APPENDIX E

Evidence and analysis on competitive constraints: Airlines

Introduction

E1 Market power is the ability, profitably, to sustain prices above the competitive level or restrict output or quality below competitive levels. Market power is not an absolute term but a matter of degree which varies according to the individual circumstances of the case.

E2 This appendix seeks to assess, in aggregate, the competitive constraints from both within and outside the relevant market. In particular, this appendix considers the existence and potential strength of the competitive constraints faced by Gatwick Airport Limited (GAL), including:

- The ability and likelihood of airlines switching marginal services away from Gatwick as a reaction to a price increase or a decline in service standards.
- Whether the extent of such substitution would be sufficient to constrain GAL's behaviour, including with respect to pricing.

E3 If aggregate constraints are sufficient, they could prevent GAL from increasing prices above, or reducing investment or service quality below, the levels expected in a well-functioning competitive market.

E4 In contrast to market definition (appendix D), which considers substitutability over a one-year period, this appendix considers the effectiveness of constraints over the Q6 period (April 2014 to at least March 2019). In other words, the CAA is seeking to answer the question, '*Would market mechanisms offer an alternative to regulation as an effective means of constraining market power?*'

E5 As noted above, to assess the degree of market power held by an airport operator the CAA has sought to identify the existence and assess the combined strength of all competitive constraints affecting GAL. For presentational purposes, each issue has been set out separately. However, this does not mean that each issue has been considered in isolation. The CAA has taken into account the cumulative effect of the constraints in reaching its conclusion.

E6 The analysis that is undertaken in this appendix is structured as follows:

- Section 1 outlines the framework under which CAA has conducted this analysis.
- Section 2 summarises the conclusions from the CAA's Consultation on Gatwick market power assessment (the Consultation).[1] It also outlines the key points raised by stakeholders.
- Section 3 outlines the CAA's formal consideration of constraints posed by airlines, the level of switching costs, capacity constraints and buyer power.
- Section 4 outlines the CAA's conclusions on constraints from airlines for the purpose of the Determination.

Section 1: Framework

E7 This section sets out the CAA's main considerations with respect to the framework it has adopted in its assessment of the market power held by GAL. It also sets out (briefly) the ways an airline may discipline an airport operator and the indicators that should be considered when assessing countervailing buyer power.

E8 In undertaking its analysis of switching costs, the CAA refers to the categories of switching costs outlined in the Competition Commission's (CC) 2009 BAA Report, which are summarised in Box E1 (below).[2]

Means of switching

E9 As part of its analysis, the CAA has considered the methods an airline could use to discipline an airport operator, including:

- Grounding aircraft or reducing the use of based aircraft during a particular traffic season.
- Decreasing the frequency of existing services to and from a particular airport, for based and/or inbound aircraft.
- Moving based aircraft to other bases, or opening a new base by relocating aircraft currently at an airport.

1 This document is available at: http://www.caa.co.uk/default.aspx?catid=1350&pagetype=90&pageid=14784

2 The CC's consideration on airline switching costs is available at: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/545_3_1.pdf (accessed 29 October 2013).

- Volume growth being allocated to other airports (by opening new routes or increasing frequencies on routes operated elsewhere).

E10 The strength of each of these methods, either individually or in combination, depends on the market for airport operation services and the individual airline(s) in question.

E11 The CAA has considered each of the methods outlined above and considers that:[3]

- Switching growth does not pose a significant constraint on an airport operator's behaviour. Switching growth is only likely to have a disciplinary effect where additional growth has been signalled by an airline and where this expected growth is then cancelled and/or where the airport operator has significant spare capacity. In either case, the removal of this expected growth has no effect on current traffic levels at an airport as no actual traffic has been switched or cancelled.
- Grounding of aircraft at Gatwick does not pose a significant constraint on GAL's behaviour. It also considers that regardless of the business model adopted, airlines seek to maximise the use of their assets so this strategy could be counter-productive. However, while short term grounding may be possible in theory, it is unlikely to be a credible threat.
- For full service carriers (FSCs), reducing frequency appears to be the most effective means of switching away while, for low cost carriers (LCCs), switching aircraft to alternative bases is likely to pose the most credible threat to airport operators, where credible switching alternatives exist.

[3] The CAA considers this to be the case based on the analysis it outlined in the Consultation as well as the responses to the Consultation.

Box E1: Summary of the switching costs identified in the CC's 2009 BAA Report
Cost of physical relocation: these are one-off costs incurred when rebasing aircraft, which could include relocating flight crew if the airport to which the aircraft is rebased is a considerable distance from the current airport. There may also be ground staff redundancy or recruitment expenses. If an aircraft is being relocated to an airport where the airline has existing operations, these costs may well be smaller than if it were opening a new base, in which case some additional start-up expenses might be incurred.
Long-term commitments: an airline might have a multi-year contract with an airport operator where the charges it pays are linked to the volume of passengers it carries. An airline could also have long-term arrangements for maintenance facilities at the airport. Full or partial switching of aircraft or services could well break these agreements, and the benefits of these agreements would need to be considered against the offer at an airport to which the airline may switch.
Loss of economies of scale: switching away one or more aircraft from a base could result in the loss of economies of scale at that particular airport as the size of the airline's operations is reduced. However, this switching cost might be offset by the creation of economies of scale at the airport to which the aircraft is (are) being relocated, or may not be significant if the aircraft switching occurs between two or more sizeable bases.
Market effects: these include transitory costs of switching aircraft to substitute airports. Marketing costs can be incurred for new routes, and the lower yields in the first year(s) of a route's operation as the yields reach maturity. These costs could be offset to an extent by the operator of the airport to which the aircraft is (are) relocated offering discounts (or direct marketing support) to new airlines or for the operation of new routes. In addition, these costs may be smaller if the aircraft and routes are moved to airports that are proximate to the original airport, and whose catchment area(s) overlap with it. However, there may be longer-term market effects resulting in lower yields, even on mature routes, which could occur from operating routes from airports whose location is less attractive or where the airline faces more direct competition.
Network effects: network effects can occur at an airport where the number of airlines or routes offered increases the number of passengers choosing to fly from the airport, which in turn can make the airport more attractive to other airlines. Switching away from an airport, in particular to a smaller airport, might result in the airline losing the benefits of these network effects. However, the strength of these effects varies on a case-by-case basis.
Capacity constraints: capacity constraints at other airports that are seen as substitutable by an airport's incumbent airlines can reduce the threat and likelihood of airline switching as airlines might be less able to relocate aircraft in a profitable way and on a sufficient scale to constrain the airport operator. These capacity constraints can occur, for example, from a lack of suitable runway slots, aircraft parking stands capacity, and/or terminal capacity.
Sunk costs: these are irrecoverable costs resulting from an airline's investment in infrastructure and facilities at an airport, either through purchase or leasing. Where the assets are owned by the airline, the initial investment costs might be, to an extent, recoverable through the sale of the assets, thereby reducing the size of the sunk costs.

Buyer power

E12 Buyer power is broadly defined as a purchaser's ability to leverage its importance to a seller's business to gain preferential terms. For example, an airline may be able to constrain an airport operator's pricing power by leveraging the importance of its operations to the airport operator during negotiations. As stated in OFT guidance[4], buyer power is '*most commonly found in industries where buyers and suppliers negotiate, in which case buyer power can be thought of as the degree of bargaining strength in negotiations*.' This guidance also states that '*size is not sufficient for buyer power. Buyer power requires the buyer to have choice*.'

E13 A buyer's bargaining strength might be enhanced if the following conditions hold:

- The buyer is well informed about alternative sources of supply and could readily, and at little cost to itself, switch substantial purchases from one supplier to another while continuing to meet its needs.
- The buyer could commence production of the item itself or 'sponsor' new entry by another supplier (e.g. through a long-term contract) relatively quickly and without incurring substantial sunk costs.
- The buyer is[5] an important outlet for the seller (i.e. the seller would be willing to cede better terms to the buyer to retain the opportunity to sell to that buyer).

E14 The European Commission's (EC) Merger guidelines explain that one source of countervailing buyer power (CBP) would be:

If a customer could credibly threaten to resort, within a reasonable timeframe, to alternative sources of supply should the supplier decided to increase prices.

E15 The Competition Appeal Tribunal (CAT) has also noted (in Hutchinson 3G v Ofcom [2005] CAT 39) that:

Various factors are relevant in determining whether there is [significant market power] SMP and one of those is CBP.[6]

[4] OFT, Assessment of market power guideline (OFT 415).

[5] Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (2004/C 31/03).

[6] [2005] CAT 39 at paragraph 110(b).

E16 The CAT (in the same case) also indicated that the degree of buyer power is important in any assessment of SMP:

CBP is the power of counterparties to offset the powers of the party whose allegedly superior powers are under consideration, and the important question is what degree of CBP is there, and (bearing in mind all the circumstances) does it operate to a sufficient extent so as to mean that there is no SMP?[7]

E17 Taken together, this suggests that to have a degree of CBP an airline would typically need to:

- Represent a significant proportion of a particular airport operator's business.
- Have at least one substitute airport to which it could credibly threaten to switch in response to that particular airport operator's behaviour.
- Have the ability to switch sufficient volumes to discipline the proposed price increase.

Section 2: The consultation process

Consultation view

E18 Since the publication of the Consultation, and following receipt of Consultation responses, the CAA has changed its definition of the relevant market within which GAL operates. The CAA now considers that the relevant market for GAL is a unified product market for the supply of airport operation services to airlines (regardless of business model) at Gatwick (see Appendix D).

E19 Changing the market definition for GAL has necessitated the CAA reviewing the position it outlined in the Consultation on competitive constraints. However, for completeness the CAA summaries the view it outlined in the Consultation.

E20 In the Consultation, the CAA considered for LCCs and charter airlines (charters) that:

- The ability to switch marginal aircraft out of Gatwick was limited, given the level of sunk and strategic switching costs.
- The largest airlines at Gatwick had limited buyer power, given the apparent lack of credible switching alternatives.

7 [2005] CAT 39 at paragraph 110(c).

- Capacity constraints are expected to tighten over the next five years and this is likely to increase the degree of market power enjoyed by GAL. The CAA also noted that these capacity constraints were unlikely to lessen until after 2025.[8]

E21 The CAA also considered that for FSCs and associated feeder traffic airlines that:

- The reduction of marginal frequencies is the most likely route through which they could seek to restrain an increase in charges. However, it also noted that the cost of such switching was likely to outweigh any benefits that an airline may derive from it.
- The cost of entry into Heathrow (the preferred substitute to Gatwick), would be significantly higher than the costs faced by airlines as a result of a 10 per cent rise in airport charges at Gatwick.
- Heathrow is effectively full and does not present a realistic switching alternative.
- Other airports in the south east of England are not considered substitutes for Gatwick due to unsuitable facilities, lack of connecting traffic and weaker catchment areas.
- FSCs at Gatwick have limited buyer power given their low share of GAL's operations and the lack of credible switching alternatives.
- Capacity constraints are expected to tighten over the next five years and this is likely to increase the degree of market power enjoyed by GAL. The CAA also noted that these capacity constraints are unlikely to lessen until after 2025.

Stakeholders' views

E22 The CAA received five responses to the Consultation:

- British Airways (BA);
- easyJet;
- GAL;
- Gatwick Airport Consultative Committee (GACC); and

8 The 2025 date assumes that action on capacity expansion is taken directly following the publication of the Airports Commission report. Given possible requirements for project development, public consultation, the planning process and construction solutions may not be operational until around 2025.

- Virgin Atlantic Airways (VAA).[9]

E23 GAL criticised the CAA for dismissing the relevance of observed airline switching as not being a response to price changes. In particular, GAL considered that non-price factors were relevant in airlines' decisions to switch airports and that airlines switch in the absence of price changes.[10]

E24 GAL also considered that the CAA had not recognised the full potential for switching in response to a price increase above competitive levels. GAL considered, because economic regulation set charges below market clearing levels, that this changed airlines' incentives on where to deploy aircraft, as price controls transfer location and scarcity rents to airlines.[11]

E25 In addition, GAL considered that the CAA had not presented any analysis of individual airline route profitability to identify the extent to which individual airlines would be likely (or unlikely) to respond to an increase in airport charges by ceasing the operation of the most marginal routes from Gatwick.[12]

E26 GAL did not agree that the strategic importance of London for incumbent airlines could indicate airport operator market power. GAL considered that the importance of London is evidence that the prevailing (regulated) price at Gatwick is below the competitive price as the attractiveness of London can be characterised as a result of the locational value of London combined with the relative scarcity of airport capacity. GAL also considered that, even if operating from London was in some way considered critical for an airline, this could be achieved with varying levels of frequency/aircraft and the use of other London airports.[13]

E27 With respect to capacity constraints, GAL considered that Heathrow Airport Limited (HAL) could increase capacity at Heathrow by, for example, encouraging the use of larger aircraft. GAL also noted that HAL

9 Non-confidential responses to the Consultation are available on the CAA's website: http://www.caa.co.uk/default.aspx?catid=1350&pagetype=90&pageid=14784

10 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.50.

11 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.52.

12 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraphs 3.54 to 3.56.

13 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraphs 3.63 to 3.71.

has consistently increased the number of passengers using Heathrow, despite having been considered full for many years.[14]

E28 GAL also considered that even within a capacity constrained environment there is competition, be it competition for larger aircraft or for airline business models with higher yielding passengers in terms of non-aeronautical revenues.[15]

E29 The GACC agreed with the CAA's analysis that the limited ability for airlines to switch away from Gatwick facilitated GAL being able to increase prices; act in an uncompetitive manner and not suffer a material loss in profits. The GACC also strongly agreed with the CAA's finding that there was no evidence to suggest that any airlines can exert any degree of buyer power over GAL.[16]

E30 BA agreed with the CAA's assessment of market power at Gatwick (regardless of its position in relation to market definition). In coming to this view, BA noted that:

- The severe capacity constraints at Heathrow limited its (and other airlines') ability to credibly threaten to switch.
- The capacity constraints at Gatwick and the valuable nature of its landing slots at Gatwick to airline business models result in the backfill of vacated slots. It also noted that GAL's market position was illustrated by Flybe's exit from Gatwick following year-on-year increases in charges and that GAL was not constrained by Flybe's exit as the slots were sold to easyJet.
- Its ability to swap routes between Gatwick and Heathrow had limited impact on GAL's behaviour. In swapping routes, it continues to use the same aircraft and slots so there is no disciplinary effect at either airport.
- It disputed the CAA's consideration that switching costs associated with the physical relocation of aircraft were low.

E31 easyJet supported the CAA's analysis of competitive constraints at Gatwick and the limited ability of airline switching to constrain GAL. It also agreed that allocating volume growth to another airport would have limited impact on GAL, given the excess demand for early morning slots and

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14 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.73.

15 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.78.

16 GACC, Response to CAA document: Consultation on Gatwick market power assessment.

limited capacity at other airports. It also considered that the option to use other switching methods to discipline GAL was limited.

E32 VAA agreed with the CAA's assessment of market power at Gatwick. It noted that Heathrow was the only credible alternative airport but that it is capacity constrained. VAA also considered that the various forms of switching were not vigorous enough to constrain GAL's pricing. It also agreed with the CAA that switching costs for based aircraft were high and that the network effects present, due to connecting traffic, at Gatwick were important for route viability.

Section 3: CAA analysis

E33 In light of the representations from stakeholders as part of the Consultation, the CAA has re-evaluated its assessment of the evidence on competitive constraints and maintains the position it outlined in the Consultation.

E34 For the purposes of this Determination, that there are sufficient barriers which limit the ability of airlines to switch from Gatwick, in the face of rising prices or degradation in service quality. To the extent that there is marginal switching, it is of insufficient volume to discipline the airport operator's behaviour.

E35 The evidence and reasons for the CAA's conclusions are set out in the section below on an issue by issue basis. In particular:

- Section 3.1 discusses switching costs;
- Section 3.2 discusses capacity constraints; and
- Section 3.3 discusses buyer power.

E36 The CAA received a number of responses to the Gatwick - Market Power Assessments, the CAA's Initial Views - February 2012 (the Initial Views) and the Consultation. It has carefully read and considered all the points made in each response. This Determination contains summaries of, and answers to, many of the points made.

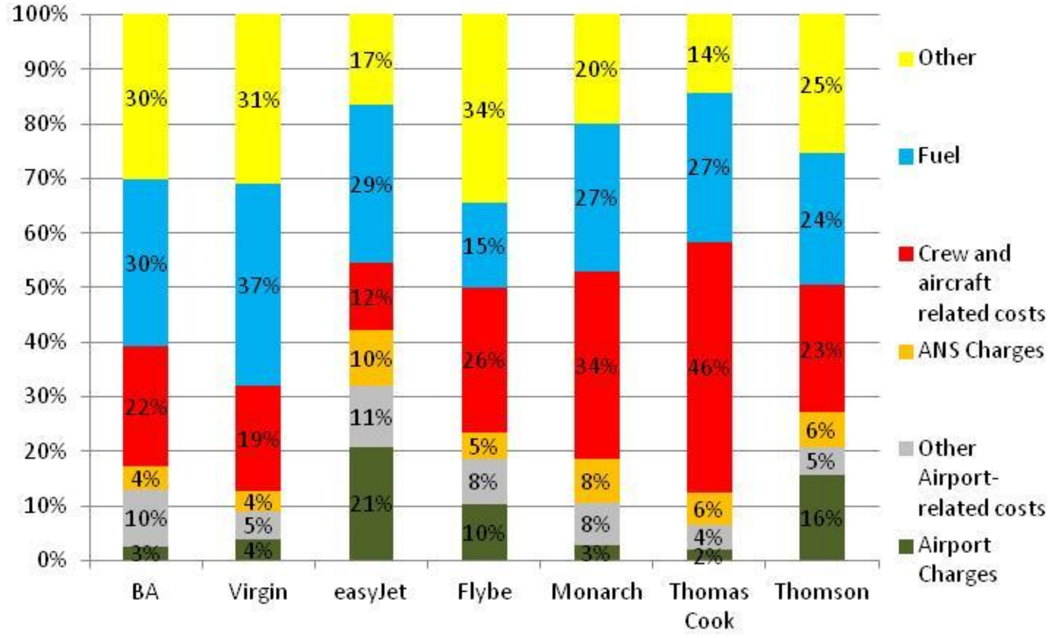
Section 3.1: Switching costs

E37 The CAA considers that an airline is most likely to be able to discipline an airport operator by either a reduction in frequencies or relocation of aircraft to other airports.[17]

E38 This section examines the switching costs that airlines at Gatwick might incur in practice and explores whether airlines switching marginal units would be sufficient to constrain GAL. However, the amount of switching that occurs in practice will not depend on switching costs alone. Other issues, including capacity constraints, also play an important role and are discussed later in this appendix.

E39 The costs associated with grounding and/or switching marginal aircraft varies across different airline business models. For example, LCCs are likely to be the most sensitive of business models to any increase in prices by an airport operator, as these charges represent a larger proportion of their costs. The proportion of airport charges and other operating costs for some of the airlines operating at Gatwick are outlined in Figure E.1 below.

Figure E.1: Cost breakdown for various airlines



Source: CAA airline account information, latest available financial years.

E40 Figure E.1 shows charges levied by the airport operator on airlines vary significantly as a proportion of their overall costs depending on the business model and operation of the airline being considered.

17 See paragraph E9.

Cost incurred from operating at an airport

E41 A number of airlines have also outlined the nature of the costs that they incur in operating from Gatwick. For example, Aer Lingus, which currently has one based aircraft at Gatwick, told the CAA that:

The costs associated with having a base and based aircraft are; staff members and their needs, crew facility, pilot briefing facility, engineering presence.

Basing aircraft also drives issues surrounding the whole integration and scheduling of aircraft. This can provide opportunities and challenges.[18]

E42 Similar representations were made by other airlines that have (or used to have) based aircraft at Gatwick. For example, VAA noted that it incurred the costs associated with the use of commercially important passenger (CIP) lounges and maintenance facilities[19]; while Flybe noted that it outsourced maintenance at Gatwick but that it incurred costs associated with a number of front of house facilities, such as check-in desks and ticket sales.[20]

E43 Inbound operators to Gatwick have similarly indicated that they incur a number of costs. For example, Emirates told the CAA that:

a. It offers limousine drop off services outside the terminal.

b. It uses the 'check in' in the north terminal's new wing.

c. It uses the fast track security service (especially for business passengers.

d. It leases a personal business lounge.

e. It uses Pier b, and Gates 50-60.

f. It can use the facilities for connecting passengers.[21]

18 Source: Aer Lingus, [✂].

19 Source: VAA, [✂].

20 Source: Flybe,[✂].

21 Source: Emirates, [✂].

E44 Ryanair has indicated, in relation to Stansted, that it had very little tangible investments, but has large sunk switching costs associated with:

- The expenditure it has incurred through marketing and promotional fares offered on more than 100 routes at Stansted over the past two decades – costs that Ryanair considers are substantial and which prevent it from withdrawing a significant part of traffic on a year-round basis.[22]
- Loss of yield (relative to a mature route) from opening a new route[23], redundancy costs, the loss of efficiency of engineering facilities and economies of scale.[24]

E45 Costs similar to those highlighted by Ryanair are likely to be faced by other airlines at Gatwick, on a scale consistent with their operations at the airport. In other words, a number of these costs are likely to increase as the size of an airline's operation increases (and that large costs are likely to be associated with larger operations). This scaling effect is supported by evidence submitted by both VAA and Aer Lingus. For example, VAA told the CAA that:

the operating costs at [Gatwick and Heathrow] would increase (decrease) with the addition (withdrawal) of aircraft.[25]

E46 Aer Lingus has highlighted that there are some costs associated with exiting or entering a base. In particular, it noted that there could be a loss of network effects, particularly those attributable to route planning. However, the CAA also considers that there would be network costs that arise from the presence of partner airlines. These can take the form of either alliance membership or other such agreements with non-aligned carriers. For example, BA told the CAA that the benefits from interlining agreements can include:

a. feeder traffic;

b. back up when there are disruptions and unforeseen circumstances;

c. it helps ensure connectivity at non-hub airports;

d. it allows for increased frequencies on certain routes and increased passengers demand for the services of both interlining partners; and

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22 Source : Ryanair, [✂].

23 Source: Ryanair, [✂].

24 Source: Constructive Engagement Working Group, September 2012,[✂].

25 Source: VAA, [✂].

e. can increase bellyhold cargo feed.[26]

E47 In addition, Aer Lingus has noted that:

Although LGW is not a hub, its interlining agreements provide pax with some connectivity which improves viability, produces higher frequency and demand and a greater choice in pax destinations. The same applies for its cargo operations.[27]

E48 While Gatwick does not currently have a similar hub status as Heathrow, the airlines at Gatwick do have a number of airline partnerships. The CAA therefore considers that the loss of the benefits associated with these airline partnerships are worth considering as they form an important cost that has to be considered. Examples of airline partnerships at Gatwick include:

- BA signing an interlining agreement with Vueling in July 2012, allowing its passengers to transfer at Barcelona on to Vueling's flights.[28]
- Air Berlin, who joined the One World airline alliance in 2012 and relocated a number of its routes to Gatwick[29], stated that:

  An additional consideration in its move to Gatwick is that it is part of the 'One World' alliance and Gatwick offers greater connectivity than Stansted.[30]

- Flybe told the CAA that it has Special Prorate Agreements with 8 airlines: American Airlines, BA, Delta, Emirates, Qatar, TAP Air Portugal, US Airways and VAA.[31]

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26 Source: BA, [✂].

27 Source: Aer Lingus, [✂].

28 See: http://www.vueling.com/en/we-are-vueling/press-room/press-releases/corporate/vueling-network-to-expand-to-100-destinations-from-barcelona-el-prat-airport-in-2013/ (accessed February 2013), http://www.vueling.com/en/we-are-vueling/press-room/press-releases/corporate/vueling-flights- from-el-prat-barcelona-to-connect-with-british-airways-broad-network/ (accessed February 2013) and http://www.businesstraveller.com/news/ba-and-vueling-launch-interline-agreement (accessed February 2013).

29 The CAA understands Air Berlin has now withdrawn from Gatwick, see: http://www.businesstraveller.com/news/air-berlin-to-drop-gatwick-nuremberg-route (accessed April 2013).

30 Source: Air Berlin, [✂].

31 Source: Flybe, [✂].

- Aer Lingus has interlining agreements with a large number of partner airlines including BA, Emirates and VAA.[32]
- VAA has interlining agreements with at least [✂] airlines at Gatwick.[33]

E49 The CAA considers that there is a consistent pattern of the types of switching costs that an airline may face. The majority of those costs summarised in Box E.1 (above) have been raised by airlines irrespective of their operating model at the airport.

Level of switching costs

E50 This section considers the level of switching costs that airlines face in closing operations at Gatwick. Based carriers are considered first, followed by inbound carriers and network effects, which may apply to either based or inbound carriers.

Based carriers

E51 BA, the largest FSC at Gatwick, has provided evidence to the CAA on the scale of its infrastructure costs at Gatwick. In particular, BA indicated that:

Given the scale of these costs, we do not believe that it would be viable to move a single aircraft [to a new airport].

And:

It would be more appropriate therefore, to think about the costs of moving an operation. It is clearly not viable to move our LHR operation, for a number of reasons, including the lack of sufficient hub capacity in the London market area. Similarly, our Gatwick operation has [✂] short-haul aircraft and [✂] long-haul aircraft. We do not believe that there is an airfield suitable and with the capacity to absorb this size of operation in the London market area.[34]

E52 In addition, on the basis of evidence from BA, the CAA has estimated that an airline incurs approximately [✂] annual charges in lease costs at Gatwick, with a similar amount incurred for service contracts with third parties for maintenance, on-board catering and groundhandling services.[35] This equates to around [✂] of cost or [✂] per passenger.

32 Aer Lingus, see http://www.aerlingus.com/i18n/en/htmlPopups/baggageinformation.html (accessed February 2013).

33 Source: VAA, [✂].

34 Source: BA, [✂].

35 Source: BA, [✂].

E53 easyJet engaged Frontier Economics[36] to consider the switching costs that it may face at Gatwick and submitted this information to the CAA.[37] This report indicates (amongst other things), that easyJet faces [✂] per passenger in additional marketing costs in the first year of operating a new route. It also provided information on how these costs changed over time. Specifically, this report noted that:

[✂];[38]

And:

[✂].[39]

E54 The Frontier Economics report prepared for easyJet also:

- Provided switching cost estimates from Gatwick on a per passenger basis. It found, for example, that an increase of airport prices equated to switching costs that ranged from [✂] to [✂] per passenger. In contrast, as a result of a small but significant non-transitory increase in price (SSNIP) by GAL, the airline would face a per passenger price increase of [✂], which would be a recurring cost if it were to remain at Gatwick.[40]
- Noted that easyJet would be likely to absorb an increase in charges in the short run but that in the longer term this would have to be passed through to easyJet's customers.[41]
- Noted that excess demand at Gatwick may insulate GAL from the effect of incumbent airlines switching to other airports. In particular, it indicated that excess demand may exacerbate market power at Gatwick as the airport operator could expect vacated slots to be filled by other operators who are currently unable to obtain a peak hour slot.[42]

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36 Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared for easyJet, confidential version.

37 There are limitations to the analysis presented within the report. These were discussed at length in the Consultation (paragraphs 6.85 to 6.95).

38 [✂].

39 [✂].

40 Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared for easyJet.

41 Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared for easyJet.

42 Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared

E55 The differences in the costs put forward by easyJet are considerable. While these are only estimates, and might vary on a case-by-case basis, they provide an indication of the potential switching costs faced by easyJet and its likely switching reaction in practice.

E56 easyJet has also indicated that it would need to take into account the likelihood and extent to which other airlines would replace their operations in a scenario where they switched away based aircraft. It noted, for example, that an airline's threat to switch would lose credibility in face of potential backfill of vacated slots by other airlines as this may allow the airport operator to maintain its passenger base.[43] As part of this, it noted that there are two aspects which may constrain airline switching:

- First, the airport operator may not be constrained by an airline exiting a route, as another airline would be likely to take its place.
- Second, airline backfill by a competing airline may reduce the profitability to the airline operating the route from another airport.

E57 The backfill effect materialised when Flybe announced its exit from Gatwick in response to GAL's increased charges. Flybe was able to sell its slots to easyJet, which will take over the operation of them from 2014 with its larger A320 aircraft. This means that GAL will not suffer any disadvantage as a result of the exit.

E58 Thomas Cook indicated that other than the cost associated with operating new slots; there would be staff redundancy and recruitment costs involved in moving airports. As a result, some financial and reputational costs would be incurred.[44]

E59 Thomson Airways indicated that typical switching costs would include crew relocation, labour/union issues, and selling and buying office space.[45] It also noted that its airline has an engineering facility at Gatwick.[46]

E60 In 2011, as part of its section 41 complaint to the CAA, Flybe (which had one based aircraft at Gatwick), indicated that it incurred significant costs operating at Gatwick. Specifically, it indicated that it:

has committed huge sums in establishing a network of services at LGW.

for easyJet.

43 Source: easyJet, [✂].

44 Source: Thomas Cook, [✂].

45 Source: Thomson Airways, [✂].

46 Source: Thomson Airways, [✂].

Much of these costs will qualify to be regarded as sunk costs because they would not be recovered in the event of a switch from to [another] London airport.

And:

Even if Flybe were to begin operations at another London airport, there are substantial sunk costs of entry in setting up a base equivalent in scale and scope to the existing base at LGW.[47]

E61 Furthermore, Flybe has told the CAA:

It has invested significantly at LGW, even though it no longer has a base. If it were to move, costs that it would face include:

a. advertising/marketing costs

b. interlining costs

c. code share costs (which cost £50,000 to set up)

d. slots (which were very expensive in 2008)

e. route development costs.[48]

E62 Monarch indicated that if it were to move its operations it would '*have to invest in crew location, crew facilities and air side support*'.[49] In addition, it noted that:

It is a unique airline as it doesn't have a standardised fleet. As LGW groundhandling operators deal with a variety of different fleets, they can handle this. Elsewhere, other groundhandlers wouldn't be able to cope with the complexity of its operation model (this would also be very costly).[50]

E63 The evidence from based operators suggests that there could be significant switching costs associated with an exit from Gatwick. These costs include both staff costs and airport specific investment costs. There is also evidence of the intangible costs such as those arising from backfill of slots at the airports which limits the impact of switching on the airport.

47 Source: Flybe, [✂].

48 Source: Flybe, [✂].

49 Source: Monarch, [✂].

50 Source: Monarch, [✂].

Inbound carriers

E64 Evidence from airlines operating inbound services into Gatwick suggests that these airlines may face relatively lower switching costs. Air Asia X, for example, provided the CAA with evidence on the level and type of costs that it incurred when switching airports. In particular, it noted:

- It did not encounter any significant costs of switching from Stansted to Gatwick, largely because it did not have any based aircraft in the UK.
- Catering, groundhandling and hotel contracts were terminated, and notice served.
- There were some costs of transferring passengers impacted by the move to Gatwick, e.g. because they were connecting to a Ryanair flight at Stansted or live around Stansted and that transportation (bus or taxis) was arranged to remedy this.[51]

E65 However, Air Asia X noted that the situation outlined above would have been totally different if it had based aircraft in Stansted. In particular, it noted that in the event that it had based aircraft at the airport, its move would have been far less simple and that the costs it would have incurred '*would have included moving staff, crew, parts, equipment, etc*.'[52]

E66 Similarly, Air Berlin told the CAA that:[53]

... apart from slots, it would probably need to undertake some new investment at a new airport and that there would be costs associated with that and ticketing (plus other costs) and this would take both time and resources. However, it noted that as it uses a handling agent and a ticketing agent these costs are relatively small.[54]

E67 Air Malta and Wizz Air also made similar representations to the CAA:

[Air Malta] wouldn't face costs in terms of breaking leases etc, and doesn't have any other liabilities apart from 1 employee (who is based at LGW).[55]

As Wizz Air is an inbound carrier into LTN, it said it would not face many switching costs. Though it would face some operational costs, its crew

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51 Source: Air Asia X, [✂].

52 Source: Air Asia X, [✂].

53 The CAA understands Air Berlin has now withdrawn from Gatwick, see: http://www.businesstraveller.com/news/air-berlin-to-drop-gatwick-nuremberg-route (accessed April 2013).

54 Source: Air Berlin, [✂].

55 Source: Air Malta, [✂].

and aircraft are based in Central and Eastern Europe. In order to rebuild part of its passenger base after a move to another airport such as STN, one-off marketing costs support would be needed but this would not be likely to be major.[56]

E68 The evidence from inbound operators suggests that they are likely to face similar types of costs in to based operators. However the magnitude of these costs appears to be lower than based operators as they have less airport specific investments.

Network effects

E69 With respect to the switching costs relating to network effects, connecting traffic accounts for 6.9 per cent of passengers at Gatwick. However, connecting passengers are of greater significance to FSCs at Gatwick as they allow passengers to connect in an integrated manner.

E70 By reducing frequency or removing services from an airport, an airline with connecting traffic would have to account for the possible additional loss of revenue from this traffic and the loss of the sunk costs incurred in setting up the relevant agreements with partner airlines. Figure E.2 (below) highlights the significance of connecting passengers to FSCs. For these airlines, switching routes or frequency the loss of connecting traffic could be a significant cost. However, where an airline was able to switch to another airport where there was significant connecting traffic, the costs associated with the loss of connecting passengers at Gatwick are likely to be mitigated.

Figure E.2: Percentage of connecting passengers by airline (2012)

Airline Name	Total Pax at Gatwick	% Conn at Gatwick	% Gatwick Total
Czech Airlines	64,509	29	0
Air Baltic	81,538	28	0
Flybe	1,141,613	24	3
BA	5,150,374	21	15
Aurigny	201,161	18	1
Qantas	97,330	15	0
Aer Lingus	642,100	13	2
Air Berlin	122,213	13	0
Ukraine Intl Alns	100,466	13	0
TAP	229,665	12	1
Thomas Cook	400,673	11	1

56 Source: Wizz, [✂].

Airline Name	Total Pax at Gatwick	% Conn at Gatwick	% Gatwick Total
Virgin Atlantic	1,376,027	10	4
AMC Airlines	86,543	10	0
US Airways	165,803	7	0
Emirates	620,553	7	2
Total/Average	10,480,568	18	31

Source: CAA Passenger Survey 2012
Note: CAA airport statistics include both self-connecting and connecting passengers. These figures may slightly over-estimate the actual proportions of inter- or intra-lining passengers.
Note: Airlines that served Gatwick with more than 50,000 passengers and had more that 5 per cent of their passengers connected at Gatwick in 2012.

Summary of the level of switching costs

E71 Based on the evidence outlined above, airlines with operations based at Gatwick tend to have greater switching costs than those providing inbound services. In particular, evidence from:

- BA and easyJet, both based airlines, suggests that the level of switching may be prohibitive; and
- inbound airlines, such as Air Asia X and Air Berlin, suggests that they face relatively limited switching costs.

E72 However, the presence of network costs may be a factor that some airlines need to consider.

E73 The CAA therefore considers that the switching costs faced by airlines at Gatwick sit on a continuum, with the highest costs faced by those airlines with large based operations (which are likely to be sufficiently large to outweigh the effects of a 10 per cent increase in airport charges) and the lowest faced by those airlines with small inbound operations.

Strategic switching costs

The Consultation

E74 In the Consultation, the CAA considered that some airlines at Gatwick may face strategic (commercial) switching costs from switching between London airports, or to other non-London airports in the UK or in continental Europe. This was principally due to the importance of London to their respective current and potentially future networks. This last issue was considered particularly important where there were capacity constraints at the airport during times when LCCs need access.

E75 The CAA also considered that charters look to serve the core catchment associated with the airport that they operate from and prefer to consolidate their flights from one leisure hub. Thomas Cook, Thomson Airways and Monarch have emphasised Gatwick's must have status as the default airport for holiday flights,[57, 58] with its large catchment area[59] and tour operator support networks.[60]

E76 The CAA also considered that the evidence pointed to FSCs and associated feeder traffic airlines having a strategic requirement to operate to, and from, London for reasons related to the strength of passenger demand and the difficulty of switching away.

Stakeholders' views

E77 GAL acknowledged the undoubted importance of London as an aviation market, with a large population, wealthy catchment, high propensity to travel by air and attractiveness. However, it noted that even if operating from London is accepted as being critical for an airline, this implies only that carriers have some presence, it does not say how much.[61]

E78 GAL does not agree that the strategic importance for incumbent airlines to serve London can be indicative of its airport market power. GAL's view is that this is further evidence that the prevailing regulated price is below the competitive price level as the attractiveness of London can be characterised as a result of the locational value of London combined with the relative scarcity of airport capacity. GAL therefore considers that this is a rerun of the argument that there are higher yields at Gatwick that would be lost by switching away. Furthermore, GAL noted that even if it accepted that operating from London was critical for an airline; that could be achieved with varying levels of frequency/aircraft and operations at other London airports.[62]

E79 easyJet, as part of its response to the Consultation, considered that the opportunity cost of switching is the main determinant of switching costs. It also noted that it agrees that strategic costs of switching are significant,

57 Source: Thomas Cook, [✂].

58 Source: Thomson Airways, [✂].

59 Source: Thomson Airways, [✂].

60 Source: Monarch, [✂].

61 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraphs 3.63 to 3.71.

62 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraphs 3.63 to 3.71.

particularly given that Gatwick has capacity constrained and the importance of the London market.[63]

E80 The other respondents provided no specific comment on strategic switching costs.

CAA views

E81 The CAA considers that some of the airlines at Gatwick may face strategic switching costs if they were to switch to another London airport or another airport in the UK or in continental Europe. The CAA considers that this is a factor that needs consideration when examining an airline's decision on whether or not to switch.

E82 A strategic switching cost arises when there are features of the market which mean that withdrawing or reducing operations in London, or ceasing to grow in London and moving the relevant capacity to other cities, results in a long run reduction in profitability – this reduction reflecting a lost opportunity cost for the airline that is greater than the increase in airport charges that it potentially faced.

E83 The CAA considers that the strategic importance of London to an airline's network will vary depending to its business model and potentially the historic and socio-demographic reasons that affect passenger demand for travel to and from London. Examples of this are illustrated below.

Importance of London for based carriers

E84 The aircraft of the largest based FSCs at Gatwick, BA and VAA, are in large part based at London airports: the three bases of BA are Heathrow, Gatwick and London City[64], while VAA's aircraft in London are based at Heathrow and Gatwick. As domestic based carriers the importance of London is evident to their operations. Highlighting the importance of London to its operations, VAA has indicated:

Operating from Heathrow and Gatwick is vital to our operation and business strategy.[65]

E85 Aer Lingus has told the CAA that:

63 easyJet, easyJet response to CAA consultation on Gatwick airport market power, July 2013.

64 Source: BA, [✂].

65 Source: VAA, [✂].

It needs to fly [passengers] to make a profit, and to do that it needs to fly where demand supports its services. London is a very important part of its demand profile and London has many airports.[66]

Importance of London for inbound carriers

E86 Inbound carriers also appear to see a strategic benefit from operating to London. For example, Delta told the CAA that:

It also serves all the other major European business markets but, in terms of volume, London remains the most important market from a transatlantic perspective.[67]

E87 Emirates, though with an apparent focus on Heathrow, added:

Its operations to London are vital and are built around the connectivity of the 'universally recognised' LHR hub:

- *These start in London and connect to points throughout the Emirates network including Australia, Asia and India sub-continent.*
- *London is so appealing because it is where the world wants to travel to and London is a huge magnet for the whole world in terms of retail, culture etc.*[68]

E88 In addition, Air Malta has told the CAA that London is important to its network, stating:

The UK is its main market and its London routes are its prime routes in its network.[69]

The importance of London study – York Aviation and CTAIRA report

E89 To better understand the merit of airlines' claims on the strategic importance of London, the CAA commissioned York Aviation and CTAIRA, independent aviation consultants, to undertake a study on the strategic importance of London to airlines.[70]

E90 This report found that:

66 Source: Aer Lingus, [✂].

67 Source: Delta, [✂].

68 Source: Emirates, [✂].

69 Source: Air Malta, [✂].

70 York Aviation & CTAIRA, The strategic importance of London to airlines, September 2013. Available at: http://www.caa.co.uk/docs/78/rpt%20strategic%20importance%20of%20London%20final.pdf

- On a range of economic and related measures that London represents the strongest O&D market in Europe.
- London is fundamentally attractive with the potential to deliver high levels of profitability to airlines.

E91 York Aviation and CTAIRA also considered that airlines are likely to face reduced long-term profitability if they are forced to switch marginal capacity (routes, frequencies or aircraft), away from London.

E92 In coming to this view, York Aviation and CTAIRA noted that:

- While no single feature marks London out as unique, it offers a combination of features that would be difficult to replicate elsewhere.
- London is fundamentally attractive for airlines to serve, with its potential to deliver high levels of aggregate profitability.
- It is unlikely that the combination of volume and value that defines London can be replicated elsewhere and hence there is the potential for London to be strategically important to airlines.
- In terms of European cities, it had not found any real comparators to London, with the closest comparators being Paris and to some extent Milan.

E93 However, connected to the last point above, York Aviation and CTAIRA identified a number of second tier comparators to London, including Brussels, Frankfurt, Madrid and Munich. The business environment statistics for these cities, summarised in Figure E.3 (below), show that there is a range of factors that contribute to attractiveness. Fundamentally:

- London is bigger in population and economic terms than other European cities.
- London is served by a wide variety of airline business models.
- London is more balanced in terms of inbound and outbound flows providing a more stable passenger demand for air services.
- London has stronger drivers in terms of value through the size of the business and premium travel segments.
- London is the number one tourist destination in Europe by far.
- London has strong point to point demand (52 per cent higher than Paris).

Figure E.3: Macro Environment Indicators

	London	Paris	Milan	Frankfurt	Munich	Madrid	Brussels	Amsterdam
1 - GDP ($ bn)	731.2	669.2	289.3	226.9	210.3	264.0	245.3	322.3
2 - GDP per capita ($ 000s)	52.0	53.9	37.9	51.6	54.5	40.0	45.6	46.0
3 - Employment (m)	7.9	6.1	3.6	2.5	2.3	3.0	2.4	3.9
4 - Population (m)	14.1	12.4	7.6	4.4	3.9	6.6	5.4	7.0
5 - Fortune Global 500 HQs	17	19	2	4	4	5	3	5
6 - Tourism Arrivals (000s)	15,106	8,404	2,075	1,596	2,135	3,431	2,285	4,202
7 - European Cities Monitor Score	0.84	0.55	0.12	0.32	0.19	0.25	0.25	0.26
8 - Size of Air Transport Market	131.4	88.8	36.7	60.3	38.4	45.2	19.0	51.0
9 - Business Passengers (m)	31.5	n/a	n/a	n/a	17.3	n/a	6.1	16.3
10 - Connecting Passengers (m)	28.8	21.3	1.1	31.5	15.0	14.9	3.0	20.9
11 - Point to Point Passengers (m)	102.5	67.5	35.6	28.9	23.4	30.3	16.0	30.1
12 - One Way Premium Class Seats (m)	9.4	6.5	1.9	3.0	1.1	1.9	1.2	3.2
13 - One Way Long Haul Seats	27.0	16.5	1.9	13.2	3.6	5.6	2.1	8.7

Source: York Aviation & CTAIRA, 'The strategic importance of London to airlines', October 2013. Note: 1 to 4 – Brookings Institute Metro Monitor 2012, 5 – Fortune Global 500, 6 – Euromonitor Top City Destinations and City of Frankfurt, 7 – Cushman & Wakefield European Cities Monitor 2011, 8 to 10 Civil Aviation Authorities and Airport Websites, 12 to 13 – OAG.

E94 While these factors contribute to the attractiveness of serving London, York Aviation and CTAIRA also considered that the importance of London to any particular airline depends on a range of factors. The strategic importance of London is therefore considered to be airline specific and dependent, not just in terms of airline type but also the domicile of the airline.

E95 The York Aviation and CTAIRA report indicates that it is fundamentally attractive for airlines to serve London with its potential to deliver high levels of aggregate profitability. It is unlikely that the combination of volume and value that defines London can be replicated elsewhere and hence there is the potential for London to be strategically important to airlines.

E96 The York Aviation and CTAIRA report findings are similar to those of an RBB report commissioned by Ryanair. For example, this report set out reasons why a strong presence in London is important, including that:

- A strong presence in London affects the brand value of an airline.
- The thickness of demand in London allows a large number of routes to be operated from the same base, which results in efficient aircraft utilisation.
- New routes can be launched with lower risk, in regard to profitability, from London airports rather than from non-London airports.
- For Ryanair (which maintains that it has significant sunk costs in marketing its London bases), there is a significant option value to a London presence associated with the ability to operate from London in the future.

UK based versus non-UK based

E97 York Aviation and CTAIRA considered that for UK airlines that are based at Gatwick, the strategic position of London is clear cut. They considered that it is unlikely, whatever airlines' operating model, that they would be able to replicate the volume and value characteristics of London elsewhere. London is therefore of fundamental strategic importance to them. This was particularly the case for UK based airlines such as BA or VAA, which were unlikely to switch marginal services away from London. The CAA notes over 85 per cent[71] of passengers using Gatwick do so with airlines based at Gatwick.

E98 For non-UK based airlines, whether FSC or LCC, while London might be an important and indeed a profitable destination, York Aviation and CTAIRA considered that it is likely to only represent a relatively small part of their respective business. However, in the light of the statistics presented by York Aviation and CTAIRA, the CAA considers that the volume and value of both inbound and outbound traffic available in

71 Source: CAA Airport Statistics. Airlines considered to have bases at Gatwick are: easyJet, BA, VAA, Thomson, Monarch, Thomas Cook, Norwegian Air, Flybe and Ryanair.

London would be difficult to find in any single other European city, although they could switch away, allocating aircraft across their networks.

Airline business models

E99 York Aviation and CTAIRA considered that Gatwick does not operate as a hub in the same way as Heathrow.

E100 York Aviation and CTAIRA also noted that a combination of favourable circumstances in respect of market access and airport capacity has allowed easyJet to grow its capacity at Gatwick. It also found that although there are signs that LCC airlines are seeking to expand their presence in other European cities, the fundamental strengths of London means that the city is so embedded as an origin or destination within their networks that disentangling and moving from London would be difficult given that:

- London acts as an anchor to the network, offering a 'safe' demand pool with strong two way flows of inbound and outbound traffic for establishing new bases and new destinations.
- The size of demand in London has enabled the airlines to develop major bases that enable optimal aircraft utilisation, mixing and matching routes and timings to reach a profitable solution.
- As it enables these airlines to deal with the ongoing issue of market maturity, enabling them to 'churn' routes and adjust frequency and capacity on routes through different parts of the life cycle.
- It has enabled the airlines to maintain their slot portfolio against the background of the 'use it or lose it rules'. The strength of business demand for London routes will also provide opportunities for easyJet in particular as it seeks to move more heavily in to business markets.

Conclusion on the strategic importance of London

E101 The strategic importance of operating to and from London is an important issue when evaluating airlines' ability and willingness to switch from London. This is particularly so for based airlines and for inbound FSCs and feeder airlines, where it appears to be a considerable switching constraint against relocating to other non-London airports in the UK and in Europe.

E102 In making this conclusion, this does not imply a fixed level of capacity has to be allocated to serving London, rather it implies that there are attractions to serving London that would be difficult to replicate and would be likely to make airlines reluctant to switch away. This is particularly so because any decision to leave London may be irreversible as capacity tightens in the future.

E103 The CAA does not consider that the strategic importance of London rests in a single characteristic. Rather, the strategic value that airlines attribute to London arises from a combination of factors, such as its locational value, high airline yields, scarce capacity and, more fundamentally, the volume and value of demand presented by routes serving London and how that contributes to the airlines' business models.

Summary of switching costs

E104 The CAA consider that there is a range of switching costs applicable to airlines that seek to move from Gatwick, including:

- Sunk investments in marketing and infrastructure at Gatwick.
- Exit costs, including those associated with terminating staff contracts and third party handlers at Gatwick.
- Set up costs of opening routes at an alternative airport, including marketing, promotional fares and costs associated with new handler contacts.
- Opportunity costs associated with the switch as routes take time for yields to mature.

E105 Estimates of the costs associated with switching provided by the airlines range from three to ten times the cost the level of a 10 per cent price rise imposed by an airport operator. However, a number of inbound airlines have suggested that the costs faced in switching may be lower than this as a result of fewer physical ties to the airport.

E106 Airline evidence and the CAA's analysis also suggest that the network effect from the connectivity at Gatwick is likely to contribute an additional switching cost to some airlines at Gatwick. Airlines with significant levels of connecting passengers represent around a third of GAL's passenger base.

E107 Additionally, analysis conducted by and on behalf of the CAA suggests that there is an additional constraint imposed on airlines serving London given its unique mix of features.

E108 The CAA therefore considers that the switching costs faced by airlines at Gatwick sit on a continuum, with the highest costs faced by those airlines with large based operations and the lowest faced by those airlines with small inbound operations.

Section 3.2: Capacity constraints

E109 For an airline to be able to switch or threaten to switch away from an airport, they require a credible alternative source of supply. Therefore, as well as the costs of switching it is necessary to evaluate the possible credible alternatives that may be available to it. The main factor affecting credibility to switch to alternative airports is therefore the available capacity at that alternative airport.

E110 This section considers:

- The views the CAA outlined in the Consultation and stakeholders' views.
- Relevant regulatory barriers.
- Capacity at the smaller London airports.
- Capacity at Heathrow.

Consultation view and stakeholders' views

E111 In the Consultation, the CAA considered that the lack of available capacity at other London airports (with the exception of Stansted), constrained airlines' ability to substitute away from Gatwick.[72]

E112 In response to the Consultation, GAL indicated that:

- HAL could increase capacity by, for example, encouraging the use of larger aircraft. It also noted that HAL has consistently increased the number of passengers, despite having been considered full for many years.[73]
- The underutilisation of Stansted, taken with Manchester Airport Group's (MAG's) declared intentions to target growth, provides significant switching capability away from Gatwick in the event of price increases.

[72] The Consultation, paragraphs 6.194, 6.202, 6.205, 6.207 and 7.184.

[73] GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.73.

- Even within capacity constraints there is competition, be it competition for larger aircraft or for airline business models with higher yielding passengers in terms of non-aeronautical revenues.[74]

E113 GACC, BA and VAA all supported the CAA's position:

- GACC noted the limited choices available to airlines to move to other airports;[75]
- BA noted capacity constraints at Heathrow were unlikely to alleviate until 2027 and that other airports were not commercially viable for its operations. It also noted that the costs of switching would be prohibitively expensive;[76] and
- VAA noted that Heathrow is the only alternative to Gatwick but as it is at its maximum capacity this limits the scope for switching to constrain GAL's prices. [✄].[77]

E114 The discussion of capacity constraints needs to be considered within the context of the Government's current aviation policy. The Government has currently put a hold on the expansion of the London airports and the Airports Commission, which is examining the options for capacity development at airports within London and the South East and is not expected to bring out an interim report until the end of 2013, with a full report in summer 2015.

E115 The CAA considers that any change in Government policy following the release of the Airports Commission final report is likely to take some time to be implemented and that any significant capacity expansion is not expected until 2025, outside the timeframe that the CAA is considering as part of this particular market power assessment.

Relevant regulatory barriers

E116 In the Consultation, the CAA described at some length the effect of regulatory barriers on the ability to switch away from Gatwick. This

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74 GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, reference Q5-050-LGW60, 26 July 2013, paragraph 3.78.

75 GACC, Response to CAA document: Consultation on Gatwick market power assessment, 26 July 2013, paragraph 1.9.

76 BA, Response to CAA consultation on Gatwick market power assessment of May 2013, section 3.

77 VAA, Virgin Atlantic Airways Response to CAA Consultation on Gatwick Market Power Assessment.

discussion centred on the European Union – United States of America Open Skies Agreement.[78]

E117 The CAA considers that the switching resulting from 'Open Skies' was unique as it resulted from a legislative change rather than a change in relative prices or airport attractiveness to airlines. Furthermore, the CAA considers that there are unlikely to be any significant or similar events likely to occur over the medium term.

E118 The CAA is not aware of any additional regulatory barriers that would adversely affect the ability of airlines to switch away from Gatwick or to switch to other airports. Therefore the CAA does not consider that there are any regulatory barriers preventing switching from and to Gatwick.

Capacity at the smaller London airports

E119 On GAL's argument that there is available capacity at Stansted and to a lesser extent Luton,[79] London City and, to a certain extent, Southend these airports cannot compete across a sufficiently wide range of aircraft.[80] Although, as noted in the market definition (appendix D), airport operators do not need to be able to compete for all types of traffic at Gatwick, the constraints on London City and Southend does limit the scope of substitution to these airports.

E120 Luton, Stansted and Southend were excluded from the market definition based on demand side evidence provided by airlines that suggested that they were not substitutes for Gatwick for the following reasons:[81]

- Not suitable for passengers that currently want to fly from Gatwick.
- Poorer catchments that would not support the traffic currently at Gatwick.
- A lack of connecting traffic.

E121 This assessment has been made on the basis of a wider unified product market definition i.e. services provided for all airlines regardless of business model than that proposed in the Consultation. The CAA considers that the evidence presented by the FSCs (as outlined in Appendix D) shows that an even weaker constraint is posed by Luton, Stansted and Southend these airports for FSCs compared to LCCs.

78 The Consultation, paragraphs 7.242 to 7.248.

79 Annex D, paragraph D324 and D328.

80 Annex D, paragraph D182, D329 and D336.

81 Annex D, paragraphs D271, D290 and D338.

E122 With respect to Luton, although capacity is available:

- Luton is likely to have sufficient capacity for inbound aircraft to substitute from Gatwick to Luton in the morning peak period.
- There is insufficient capacity at Luton for the substitution of based aircraft from Gatwick due to binding stand capacity constraints.
- Luton is near terminal capacity at peak times.[82]
- Although additional stand capacity is planned at Luton this is limited and is not planned to be operational until 2019.[83]

E123 Stansted, as GAL points out, does have significant spare capacity as it is currently operating at around 50 per cent capacity (although this capacity is mostly available in the off peak periods). Over the next five years Stansted Airport Limited (STAL) is actively seeking growth from its current airline community, with both its main carriers having signed deals with the aim of doubling their traffic levels. This will, all else being equal, tighten available capacity at Stansted going forward. This is in addition to the general tightening of capacity in the London system that is expected over the Q6 period. The CAA notes that in some of the deals that STAL has agreed to [✂].[84] The CAA considers that this clearly suggests capacity tightening at Stansted and STAL is trying to manage this proactively. However similar to Luton and Southend, Stansted has also been excluded from the market definition on the basis of demand side factors relating to its location, poor catchment area, lack of interlining and alliance networks and poor surface links.

E124 Luton and Stansted therefore have the theoretical potential to be alternatives for airlines to operate from instead of Gatwick. However, the CAA considers that although there is potential for them to offer supply substitutes, from a demand perspective these airports are not (currently) considered as substitutable for the reasons set out at above.

E125 Therefore, for the purposes of this document, the CAA considers it is unlikely that other London airports, including Stansted and Luton, provide a sufficiently credible substitution possibility for LCCs and FSCs operating from Gatwick and therefore a limited competitive constraint on GAL.

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82 The minded to Consultation, Appendix 4, paragraphs 3.29.

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

84 Source: STAL, [✂].

Capacity constraints at Heathrow

E126 The section considers the capacity constraints at Heathrow and other barriers that may limit airlines ability to switch operations to Heathrow.

E127 Heathrow has been excluded from geographic scope of the relevant market in which GAL operates.[85] However, given the apparent preference by airlines for Heathrow services, and the presences of specific entry barriers at Heathrow, further discussion on Heathrow is required to assess the level of constraint that it imposes on GAL's behaviour. The CAA maintains the position that Heathrow is only a substitute for the FSC airlines at Gatwick.[86]

E128 In 2012, 70 million passengers travelled through Heathrow, amounting to 472,000 air transport movements (ATMs), which is close to its movement cap of 480,000. This movement cap is unlikely to be lifted in the short to medium term, in particular as mixed mode operations on its runways are prohibited.[87]

E129 Based on the Airport Coordination Limited (ACL) Start of Season reports for summer 2012 and 2013, which are representative of historical patterns, there is, on average 4 to 7 per cent excess demand (i.e. 104 and 107 per cent) for departure and arrival slots at Heathrow.[88] A similar pattern of excess demand can be seen in the Winter traffic seasons.

E130 GAL has suggested that capacity constraints at Heathrow can be overcome to an extent through:

...better use of infrastructure at all airports, including by increasing the number of ATMs, raising aircraft sizes, changing the service mix, or by raising load factors; and

Even when capacity is fully utilised, churn remains high and there is scope to compete for higher value traffic.[89]

85 See appendix D.

86 The Consultation, paragraphs 6.206 and 6.207.

87 Mixed mode operation of the runways allows both runways to be used simultaneously for a mix of arrivals and departures, increasing the capacity of the runways.

88 In general, these figures are lower for the previous two Summer traffic seasons. For departure and arrival slots, the highest excess demand is 28 and 20 per cent respectively. There are a small number of instances where demand is below capacity, though the minimum is 80 per cent slot demand.

89 GAL, Airport competition: Competing to grow and become London's airport of choice, An initial

E131 However, as outlined above, Heathrow is within 2 per cent of its ATM cap. In addition, as Heathrow operates as a hub airport, HAL's incentives are to obtain the optimal mix of traffic for connectivity between different air transport services. In practice this means HAL’s focus is on FSC airlines and those providing connecting services rather than LCC and Charters which provide just point to point traffic.

E132 In light of these two considerations, the CAA considers that HAL would need to balance the efficient use of its limited capacity (e.g. structuring airport charges to increase aircraft size) against the need to ensure a suitable mix of services to maintain the airport as an effective hub. In addition, decisions by airlines to increase aircraft sizes (or to try and raise load factors) will be affected by their network considerations and passenger demand for services to and from Heathrow. So, while in theory an airline could increase the size of its aircraft, if there was insufficient demand for the particular route that aircraft was on, the CAA considers that this would not be a rational position for a profit seeking airline to adopt.

Availability of suitable slots at Heathrow

E133 To switch away marginal services from Gatwick to Heathrow, an airline would need to be able to access suitably timed slots to operate their routes, probably at a similar time to when its service is currently operated from Gatwick.

E134 As noted in the Consultation, the CAA considers that:

- Long haul routes require at least one suitable slot pair a day to switch a daily service. Departures for this type of routes at Gatwick are typically between 0900 and 1430, with arrivals typically between 0600 and 1035. This timing reflects the fact that most long-haul flights to and from Gatwick are to the Americas.[90]
- That the arrival and departure of short haul flights would likely need to be timed to support feeder for long-haul routes. To ensure sufficient use of the aircraft additional daily rotations of short haul aircraft are likely to be required and, as such may require a number of slot pairs throughout the day.[91]

submission from Gatwick Airport to inform the CAA’s review of airport competition, November 2011, Q5-050-LGW05, p. 50.

90 The Consultation, paragraphs 7.196 to 7.198.

91 The Consultation, paragraphs 7.199 to 7.202.

- While long-haul carriers appear to need at least one slot pair a week for a weekly service, this would rise to a slot pair a day for daily long-haul services and up to three slot pairs a day for a full short haul service.[92]

E135 In presentations to airlines, HAL set out the availability in the slot pool for Heathrow, as shown in Figure E.4 (below). The figure shows for summer 2013 that:

- There were, on average, 11 available departure and arrival slots across the week, although this availability ranges from two arrivals and one departure on a Tuesday to 42 arrivals and 29 departures on a Saturday.

  Slots were not available throughout which day with availability tending to be in the afternoon. This suggests that some additional long-haul movements may be possible during week days, dependent on destination and required aircraft turnaround.

- The weekend appears suitable for some limited short-haul development as there are slots available for arrival in 11 hours on the Saturday and 7 hours on the Sunday and departures available for 12 hours on the Saturday and 8 hours on the Sunday allowing for multiple rotations.

- Whether operating short-haul or long-haul flights it would be difficult to commence a schedule of operations of more than a couple of days a week.

E136 Despite the marginal unit being only one slot pair a day for a long-haul service and one to three slot pairs for a short-haul service for a Gatwick airline, the scope for an airline to move is limited given the scarcity of available suitably-timed slot capacity. For example, in the context of whether it was possible for Flybe to move from Gatwick to Heathrow, Flybe indicated that:

Slot constraints there are such that there is no prospect of Flybe being able to construct a weekly timetable for its regional services which would be timed consistently day by day and operate at times which fitted the relevant markets and were operationally achievable.[93]

[92] The Consultation, paragraphs 7.199 and 7.202.

[93] Source: Flybe, [✂].

Figure E.4: Heathrow slot pool[94]

S13	Arrivals							Departures						
	Mon	Tue	Wed	Thu	Fri	Sat	Sun	Mon	Tue	Wed	Thu	Fri	Sat	Sun
500	0	0	0	0	0	1	0	0	0	0	0	0	2	8
600	0	0	0	0	0	0	0	0	0	0	0	0	2	7
700	0	0	0	0	0	0	0	0	0	0	0	0	1	3
800	0	0	0	0	0	0	0	0	0	0	0	0	0	1
900	0	0	0	0	0	0	0	0	0	0	0	1	0	0
1000	0	0	0	0	0	1	1	0	0	0	0	0	0	0
1100	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1200	0	0	0	1	1	1	1	0	0	0	0	0	0	0
1300	0	0	1	0	1	1	0	0	0	2	0	0	3	0
1400	0	0	0	0	0	0	0	0	0	1	1	0	2	3
1500	0	1	0	1	0	1	1	0	0	0	0	0	1	0
1600	0	1	0	2	1	5	2	0	0	0	0	0	2	1
1700	0	0	0	0	0	2	0	0	0	0	0	0	1	0
1800	0	0	1	0	0	7	2	0	0	0	0	0	6	2
1900	1	0	2	1	0	4	1	0	0	2	1	0	4	0
2000	2	0	0	1	3	14	4	2	1	1	0	0	4	0
2100	0	0	0	0	1	5	0	1	0	3	1	3	1	4

Source: *HAL representation of ACL data*

E137 It can be argued that airlines currently holding slots at both Gatwick and Heathrow may find it comparatively easy to switch marginal services between the two airports without acquiring additional slots at Heathrow. However, relocating from Gatwick to Heathrow (by allocating it to an aircraft at Heathrow), would require the displacement of a route that is currently operated from Heathrow. For an airline to be willing to displace a service currently operated at Heathrow, the expected future yield of the switched route would need to be equal to, or greater than, the yield of the route it would displace. For an airline to consider doing this it would have to have a neutral or positive effect on the airline's overall profitability.

E138 To gain a better understanding of this issue, the CAA requested BA to provide detail on the business cases that it has used when considering swapping routes between Gatwick and Heathrow. These business cases illustrate that where [✂]. BA considers [✂].[95] Routes switching into Gatwick are those which BA considers have [✂]. The swapping of routes therefore appears to be taking place where there is positive effect on the airline's operations.

E139 Overall, the limited spare slot capacity available at Heathrow would restrict the ability of carriers at Gatwick to move marginal services to Heathrow. There are, however, other means of slot acquisition where current availability may not be such an issue, including secondary slot

94 Source: HAL, [✂].

95 Source: BA, [✂]..

trading, leasing of slots and the acquisition of rival airlines. These issues are discussed in the following section.

Means of slot acquisition

E140 Airlines holding slots at an airport acquire grandfather rights that allow them first refusal of the same slot in the corresponding season the following year. Once allocated by ACL (the independent slot coordinator), slots are operated under a use-it-or-lose-it rule whereby an airline is required to have a utilisation level of 80 per cent for each of its allocated slot pairs over its slot series. Where an airline cannot justify its utilisation below 80 per cent, it must release the slots back to the slot pool, or trade or sell it to another carrier.[96]

E141 In describing slot trading, HAL has explained that a slot transfer involves both the runway slot pair(s) and the associated historical terminal and stand capacity rights:

Traded components:

- *Runway slots:*
  - *These can be retimed if the runway slots are available.*
  - *Any retime must also fit the terminal and stand capacity.*
- *Terminal and Stand Capacity:*
  - *The Buyer purchases the Historic Terminal and Stand Capacity and can operate from the Historical Terminal.*
  - *e.g. code D aircraft with 150 seats in T3.*
- *A change of terminal/aircraft stand size can be requested and would be assessed against declared capacity.*
- *A new entrant would be assessed against all terminals and allocated to the terminal with the most suitable capacity.*[97]

E142 HAL has also indicated that notwithstanding the benefits associated with slot trading '*requests to change to historic terminal capacity [are] not guaranteed*.'[98]

96 The European slot regulations are currently undergoing review.

97 Source: HAL, [✂].

98 Source: HAL, [✂].

E143 The CAA considers that this means that the ability of an airline to find one or more suitable slot pair(s) to enter Heathrow depends on the timing of the slot pair but also on whether the airline is able to operate from a suitable terminal location at the airport, relative to its strategic partners.

E144 In its presentations to potential new entrants, HAL also set out the advantages and disadvantages of the ways to acquire slots to operate from Heathrow. This is reproduced in Figure E.5 below.

Figure E.5: Accessing Heathrow

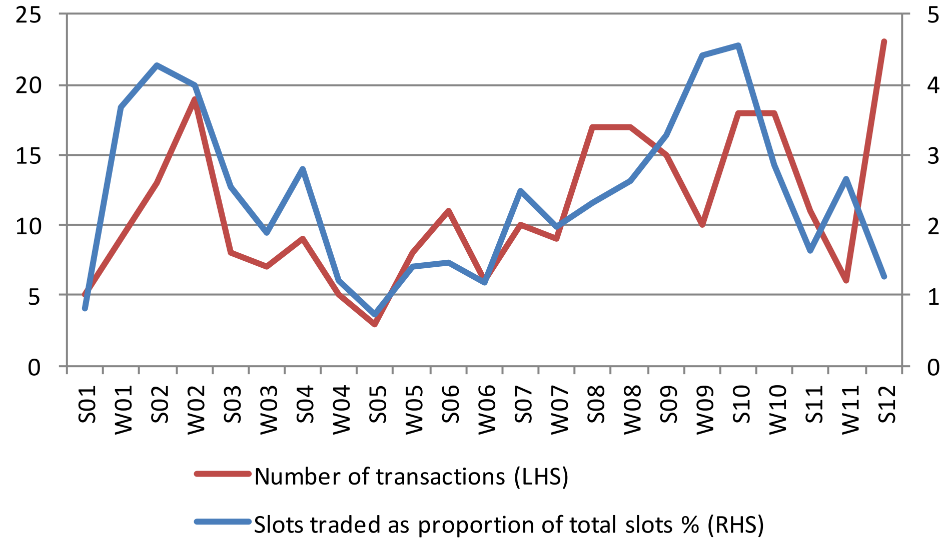
Option	Pros	Cons	Indicative proportion of slot acquisition (%)
From slot pool via ACL	Free of charge	Very limited slots available Times likely to need flexible approach	8
Slot trade - buy slot from another airline	Permanent access to airport Schedule can target ideal times	Higher initial cost	34
Slot lease - lease slot from another airline	Spread cost over time Schedule can target ideal times	Not permanent	38
Alliance partner - trade, lease or JV with alliance partner	Deal can be more flexible Schedule can target ideal times		20

Source: HAL [✂]

Secondary slot trading

E145 Slots can be traded on the secondary slot market, with all transactions being recorded by ACL on its slottrade.aero platform. In practice, the number of slots traded as a proportion of slots at Heathrow has been on average two per cent of the total slots (approximately 190 of 9,500 weekly slots) in a particular traffic season between summer 2001 and Summer 2012. This is shown in Figure E.6 below.

Figure E.6: Slot trading at Heathrow[99]



Source: CAA analysis of slottrade.aero data

E146 Figure E.6 (above) suggests that the secondary slot market at Heathrow is relatively illiquid with the average proportion of slots traded being less than three per cent in any season. This implies that airlines at Gatwick would be restricted in their ability to acquire the necessary slots to move marginal aircraft and services. It also implies that the level of airline churn is low at Heathrow.

E147 However, it is not currently possible to ascertain with certainty the nature of a particular slot transaction. For example, ACL told the CAA that:

Trading/leasing/"babysitting" of slots are all regarded as a slot "Exchange" between two airlines, covered by an underlying contract to which ACL is not party.[100]

E148 Given the above, the CAA considers that the apparent illiquidity of the secondary slot market at Heathrow suggests that the purchase of slots is unlikely to be, in general, a viable means of switching services from Gatwick to Heathrow.

E149 Despite the limited trading observed, slots at Heathrow have demonstrable commercial value. Estimates have been calculated for the purchase of Heathrow slot prices between £1 million and £25 million per

[99] The peak in transactions in S2012 is attributable in part to the return of slots by lessees of bmi slots following the acquisition of bmi by IAG.

[100] Source: ACL, [✂].

slot pair over the 2001 to 2010 period, with morning slots being more expensive than those in the afternoon and evening.[101] More recently, BAA was quoted as saying that the average slot value at Heathrow was £7 million per pair with morning slots at around £15 million a pair.[102] It was also reported that in 2012 Delta purchased two slot pairs at an average of £15.4 million a pair[103] and in 2013 Etihad purchased three slot pairs at a similar price.[104]

E150 Given the departure and arrival times of current long-haul services at Gatwick, this implies that, to switch a long-haul aircraft to serve a route at Heathrow, an airline would be likely to face entry costs of up to £25 million, although on more recent estimates around £15 million to acquire a suitable pair of slots (if such slots were available either through sale or lease). This compares to the more modest slot values at Gatwick. The recent sale of slots at Gatwick by Flybe was approximately £20 million for 25 slot pairs (£0.8 million per slot pair), which is significantly less than slots traded at Heathrow.[105]

E151 Such a variance in slot prices has also been noted by ACL, which told the CAA that:

It is widely understood that there are modest amounts of trading at LGW, and these are traded for modest sums. For example, the value of a slot pair at LHR is reportedly around £10-20m+, and less than £1m at LGW. Many Gatwick slots are also not traded for a monetary value.

Adria Airways tried to sell LGW slots it obtained after selling those at LHR. The airline reportedly tried to link the value of the slots at LGW to those it sold at LHR previously. This did not work, as the price was reportedly excessive for LGW, the slots were not traded and were returned to the slot pool where they were allocated to airlines on the waitlist.[106]

101 Source: ICFI, [✂].

102 Reported in Euro and converted to GBP at a rate of 1.24 2nd July 2012 estimated from xe.com values reported by route-news.com. See: http://www.routes-news.com/airlines/item/887-heathrow-airport-slot-trading (accessed February 2013).

103 See: http://buyingbusinesstravel.com/news/2320624-delta-reveals-cost-more-heathrow-flights (accessed 23 October 2013).

104 See: http://www.businesstraveller.com/news/etihad-buys-jet-airways-heathrow-slots (accessed 23 October 2013).

105 See http://www.flybe.com/corporate/media/news/1305/23.htm

106 Source: ACL, [✂].

E152 Entry with short-haul routes would also face similar costs, depending on their time of operation. For example, relocating an aircraft from Gatwick (or from any other airport) to operate short-haul routes several times a day into Heathrow – requiring typically three slot pairs – could entail a possible average expenditure of £25.5 million for suitable slot pairs.[107] The costs involved strongly suggest that purchasing slots will not be a realistic reaction to a 5 to 10 per cent price increase.

Slot leasing

E153 The strategic trading of slots is likely to constitute a further barrier to entry at Heathrow for certain airlines, such as those not party to an alliance or with few strategic partners. This view is supported by evidence from ACL, who told the CAA that:

It would appear the slot trades often stay within airline strategic groups, which results in fewer slots returning to the slot pool for reallocation to other carriers, including competitor airlines.[108]

E154 The ACL also highlighted, by way of an example, that:

BA has leased slots to Aer Lingus, Air Berlin and Flybe which are all strategic partners of BA through either interlining agreements or alliance membership in the case of Air Berlin; and

easyJet has leased slots from Delta, Continental and Virgin.”; and that

At Gatwick, BA has approximately 100 fewer slots a week than 5 years ago in the morning peak, while easyJet has increased its slot holdings by approximately 100. However, these slots were not traded between these two airlines.[109]

E155 BA told the CAA that it leases slots at Heathrow. Specifically:

[At Heathrow], BA currently leases in [✂] daily slot pairs [✂].

[At Heathrow], BA currently leases out [✂] daily [slot pairs] [✂], including 13 required by competition authorities and [✂].[110]

107 This figure is only indicative and was calculated on the basis of the average estimated slot value for 1 morning (£15 million), 1 afternoon (£8.5 million) and 1 evening slot pair (£2 million).

108 Source: ACL, [✂].

109 Source: ACL, [✂].

110 Source: BA, [✂].

E156 Conversely, for Gatwick, airlines which have strategic partners at Heathrow, may be able to acquire slots at suitable times to facilitate the switching away of services from Gatwick to Heathrow.

E157 For example, GAL stated in internal documents that Delta:

[✂].[111]

E158 Indeed, Delta told the CAA that:

It had to negotiate and lease slots from its partners Air France-KLM, which was a separate process independent from the airport development.[112]

E159 Delta also told the CAA, in relation to its recent share purchase in VAA, that:

Its need to expand at LHR was of critical importance. This is why it chose to take a 49% equity share in Virgin Atlantic, which in turn provides a much bigger LHR footprint as well as the ability to offer many more gateways (Atlanta, Los Angeles, Miami, San Francisco, Boston and New York).[113]

E160 The possibility of leasing or purchasing slots from strategic partner airlines may allow certain carriers to switch services from Gatwick, provided they are suitably timed and that the service being moved will be comparatively advantageous, or equivalent, to the slots' current use. Further, the use of joint ventures by airlines to increase their respective presence at Heathrow further demonstrates the high barriers to entry at the airport that would be faced by an airline seeking to move a marginal service.

Mergers and acquisitions

E161 Another means of slot acquisition is through airline mergers and through any related slot-based remedies stipulated by competition authorities. For example, in the IAG/bmi merger, IAG and VAA achieved increased slot holdings through slot remedies.[114]

111 Source: GAL, [✂].

112 Source: Delta, [✂].

113 Source: Delta, [✂].

114 Indeed, VAA has commenced short-haul services from LHR. See, for example, http://www.virgin-atlantic.com/en/gb/frequentflyer/offersandnews/latestnews/newrouteaug12.jsp (accessed February 2013).

E162 In internal documents, GAL also commented on the IAG/bmi merger and noted that:

[✂].[115]

E163 In addition, ICFI noted in a report for GAL, as a result of the IAG/bmi merger, that:

[✂]

And:

[✂].[116]

E164 Regarding the IAG/bmi merger, it appears that BA has acquired the bmi mainline aircraft. The aviation press quotes BA as saying:

BA says that there will be a "gradual transition of flights during the summer [2012] period" as it integrates bmi into its Heathrow operations, and during this period "the exterior and interior design of bmi's aircraft, as well as the onboard experience will gradually transform into British Airways' style.[117]

E165 This evidence suggests that mergers, or the acquisition of an airline which is likely to also involve the acquisition of its fleet, is unlikely to result in significant scope to switch aircraft between airports, as the resulting network planning is likely to involve all existing (and at least a proportion of merger-acquired) aircraft.

E166 Although mergers clearly presents a method of entry or expansion into Heathrow; generally airlines are purchased with a selection of aircraft, staff and routes already served and are therefore not purchased as empty slots. The CAA considers that mergers and acquisitions are likely to take place for wider strategic reasons rather than as a response to GAL pricing behaviour.

ICFI's risk assessment of Gatwick's carriers with respect to Heathrow capacity

E167 In a January 2012 report commissioned for GAL, ICFI performed an assessment of the perceived likelihood that the airlines at Gatwick might switch away to Heathrow. Of the largest carriers at Gatwick, [✂] is seen as having:

115 Source: GAL, [✂].

116 Source: ICFI, [✂].

117 See: http://www.businesstraveller.com/news/ba-starts-bmi-integration (accessed April 2013).

[✂][118]

[✂][119]

E168 Figure E.7 summarises ICFI's assessment of the smaller FSC and associated feeder carriers remaining at Gatwick in February 2013.

Figure E.7 Summary of ICFI's risk assessment for relevant Gatwick airlines

Airline	ICFI's risk assessment
Short-haul	
[✂]	[✂]
[✂]	[✂]
[✂]	[✂]
[✂]	[✂]
[✂]	[✂]
Long haul	
[✂]	[✂]
[✂]	[✂]
[✂]	[✂]
[✂]	[✂]

Source: CAA presentation of ICFI research

E169 The CAA considers that ICFI's assessment of potential airline switching shows that there is limited scope for airline switching from Gatwick to Heathrow. This is consistent with evidence provided by airlines and the assessment of capacity constraints at Heathrow.

Assessment on capacity constraints

E170 Overall, based on the evidence outlined above, in particular, the capacity constraints at Heathrow and the unsuitability of other London and regional airports, airlines are severely limited in their ability to constrain GAL's pricing behaviour by switching away marginal aircraft or services.

E171 Heathrow is also, in effect, operating at full capacity, which will limit the ability of an airline to switch there. While the marginal units that would be required to move are relatively small – one slot pair for long-haul and between one and three for short-haul routes – the availability of suitably-

118 Source: ICFI, [✂].

119 Source: ICFI, [✂].

timed slot pairs at Heathrow for services currently operated Gatwick appears to be very limited.

E172 As there is typically only one or two (if any) slot pairs available in the Heathrow slot pool, from which slots can be obtained at no cost, this means that the more likely means of slot acquisition would be through:

- buying from the relatively illiquid secondary slot market;
- leasing slot pair(s) from partner airlines;
- entering into joint ventures with other airlines; or
- merging with or acquiring another airline.

E173 There are, however, significant costs – for example financial and/or coordination costs – associated with obtaining the rights to operate from Heathrow. In the purchase or lease of slots there is an additional barrier from the lack of liquidity in the market and the need to find an airline willing to transfer (at least temporarily) some of its slot rights at a congested and capacity constrained hub airport.

E174 Overall, the costs of slot acquisition at Heathrow are likely to significantly exceed a 5 to 10 per cent increase in airport charges at Gatwick. As a result, it appears highly unlikely that airlines would be able and willing to switch marginal services to Heathrow of a sufficient scale to constrain GAL from increasing airport charges.

E175 With respect to airport entry and expansion, the scope for capacity expansion is limited and insufficient to constrain GAL's pricing in both the short and medium term.

Section 4.3: Countervailing buyer power

E176 In this section, the CAA considers the ability of airlines to constrain an airport operator’s pricing power by leveraging the importance of its operations during negotiations. GAL's behaviour with regard to attracting new traffic and negotiating with airlines is considered in appendix G. In particular, this section covers:

- the relative importance of Gatwick and its airlines to their respective operations;
- analysis of marginal routes; and
- future demand and backfill.

E177 In late November 2013[120] the CAA was formally made aware that GAL had entered into commercial negotiations with airlines under the proposed regulatory commitments framework. A full discussion of these is provided in appendix G. As regards countervailing buyer power the CAA sees these commercial negotiations as a product of the regulatory process. It does not consider that absent prospective regulation these negotiations would have taken place. The CAA therefore does not consider that these negotiations provide any additional evidence for it analysis of buyer power and the constraints that may limit or otherwise GAL’s potential market power

E178 In the Consultation, the CAA considered that there was limited scope for airlines to leverage their buyer power by credibly threatening to switch away from Gatwick.[121] The CAA continues to consider that this is the case.

Relative importance of Gatwick and its airlines to their respective operations

E179 As a starting point, the CAA has considered the relative importance of Gatwick, and its airlines, to their respective operations. Figure E.8 shows the top 12 airlines by passenger numbers operating from Gatwick.

E180 Figure E.8 shows that easyJet is the largest airline operating at Gatwick, with BA having the second largest share (14.2 per cent). With 53 airlines operating from the airport there is a long tail of airlines with less than 1 per cent share; these airlines are unlikely to be sufficiently important to Gatwick’s operations to hold any significant degree of countervailing buyer power.

E181 While easyJet and BA have the largest share of passengers at Gatwick, other airlines appear more valuable in terms of total income (including commercial retail expenditure) per passenger. This suggests that some of the smaller airlines can be important contributors to GAL's revenue.

120 Source: GAL, [✂].

121 The Consultation, paragraph 6.196 and 7.172 to 7.173.

Figure E.8: Relative importance of Gatwick and its top 12 airlines to their respective operations

Airline	Airline's passengers as share of airport's passengers (2012) (%)	Share of airline's passengers that are served from Gatwick (2012)(%)	Total income (aero + retail) per passenger 2010/11
easyJet	40%	23%	[✂]
BA	15%	12%	[✂]
Thomsonfly	8%	25%*	[✂]
Monarch	6%	14%*	[✂]
Thomas Cook	4%	21%*	[✂]
VAA	4%	23%	[✂]
Norwegian	4%	7%	[✂]
Flybe	3%	13%	[✂]
Ryanair	3%	1%	[✂]
Aer Lingus	2%	7%	[✂]
Emirates	2%	2%	[✂]
easyJet	40%	23%	[✂]

Sources: CAA Airport Stats, OAG, GAL, [✂]

Note: *These numbers are share of passengers and come from CAA airport Stats, other airlines' shares have come from the OAG.

E182 GAL has raised this point in its evidence to the CAA:

British Airways (14%) and Virgin (5%) are also important customers for Gatwick. However, as these airlines have their main operations located at Heathrow and Gatwick services could potentially be switched to Heathrow through purchase of the necessary slots, mergers or changing the use of existing slots. This increases the risk of certain routes ceasing at Gatwick and being focussed instead at Heathrow. For example, changes at bmi, if it is sold, could result in more efficient use of slots at Heathrow.

Other long-haul carriers may be smaller than British Airways and Virgin, but they are difficult to replace (at least with similarly valuable services) and these carriers are well able to play-off different airports, even beyond the South East and the UK, against each other. This is particularly true *when the airport acts as a spoke in an airline's hub network, which is often the case for Gatwick.*

It is the case that several airlines at Gatwick have significant levels of buyer power when negotiating with Gatwick. If Gatwick were to attempt to raise prices above competitive levels, it would be constrained in its ability to do so by the credible threat and ability of airlines to switch their demand away, or to cease to fly certain routes, or to cut back their growth plans for the future.[122]

Airlines' evidence

E183 A number of airlines operating from Gatwick have also provided evidence of their perceived ability to credibly threaten, as part of their negotiations with GAL, to switch away from the airport.

E184 For example, easyJet told the CAA that it [✂].[123]

E185 In addition, easyJet informed the CAA of the importance of the London market (see earlier section on the strategic constraints on switching) and that: '*it invests long term and that it costs a lot to move assets around and it is not easy to move aircraft from base to base*.'[124] It has also indicted that (with reference to analysis undertaken by Frontier Economics) that the costs faced by airlines in switching routes from one airport to another prevent it from switching enough routes to impact the airport's passenger volume (or in other words, 'switching costs are too high').[125]

E186 During a stakeholder meeting with the CAA Board (16 January 2013), easyJet suggested that, notwithstanding it having a relatively strong presence at Gatwick, it was unable to exert sufficient influence (countervailing power) to make the airport operator change its position on numerous issues. Other (smaller) airlines present at the stakeholder meeting also highlighted that if easyJet did not have countervailing power, what chance did they have?

E187 BA told the CAA:

It pays the published tariffs and GAL always charge to the cap.

[122] GAL, 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, November 2011, Q5-050-LGW05, p. 76 and p. 80.

[123] Source: easyJet, [✂].

[124] Source: easyJet, [✂].

[125] Source: easyJet, [✂].

[✂].

In [Airport Consultation Committee] ACC meetings, GAL has a 'take it or leave it' approach and present their proposals rather than using it as a forum to consult.[126]

E188 Another airline also indicated that it has a challenging relationship with GAL and that it has, at times, found it difficult to engage effectively with it. In particular, it noted:

It does not receive discounts on aeronautical charges or marketing support for its routes at LGW, and that previous negotiations have not come to anything.[127]

E189 Air Malta similarly stated:

It does not receive any support from LGW (it hasn't tried to negotiate any discounts, and nothing has been offered). It added that it would be futile to do so.[128]

E190 Another stakeholder, [✂], also indicated that:

Negotiations are driven by GAL as opposed to being run collaboratively with airlines.[129]

[GAL] knows they will always have a presence at the airport because there is nowhere else for them to go. For that reason they do not need to 'play court' and don't bother.[130]

E191 Evidence from Flybe also suggests that attempts at negotiating discounts on the tariff aeronautical charges have not been successful.[131]

E192 GAL has provided evidence to the CAA that a number of FSCs and feeder airlines have ceased or reduced operations at Gatwick. If these airlines' decisions were related to price or service quality, this could indicate that they exercised a degree of countervailing buyer power. For example, GAL indicated that [✂], having commenced its route to [✂], has:

...recently announced their intention to cease the Gatwick operation

126 Source: BA, [✂].

127 Source: [✂].

128 Source: Air Malta, [✂].

129 Source: [✂].

130 Source: [✂].

131 Source: Flybe, [✂].

[✂].[132]

E193 The CAA examined this claim and the motive behind the closure does not appear to be related to the level of airport charges or service quality at Gatwick. In particular, [✂] stated that:

- *It withdrew the service for the Winter 2012 traffic season due to lack of demand. This decision was not related to pricing at Gatwick.*
- *It is recommencing the service (one daily frequency) for the Summer 2013 traffic season. Demand for this service is sufficient in Summer but not in Winter traffic seasons.*
- *It added that GAL is generally active in seeking to retain services.*[133]

E194 In addition, GAL told the CAA that Air Berlin, having switched two services from Stansted in February 2011, had become:

[✂].[134]

E195 Regarding its route to Hannover, Air Berlin[135] told the CAA that:

From February 2011, it flew from Gatwick to Hannover but closed this route for commercial reasons.[136]

E196 GAL also provided evidence to the CAA that Hong Kong Airlines, having commenced operations to Gatwick in March 2012, terminated its services in September 2012 citing the poor economic climate in Europe.[137]

E197 The CAA also understands that Korean Air, having begun operating from Gatwick in April 2012, and previously suspended their operations during the Winter 2012/13 traffic season, has announced an end to its Gatwick services from April 2013.[138]

E198 The above examples show that a number of airlines at Gatwick have ceased their operations, but they appear to have done so for reasons that were not directly related to price or the balance of power in negotiations with GAL. In some of these cases, GAL had made offers to an airline to

132 Source: GAL, [✂].

133 Source: [✂].

134 Source: GAL, [✂].

135 The CAA understands Air Berlin has now withdrawn from Gatwick.

136 Source: Air Berlin, [✂].

137 Source: GAL, [✂].

138 See: http://www.routesonline.com/news/38/airlineroute/175401/korean-air-closes-reservations-for-london-gatwick-service-in-s13/ (accessed April 2013).

remain at the airport but the airline did not change its decision. Furthermore, as these airlines each accounted for less than 2 per cent of the airport's passengers, the CAA considers that it is unlikely that they would have been in a position to leverage any degree of buyer power.

E199 Set against the above are comments made by Wizz Air and the treatment of Norwegian Air Shuttle (Norwegian Air), the second largest LCC, at Gatwick.

E200 Wizz Air noted that:

Overall, the London airport market contains lots of choice for Wizz Air. The airline can play airports against each other during negotiations, and the decision to operate from an airport ultimately comes down to operational considerations.[139]

E201 Norwegian Air has indicated that it has had a positive experience with GAL since its move to Gatwick.[140] In particular, it has indicated (amongst other things) that:

Under BAA, NAS [Norwegian Air] was a smaller player and didn't get any attention. BAA's whole focus was on base carriers. BAA's approach was "this is what we have, take it or leave it". It has noticed dramatic changes in attitudes and improvements since new ownership at LGW' [and] *'When travelling around Europe, it always use GAL as an example for how other airports should behave and work with partner airlines'.*[141]

E202 However, this positive relationship may reflect GAL's desire for the airline to base itself at the airport (and grow). In particular, Norwegian Air has recently announced it has established a base at Gatwick. In addition, based on the evidence of other stakeholders, this positive experience may not continue. In particular, numerous stakeholders have suggested that GAL's approach to incumbent airlines is quite different to that which Norwegian Air (as a new airline at Gatwick) has experienced. For example, [✂] indicated:

New carriers get more say than incumbent airlines; for example Norwegian Air Shuttle has a big marketing campaign, significant space and discounts. GAL's strategy is to focus on attracting new carriers and then once they start operating, it focuses its attention on another new

139 Source: Wizz Air, [✂].

140 Source: Norwegian Air, [✂].

141 Source: Norwegian Air, [✂].

carrier, without maintaining its incumbents.[142]

E203 In November 2013[143] it was announced that Norwegian Air had signed a bilateral agreement with GAL under the regulatory commitments framework. A condition of this agreement[144], as made available to the CAA, is that Norwegian Air will *'support the Commitments regime in writing to the CAA.'* This does bring into doubt the level of commercial leverage that Norwegian Air considers it has.

E204 The evidence from airlines on their ability to leverage buyer power indicated that the airlines appear to be a disadvantage with regards to negotiations with the airport operator. Inbound and growing carriers appear to be in a stronger position although these individually form a limited part of the airport operators business.

Analysis of marginal route profitability at Gatwick

E205 The CAA analysed route revenue and profitability data it has received from easyJet and BA[145]. The objective of this analysis was to identify the extent to which marginal routes at Gatwick were at risk of being cut in response to a 5 to 10 per cent increase in GAL's airport charges and how many passengers those routes carried as a proportion of the total.

E206 To achieve this, the CAA looked at the bottom of the route profitability distribution for each carrier and considered how much a £1 reduction in profit per passenger would affect that distribution. However, it is difficult to tell exactly where the cut-off for a marginal route to be removed from an airline's network is, let alone if that cut off actually exists as airlines may maintain routes for strategic reasons. Therefore, the CAA took a range of cut-off points towards the bottom of the route profitability distribution and estimated the number of passengers in routes within £1 of that range of cut-off points. The CAA then compared relative reduction in passenger numbers with the relative increase in terms of airport charge that a £1 increase represents to compute implied airport charge elasticities.

142 Source: [✂].

143 GAL, Norwegian and London Gatwick sign landmark long term commercial partner, press release, 28 November 2013 url: http://www.mediacentre.gatwickairport.com/News/Norwegian-and-London-Gatwick-sign-landmark-long-term-commercial-partnership-87a.aspx.

144 GAL, Heads of terms of an Agreement in relation to Airport Services & Charges beyond Q5: Norwegian Air Shuttle, 26th November 2013 Subject to Contract, Signed.

145 easyJet and BA are the two largest Gatwick airlines representing, respectively, 40 and 15 per cent of Gatwick's 2012 passenger numbers.

E207 There are however several limitations in using this data to infer an airport charge elasticity of demand in this way:

- This analysis assumes that the airlines are not able to pass on any airport charge increase to passengers and instead airlines absorb all the airport charge increase.
- This analysis also assumes that, faced with a price increase, the only tool available for airlines to respond to the airport charge increase is to close routes. In practice, airlines also have the ability to reduce frequency and continue serving some of these marginal routes as well as to reduce frequency on non-marginal routes. Airlines can also try to increase the efficiency and adjust the offering of their services.
- Capacity and route selection decisions are much more complex than is assumed by this analysis. Considerations on route maturity, corporate strategy and product range, strategic competitive effects, economic expectations, completing an efficient schedule and retaining strategic slots or volume deals will play a part on the airline's decisions to drop or maintain a route.

E208 The combined effect of these limitations on the elasticity estimates is uncertain. Nevertheless, the CAA presents the analysis of confidential data received from easyJet and BA in turn below.

easyJet

E209 Figure E.9 below shows the number of passengers and 'contribution' (a measure of route profitability in terms of contribution to overheads provided by easyJet) per passenger for the [✂] easyJet routes at Gatwick, in 2011. If all costs were inputted to the routes, this curve should shift downwards.

E210 The smallest route considered had 6,000 passengers and the largest had 497,000. Route average contribution per passenger ranged [✂].

Figure E.9: Route Contribution and passengers on easyJet's routes at Gatwick (page 54)

[✂]

Source: CAA analysis of easyJet's data

E211 It is difficult to tell where exactly where the cut off for a marginal route to be removed from the network is, let alone if that cut off actually exists. Therefore, the CAA looked at the bottom of the route contribution distribution and considered how much a £1 variation in profit per passenger would affect that distribution. The CAA considers that routes with average contribution per passenger [✂] to be the most likely to be marginal with respect to airport charges. [✂]. The routes in this range represented [✂] of easyJet's passengers at Gatwick.

Figure E.10: Routes and passenger numbers in selected £1 profit intervals of easyJet's routes at Gatwick (page 55)

[✂]

Source: CAA analysis of easyJet's data

E212 Based on the data presented in Figure E.10 above, the CAA estimates that the passenger loss accruing from marginal route loss, if easyJet were to be faced with a £1 profit reduction per passenger, would be around [✂] If £1 represents an increase of about 12.5 per cent increase on a £8 airport charge, then that would imply an airport charge elasticity of about [✂]. This estimate is [✂] and it would therefore mean that marginal route switching would be unlikely to be able to constrain significantly GAL's pricing.

BA

E213 Figure E.11 below shows the number of passengers and Profit (EBIT) per passenger for [✂] routings[146] at Gatwick with more than 100 flights, in 2012. The smallest routing considered had 12,000 passengers and the biggest had 336,000. Route average profit per passenger ranged between [✂].

E214 The CAA considers that routes with an average profit per passenger of between [✂] to be the most likely to be marginal with respect to airport charges, and effectively ignored [✂]. These routes represented around [✂] of BA's passengers at Gatwick.

E215 Figure E.11 also shows that [✂]. Given this historical background the CAA considers that this picture will likely change in the coming years and that this limits the weight that the CAA can place on this analysis

146 Some of these routeings are multi-sector flights such as LGW-Antigua-Grenada and LGW-Antigua-Tobago.

Figure E.11: Figure E.11: Route Contribution and passengers on BA's routes at Gatwick (page 56)

[✂]

Source: CAA analysis of BA's data

Figure E.12: Routes and passenger numbers in selected £1 profit intervals of BA's routes at Gatwick (page 56)

[✂]

Source: CAA analysis of BA's data

E216 Based on the data presented in Figure E.12, the passenger loss accruing from marginal route loss, if BA were to be faced with a £1 profit reduction, would be of around [✂]. Since £1 represents an increase of about 12.5 per cent increase on an assumed £7 initial airport charge, then that would imply an airport charge elasticity of about [✂]. This estimate is [✂] and it would therefore mean that marginal route switching would be unlikely to be able to significantly constrain GAL's pricing.

Conclusion from the analysis

E217 In reaching its market power decision, the CAA has placed limited reliance on this analysis (particularly on any point estimates of price sensitivity) given the limitation of the analysis identified above.

E218 Overall, the CAA considers that the effects of a 5 to 10 per cent increase in airport charges on route profitability alone is unlikely to lead airlines to cut routes to such an extent that it would prevent GAL from profitably increasing its charges. That is mainly because a 5 to 10 per cent increase in airport charges represents a small amount compared with the airlines' total profits per passenger and its variance across routes.

E219 However, the CAA could not see evidence that a 5 to 10 per cent increase in airport charges would be sufficient to, on its own, induce a large drop in passenger numbers because of airlines cutting routes with marginal profitability per passenger.

Future demand and backfill

E220 One of the limiting factors that is likely to affect the ability of airlines to discipline an airport operator is the presence of future demand, excess demand and the likelihood of back fill should operations be exited. The presence of either of these limits the effect of airline actions on the airport operator's revenues and therefore lessens the disciplinary impact.

E221 With regards to the potential for back fill, following the recent Flybe exit from Gatwick[147], Flybe has not sought to develop entry at the other London airports. The 25 slot pairs have been sold to easyJet for a reported £20 million. This illustrates that currently there is a value in landing slots at Gatwick. The slots represented a portfolio and the pricing may relate more to the slots within the more constrained Gatwick peak. The affect on GAL as a result of Flybe's exit is likely to be limited by the back fill as Flybe's slots were purchased immediately without any significant gap in slot usage. In this instance GAL may actually benefit from the exit of Flybe, as easyJet's average passengers per ATM is twice that of Flybe's and its passengers have a greater retail spend.[148]

E222 GAL considers that 'LGW will benefit from LHR overflow traffic, once slots there become full and there is no room for extra capacity/new entrants'.[149] GAL marketing material also supports this view. In particular, evidence submitted by GAL suggests while it has limited capacity it will benefit from airport growth in the London market as Heathrow is full. Specifically, GAL indicated:

- *London market growth 31% to 2017*
- *London Heathrow is full with no mixed mode possible*
- *Gatwick has limited capacity*
- *Significant differential in airport charges vs. Heathrow.*[150]

E223 The view that there are constraints in the London system is further supported by more recent (2012) work undertaken by GAL's consultants, assessing the risks presented by a commercial transaction, which noted (amongst other things):

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147 See: http://www.flybe.com/corporate/media/news/1305/23.htm

148 Source: GAL, [✂].

149 Source: GAL, [✂].

150 Source GAL, [✂].

- Heathrow is operating very close to its maximum ATM capacity limit, which is not expected to rise further;
- Grandfathered rights for existing users make it very difficult (and/or expensive) for new entrants to grow at Heathrow. This, coupled with the airport's operational resilience challenges, [✂];[151] and
- [✂].[152]

E224 GAL's consultants have, however, identified that while Heathrow's runways are full, the airlines that have slots could increase capacity through using larger aircraft in line with terminal capacity. There is considerable evidence that airlines are already doing this, particularly with the introduction of the 'double decker' airbus A380 aircraft on key long-haul markets. In addition, certain secondary slot trading mechanisms (as discussed above) can facilitate market entry to Heathrow, particularly for long-haul airlines buying slots from short haul carriers.[153]

E225 GAL's 2012 Master Plan also highlights that '[a]s local markets grow beyond the capacity of individual airports, the unfulfilled demand will either spill to another airport or will be lost to the wider market. With a single runway Gatwick has sufficient runway capacity until around 2024/25 when some traffic is expected to be forced elsewhere'.[154]

E226 Importantly, over the forecast period, GAL's 2012 Master Plan notes that:

- The mix of routes it caters to is expected to change as it attracts new long-haul services to Gatwick.[155]
- In 2011/12 6.2 per cent of all passenger ATMs at Gatwick were destined for long-haul markets. By 2021/22 long-haul destinations are expected to account for 8.2 per cent of passenger ATMs although it should be noted that a higher proportion of charter traffic will also be flying on long-haul routes (about 15 per cent of charter total).
- There is potential for long-haul leisure markets to shift from Heathrow to Gatwick and potential for more long-haul services from Gatwick to some of the world's fastest growing economies.[156]

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151 Source: GAL, [✂].

152 Source: GAL, [✂].

153 Source: [✂].

154 GAL, Gatwick Master Plan, July 2012, page 34.

155 GAL, Gatwick Master Plan, July 2012, page 36.

156 GAL, Gatwick Master Plan, July 2012, page 36.

- There is an expectation that the average load, which was 140 passengers in 2011/12, will rise to 148 in 2021/22 and that this increase is expected to be achieved through a combination of higher load factors and increasing seats per aircraft movement, as airlines up-size their fleets over time.[157]

E227 Looking to further consider the relevant information available, the CAA has considered the Department for Transport's (DfT's) 2012 Aviation Demand Forecasts. These forecasts state that:

In the central forecast, the five largest South East airports are forecast to be full by 2030. However, the high and low demand scenarios underline the uncertainty around this conclusion. With the range of demand used they could be full as soon as 2025 (the high case) or take until 2040 (the low case). Heathrow had effectively reached capacity in 2011 and it is forecast to remain at capacity in all scenarios. In the high and central demand cases, a number of other airports are expected to reach capacity over the forecast period including Birmingham, Bristol, East Midlands and Manchester.[158]

E228 DfT's constrained forecasts do, however, make a number of assumptions, including:

- No new runways are built in the UK. The CAA considers this to be reasonable for forecasts, at least up to 2020, as the Airports Commission is scheduled to report in 2015 and there would a lag in capacity becoming available following this decision.
- Schemes that are already in the planning system and the airports' masterplan are implemented by 2020.
- Incremental growth to full potential long-term capacity by 2030 taking into account the airport operators' own longer term plans, physical site constraints and up to 13 per cent capacity gain (where possible) through operational and technological improvements.
- Terminal capacity increased incrementally to service additional runway capacity.
- No changes after 2030.

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157 GAL, Gatwick Master Plan, July 2012, page 36.

158 DfT, Aviation Forecasts 2012, p. 8, available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/70259/aviation-forecasts.pdf

E229 Based on those assumptions, DfT's Aviation Forecasts find that capacity utilisation will reach 100 per cent for Heathrow and Gatwick by 2020, and London airports overall will have 86 per cent utilisation.[159] This is illustrated in Figure E.13 below:

Figure E.13: DfT's runaway capacity forecasts – UK airports runway capacity used, 2010-2050, 'max use' capacity scenario (central forecast)

Airport	2010	2020	2030	2040	2050
Heathrow	99%	100%	100%	100%	100%
Gatwick	90%	100%	100%	100%	100%
Stansted	58%	69%	100%	100%	100%
Luton	59%	60%	100%	100%	100%
London City	56%	87%	100%	100%	100%
Southend		42%	100%	100%	100%
London	81%	86%	100%	100%	100%
Manchester	49%	57%	55%	58%	100%
Birmingham	45%	56%	79%	100%	100%
Bristol	35%	38%	37%	100%	100%
East Midlands	22%	17%	20%	43%	100%
Southampton	27%	36%	52%	100%	100%
Other modelled	22%	24%	28%	33%	43%
National	39%	43%	50%	54%	63%

100 per cent = runway or terminal capacity exceeded, other per cent refer to runway usage.
Mainland UK airports only
Source: DfT Aviation Forecasts 2012

E230 In addition, the analysis suggests that Gatwick (and Stansted) may benefit from spill of international destinations from Heathrow up to 2030 – see Figure E.14 (below). While this figure suggests that Heathrow can grow, this growth is limited, with the number of international destinations that Heathrow is able to service between 2011 and 2030 only increasing by 1 destination.

159 DfT's 2012 constrained forecasts are lower that the forecasts that it produced in 2011. However, the CAA considers that the evidence clearly suggests that capacity constraints will tighten in the short to medium term up to at least 2020, as no new runway capacity is currently expected before that date.

Figure E.14: Modelled international destinations served at selected UK airports, 2011, 2030 & 2050, central demand

	All types of carriers 2011*	All types of carriers 2030	All types of carriers 2050
Heathrow	135	136	121
Gatwick	79	86	83
Stansted	56	74	68
Luton	26	42	31
London City	17	22	14
Southend	0	5	4
London **	178	212	230
Manchester	40	65	105
Birmingham	21	40	67
Glasgow	6	6	12
Edinburgh	11	20	31
Newcastle	6	8	17
Belfast International	1	9	16
Bristol	13	28	41
Liverpool	15	23	35
East Midlands	7	9	54
Other modelled airports	22	49	79
Total **	178	215	242

*2011 is modelled. Modelled numbers will vary slightly from observed patterns because they represent a full year of operation: observation data will include seasonal services and new start-ups or routes withdrawn during the course of the year.
**Total different destinations available, not sum of individual airport destinations.
Source: DfT Aviation Forecasts 2012

E231 Based on the evidence outlined above, the CAA considers that, notwithstanding the scope for better utilisation of runways and the potential use of larger aircraft, Gatwick is likely to benefit from the expected tightening of capacity constraints across the south east of England. In particular, this outcome may increase the relative power of GAL in its negotiations with airlines.

E232 While larger aircraft and better utilisation of slots may, to a certain extent, help to address expected capacity constraints, based on DfT's and GAL's passenger forecasts, the CAA is minded to conclude that, in the next five years, the tightening of capacity constraints at Heathrow are likely to result in an increase in the degree of market power at the London airports that have spare capacity.

E233 On 3 October, GAL announced a significant increase to its scheduled capacity limits for Summer 2014/15[160]. This announcement of the 21 new daily slots[161] - which included 8 morning peak departing slots - constitute around 2.4% of the total runway movements allocated on a peak summer week during Summer 2014.[162] The CAA is aware that these slots have been taken. As discussed in Annex B of CAP1102[163], GAL considered that this expansion fulfilled excess demand and did not add to forecast traffic. However as a result of these slots the CAA did increase its regulatory forecast for passengers at Gatwick. For this determination the CAA does not consider that the release of these slots impact significantly on the discussion presented above, it may have brought forward the time at which Gatwick is considered full.

E234 Given the increasing constraints in the future it appears likely that excess demand may occur and with this a corresponding rise in the likelihood of backfill. This is likely to lessen the bargaining power of airlines.

Assessment on countervailing buyer power

E235 The evidence suggests that Gatwick forms an important component of a number of its top airlines' networks and that there is a long tail of operators where operating from Gatwick forms a small part of their network. FSCs and charters are likely to be of greater value to GAL than

160 'Gatwick Airport Scheduling Declaration for Summer 2014', 3 October 2013.

161 These were made available through operational improvements on the ground and improved separation control.

162 Total runway movements allocated in a peak week during summer 2014 is 6021 movements according to the ACL London Gatwick Summer 2014 Initial Coordination Report.

163 CAA, Notice to grant a licence for GAL CAP 1102, January 2014.

LCCs. While LCCs provide significant volumes of traffic, the LCC revenue per passenger is lower.

E236 Airlines also consider that they have limited buyer power in negotiations with GAL.

E237 In considering marginal routes at the airport there is not sufficient evidence to suggest that altering airport charges would have a significant impact on the profitability of these routes. The number of marginal routes following an airport price increase is unlikely to alter to a sufficient degree to constrain GAL's behaviour. Given the discussion on switching costs above, this may limit the ability of the airline to credibly threaten the airport operator with switching.

E238 Finally, increasing capacity constraints and the likelihood of backfill will limit the ability of airlines to credibly threaten to switch to another airport. To illustrate presence of backfill means that should an airline threaten to switch away from the airport any vacated slot would be likely taken by another possibly competing airline. This means that the airport would be insulated from the affects of the potential switching, in the case of the Flybe slots at Gatwick the airport is likely to benefit due to increase aircraft size. What is more the airport operator is aware of the level of demand to operate service from its airport. An additional consideration that both the airline and the airport will be aware of the potential beneficiaries of the vacated slot and there may be a much higher strategic cost associated with the airline loosing the slot to a competitor effecting its competitive position at the airport. This clearly undermines the bargaining position that an airline may have, especially where that airline faces direct competition at the airport, as has been argued and is observed in the case of Gatwick.[164]

E239 Taken together, there appears to be limited scope for airlines to exercise buyer power and this is likely to be further limited as capacity conditions tighten over the course of the Q6 period.

[164] See appendix D, paragraphs D156 to D173.

Section 3: Conclusion on the potential competitive constraints

E240 The CAA considers that airlines, in response to an increase in airport charges or decline in service quality, are unlikely to be able to credibly threaten GAL with switching to alternative airports to such a degree that they would be able to effectively discipline GAL's pricing behaviour. The CAA has come to this view considering the individual and cumulative effect of a number of issues, including:

- Significant costs to switching.
- Risk of competitive backfill to vacated slots.
- Tightening capacity.
- Lack of credible supply alternatives.
- Lack of CBP.

E241 The CAA considers that reducing marginal frequencies or removing routes appears to be the most likely type of switching that airlines might undertake in an attempt to constrain GAL's pricing. However, the costs of this type of switching are still likely outweigh any benefits that might arise from constraining a 5 to 10 per cent price increase.

E242 The switching costs appear to be on a continuum with large based airlines facing higher costs at one end and smaller inbound operations bearing lower costs at the other. However, in some cases small inbound operators may face significant costs, if Gatwick routes are their only service into the UK.

E243 Although physical switching costs appear to be low, there appear to be more significant sunk costs[165] with regards to marketing and the development of a route portfolio, loss of scale economies and the opportunity costs of operation.

E244 The airlines' evidence and CAA's analysis also suggests that the network effects from the connectivity at Gatwick is likely to contribute an additional switching cost to a number of airlines at Gatwick. The airlines with significant levels of connecting passengers represent around a third of GAL's passenger base.

165 Sunk costs, to the extent they need to be replicated elsewhere, can be evidence of switching costs.

E245 The analysis conducted by and on behalf of the CAA also suggests that there is a strategic constraint imposed on airlines serving London, given its unique mix of features.

E246 The CAA considers the evidence shows that the viable switching opportunities for airlines at Gatwick are limited. Although there is capacity at the north London airports, these airports are clearly a less preferred option for airlines than operations from Gatwick, because they do not have a combination of the necessary facilities, e.g. runway length, feeder traffic or wealthy catchment area. With respect to Heathrow, the evidence from airlines clearly suggests that it is a preferred airport to Gatwick. However, there are a number of high barriers to entry due to capacity constraints, which prevent effective switching to Heathrow as a reasonable response to a price increase at Gatwick.

E247 While the use of larger aircraft and relatively small scale expansion is possible at Heathrow. However, the timescale required for adequate airport expansion/new entry to accommodate sufficient switching is likely to be too long to impose a constraint in the short term. DfT’s and GAL’s passenger forecasts suggest that over the next five years the tightening of capacity constraints at Heathrow are likely to result in an increase in the degree of market power at the London airports that have spare capacity, including Gatwick.

E248 Overall, while airlines might be able to increase aircraft capacity at the margins, there is limited scope for capacity expansion to constrain GAL's pricing in the short to medium term.

E249 With regards to countervailing buyer power, the CAA has found limited evidence of airlines being able, credibly, to threaten to switch away from Gatwick to discipline GAL’s pricing behaviour. This is the result of a number of factors including the capacity constraints, presence of backfill and the credibility and effectiveness of alternative switching options.