengers (and could carry many more), often in competition with LCC or charter operators.

The airlines' and CAA's analysis of airline yields focuses on average yields,⁹ rather than marginal yields, understating therefore the potential for switching and making this evidence irrelevant for assessing competitive constraints. For yield analysis to be relevant, it should be conducted on the basis of marginal yields i.e. yields on those services that are most vulnerable to price increases, as it is the potential for those services to switch that imposes constraints on an operator's ability to increase prices.

However, more fundamentally, the possibility that yields at Gatwick are higher than at other London airports (excepting Heathrow) does not create a "switching cost". Higher relative yields are most likely to be reflective of scarcity and locational rents at Gatwick and the CAA has consistently argued that the presence of such scarcity and locational rents does not equate to market power. The fact that they appear to rest in the hands of the airlines is a product of the constraining effect

⁸ A point the CAA recognises - Table 5, page 64.

⁹ This is recognised by the CAA in paragraphs 3.38 and 3.39.

YOUR LONDON AIRPORT

Gatwick

of regulation. For the CAA to use them in its analysis of switching would be effectively to rely on evidence from an artificially constrained market when that analysis should be directed to the underlying fundamentals of the market absent regulation.

This is one of the reasons why the CAA has traditionally, and in its most recent market power guidelines, put such emphasis on the criticality of the competitive price level to competition analysis. The CAA has always recognised the need to look beyond the distorting effects of current regulation. As mentioned above, it is therefore disappointing to see this area so sketchily treated in the CAA's Initial Views.

As the CAA acknowledges, Gatwick included significant evidence and analysis in its November submission on the issue of the competitive price level, adopting approaches consistent with the CAA's competition guidelines. However, the CAA dismisses our evidence and analysis with insufficient reasoning and in ways that appear inconsistent with its previous analysis and its own competition guidelines. Moreover, the CAA fails to provide any substantial evidence of its own to support its view that the regulated prices at Gatwick are not significantly below the level that would be expected in a competitive market.¹⁰

The CAA uses a set of comparator airports against which to benchmark Gatwick's prices to assess whether they are out of line with the competitive price level. However, the CAA fails to explain why these comparators are those most appropriate to Gatwick's position. Gatwick submits that they are not appropriate. They comprise a set of UK airports which are significantly smaller in capacity terms (with perhaps the exception of Stansted) and which are operating well within their capacity limits. As such they have an inherent cost advantage, which will be reflected in lower prices. Moreover, the fact that there is excess supply at some of the comparator airports means that a value-based price will be lower than is the case at Gatwick.

In terms of the ATRS benchmarks used by the CAA, many of the same criticisms apply, especially in respect of the presence of capacity constraints. Moreover, as the CAA recognises, the aircraft configurations and load factors used in the price comparisons are not reflective of those at Gatwick and as such risk providing distorted impressions of relative charges. Moreover, the CAA simply ignores the analysis submitted by Gatwick, which shows that Gatwick's charges are at the low end of the spectrum when compared to the Leigh Fisher data set of 50 world airports.

The data provided by easyJet and Ryanair was excised from the CAA's document so we are not in a position to comment on the relevance of that data.

We also consider that the CAA erroneously disregards the evidence from the relatively higher yields available to airlines operating at Gatwick from its consideration of the competitive price level. While the CAA seems keen to categorise this as a 'switching cost', it fails to recognise the possibility that this is a piece of market intelligence highly relevant to its consideration of the competitive price level. Given that many of the airlines at Gatwick operate significantly similar services to those they operate at other airports (given their uniform business models) the most

¹⁰ The deficiencies in the CAA's analysis of the competitive price level at Gatwick are replicated in its Stansted work where its finding of possible SMP in relation to peak hours in the morning takes no account of what the appropriate competitive price should be even though it notes that Stansted does not currently price differentiate by time of day.

YOUR LONDON AIRPORT

Gatwick

likely explanation for the higher yields is that they arise from the current regulated airport price being set below the competitive price level.¹¹

A potential counter argument to this interpretation of the market evidence could be if there were evidence that the airport had artificially sought to constrain supply and/or capacity. However, as the CAA is aware Gatwick is the busiest single runway airport in the world and is striving to increase its peak capacity even further in order to make available further capacity to the market, both in terms of aircraft movements and in terms of the total number of passengers being served by the airport. Thus, this potential line of counter argument cannot be sustained. Indeed, the CAA in footnote 53 noted that it "...has identified no evidence to suggest that the airport is under-investing or hoarding capacity."

To the extent that the CAA is going to undertake further analysis of relative airline yields it will need to widen the scope of its inquiries to consider how far this evidence, which originates clearly from the Gatwick market, is in fact more relevant to the debate about the competitive price level than it is about switching. In so far, however, as switching remains an issue, the CAA will need to ensure that the analysis is conducted on a marginal basis, rather than an average basis. More generally, it will need to have all relevant data available to it in order to conduct the appropriate analysis. This will mean ensuring that the CAA obtains comprehensive data from airlines, potentially through the use of formal information requests.

Passenger switching

The CAA acknowledges that most passengers have a real choice between different London airports, citing that 76% of short haul routes that are served from Gatwick are also served from other London airports. However, the CAA:

- Finds that some passengers do not consider Stansted a particularly close alternative; and
- Argues 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.

In Gatwick's view, the manner in which the CAA considers passenger switching is not appropriate to assessing competitive constraints. It is well established in competition economics, and, indeed, in previous work conducted by the CAA, that when assessing constraints emanating from customers, 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. The existence of some captive customers does not point to market power if there are sufficient marginal customers to discipline Gatwick. On this basis, the evidence (including from its survey) provided by the CAA is that substantial numbers of passengers do have a choice, actively consider alternatives, and have in fact exercised that choice in the past to fly from elsewhere than Gatwick.

Therefore, a more appropriate interpretation of the evidence cited above is that for 40% of long haul routes there is a very close substitute available to passengers. Similarly, the fact that some passengers do not view two airports as close substitutes is significantly less relevant to a competition analysis than the proportion of passengers that do consider that they are close substitutes. From the data presented by the CAA, it is clear that the majority of Gatwick's

¹¹ This is potentially different from the higher yields experienced at Heathrow, which could be contributed to, at least in part, by the presence of network externalities, which drive value.

YOUR LONDON AIRPORT

Gatwick

customers are not “captive”. This is not consistent 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 conclude that Gatwick no longer holds SMP” on the basis of three main points:

- i) while Gatwick’s market power might have reduced since sale, it might still have SMP;¹²
- ii) any change in conduct could be driven by the new owner attempting to maximise the return on its investment rather than a step change in the level of competition and that it is difficult to distinguish between these two factors; and
- iii) there is mixed evidence on the extent to which there is a significant change in the airport’s incentive to compete for airline business.

Overall, the CAA concludes that that there is “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 important corroboration of other evidence demonstrating that Gatwick does not have SMP.

Gatwick considers that 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, is a highly selective reading of the available market evidence. For example, it is unclear why a simple change of management should have such a profound effect on conduct, which is the implication of the CAA’s reasoning, whereas it is entirely understandable that conduct would be affected by an increase in competition resulting from the break up of BAA and change in ownership. Accordingly, the increase in competition is *a priori* the *most likely* explanation for changed behaviour, and as such should be given weight by the CAA.¹³ The CAA has presented no evidence to suggest that the change in behaviours has been driven by anything other than the increase in competitive pressures. To conclude otherwise in the absence of evidence can only be speculation. Neither has the CAA presented any evidence of Gatwick behaving in ways consistent with those characteristic of a dominant operator, or an operator that would seek to abuse any dominance it holds.

As we evidenced in our November 2011 submission, the change of behaviour at Gatwick is highly correlated with the expectations of airport competition of the CC and the CAA, as set out by these authorities at the time of the CC’s airports market investigation. Furthermore, the CC and CAT

¹² The underlined terms highlight that it appears the CAA is progressing as if the default conclusion is that Gatwick is dominant unless there is proof to the contrary. However, this is not appropriate. In particular, Gatwick’s current designation – deriving from entirely different circumstances – cannot be the starting point for the CAA’s consideration of Gatwick’s market power.

¹³ Even if both explanations were equally valid *a priori*, that would still leave a large probability that part of the conduct observed did reflect increased competition.

YOUR LONDON AIRPORT

Gatwick

decisions to require divestment of Stansted recognised the change in Gatwick's conduct as being associated with increased competition.¹⁴ The CAA has not recognised these facts and judgements.

The CAA has also not adequately taken into account the impact of regulation in its analysis of behaviour. In order to sustain the argument advanced by the CAA, it would need to demonstrate that, absent price and service regulation, we would not be striving to increase our levels of service and our efficiency. It has been a consistent mantra of Gatwick under new ownership that it is seeking to increase the levels of service at the airport. This includes levels of service to passengers and airlines, including through seeking to improve the performance of non-airport partners, e.g. through working with UKBA and airlines themselves. This has been done with a focus on efficiency, in terms of our own operating costs as well as seeking opportunities for our partners to increase their own efficiency and through our capital investment programme. The CAA has not presented any evidence to suggest that these behaviours would cease if Gatwick were not subject to price and service regulation.¹⁵

The CAA has also not addressed some of the other service examples that we have provided to demonstrate we are actively competing. These have involved significant service innovation and cannot be put down simply, as the CAA has characterised it, as being driven by "the change of owner attempting to maximise the return on its investment". For example, our new South terminal security search area required Gatwick to forego approximately £5 million per annum of commercial revenues, thus causing a deficit against the Q5 price control settlement. In a non-competitive environment, the 'efficient' investment would have been to delay introduction of the new security area to the next regulatory period, where an allowance would be made for the lost commercial revenues as well as for the capital expenditure. However, the new management team, operating in a competitive environment, placed a priority on improving and innovating facilities to attract and retain passengers and airlines.

A further example is our investment in improved PRM facilities, which can also only be put down to improving our service offer to compete as can our investment in Family security lanes. These new

¹⁴ In the CAT judgment (1185/6/8/11 BAA Limited v Competition Commission) released on 1 Feb 2012, the CAT dismissed BAA's claim for review of the 2011 report by the CC. In para 44, the CAT noted that the CC reviewed the experience of the divestment of Gatwick and concluded that "there were 'tangible signs already of non-price competition for airlines and their customers by Gatwick' and that it would 'expect benefits from service quality improvements to continue at Gatwick and to intensify with further competitive rivalry...'" The CAT continued that it would "not accept [BAA's] submission that these changes represent nothing more than plans and expectations as distinct from concrete evidence in support of the CC's views. The CC was entitled to consider that the evidence of actual changes in the approach at Gatwick in the limited time that had elapsed since divestment by BAA was significant supporting material to reinforce its view that there was scope for competition between the airports which could be expected to be consolidated and developed over time."

¹⁵ In the discussion of our evidence on service quality and relationship with our users the CAA misinterprets a point that we made in October 2011 in response to a CAA consultation on Q6. In that response we argued that the evidence of Gatwick's performance against the ACI's ASQ regime indicated that the CAA's service regulation regime had not met the needs of passengers. The point we were making is that historic regulation has failed and that airport competition and commercial arrangements, rather than regulation, would be better aligned with passenger interests. We were clearly not arguing, as the CAA suggests, that we have focussed on satisfying regulatory targets rather than meeting passenger expectations. In fact, the evidence we have provided suggests the contrary – we strive to meet the regulatory targets but do not settle at this and seek to go beyond these by innovating in the services we provide as we have to if we are to continue attracting passengers to the airport.

YOUR LONDON AIRPORT

Gatwick

services generally go far beyond the minimum regulatory requirements and offer a best in class product in order to attract and retain passengers.

Our working with airport partners to improve service is also a key indicator of increased competitive behaviour. Measuring queues and baggage return data, and as a result identifying and addressing problems, helps to make our products better for passengers. Working with our airlines to innovate helps develop new products to retain and attract airlines. Publishing information for passengers helps passengers make informed choices, as well as driving performance. We do not see how such behaviours, which have been instigated by the airport, can be attributed to the change of owner attempting to maximise the return on its investment and the CAA has not presented any evidence that they are.

On the CAA's point that there is "mixed evidence" of the extent to which there has been a significant change in the airport's incentive to compete for airline business, we would contend this is not the case. Gatwick is competing much more actively than it has previously to attract airlines to the airport. In any case, mixed evidence of whether or not there is a clear break from the past cannot credibly be interpreted as evidence of dominance.

There are several other areas where the CAA has questioned whether our behaviours are illustrative of competition. We do not address these here, but again note that the CAA has not presented evidence to support its view. As such, this cannot be used as evidence that Gatwick is dominant.

[The CAA has ignored important aspects of competition between airports that should have been properly taken into account](#)

The CAA has not provided a forward-looking view of how competition will develop. Much of its analysis relies on historic data from 2010 at the latest. This was only shortly after the sale of Gatwick by BAA and as such the data, at the very least, significantly reflects elements of joint ownership and the associated adverse effects on competition identified by the Competition Commission in its airports market investigation. The CAA cannot rely on such data alone to inform its forward-looking view of how competition will develop, or to conclude that Gatwick is currently dominant or can be expected to be dominant beyond the end of Q5. To do so would be to ignore an important element of the judgements it would need to make.

Moreover, the CAA's analysis does not place adequate weight on the likelihood that deregulated airports would take a dynamic, innovative and unpredictable approach to their market positioning, implying that observations of "how things are now" (e.g. in respect of Gatwick's traditional position in "outbound holiday passengers") may not be long lasting. Indeed, more recent trends indicate a shift to inbound passengers and business passengers being a greater proportion of Gatwick's passenger base. While therefore, the CAA's analysis is primarily static in nature, the reality is that operators in competitive markets are constantly seeking new, profitable opportunities, innovating in products and quality of services and taking away sales and profits from their rivals, for example through investment in capacity.

Failure to take due account of such competitive dynamics, and to recognise that continued regulation will constrain them, is a major omission. The CAA has itself in the past fully recognised that it is artificial to look at airport competition solely on a static basis. Competition to deliver new runways and/or other forms of capacity expansion (or market re-orientation) remains a real

possibility. By focussing solely on the state of competition at a “snapshot” in time,¹⁶ the CAA fails to take into account the likelihood that continuing to regulate will result in major distortions to incentives in respect of capacity and service provision.

The CAA has not been clear as to what it considers is the legal test it needs to satisfy to demonstrate SMP

The CAA's competition guidelines state clearly that the competition law concept of dominance and substantial market power (SMP) are equivalent.¹⁷ This interpretation is consistent with other regulated sectors, e.g. telecommunications. Therefore, 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 it in the future.¹⁸

The CAA needs to demonstrate, with reference to strong and compelling evidence that Gatwick is dominant.¹⁹ It is not appropriate to proceed, as the CAA appears to be doing, as though the default conclusion is that Gatwick is dominant unless there is proof to the contrary. The fact is that the break-up of BAA has changed fundamentally the competitive landscape, Gatwick's previous 'dominance' and the associated need for regulation that flowed from BAA's monopoly position, not the specific position of Gatwick. Gatwick's market position now needs to be considered entirely afresh. Accordingly, since the CAA has not, at this stage, been able to come to any definitive finding that Gatwick has SMP²⁰ the natural conclusion is that the first step in the case for applying regulation at Gatwick is not satisfied.

The CAA does not, in its document, acknowledge that dominance is the relevant (minimum) standard,²¹ nor does it provide an adequate appraisal of whether Gatwick is dominant. Accordingly the CAA's analysis cannot be regarded as a reliable basis for concluding that there is an prima facie case for continuing to regulate Gatwick.

¹⁶ The CAA does look at whether, given existing runway expansion prospects, Gatwick's market power is likely to change and concludes that it will not. However, that is a different issue to the matter of competition to deliver new capacity. As the CAA will be aware, notwithstanding the Coalition Government's initial policy positions regarding new runway capacity in the South East, the debate is very much alive.

¹⁷ *Guidance on the assessment of airport market power*, CAA, April 2011, paragraph 2.11.

¹⁸ The CAA has itself acknowledged that all airports may have some element of market power, and that the question is one of degree.

¹⁹ We note the CAA has not clearly stated whether it agrees with our formulation of the legal test, or if it doesn't agree, what it considers the relevant test to be.

²⁰ *Gatwick – Market power assessments: the CAA's initial views*, CAA, February 2012, paragraph 28.

²¹ Although the CAA, when discussing market shares, implies that it may have a dominance standard in mind, see for example *Gatwick – Market power assessments: the CAA's initial views*, CAA, February 2012, paragraphs 3.26-3.29, *Heathrow: Market power assessment: the CAA's initial views*, CAA, February 2012, paragraph 3.15 and *Stansted: Market power assessment: the CAA's initial views*, CAA, February 2012, paragraphs 3.9-3.10.

Gatwick is potentially prejudiced by the process adopted by the CAA

The CAA appears to have ignored important evidence and precedent

As summarised above, the CAA's case is essentially that Gatwick has market power due to:

- its location and strong position in some market segments;
- the presence of barriers to airline switching;
- a potential lack of passenger switching to discipline airport charges; and
- a lack of step change in behaviour which can unequivocally be attributed to increased competition and not to a more efficient dominant operator.

This to a large extent is at variance with the CC's analysis in the BAA market investigation and with the CAA's own perspectives in recent years. This includes:

- the prospects for competition between the London airports under separate ownership, even with constraints;
- expected airport behaviours in a competitive market;
- the need to focus analysis on marginal passengers, airlines and routes; and
- the lack of evidence or economic rationale to suggest that there are narrow economic market segments.

In particular, in terms of interpreting whether market conduct since the sale of Gatwick indicates that competition is emerging, the CAA's position seems to be substantially at variance to that of the Competition Appeal Tribunal's (CAT's) recent judgement.

The CAA's position with regard to competition between Stansted and Heathrow also appears at odds with the findings of the CC and the CAT from which it is clear that the two airports compete (now or in the future) in the same relevant economic markets. Moreover, 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 previous views of the CAA, CC and CAT were key inputs into regulatory decisions which have ultimately had profound consequences. It is therefore incumbent on the CAA to consider those views fully. Given the weakness of some of the CAA's own evidence, the existence of these contrary views and rulings, unless now rebuttable by the CAA, provides further reason to conclude that the CAA has not satisfied the high hurdle of demonstrating that Gatwick is dominant.

The CAA does not provide in its document an examination of the numerous points raised by Gatwick in its November submission, or its reasons for rejecting them. The CAA ignores much of the evidence presented by Gatwick, and when the CAA does acknowledge our submission it provides only cursory comment. This is surprising as the CAA requested submissions by the end of November in order that it could take them into account in forming its initial views. It also compromises Gatwick's ability properly to respond to the CAA's new analysis since it is unclear to

Gatwick why its previous material has been ignored or rejected. The evidence previously presented by Gatwick, but not addressed (or dismissed without adequate discussion) includes consideration of data on marginal passengers and airlines, capacity evidence, estimates of LRAIC (dismissed without full and proper investigation) and the use by the CAA of weaker alternative evidence (e.g. price benchmark data without discussion on whether these alternative comparators are appropriate).

We recognise that the CAA is not obliged to maintain its previous views when circumstances change. Similarly, it can diverge from the views of other regulatory and competition authorities and disagree with stakeholder submissions. 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. To do otherwise increases regulatory risk and prejudices our position.

The CAA is effectively treating its work on assessing competition as a sufficient precursor to regulatory design when the test clearly has three parts

The CAA appears to be substantially narrowing the options for future regulation on the basis of an unconvincing analysis of substantial market power, which even the CAA acknowledges does not allow the CAA to come to a definitive finding.

Moreover, the magnitude of any market power held by Gatwick is plainly germane to a proportionate approach to regulation. This is encapsulated in Parts B and C of the Market Power Test proposed in the Civil Aviation Bill, on which the CAA has not come to a view. Even if the CAA could substantiate that Gatwick has some element of market power in respect of some particular carriers (e.g. those that have sunk large investments in their Gatwick operations) or particular segments (e.g. long haul services), that is not sufficient to support continued regulation at Gatwick. It is, for example, unlikely that the significant costs and distortions associated with continued regulation will be outweighed by any benefits that can only be limited to a segment of Gatwick's traffic.

Moreover, even if the CAA can establish dominance with regard to some market segments, it has failed to develop a theory of harm arising from any market power identified. To the extent that it is appropriate to put protections in place, these should naturally be targeted and specific to those segments where potential harm has been identified and where it has been demonstrated with evidence, that such harm is likely to arise. This is required by Part B of the Market Power Test, where the CAA has to identify the risks of abuse of any SMP. The CAA has failed to do this, including in the stakeholder workshops held in March where the CAA's exploratory views on Test B were limited to the potential protections afforded by competition law without this being framed in reference to clearly identified risks of abuse that may emerge.

Fulfilment of all three parts of the Market Power Test proposed in the Civil Aviation Bill is central to providing an appropriate foundation for the regulation assessment that is to follow. The CAA has stated that it does not have the power to instigate Test B or C until the new Bill becomes law.²² While the CAA does not currently have the precise powers it will be given when the Bill is enacted,

²² *Implications for Q6 and improving regulatory design: Discussion material and exploratory thinking, CAA workshop, 6 March, slide 6.*

it clearly does have the power to conduct the same assessments when considering whether ex ante regulation is required and what form it should take.²³

Moreover, the CAA clearly has begun thinking about these issues as evidenced by its recent workshops. It has done so without seeking prior evidence and, on the basis of what has been shown, its assessment is very partial. Tests B and C need to be conducted thoroughly. In particular, we would expect the CAA clearly to articulate what it considers the risks of abuse of any dominance are and to do so with reference to evidence. It is not sufficient to argue that if dominance can be substantiated that automatically leads to a risk of abuse of that dominance, let alone one which justifies ex ante price and service regulation.

In conclusion the CAA is not in a position to substantiate that Gatwick is dominant or that it should continue to be regulated beyond the end of Q5

From the above, it is clear that the CAA is not currently in a position to substantiate that Gatwick is dominant or can be expected to become dominant. This means there is insufficient reason for the CAA to assume there will be a requirement for ongoing ex ante regulation at Gatwick beyond the end of Q5.

Gatwick will continue to engage with the CAA on various points of evidence. However, for the avoidance of doubt, Gatwick's position is that the CAA has failed to make its case in the material advanced thus far. Accordingly, Gatwick submits that the only option for the CAA is to proceed with its planning for the end of the Q5 price control on the presumption that Gatwick should no longer be subject to ex ante economic regulation.

²³ The CAA has undertaken such assessments in the past, most recently in its consideration of the appropriate regulation to be imposed at Stansted during the Q5 review.