CONSULTATION ON
STANSTED MARKET POWER ASSESSMENT

Summary

December 2012

UK Civil Aviation Authority
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Purpose of this document

S1. The CAA is minded to find, consistent with its section 1 duties under the Civil Aviation Act 2012 ("the CA Act"), that the market power test as set out in the CA Act[1] is met in relation to Stansted airport (Stansted). This document sets out the reasons for this provisional view. The CAA wishes to consult on its provisional view and will now consider representations and reach a final decision in 2013 by determining whether the test is met in relation to Stansted. The CAA especially welcomes new evidence from stakeholders and also their views on how the CAA should weight evidence that has so far been provided and presented in this document.

Potential implications for regulation of the operator of Stansted

S2. The practical consequence of the market power test being met is that the airport operator would be unable to charge for most services unless it has a licence granted by the CAA[2]. The CA Act sets out the primary duty of the CAA as being to further users' (which is to say, passengers' and cargo owners') interests in the provision of airport operation services; and, where appropriate, to do this by promoting competition[3]. It also sets out the provisions for the grant of a licence and what a licence may contain[4]. A licence may include such conditions as the CAA considers necessary or expedient in relation to risks of abuse of market power. This may include price control conditions. Any regulatory intervention must be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed[5].

S3. The CAA has consulted in general terms about options for the form of future regulation, but has not taken any decisions about the precise form of any licence issued to Stansted's operator, nor whether a licence should contain a price control condition at all. Stakeholders should not draw conclusions about how these questions will be answered from the content of the present consultation. The CAA will consult on these issues in April 2013.

The market power test

S4. The market power test has three parts:

- Test A is that the relevant operator has, or is likely to acquire, substantial market power. This must be in a market for or including one or more types of airport operation services provided in the airport area and that market must include geographically all or part of the airport area.

- Test B is that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that substantial market power. Such conduct may, in particular, include behaviour defined under UK competition law as abuse of a dominant position. However, "competition law" in this context is not limited to UK anti-

1 Section 6 of the CA Act.
2 Section 3 of the CA Act.
3 Section 1 of the CA Act.
4 Chapter 1 of the CA Act.
5 Sections 1(3) and (4) of the CA Act.

trust law aimed at abuse of dominance but also includes UK prohibitions on anti-competitive agreements, the European competition rules on anti-competitive conduct, and the UK market investigation regime.

- Test C is that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.

S5. The CAA's assessment has focused broadly on the current position and the period 2014-2019, although some of the trends reviewed seem likely to extend beyond that period.

Test A

Market definition

S6. The CAA has adopted the standard approach of regulators engaged in assessing market power and has sought, as a starting point for its analysis, to define the relevant markets in which Stansted Airport Limited (STAL) operates. This provides the framework for analysing competitive constraints, whether they come from within or outside the market. The CAA is minded to take the view that STAL currently operates in two distinct markets, combining the product and geographic dimensions of market definition[6]:

- Core aeronautical services[7] for Low Cost Carriers (LCC) and charter airlines covering a geographic market that includes at least Stansted, Luton, Southend and possibly Gatwick. This market is referred to as the Stansted short-haul market.

- Core cargo aeronautical services[8] provided to cargo-only airlines at Stansted. This market is referred to as the Stansted cargo market.

S7. These market definitions are based on evidence including the views of airlines and airport operators on the substitutability of other airports for Stansted, evidence on switching behaviour and the analysis of passenger preferences and behaviour.

S8. In February 2012 the CAA published its Initial Views on STAL's market power[9]. That document discussed whether Stansted should be considered as part of a Europe-wide market. However, further information gathered since then has shown that the competitive constraints posed by airline switching (or threat of switching) to European airports from UK airports including Stansted appears to be relatively weak, and little evidence has come to light of actual switching of established airline capacity from

6 Note that at this stage, the CAA has not defined the markets for non-aeronautical services. The CAA has also not defined a separate market for the small amounts of long-haul and non-commercial aviation at Stansted, as it considers these to be marginal to the question of market power.

7 These activities include facilitating the use of runway and taxi-ways, aerodrome ATC, aircraft parking, ramp handling services, fuel and oil handling, and aircraft maintenance, as well as the minimum activities required for the processing of passengers at the airport, the provision of a terminal and the facilities for check-in, baggage handling, security screening and the transit of passengers to and from the aircraft.

8 These activities include facilitating the use of runway and taxi-ways, aerodrome ATC, aircraft parking, ramp handling services, fuel and oil handling, and aircraft maintenance, as well as the minimum activities required for the processing of cargo at the airport.

9 The CAA's initial views on Stansted Market Power Assessment published February 2012

London airports to European airports. The Initial Views document also explored whether a temporal market definition might be relevant (morning peak versus non-peak hours). Information gathered subsequently has suggested that there are in fact several peak periods through the day (because LCCs need access to a range of slots throughout the day to allow for the aircraft to fly out and return). Defining a “morning peak” separately would therefore not properly capture the actual dynamics of this market.

S9. For ease of reference this summary sets out the CAA’s views first on the short-haul market, and then returns to consider the cargo market.

Current and future competitive constraints on the airport operator

S10. The CAA has examined whether there are sufficiently strong competitive constraints (from within and outside the relevant markets defined above) such that STAL cannot profitably raise its charges above the competitive price. The CAA has carefully considered evidence on the possibility of airline and passenger switching and the constraints they face in doing so.

S11. Switching costs faced by Stansted’s airlines are found to be relatively low, compared to the turnover and profitability of these airlines on relevant routes, and airlines including LCCs have reduced their capacity at Stansted over the past few years. However, the response of STAL to the actual withdrawal of capacity or threat of switching by both easyJet and Ryanair appears to have been muted.

S12. Looking to the future, LCCs with based aircraft at Stansted (especially Ryanair, less so easyJet) appear constrained in their ability to switch significantly more based aircraft. This is because serving London has major strategic importance to their business models, and capacity constraints at other London airports mean they do not have the option to switch away from Stansted and still serve London. This is likely to become an increasing factor as demand recovers in line with economic growth and capacity constraints in the London region further tighten.

S13. With regards to passenger switching, there are some significant overlaps between passenger catchment areas in the London system, which might suggest that passengers have significant choice. However, the CAA considers it unlikely that enough passengers would choose to switch to another airport such that this would constrain the airport operator’s pricing. To reach this view the CAA has in particular considered evidence relating to: the limits to route choice; passenger preferences as to airport choice; and relatively low passenger sensitivity to increases in airport charges (as opposed to increases in airfares).[10]

Indicators of market power

S14. In addition to competitive constraints, the CAA has also considered the following potential indicators of market power.

- Stansted has a high market share - 70% - of the relevant short-haul passenger market when Gatwick is excluded and 37% when Gatwick is

10 This analysis reflects the current pattern of airport competition; we recognise that changes in passenger or airline behaviour could lead in time to greater interactions between Stansted and other airports such as Heathrow.

included within the relevant market. Given the limitations of market share data, the CAA does not draw strong conclusions from this analysis on its own and has therefore sought to review other relevant evidence.

- STAL is pricing to its regulatory price cap, and there is evidence to suggest that it is pricing above the competitive level. For example, the CAA has commissioned an independent benchmarking study which shows that Stansted's prices are likely to be above the level of comparator airports.

- The CAA has reviewed trends since 2007. In that year the airport operator withdrew pre-existing large discounts on the regulated price from Ryanair and easyJet. This was profitable for STAL for some time but the increase in profitability was eroded with subsequent traffic reductions. This reduction in traffic could be a response to the price increase, or a consequence of economic pressures that bear on many other UK airports, particularly ones serving LCCs, or partly of both or of other factors. In any case, the reduction does not appear to have disciplined STAL's pricing. For instance, it has not to date concluded agreements with existing airlines to discount prices significantly, despite the decline in overall traffic. It has, however, offered significant discounts to attract new airlines or new traffic in non-peak periods, although these pricing initiatives have not generally been taken up by the airlines.

- The CAA has seen some evidence from internal company documents that STAL may be accepting a short-term decline in profitability because it sees long-term gains from not concluding discounted long-term agreements with existing user airlines.

- The CAA has seen no evidence that competitive constraints have driven efficiency initiatives at Stansted. However, the unique circumstances must be borne in mind within which STAL and its airlines have been conducting business in the past three years: a deep recession; uncertainty linked to the forced sale of Stansted; and potential distortions of STAL's behaviour owing to its joint ownership with Heathrow. These may have artificially distorted the incentives and behaviours of both the airport operator and its airlines.

The CAA's 'minded to' conclusion for the short-haul market

S15. The CAA appreciates that the evidence does not all point in one direction and a judgement is therefore needed on the balance of the evidence it has reviewed. On this basis, the CAA is minded to conclude that, in relation to the Stansted short-haul market, STAL holds a degree of market power which *may* currently be substantial, and *is likely* to become substantial over the period 2014-2019.

S16. The most likely source of market power possessed by STAL is the inherent attractiveness of the London market and its strategic importance to airlines, combined with capacity constraints in the London system, which limit the number and size of available alternatives. Over 2014-2019 these capacity constraints are expected to tighten further and lead to a spill of traffic from other London airports to

Stansted. This tightening can be expected to reduce STAL's incentive to price keenly to incentivise growth.

S17. The CAA acknowledges there are some uncertainties and that in the future its analysis could change over the longer term. For example, the change of ownership of Stansted could establish different behaviours and relationships with the airlines. The outlook for the economy is uncertain and future government policy in relation to new capacity in the South East could change. Moreover, the airlines operate in a market that is characterised by change and hence the business models operating at Stansted could change, as could passenger preferences.

The CAA's 'minded to' conclusion for cargo

S18. In relation to cargo services, the CAA has received consistent and credible evidence from STAL's cargo customers that access to London is essential to their operation and that they have no ability to switch to other airports. The CAA is therefore minded to conclude that STAL currently *has* substantial market power in the Stansted cargo market.

S19. This market was not covered in the CAA's Initial Views document, so evidence on this market has not been tested previously by public consultation. The CAA will therefore consider carefully representations relating to this market, and will in particular consider further whether the ability of downstream customers to switch from cargo-only carriers operating from Stansted to belly-hold carriers operating from other London airports could indirectly constrain the behaviour of STAL.

Test B

S20. The CA Act gives the CAA the power to enforce competition law in relation to the provision of airport operation services concurrently with the UK's general competition authorities. The CAA has welcomed these new powers and expects that they will provide important new ways to protect users and competition. Test B does not require the CAA to take a view about whether competition powers are in some sense more or less effective than regulatory powers, but rather to assess whether competition powers alone are sufficient to address the risk of abuse. In other words, the assessment addresses whether a licence could offer additional protection that is necessary if risks of abuse are to be sufficiently mitigated.

S21. The CAA has considered the aims of regulation and those of competition law, identifying some limits to how, in general, competition law can mitigate risks of abuse. These limits relate to: the timing of cases; potential mis-matches in some cases between abuses and the formal tests of competition law; and the limitations of potential remedies. These factors have led some authorities to argue that regulation might continue to play a role until competition is firmly established.

S22. Regarding the airports sector in particular, two behaviours are particularly relevant, exclusionary and exploitative behaviour:

- The courts have examined exclusionary behaviour by airport operators. The precedents share the fact that the operators in question have had an interest within the downstream market. Since this is not the case for STAL, this could limit their applicability in this case.

- However, even without a downstream presence, airport operators that favour a particular airline or group of airlines can in principle face sanctions under the competition law regime. For this reason, exclusionary behaviours could in principle be tackled adequately by competition law alone.

- However, there are some grounds to doubt whether a competition investigation, which would typically be prompted by the concerns of a particular complainant, would necessarily produce a sufficiently comprehensive solution; and also whether it would be a swift enough process to avoid irreparable harm to competition in the market. It may also be appropriate to look to licensing under the CA Act where there are concerns around issues such as cross-subsidisation and lack of information.

- With regard to exploitative behaviour, the case law on excessive pricing is still developing but at present sets a relatively high evidential hurdle. These tests might, for various reasons, be difficult to apply in the airports sector. There have been some infringement decisions, but those cases contain circumstances which off-set the challenges associated with the relevant legal tests. The CAA is minded to consider that the evidential threshold for a finding of infringement based on excessive pricing limits the ability of competition law to discipline this behaviour. Given that the law in this area is still relatively early in its development, the uncertainties associated with this type of investigation are high. As competition law develops in this area the CAA will adjust its approach accordingly.

- In principle, competition law could address exploitative abuse arising from service quality or product quality. However, to the CAA's knowledge no competition law cases have been pursued on such a basis. It is therefore difficult to assess whether the evidential hurdle would be as high. In these circumstances, it appears risky to see competition cases as the way consumers might be protected from exploitative abuse arising from service quality or product quality.

S23. The CAA therefore tends to the view that competition law may be a useful tool to respond to some kinds of abuses. However, in the instance where an airport operator has substantial market power, regulation might prove incrementally beneficial in some cases: for instance, in relation to concerns about cross-subsidisation and lack of information. The CAA also tends to consider that, for some kinds of cases (e.g. in relation to exploitative abuse), there must be some uncertainty about whether the tests flowing from competition case law can be successfully applied in the airports sector, and so whether competition cases could actually bring such abuses to an end.

S24. Regarding STAL in particular, our 'minded to' position in relation to test A tends to suggest that there may be a risk of STAL being in a position to engage in exploitative behaviour. Given the size of the operation at Stansted, the potential harm to the user from any such abuse could be significant. The CAA's responses to emerging problems might be slower if it had to prove established dominance and the remedies for such exploitation might also take time to formulate and implement, during which time damage to the structure of competition might continue. Further, the current moratorium on airport expansion within the South East means that scarcity will not in the short term lead to investment to produce extra capacity. As such, reliance only on the functioning of the market could see higher prices. Although these might not be enough to motivate individual passengers to change which airport they use, nevertheless collectively these will not necessarily be in the best interests of passengers and cargo owners, as they will not drive market entry or additional capacity expansion. Therefore, this approach may not be consistent with the CAA's duty under the CA Act to promote the interests of passengers and cargo owners.

S25. On balance, the CAA is presently minded to find that test B is met. It is likely that some form of regulation under the CA Act would provide a more effective safeguard than competition law alone against the risk of exploitative abuse. This is particularly because regulation under the CA Act can be tailored so as to protect the interests of passengers and cargo owners from exploitation. Regulation would potentially allow a range of safeguards, such as (for example) on-going monitoring of prices and quality, to be put in place with a view to maintaining effective competition as the market and the wider economic context develops over the short to medium term.

S26. The CAA appreciates that this is the first time it has explored these issues in detail in relation to Stansted and therefore it is keen to understand stakeholder views before coming to a final decision.

Test C

S27. Test C requires the CAA to assess whether the benefits of a licence regime are likely to outweigh the adverse effects. The CAA does not consider that, given the level of market power identified in relation to Stansted, the Airport Charges Regulations or Airport Groundhandling Regulations would necessarily provide sufficient protection for users. The CAA's assessment of licence regulation focuses on the topics most commonly addressed by economic regulation, in assessing the likely impact at Stansted.

- Price. As STAL is currently pricing at its regulatory cap, and there is evidence to suggest this is above the competitive level, there is a reasonable expectation that if the price cap were removed then charges would rise. Potential risks from setting prices too low under a licence are likely to be reduced by improved knowledge of the competitive price level. Also, Luton appears to be taking forward investment plans irrespective of the uncertainty over future prices at Stansted, which suggests the risks of stifling investment are limited at present.

- Efficiency (which impacts on future prices). The impact of regulation on efficiency is difficult to judge. However, the CAA has not seen evidence to suggest that competition has significantly driven improved efficiency at Stansted, and it appears unlikely that the removal of licence regulation would lead to an improvement in efficiency in and of itself. Given the potential reduction in competitive pressure forecast during 2014-2019, the incremental benefits of licence regulation on efficiency are likely to increase, although the distortions of incentives, from RAB-based regulation in particular, should be acknowledged.

- Service quality, in terms of the range and level of services. STAL's improved service quality performance appears to coincide with greater regulatory scrutiny since the start of the Q5 review and the introduction of the SQR scheme in quarter 2 2009. While it cannot be said for certain that this improved service quality performance reflects the impact of regulation, the CAA has not seen evidence to suggest that competition itself has driven the improved performance. The CAA was concerned at one time that regulation might reduce service quality as a by-product of greater pressures for operational efficiency, but such a trend has not in fact been observed. Service quality could be set by regulation higher than passengers actually want, but evidence suggests this has not happened in practice.

- Investment, which can affect future levels of service quality. Regulation can distort investment incentives, with a potential bias of RAB-based regulation towards capital spend. However, although such a distortion may exist in principle, evidence has not been found that it has had a significant impact on STAL's recent behaviour. Some distortive effects (e.g. fixing investment too far in advance and dis-incentivising investment for new customers) can be addressed by modifying the detail of regulatory process. Nevertheless, licence regulation would necessarily lead to some costs in terms of rigidity, particularly in terms of investment consultation and changes to service quality and charges.

S28. The assessment also considers whether users may benefit from other additional licence requirements that are not directly related to market power, but that the CAA considers necessary or expedient having regard to its statutory duties. Some such benefits are expected from a licence containing provisions on operational resilience.

S29. The assessment has considered the adverse effects of licence regulation in terms of:

- Direct costs to the CAA, regulated companies and their users for example in manpower and consultancy. Depending on the form of regulation, these are estimated as £2m - £5m per annum; and

- Indirect costs/effects (which are difficult to quantify). These include those mentioned above and also: management distraction; distortions to incentives; crowding out of a more commercial approach; and distortions to competition more widely, for example on other airports.

S30. The costs of regulation under the CA Act can be lower than under the Airports Act 1986 since regulation can now be tailored to the particular circumstances of the case. It is also noted that the potential distortion-costs of regulation may be lower now than when this question was considered in 2007, given that airlines at Stansted are not being asked to fund the significant costs of a new runway and terminal through a RAB.

S31. It is not necessary, in assessing whether test C is met, to define precisely the type of regulation that would apply; only whether the benefits of some form of licence-based regulation are likely to outweigh the adverse effects. Overall, the CAA is minded to find that test C is met and that some form of licence regulation should apply to STAL.

S32. The CAA would ensure that a licence is proportionate to the specifics of Stansted and any conclusions under the market power assessment. The CAA will make proposals on the form of regulation that would apply at Stansted as part of its Q6 initial proposals, published in April 2013.

S33. The CAA appreciates that this document is the first time it has explored these issues in detail in relation to Stansted and therefore it is keen to understand stakeholder views before coming to a final decision.

CAA December 2012