Consultation on Gatwick market power assessment: Summary

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Purpose of this document

1. This document summarises the CAA's provisional analysis of whether the market power test (MPT) is met in relation to Gatwick airport (Gatwick). Under the "deeming provision" in the Civil Aviation Act 2012 (the Act) the test is currently treated as being met in relation to the areas of Gatwick for which Gatwick Airport Limited (GAL) has overall responsibility. The full consultation document that accompanies this summary will be published by the end of May 2013.

2. The CAA is minded to find, consistent with its section 1 duties under the Act, that the MPT is met in relation to, at least, the core area of Gatwick.

3. This document sets out the CAA's reasons for this provisional view. The CAA wishes to consult on its provisional view, consider representations and reach a final decision later in 2013. The CAA especially welcomes views on how it should weigh evidence that has so far been provided.

4. The CAA requests views on the full consultation document by no later than 26 July 2013.

Potential implications for regulation of Gatwick

5. The practical consequence of the MPT being met is that GAL, the main operator of Gatwick, would be unable to charge for airport operation services from April 2014 unless it has a licence granted by the CAA.[1] The Act sets out the primary duty of the CAA as being to further users'[2] interests regarding the range, availability, continuity, cost and quality of airport operation services; and, where appropriate, to do this by promoting competition.[3] A licence may include such conditions as the CAA considers necessary or expedient in relation to risks of the airport operator abusing its substantial market power (SMP). This may include price control conditions. Any regulatory intervention must be transparent, accountable, proportionate, consistent and targeted where it is needed.[4]

6. The CAA published on 30 April 2013 specific proposals for the future regulation of GAL, available here: www.caa.co.uk/CAP1029

1 Section 3 of the Act.

2 Users are defined in section 69 of the Act as passengers and those who have a right in property (cargo). Users are defined as both present and future users.

3 Section 1 of the Act.

4 Sections 1(3)(g) and (4) of the Act.

The market power test

7. The MPT is applied to the relevant airport operator (GAL). The MPT has three parts.

- Test A is that the relevant airport operator has, or is likely to acquire, SMP. 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 airport operator may engage in conduct that amounts to an abuse of that SMP.
- 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.

8. The CAA's assessment has focused broadly on the current position and the Q6 period, 2014 to 2019, although some of the trends reviewed seem likely to extend beyond that period. The evidence that the CAA has considered in making its market power assessment for GAL post-dates the sale of the business in 2009. Evidence from the airlines is current and statistical evidence is the latest available.

Test A

Market definition

9. The CAA has adopted a standard approach of regulators and competition authorities engaged in assessing market power and has sought, as a starting point for its analysis, to define the relevant markets in which GAL operates. This provides the framework for analysing competitive constraints, whether they come from within or outside the market.

10. The CAA is minded to take the view that GAL currently operates in two distinct markets, combining the product and geographic dimensions of market definition:

- Airport operation services[5] for low cost carriers (LCCs) and charter airlines covering a geographic market that is limited to Gatwick but may include Luton and Stansted. This market is referred to as the Gatwick LCC and charter market.
- Airport operation services[6] for full service carriers (FSCs) and associated feeder traffic. The CAA's current view is that this market includes Heathrow[7]. This market is referred to as the Gatwick FSC and feeder market.

11. These markets were identified on the basis of the distinct infrastructural demands of LCC and charter airlines and FSC and associated feeder traffic as well as evidence on the substitutability of other airports for Gatwick. The market definitions were informed by the views of airlines and airport operators, evidence on airline switching behaviour and the analysis of passenger preferences and behaviour.

12. In its Initial Views[8] document published in February 2012, the CAA explored whether a seasonal market definition might be relevant i.e. whether there were separate summer and winter markets. This was considered because of the importance of charter airlines, whose business is seasonal, at Gatwick. Information gathered subsequently has suggested that the total demand for GAL's airport operation services is not markedly more seasonal than at other London airports. Furthermore, the CAA considers that defining a seasonal market would not lead to different findings on market definition or the strength of competitive constraints at Gatwick.

The Gatwick LCC and charter market

13. Overall, the evidence suggested that LCCs do not view the north London airports, Luton and Stansted, as substitutes for Gatwick.

5 For LCCs and charter airlines 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.

6 FSCs require the services listed in footnote 5 and additional facilities including those required for premium passengers and integrated airside transfer of passengers and baggage between flights.

7 The key consideration is the strength of the competitive constraint from Heathrow, rather than whether it is, or is not, part of the relevant market. The competitive constraint from Heathrow is assessed below.

8 Gatwick Market Power Assessment Initial Views, CAA February 2012: http://www.caa.co.uk/docs/5/GatwickMarketPowerAssessment.pdf

14. The CAA's "Initial Views" on GAL's market power discussed whether Gatwick should be considered as part of a Europe-wide market. GAL has argued that LCCs enjoy considerable flexibility in allocating their assets and may be able to switch either based aircraft or allocate growth to other EU airports. Information gathered by the CAA since then has shown that the competitive constraints posed by airline switching (or threat of switching) to European airports from UK airports including Gatwick appears to be relatively weak. Little evidence has come to light of actual switching of established airline capacity from London airports to European airports.

15. Charter airlines indicated to the CAA that passengers tend not to associate other south east England airports with package holiday travel and alternatives to Gatwick do not have as extensive a catchment or "pull".

16. The evidence from LCCs and charter airlines suggest that Gatwick may be a market within itself, with a number of airlines considering that there is a north/south split across London. However, a number of airlines have considered and currently operate some services from other London airports. The CAA considers that there may be a geographical market limited to Gatwick itself, but the market may possibly include Luton and Stansted.

The Gatwick FSC and associated feeder market

17. In the FSC and associated feeder market, airlines require a number of key elements to ensure the efficient and profitable running of their route networks, including the provision of feeder traffic and the provision of bellyhold cargo. If FSCs offer the facility to connect at an airport, then they will demand the infrastructure that allows them to do so, even if the number of connecting passengers is low. Apart from Gatwick, the only other London airports where FSCs can access the facilities and infrastructure they require for connecting traffic are Heathrow and Stansted. A number of airlines indicated that Heathrow would be substitutable for Gatwick if sufficient capacity were available. Some of these carriers operate in full or in part from Gatwick as they cannot gain slot access at suitable times at Heathrow.

18. Although Stansted has the required facilities and spare capacity, it does not operate with them at present. Currently, Stansted lacks a suitable feed of connecting traffic and it is difficult to see this changing appreciably over the short-to-medium term. FSCs stated that Stansted

was not a substitute for Gatwick.

Current competitive constraints on GAL

19. For ease of reference this summary sets out the CAA's views first on the LCC and charter market, and then returns to consider the FSC and feeder market. In each market, the CAA sought to identify how much of the capacity at an airport was marginal in the sense that it would be likely to switch away if GAL's airport charges were to increase by a small but sustained and non-transitory amount of 10 per cent. This analysis included the following.

- The means available to an airline to switch away capacity, and how reasonable and effective different strategies would be in constraining GAL's pricing. For example, airlines might allocate future growth to other airports; reduce the frequency of their service(s); ground marginal aircraft; or switch away their marginal based aircraft.
- The types and size of switching costs airlines might incur. These costs range from the costs of relocating aircraft, crew and facilities to costs from lost revenue if an airline has to switch away from a preferred market. The integration of services within a carrier's network and the benefits derived from the presence of alliance partners were also considered in relation to airline switching.
- The constraints to airline switching imposed by the availability of spare capacity at competing airports.
- Whether airlines could exercise buyer power to counteract any SMP that GAL might have.

Current competitive constraints on GAL: LCC and charter market

20. Airport charges are a higher proportion of LCC airlines' costs than FSCs', suggesting that LCCs might be more sensitive to an increase in GAL's airport charges.

21. The CAA has examined whether there are sufficiently strong competitive constraints (from within and outside the relevant market defined above) such that GAL 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.

22. Based LCCs, especially those with alternative London bases, have the facility to switch some of their services to those bases or further afield. Inbound LCCs have more potential to be mobile as they tend not to have significant sunk costs at Gatwick.

23. The CAA has found that direct costs of switching aircraft operations and crew are relatively low. However, there are a number of strategic costs to airlines associated with switching away from Gatwick. These costs include establishing a market position at a substitute London airport, particularly the cost of marketing new routes. Evidence suggests that, while new routes are being established, it typically takes some time for airline yields to build up to their long-run potential, which represents a switching cost. Also, if an airline were to switch to another airport, there is the possibility that it may face increased competition on its routes if a rival airline were to take up a vacated slot.

24. Substitution possibilities for LCCs are also constrained by the limited stand capacity at Luton, which would make it difficult to base significant numbers of additional aircraft there.

25. The CAA has found that charters airlines tend to regard each airport on a case-by-case basis rather than looking at a route as a city-pair. In particular, the CAA considers that the evidence suggests that charters look to serve the core catchment associated with the airport that they operate from and often look to consolidate their scheduled and chartered holiday flights from one 'leisure hub'. Charter airlines told the CAA that they are attracted by Gatwick's wide catchment and good surface links compared to the north London airports, Luton and Stansted. Gatwick has a predominant position as the main airport for holiday departures in the south east of England. Charter airlines told the CAA that it had a good brand image as a holiday airport making Gatwick flights easy to sell.

26. The CAA found no evidence in the commercial arrangements between GAL and the airlines to indicate that LCCs and charter airlines were able to exercise buyer power. This appears to be because the airlines lack credible alternatives to switch away to discipline GAL's pricing behaviour.

27. In summary, LCCs and charter airlines at Gatwick appear constrained in their ability to switch a significant number of flights to alternative airports if they were faced with an increase in GAL's airport charges.

Current competitive constraints on GAL: FSC and feeder market

28. GAL's airport charges are a lower proportion of FSCs' operating costs relative to LCCs', suggesting that they might be less sensitive to an increase in airport charges. The CAA considers that FSC and feeder airlines at Gatwick, of which BA and Virgin are the largest, are likely to find reducing the frequency of services to be the most feasible means of constraining a price increase by GAL.

29. In the FSC and feeder traffic market, the costs of relocating aircraft and crew are unlikely to be material for most based or inbound airlines at Gatwick. The strategic costs of switching from Gatwick to Heathrow also appear to be low (with the exception of slot acquisition which could be a material expense). Carriers might actually gain from switching to Heathrow. FSCs and associated feeder traffic at Gatwick have consistently told the CAA that Heathrow is their preferred option when operating from London.

30. There is evidence of some switching between Gatwick and Heathrow, but this has often been airlines that have been operating at Gatwick while they were waiting for suitable Heathrow slots to become available. The CAA considers that these instances of switching were driven by factors other than GAL's airport charges and are therefore not evidence of a competitive constraint on GAL in the normal meaning of the term.

31. The main reason why the CAA considers that Heathrow may not exercise an effective constraint on GAL's pricing is the lack of suitably timed slots at Heathrow. GAL has submitted that there is spare capacity in the London system and that even if capacity is scarce, slots can be bought to facilitate switching to other airports (Heathrow). However, the airlines told the CAA that the cost and availability of slots at Heathrow creates a high barrier to entry and expansion at that airport. As slots appear to be difficult to obtain at Heathrow, the CAA considers that the competitive constraint that Heathrow poses to Gatwick is very limited. It may be possible for some airlines to obtain slots but the CAA's provisional view is that this would be insufficient to constrain GAL's airport pricing.

32. Stansted has the capacity to accommodate additional traffic, but its lack of connecting passengers means that it is unlikely to be able to attract a significant scale of FSCs or their associated feeder traffic.

33. The CAA found no evidence to indicate that FSCs were able to exercise countervailing buyer power. Individually they do not account for a high

proportion of GAL's airline business and they appeared to lack credible alternatives to which to switch. GAL has offered discounts to some new airlines to Gatwick but not to the incumbent airlines.

Current competitive constraints on GAL: passengers

34. With regards to passenger switching, airlines may not pass on an increase in GAL's charges or may only do so after some time. Passenger switching will only occur to the extent to that any increase in GAL's charges are passed on by the airlines.

35. GAL has stressed the significant overlaps between passenger catchment areas in the London system, which might suggest that passengers have significant choice. The CAA recognises that there are significant overlaps. However, passengers have preferences that must be taken into account when trying to assess their propensity to switch in response to an increase in GAL's airport charges. Also, in order to exercise that choice some passengers require equivalent flights (sometimes to the same destinations) to be available at other airports. There appears to be more choice available to passengers seeking to fly on a short-haul service than for long-haul flights.

36. Connecting passengers represent around 8 per cent of Gatwick passengers. The CAA considers that connecting passengers will also have relatively low passenger sensitivity to increases in GAL's airport charges (as opposed to increases in airfares). Therefore, the CAA considers that the proportion of connecting passengers that might switch in response to an increase in GAL's airport charges appears to be insufficient to widen the geographical market or, when combined with surface passenger switching, to constrain GAL.

37. Passengers' preferences for a particular destination, limited route availability at other airports, and the lack of full substitutability of different types of service suggest that fewer passengers may be able, or willing, to change the airport they use than that suggested by catchment overlaps. The CAA found that route availability at other airports was relatively high for short-haul services but for long-haul, the overlap was less and much of it was accounted for by services that would not normally be considered to be substitutes, e.g. charter flights and scheduled services.

38. Analysis suggests that, at most, a 10 per cent increase in airport charges would equate to around 3 per cent on an airfare. The airfare may itself be purchased as part of a bundled product (e.g. a holiday). Therefore,

passengers' sensitivity to increases in airport charges is likely to be relatively low.

39. These factors lead the CAA to consider that only a relatively low proportion of passengers would in practice be prepared to switch to another airport in response to a 5 to 10 per cent rise in GAL's charges. A comparison of an estimate of the likely level of passenger substitution with the level required, suggests that switching by marginal passengers is unlikely to be sufficient to constrain GAL's pricing.

Indicators of GAL's market power

40. If Luton and Stansted are included in the LCC product market, GAL has a 46 per cent share of the relevant market by passenger numbers. In the FSC product market, GAL has a 14 per cent share of the relevant market by passenger numbers.

41. The CAA considers that there are a number of reasons why market share data may not be a reliable indicator of market power.

- Long-term capacity constraints at Heathrow and to a lesser extent at Gatwick may render the market share misrepresentative.
- The importance of geographical location for airport competition means that there is a continuum of substitution possibilities depending on distance and other airport characteristic.
- Any market definition beyond a single airport is, to an extent, arbitrary and assessment of market shares is unlikely to be a useful tool in itself for measuring the airport operator's market power.

42. Given these limitations, the CAA does not draw strong conclusions from this analysis on its own and has therefore sought to review other relevant evidence. Nevertheless, the CAA notes the GAL share of the LCC and charter market is above a level where dominance has been found. If Luton and Stansted are not considered to be in the market, it is above a level where dominance is presumed. Although GAL's share of the FSC market is low and below that used for a presumption of dominance, it is still of concern owning to the difficulty of switching to Heathrow. Therefore, the CAA considers that the Heathrow constraint is relatively ineffective.

43. The CAA has commissioned an independent benchmarking study which shows that prices at Gatwick are likely to be close to the level of comparator airports. Taken together with a study of long-run average

costs, commissioned by the CAA, this suggests that current prices at GAL are close to the competitive level. At present GAL is pricing to its regulatory price cap and has indicated that it believes that its prices are too low. This may suggest that GAL would increase prices if it were to be deregulated.

44. GAL has argued that it has introduced a number of service level initiatives at Gatwick since its change of ownership in 2009 and is now exceeding many service quality targets. GAL argues that this behaviour indicates that it operates in a competitive market. The CAA acknowledges GAL's commitment to raising service quality since its change of ownership. This may be because of many reasons, including increased management focus on service quality. Some of this improvement may be due to other factors such as the service quality rebate scheme at Gatwick. Increased competitive pressures may also have been a factor, but it remains unclear if the improvement seen at the airport is due to competition itself and not other factors.

45. Similarly, GAL maintained that improvements in efficiency since the change of ownership indicate competitive pressures. The CAA considers that GAL's efficiency has improved under new ownership. However, the evidence suggests that there remain a number of areas of inefficiency. The CAA therefore considers that the evidence on efficiency is open to interpretation. Businesses with SMP may also benefit from making efficiency improvements so this factor does not clearly point to the existence of a competitive market.

46. How an airport operator engages in negotiations with the airlines that use it can be informative as to the degree of its market power. The CAA considers that GAL largely sets the terms that an airline will receive and that the scope for negotiation is relatively limited. The CAA considers that there appears to be limited scope for short-haul airlines to negotiate any discounts to airport charges and the scope for charters to effectively negotiate with GAL on other issues appears limited.

47. Some of the indicators are open to interpretation and the indicators have to be weighed against the evidence that the CAA obtained from the airlines, which indicated that the competitive constraints from within and outside the relevant markets are weak.

The CAA's 'minded to' assessment for the Gatwick LCC and charter market

48. 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 LCC and charter market, GAL has SMP, which is unlikely to be eroded over the period 2014 to 2019.

The CAA's 'minded to' assessment for the Gatwick FSC and associated feeder market

49. Again, the evidence does not point in one direction. A business would not normally be found to have SMP when it has a low market share and the rest of the market is supplied by one other provider. However, the CAA considers that the conditions of competition on this market are very unusual in having a substantial part of the market supplied by Heathrow, an airport that is severely capacity constrained.

50. A contrary finding that GAL does not have SMP appears to be inconsistent with the evidence the CAA has obtained from the airlines and its analysis of passenger switching. In particular, the airlines indicated that they lacked substitution possibilities if GAL were to increase its airport charges or reduce the quality of its offer to the airlines.

51. The CAA is minded to conclude that GAL has SMP in this market, but will consider carefully any further submissions that might indicate that GAL is sufficiently constrained by competition in the Gatwick FSC and associated feeder market, in particular by the credible possibility of FSC and associated feeder carriers switching to Heathrow.

Factors contributing to GAL's market power and future developments

52. In both the FSC and associated feeder market as well as in the LCC and charter market, the CAA considers that the likely underlying source of GAL's market power 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.

53. The CAA notes that the government has currently put a hold on the expansion of the main London airports and that the Davies' Commission is not expected to bring out an interim report until the end of 2013, with a full report in summer 2015. The CAA considers that any change in government policy following the release of the Davies' Commission final report may take some time to be implemented and that any significant capacity expansion would not be expected until 2025.

54. Gatwick is likely to benefit from the expected tightening of capacity constraints across the South East. Larger aircraft and better utilisation of slots may help to address capacity constraints. However, based on the Department for Transport's (DfT) and GAL's passenger forecasts, the CAA is minded to conclude that capacity constraints are expected to tighten further over the Q6 period. This tightening can be expected to reduce GAL's incentive to price to the competitive level.

55. 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 result in it posing a greater competitive constraint on GAL. 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 Gatwick could change, as could passenger preferences.

Test B

56. Test B requires that the CAA is satisfied that competition law does not provide sufficient protection against the risk of abuse of SMP. Further, as with all of the CAA's regulatory functions, the assessment of Test B must be conducted in accordance with the CAA's primary duty. The CAA must apply Test B "in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services". Further, in so doing, the CAA must, where appropriate, seek to "promote competition in the provision of airport operation services".

57. Importantly, for Test B, the CAA has to assess the adequacy of competition law from the perspective of "users of air transport services". Accordingly, when assessing the merits of competition law, the CAA has to further the interests of passengers and cargo owners, and not the interests of commercial passenger or cargo airlines or other intermediary service providers, such as groundhandling providers, car parking or retail concessionaires.

58. Under competition law, a dominant company has a special responsibility not to allow its conduct to impair or distorted competition in the relevant market. It is not the position of dominance or SMP itself that is prohibited, but rather the undertaking using that position to prevent or distort the effective competition in the market.

59. The CAA considers that there are clear and distinct aims for ex-ante regulation and ex-post competition. The former is to foster the development of competition correcting for known impediments to the competitive process. The latter is to protect the current state of competition (as a minimum) within the market.

60. The CAA considers that there is adequate competition case law, on which it would be able to rely in order tackle vertical abuses where an airport operator has an interest in a downstream market or horizontal abuses where the airport operator is seeking to foreclose the market for a competing airport operator.

61. The CAA considers that for vertical abuses of an exploitative nature where the airport operator does not have an interest in the downstream market the CAA has insufficient comfort that it would be able to successfully discipline behaviour through the use of competition law. These include abuse of excessive pricing and service quality based abuses.

Potential detriment from relying on competition law

62. The CAA considers that the detriment to air transport users from the potential abuse of GAL's market power is likely to have effects in a number of areas.

63. Excessive prices are likely to have a direct impact on passengers'/users' ability to travel where these are passed straight through to the fare paid in the case of the Gatwick LCC and charter market. Although individually the amounts involved are likely to be limited, over the passenger group as a whole, these are likely to lead to significant sums.

64. Where the airport price rises are not directly passed through to passengers/users, this will have the direct impact on the profitability of the airline sector. This is likely to have an effect on airlines' incentive and ability to invest and innovate, for example, in new routes and also affect the viability of existing routes offered. This would be likely to affect users' interests, for example, by restricting their choice of airlines and destinations available from the airport.

65. Likewise, the CAA expects that GAL's ability to charge excessive prices may lead it to have less incentive to deliver the level of service quality demanded by users.

66. Given the nature of the detriment to the users and the difficulties that result in pursuing potential exploitative vertical abuses, the CAA is

minded to consider that, in the case of GAL, competition law is unlikely to be sufficient to curtail abusive behaviour. Therefore, this part of the MPT is met.

Test C

67. Test C requires the CAA to assess whether the benefits of a licence regime are likely to outweigh the adverse effects. 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. The CAA has a duty to perform its functions having regard to good regulatory principles, including the proportionality of any licensing proposals and targeting them only where action is needed. In order to assess the potential benefits of a licence, it is necessary to form a view of the counterfactual to a licence regime i.e. what conditions of regulation would exist in the absence of a licence.

The regulatory counterfactual

68. In January 2013 GAL put forward a set of airport commitments which would be included within its Conditions of Use. The airport commitments include a price cap for published airport charges and an enhanced service quality regime with rebates and bonuses. The commitments do not include an investment commitment apart from a requirement to meet the service quality standards and to publish a five-year investment plan. The Airport Charges Regulations (ACR) and Airport Groundhandling Regulations would also form part of the counterfactual.

Enforcement risks of commitments

69. The CAA has considered whether GAL's commitments are sufficient and that the incremental benefits of licence regulation are likely to be outweighed by the adverse effects and so Test C would not be met. In undertaking this assessment the CAA has been mindful of the lack of explicit statutory provision for the acceptance of commitments in lieu of licence regulation. Consequently, the CAA considers that it should exercise caution and would want to consider whether commitments would provide material benefits over licence regulation, in particular in relation to the CAA's statutory duties.

70. For commitments to be an effective substitute for licence regulation they must be clear and enforceable so that airlines and other stakeholders have confidence that the benefits GAL say would accrue from the commitments would be delivered in practice, and would accrue to passengers and cargo owners.

71. The CAA considers that GAL's current proposal to include commitments in the Conditions of Use raises a number of concerns about the substance and enforceability of the provisions. In particular, the CAA is concerned that the Conditions of Use (including the commitments) would be unbalanced with insufficient clarity over the facilities that GAL would provide. It would allow GAL to undertake unilateral variation or contracting out. As they would be enforced by airlines they may not offer the same protection to passengers and cargo owners as compared to a licence enforceable by CAA which has a statutory duty to protect their interests. Furthermore, the commitments commit parties to dispute resolution which could unduly delay airlines from taking enforcement action, and they provide no explicit protection from repeated failure against service quality standards.

72. In addition, the CAA is concerned that in the absence of a licence, if there are repeated failures to comply with the commitments, then while this may constitute a material change in circumstances, the process of re-introducing licence regulation may take two to three years, allowing significant passenger detriment to occur during this time. These issues could be avoided under licence regulation.

Benefits and adverse effects of a licence to users compared to the counterfactual

Benefits

73. **Price:** As highlighted earlier, the CAA considers that the current cap is not significantly below the competitive price. Consequently the CAA is concerned that GAL's commitments propose to increase the price cap by an equivalent of RPI+4 per cent per year over seven years. This is in excess of a reasonable price as judged by a RAB-based comparator, which gives a price of RPI+0 per cent, over the period. Consequently licence regulation is likely to provide additional benefits in this area.

74. **Efficiency:** The impact on efficiency of the commitments is likely to be mixed, with potential benefits from retaining the benefits from efficiency improvements for longer (at least seven years, compared to

typically five years from licence regulation), offset to some extent by the looser price cap providing less of an incentive to be efficient, and the pass through of full operational costs.

75. **Service quality:** The commitments include much the same service quality regime as used for Q5. However, the extension and the increased money at risk for bonuses could provide gains to GAL, and the inclusion of airline facing service quality targets has the potential to distort competition to the detriment of passengers. Again it may be possible to avoid these issues under a licensing regime.

76. **Investment:** The commitments do not include capital expenditure commitments or triggers. Instead, investment would be driven by the service quality regime and GAL's vision for the airport in the future. Given the position of the SMP of the airport operator there is a risk that some beneficial enhancements for users would not be taken forward. The consultation arrangements under the commitments would be based on those under the ACR. While this may save costs and speed processes, for an airport operator with SMP this means that users' interests may not be fully taken into account.

Adverse effects

77. The commitments would have benefits over a licence approach, in that they would avoid the direct costs of staff and consultancy associated with a regulatory review. GAL estimates that these costs of the existing regulatory regime are around £8m per year, mainly around consultation. In addition there would be CAA costs, estimated to be around £1m per year, and airline costs of up to £1m per year. These costs may be reduced under alternative forms of regulation. Commitments themselves are unlikely to be costless and potential cost savings would be significantly reduced but perhaps not eliminated if there is not effective partnership working between GAL and airlines, and if there were numerous complaints to the CAA under competition law or ACR. Airline feedback on the commitments has been mixed.

78. The commitments would also have benefits in terms of avoiding the potential distortions from licence regulation: avoiding management distraction, as the enforcement of the commitments would be linked to commercial negotiations; and removing some perverse incentives that may occur under a regulatory regime, for example potential distortions to capital expenditure incentives under a RAB-based framework, or the potential for regulatory "gaming". Commitments could also avoid

potential distortions to competition, for example a price cap set too low could distort charges and investment at other airports and bilateral contracts could be more likely under commitments, although GAL would be free to pursue these under licence regulation.

Assessment

79. In addition to the concerns highlighted above, the CAA has reviewed whether the provisions in the commitments would provide sufficient protection against the potential abuse of SMP, across the focuses on the topics most commonly addressed by economic regulation.

80. Overall the CAA welcomes GAL's commitment proposals. However the CAA is not sufficiently convinced that the enforceability of and the terms within the current commitment proposals provide sufficient protection to passengers and cargo owners. Overall, the CAA is minded to find that Test C is met and that some form of licence regulation should apply to GAL. Consequently the CAA considers that there would be significant incremental benefits from licence regulation, which are likely to outweigh the adverse effects and that Test C is met.