

APPENDIX G

Evidence and analysis on indicators of market power

Introduction

- G1 In the absence of regulation, an airport operator holding a position of substantial market power (SMP) may behave, to an appreciable extent, independently of its competitors and its customers, enabling it to:
- raise prices;
 - maintain levels of inefficiency;
 - compromise service quality; and
 - achieve supernormal profits.
- G2 The CAA recognises that the assessment of whether an airport operator has SMP in the relevant market requires the analysis and examination of structure of the relevant market as well as the conduct and performance of the relevant market players.
- G3 In this appendix, the CAA assesses whether the evidence suggests that Gatwick Airport Limited (GAL) has or is likely to acquire SMP in the relevant market (or segment of that market) as defined in appendix D. In coming to this view, the CAA notes that:
- Since the release of the Consultation on Gatwick market power assessment (the Consultation), it has reconsidered how it has defined the relevant market(s) for GAL.
 - It now considers that it is unlikely that separate markets by airline business model are appropriate.
 - It is mindful that there are still significant operational differences between low cost carriers (LCCs) and full service carriers (FSCs) that impact on their substitution opportunities.

- G4 To analyse the relevant market, the CAA has considered the following indicators:
- market shares;
 - efficiency;
 - price;
 - engagement with airlines and commercial negotiations;
 - quality of service; and
 - profitability.
- G5 In considering these indicators, the CAA has considered:
- Both the historical and current status of the indicators as well as their likely evolution.
 - What the indicators of market power suggest individually as well as their cumulative and combined effect.
- G6 In interpreting the evidence relating to the behaviour and/or performance of GAL in the relevant market, the CAA recognises that GAL is subject to economic regulation and that its behaviour is therefore likely to be influenced (or even driven by) regulatory requirements.

The Consultation

- G7 In the Consultation the CAA considered that:
- Indicators such as efficiency, pricing, engagement and commercial negotiations (individually and when considered as whole) suggested that GAL enjoys SMP in the relevant markets.
 - GAL will continue to hold a position of SMP in the relevant markets due to improving economic conditions, tightening capacity across the London airports and excess demand at Heathrow.
- G8 In coming to this view, the CAA recognised that more weight could be given to some indicators relative to others. For example, it noted that price and GAL's approach to its negotiations were two indicators that carried relatively more weight in its market power assessment and that:
- GAL's current pricing is not significantly above or below a reasonable price range derived from the long run average incremental costs.

- GAL largely set the terms that an airline will receive and that the scope for negotiation at the time was relatively limited.
- GAL is able to exercise price discrimination between existing and new airline customers, allowing it to compete with other airports in London for new business, while exercising SMP over airlines already present at the airport.

G9 The CAA also noted that while, at first glance, the market share analysis suggested that Gatwick has a relatively strong market presence with respect to LCCs and charters and a much smaller presence with respect to FSCs and associated feeder traffic, there are a number of limitations associated with market shares analysis, including the lack of due consideration of capacity constraints (or lack there-of) at other airports. In addition, the CAA noted that:

- Since GAL is a regulated airport operator that is subject to a quality scheme, the quality outcomes are unlikely to provide particularly strong evidence about the airport operator's market power. However, it also noted that:
 - GAL's performance had improved in a number of areas and while this was encouraging, it had only been occurring for a relatively short time period.
 - Even if the improvements seen reflected greater competitive pressures, the airport operator might still have sufficient market power to require economic regulation.
- It appeared that greater focus had been placed on improving efficiency at the airport since its sale, although several independent studies had identified areas of inefficiency.
- GAL's financial performance was unlikely to provide particularly strong evidence about the level of market power, as GAL is a regulated airport operator and it only changed owners recently.

G10 The CAA received five responses to the Consultation:¹

- British Airways;
- easyJet;
- GAL;

¹ The responses to the Consultation are available on the CAA's website:
<http://www.caa.co.uk/default.aspx?catid=1350&pagetype=90&pageid=14784>

- Gatwick Airport Consultative Committee (GACC); and
 - Virgin Atlantic Airways (VAA).
- G11 Stakeholders raised a number of concerns in response to the CAA's assessment on indicators of market power:
- GAL indicated that the CAA's analysis of indicators of market power was inappropriate and misjudged in a number of respects.²
 - In general, the other stakeholders raised various (actual and/or potential) concerns associated with price, service quality and the level of engagement/transparency. It was also considered that the presence of SMP would have a detrimental effect on these indicators.³

CAA analysis

- G12 In light of the representations from stakeholders as part of the Consultation, the CAA has re-evaluated its assessment of the evidence and maintains the position that it outlined in the Consultation. That is, the CAA considers that the indicators of market power suggest, as a whole, that GAL has SMP and that this will continue going forward, not least due to improving economic conditions and tightening capacity across the London airports.
- G13 The CAA's response to the various issues raised by stakeholders is examined in more detail below (or in the case of some of the specific modelling issues associated with estimating price in appendix H).
- G14 The CAA received many responses to the Gatwick - Market Power Assessments, The CAA's Initial Views – February 2012 (the Initial Views)⁴ and the Consultation. This final decision contains summaries of, and answers to, many of the points raised.

Market shares

- G15 Evidence on market shares is commonly used in competition assessments as the starting point in the analysis of market power providing information about the structure and concentration levels of the relevant market.

² GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Reference Q5-050-LGW60, p. 2 and pp. 29 to 31.

³ See submissions from the non-GAL respondents to the Consultation.

⁴ This document is available on the CAA's website.

- G16 However, the analysis of market shares provides only an initial indication about the potential existence of SMP in the relevant market, which is not sufficient by itself to establish the existence of SMP.
- G17 According to established European case law:
- A firm with a market share of less than 25 per cent is unlikely to have an SMP position in the relevant market.⁵
 - A firm with a market share of over 40 per cent generally raises SMP concerns in the administrative practice of the European Commission (EC).
 - Large market shares (over 50 per cent) raise by themselves, a rebuttable presumption of SMP.⁶
- G18 The above is also consistent with the Office of Fair Trading's (OFT) view⁷, that:
- The European Court has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50 per cent. The OFT considers it unlikely that an undertaking will be individually dominant if its share of the relevant market is below 40 per cent, although dominance could be established below that figure if other relevant factors (such as the weak position of competitors in that market and high entry barriers) provided strong evidence of dominance.*
- G19 According to the EU competition law⁸, an undertaking with a large market share may be presumed to have SMP if its market share has remained stable over time. However, as noted above, it is also true that high and stable market shares do not always indicate that a firm has SMP. Where

⁵ Recital 15 of Council Regulation (EEC) No. 404/89 on the control of concentrations between undertakings, OJ 1989 L395-1 states that: '*Whereas concentrations which, by reason of the limited market share of the undertakings concerned, are not liable to impede effective competition may be presumed to be compatible with the common market; whereas, without prejudice to Articles 81 and 82 of the Treaty, an indication to this effect exists, in particular, where the market share of the undertakings concerned does not exceed 25 per cent either in the common market or in a substantial part of it.*

⁶ Case C-62/86, AKZO Chemie BV v. Commission, [1991] ECR I-3359. A market share in excess of 50 per cent is said to create a rebuttable presumption of SMP.

⁷ OFT, Assessment of market power guideline (OFT 415), paragraph 2.12.

⁸ Case 85/76 Hoffman-La-Roche v Commission [1979] ECR 461, paragraph 41.

See also, by analogy, Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services, (2002/C 165/03), paragraph 75.

high and stable market shares are present they will need to be interpreted differently depending on the particular commercial and regulatory history by which the market shares came about and other features of the market such as competitive constraints from outside the market, barriers to entry and countervailing buyer power.

- G20 This is consistent with the OFT's view that *'in general, market power is more likely to exist if an undertaking (or group of undertakings) has a persistently high market share.'*⁹

Consultation view

- G21 In the Consultation, the CAA considered that GAL operated in two markets and outlined the market shares associated with those two markets.
- G22 The CAA has, however, re-considered its position on the definition of the relevant market for GAL (see chapter 4). As a result, the market share analysis that was presented in the Consultation is no longer relevant.

Stakeholders' views

- G23 GAL, in response to the Consultation, indicated that:

*[A]side from our concerns about the CAA's market definition, the CAA considers Gatwick to have SMP in the FSC and associated feeder traffic airline market, a market in which it has less than 20 per cent of the market, and in which the other operator in the market has been found to have SMP.*¹⁰

CAA views and conclusion on market shares

- G24 Following the release of the Consultation, and having considered responses to the Consultation, and having undertaken further work on the relevant market definition for GAL (see chapter 4), the CAA now concludes that:
- There is a single relevant product market for the provision of airport operation services to passenger airlines at Gatwick rather than a separate product markets for LCCs and charters, and FSCs and associated feeder traffic. However, the CAA recognises that there are different market segments within this market.

⁹ OFT, Assessment of market power guideline (OFT 415), paragraph 4.2.

¹⁰ GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Reference Q5-050-LGW60, p. 29.

- Heathrow is not in the relevant geographic market for Gatwick. That is, the relevant geographic market is limited to the services only provided at Gatwick.
 - The relevant market is defined to be the market for the provision of airport operation services to passenger airlines at Gatwick; this market is limited to the services provided to airlines at Gatwick.
- G25 In the above defined relevant market, GAL is the only operator with a market share of 100 per cent irrespective of whether it is measured by passenger numbers or ATMs.
- G26 On this basis, GAL's market share in the relevant market establishes a rebuttable presumption of GAL having a position of SMP in the relevant market.
- G27 In arriving at this conclusion, the CAA accepts that there are a number of reasons why market shares are not always a conclusive indicator of the level of market power that an airport operator may have. On their own, they may be insufficient to establish a position of SMP for an airport operator. The CAA has therefore examined additional indicators of market power to determine whether they corroborate or alter the rebuttable presumption of SMP from the market share information.

Efficiency

- G28 An airport operator enjoying a position of SMP might face insufficient competitive pressure to enhance its efficiency by putting downward pressure on its operating and capital costs. However, as GAL is currently subject to price cap regulation, which includes incentives to increase operational and capital efficiencies, it is difficult to distinguish the extent to which observed operational efficiencies at Gatwick reflect a response to regulatory requirements or to competitive pressures.

Consultation view

- G29 In the Consultation, the CAA considers that the analysis of relative cost efficiency might provide useful evidence to identify whether an airport operator is performing in a way that might be expected in a well-functioning market subject to effective competition.
- G30 The CAA also noted:
- The steps that GAL had taken to try and improve its performance and welcomed GAL's focus on improving efficiency (and service quality, which is discussed later in this appendix).

- Some stakeholders had expressed concern with GAL's approach to implementing some of these changes (see section on negotiations for further information).
- GAL's approach to addressing efficiency appears to be much improved compared to that seen under previous ownership. The CAA considered that this was indicative of GAL looking to differentiate Gatwick from other airports and attract new traffic to it.

G31 The Consultation also outlined that the CAA had commissioned several studies to assess GAL's operating expenditure (opex) efficiency and the scope for further savings in its business plan. The evidence from these studies suggests that GAL falls short of the efficiency frontier and identified a number of areas of inefficiency.¹¹ In particular, the Consultation outlined that the CAA had:

- Reviewed several pieces of independent opex benchmarking evidence, which showed that opex per passenger at Gatwick was slightly higher than the average of the samples considered (with the exception of one report).¹²
- Undertaken additional analysis of the relative performance of Gatwick based on the latest data, against relevant comparators using adjusted opex per passenger.¹³ This evidence suggested that:
 - Adjusted operating costs per passenger at Gatwick are £7.82, which is slightly below the sample average of £7.95, although higher than a number of comparable airports including Copenhagen, Stansted, Dublin, Edinburgh and Glasgow.
 - Staff costs per passenger at Gatwick are particularly high at £4.16 (compared to an average of £3.18).

¹¹ For example, several pieces of opex benchmarking evidence that the CAA had considered had been adjusted, through various processes, to normalise the indicator. Comparisons between airports are then made using the metric of opex / passenger to adjust for airport size.

¹² The samples included in the studies include a wide variety of airports, some of which are not directly comparable with Gatwick. Gatwick is slightly larger than many of the airports considered, and has a relatively high proportion of long haul flights for example. This is likely to increase costs relative to the sample average. Nonetheless, the sample average is likely to provide a useful performance benchmark.

¹³ Adjusted opex excludes costs related to depreciation, retail, rail, air navigation services (ANS) and other irregular cost items and is intended to provide a consistent measure of costs across airports.

- time series analysis indicates that adjusted operating costs per passenger at Gatwick increased by 29 per cent between 2000 and 2008 compared to a 3 per cent increase in the sample average. Since 2008 adjusted opex per passenger has fallen by 13 per cent, similar to the sample average, which suggests that there may be scope for further catch-up efficiency to address the high growth in costs between 2000 and 2013.
- Total staff costs at Gatwick (including all cash payments and pension costs) are between 23 per cent and 32 per cent higher than benchmarks (IDS employment cost study). This finding is supported by GAL's own benchmarking analysis undertaken by Hay Group.
- Rates of staff absenteeism are very high in comparison with comparative benchmarks (IDS employment cost study).
- Cleaning costs per metre square of terminal space are relatively high in comparison with benchmarks (SDG Other opex study).

- G32 The consultancy studies also highlighted that evidence suggested that GAL's personnel have relatively high rates of absence, with an average absence rate of ten days per person. This is significantly higher than the economy wide average in the public and private sector of 6 to 8 days. GAL has, however, stated that it is planning to reduce rates of absenteeism, for example, by reducing the need for security staff to carry out passenger lower body searches.
- G33 The CAA considered that, in combination, the evidence from these studies suggested that there is potential to reduce opex significantly from the figures reported in GAL's revised business plan (RBP).
- G34 With respect to capital expenditure (capex) efficiency, the CAA noted that any assessment is relatively more difficult as the actual schemes taken forward by an airport operator during a control period tend to change from that envisaged at the time of the price control. To better understand these issues, the CAA engaged a number of consultants to examine capex efficiency at Gatwick.
- G35 Based on the evidence provided on opex and capex efficiency, the CAA therefore considered that the evidence suggested that there may be insufficient competitive pressures at Gatwick both now and going forward.

Stakeholders' views

- G36 GAL was concerned that the CAA had assessed its performance against the level of competition seen in fully competitive markets and that it interpreted efficiency short of the efficient cost frontier as suggesting that competitive pressures are insufficient. In particular, GAL noted that:¹⁴
- When comparing firms in different territories there may be factors that influence costs outside the control of the firm. GAL also highlighted the level of wages as an example and noted that despite the CAA highlighting that care must be taken to understand the underlying causes of any identified inefficiency, the CAA had not done this.
 - Looking only at cost oversimplifies the comparison and all factors of production are on a price/quality scale.
 - Looking at one cost element at a time fails to recognise the overall position of a firm at the production frontier.
 - It had increased efficiency significantly since it became independent of BAA, and it is unrealistic to expect it, over a relatively short period, to move to a frontier level of efficiency.
- G37 GAL also highlighted a number of benchmarks that it considered would be better indicators of SMP:¹⁵
- Costs across a range of activities being significantly and systematically out of line with comparators.
 - Little attempt by the firm to increase efficiency.
 - There being little understanding or knowledge of costs within the firm.
- G38 GACC highlighted that despite a somewhat positive change in behaviour since the sale in terms of operational efficiency, it did not attribute this to increased competition. Rather, it considered that this change was due to the beneficial effect of new owners.¹⁶
- G39 easyJet indicated that its submission should be read alongside the GACC's submission.

¹⁴ GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Reference Q5-050-LGW60, pp. 30 to 31.

¹⁵ GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Reference Q5-050-LGW60, p. 31.

¹⁶ GACC, ACC Response to CAA document: Consultation on Gatwick market power assessment, paragraph 1.11.

CAA views

- G40 A number of stakeholders have indicated that the efficiency improvements seen at Gatwick are the result of new ownership at Gatwick rather than increased competition. This view is broadly consistent with the views that the CAA outlined in the Consultation.
- G41 On GAL's concerns with the CAA's approach to measuring efficiency, the efficiency results and their interpretation, the CAA notes that:
- Stakeholders had the opportunity to comment on the respective efficiency studies as they were being undertaken and that many revisions to the approach were adopted, although differences of opinion remain.
 - While GAL and other stakeholders may have different views on the assumption, methodology and efficiency results, the efficiency and benchmarking studies are reasonable. In addition, taken together, the results all point towards GAL being able to improve the efficiency at Gatwick.
 - GAL's ability to maintain inefficiency suggests the lack of competitive pressure and suggests that GAL has SMP in the relevant market.
 - This finding also does overturn the rebuttable presumption established by GAL's market share.
- G42 In addition, in examining efficiency at Gatwick, Stansted and Heathrow, a number of different efficiency and benchmarking studies were used – these studies were undertaken by different consultants following different approaches. In addition, the CAA undertook its own benchmarking exercise.¹⁷ Overall, this evidence indicates at all three airports (Heathrow, Gatwick and Stansted):¹⁸
- There is likely to be scope for further efficiency relative to current levels of opex per passenger.
 - Appear to be outperformed by their comparators with regards to opex per passenger and all have performed worse than average in controlling costs since 2000 both in comparison to the CAA's benchmark sample and their own major airline customers.

¹⁷ For more information on the CAA's approach to benchmarking, please see 'CAA Airport Operating Expenditure Benchmarking Report 2012', available at: <http://www.caa.co.uk/docs/33/CAP%201060%20Airport%20Operating%20Expenditure%20Benchmarking%20Report%202012.pdf>

¹⁸ CAA, CAA Airport Operating Expenditure Benchmarking Report 2012, p. 47.

- G43 In particular, the CAA's studies, which are described in detail in the Economic regulation at Gatwick from April 2014: initial proposals (the Initial Proposals)¹⁹, identified significant scope for further improvements in efficiency, including:
- Reductions in GAL's staff cash costs – these would need to be reduced by 9 to 13 per cent to be in line with benchmarks.
 - Reductions in the cost of the pension scheme.
 - Improvements to absence management.
 - Reductions in rates, utility, cleaning and police costs.
 - Reductions in maintenance costs.
- G44 On the other hand, this evidence suggests that GAL is relatively efficient in some areas, including with respect to improvements to security roster efficiency since the sale of the airport, and a relatively high security processing flow rate relative to other airports. An examination of central support costs (undertaken by Helios) also indicated that GAL's central support costs were close to benchmarks in most areas (after accounting for its relatively high staff costs). This finding was supported by GAL's own benchmarking study undertaken by AT Kearny.
- G45 The analysis of operating expenditure outlined in the Initial Proposals also indicated that in 2009, following the change in ownership, GAL was initially successful in reducing opex, with the reduction in intra-group charges, less than offset by smaller increases in costs in other areas.²⁰ While this improved efficiency is welcome, this could be due to greater management focus rather than an increase in competition.
- G46 Based on responses to the Initial Proposals and further work conducted since April 2013, the CAA has further amended its views on areas where further efficiency gains could be achieved at Gatwick. In particular, areas where there is scope for further efficiency gains include:
- Additional efficiencies related to the removal of GAL's forecast RPI+0.75 per cent wage increase (reducing opex by £6.6 million by 2018/19).

¹⁹ CAA, April 2013, Economic regulation at Gatwick from April 2014: initial proposals, <http://www.caa.co.uk/docs/33/CAP%201029%20Economic%20regulation%20at%20Gatwick%20from%20April%202014%20initial%20proposals.pdf>, chapter 6.

²⁰ CAA, April 2013, Economic regulation at Gatwick from April 2014: initial proposals, <http://www.caa.co.uk/docs/33/CAP%201029%20Economic%20regulation%20at%20Gatwick%20from%20April%202014%20initial%20proposals.pdf>, chapter 6.

- Consideration of the movement of the staff costs benchmark over Q6, taking account of an emerging economic recovery which would suggest reducing the target efficiency associated with the IDS benchmark evidence.
- Additional efficiencies related to the Helios central support study, equal to £0.7 million by 2018/19 (after accounting for the impact of staff cost efficiencies on central support costs).
- Pension cost efficiency based on the Government's Actuary Departments (GAD) conclusions that an appropriate benchmark for GAL's Defined Benefit future service pension costs would be 20 to 22 per cent of wages (efficiency of between £3.4 million and £5.0 million by 2018/19).
- Exclusion of GAL's deficit cost estimate, which is equal to £1.4 million by the end of Q6.
- Explicitly accounting for the impact of the CAA's higher traffic forecasts, increasing opex by £6.6 million by the end of Q6 based on an elasticity of 0.3.

G47 In its working paper on Empirical Methods²¹ the CAA stated that, in principle, the analysis of relative cost efficiency might provide useful evidence to identify whether an airport operator is performing in a way that might be expected in a well functioning market subject to competitive pressures. However, this working paper also noted that:

- Care must be taken to understand the underlying causes of any identified inefficiency, and whether there is evidence to suggest that relatively poor performance is transitory or can be explained by factors that do not relate to market power.
- It is difficult to distinguish the extent to which the operating efficiency of a regulated airport is due to its response to competitive pressures or regulatory incentives.

G48 While GAL has provided the CAA with information on various projects that it considers demonstrates efficiency it has not provided evidence, including in its response to the Consultation, which demonstrates that the observed efficiency improvements is a response to increased competitive pressures rather than increased (new) management focus or regulatory incentives.

²¹ CAA, June 2011, Empirical methods for assessing behaviour, performance and profitability of airports, <http://www.caa.co.uk/docs/5/Performance&BehaviourWP.pdf>

Conclusion on efficiency

- G49 The CAA considers that there are a number of areas of inefficiency at Gatwick. In particular, the evidence from a number of benchmarking and efficiency studies, carried out by different independent consultants using different approaches, indicate several areas of inefficiency at Gatwick – staff costs and pensions being the most significant.
- G50 GAL was provided numerous opportunities to comment on the efficiency studies being undertaken and that, as a consequence and where appropriate, amendments were made to reflect those comments. The CAA recognises that there may be areas of disagreement with GAL but considers that the approaches that have been used to assess efficiency at Gatwick are reasonable and their results are robust.
- G51 The CAA has also seen no evidence from GAL, (for example, strategy documents, specific information on how to re-engineer processes and cut costs, etc. documents) linking improvements in efficiency to competition, including in response to the Consultation.
- G52 Given the above, the CAA considers that GAL's efficiency performance is likely to be consistent with it having SMP in the relevant market and that there may be at present and in the future insufficient competitive pressures at Gatwick to constraint its SMP. That said, the CAA :
- Notes that GAL's efficiency has improved under new ownership and that this may reflect an increase in competitive pressures.
 - Welcomes the attention efficiency issues are being given by GAL.
- G53 Importantly, irrespective of the source of improvement seen at Gatwick, an airport operator that is in the process of starting to enhance its performance does not automatically mean that it currently faces, or will face, a level of effective competition that would constrain its SMP.
- G54 Based on the evidence outlined above, the CAA considers that GAL's operating efficiency appears to be consistent with GAL having a position of SMP in the relevant market – a market where GAL is the only operator with a 100 per cent market share.

Price

- G55 The economic concept of market power is reflected in European case law. For example, in *Hoffman la Roche v Commission* [1979] ERC 461, it was outlined that market power:

relates to a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of the consumers.

G56 This case also highlighted that:

such a position does not preclude some competition, which it does where there is a monopoly or a quasi-monopoly, but enables the undertaking which profits by it, if not to determine, at least to have an appreciable influence on the conditions under which that competition will develop, and in any case to act largely in disregard of it so long as such conduct does not operate to its detriment.

G57 The EC considers that an undertaking has SMP if 'it is capable of profitably increasing prices above the competitive level for a significant period of time' and that the reference to 'increasing prices' is used as shorthand for a variety of ways of influencing competition to the advantage of the dominant undertaking, including by decreasing output, innovation, variety or quality of goods or services.²²

G58 By analogy, the EC's SMP Guidelines state that:

However, in an ex-ante environment, market power is essentially measured by reference of the power of the undertaking concerned to raise prices by restricting output without incurring a significant loss of sales or revenues.²³

G59 Therefore, an assessment of an airport operator's pricing behaviour is an important indicator of market power. In particular, given that an airport operator having SMP will be able to profitably sustain prices above the competitive level over time, it is important to consider prevailing and historical prices in relation to the competitive price level. However, pricing at or even below the competitive level does not necessarily mean the absence of SMP.²⁴

²² EC Guidance on Article 102 Enforcement Priorities, OJ [2009] C 45/7, paragraph 11.

²³ Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services, (2002/C 165/03), paragraph 73.

²⁴ Pricing at or below marginal costs (strategic foreclosure or predatory pricing) is an abuse by dominant firms (firms having SMP).

- G60 If a competitive price benchmark could be identified with certainty it would provide the ultimate indicator of market power, as it would allow the comparison of historical and prevailing prices with that competitive price benchmark. However, there are a number of challenges associated with identifying precisely what the competitive price is for GAL and therefore a proxy (or proxies) of the competitive price need to be identified.
- G61 The main approaches to identifying a proxy for the competitive price level are benchmarking and cost modelling replicating the cost and pricing structure of a hypothetically efficient entrant.²⁵

Consultation view

- G62 In the Consultation, the CAA considered GAL's prices by examining the regulated RAB price²⁶, the long-run average incremental costs (LRAIC) and price benchmarking. The CAA commissioned Europe Economics (EE) to undertake work related to the calculation of a LRAIC-based price – a proxy for the price that would arise under competitive conditions – and Leigh Fisher (LF) to carry out a price benchmarking exercise. The details of both these studies are discussed in appendix H.
- G63 The CAA concluded, based on the analysis that it had undertaken, and considering the independent analysis on price benchmarking and LRAIC, that GAL's prices were in line with the range of prices that could reasonably reflect the competitive price.
- G64 As part of this, the CAA highlighted that:
- GAL considered that the competitive price was substantially above the current regulated price.
 - GAL had been pricing at, or close to, the regulatory cap for several years; and had indicated, based on the expectation that the CAA would not set a licence for GAL, that the best way forward would be through a commercial approach for its airlines, comprising 'Contracts and Commitments'. In particular:

²⁵ Benchmarking: Under this approach, some kind of average price is calculated from the prices of the substitutes (or comparable products). Cost modelling: This approach entails the construction of a cost model designed to replicate the cost structure of a hypothetical efficient entrant, operating in a competitive environment. The derived prices are assumed to proxy the competitive price level.

²⁶ A regulated RAB price is a price based on a Regulated Asset Base (RAB), which is a proxy for the value of (in this context) the airport operator's regulated operating assets upon which it earns a return.

...to allow the competitive market to dictate the service and price levels for the airport. Accordingly, we have developed a commercial approach for our airlines, comprising “Contracts and Commitments”.

As at other non-regulated airports and businesses worldwide, we see a future in which airline-airport relationships at Gatwick are increasingly defined through bilateral contracts. ... Of course, we recognise that some airlines may choose not to enter into bilateral contracts, and will therefore continue to access the airport under the terms of Gatwick’s Conditions of Use.²⁷

And:

These contracts would be negotiated on an individual airline basis.²⁸

- G65 Connected with the bullet point above, the CAA noted that the ability of airlines to negotiate with GAL would need to be considered when determining whether or not GAL has SMP.
- G66 The CAA also outlined a number of features associated with GAL’s proposed Contracts and Commitments:
- A key component of GAL’s proposed Contracts and Commitments²⁹ was a price commitment and that GAL’s preferred approach to pricing appeared to be a 7 year commitment to limit price increases in the average aeronautical yield from core airport services to RPI + 1.3 per cent per annum (following a one-off adjustment of 11 per cent).³⁰
 - GAL had indicated that this price limit would be taken into account each year when it publishes the tariff for core airport services in its Conditions of Use.³¹ It also noted GAL’s position that this approach would offer a substantial price improvement relative to its estimate of the RAB-based price control.³²
 - GAL’s proposed price commitments were based on its view that it does not have market power. The CAA also noted that in the event that the evidence suggests that GAL does have SMP, the merits of such an approach may be more limited.

²⁷ Source: GAL, [redacted].

²⁸ Source: GAL, [redacted].

²⁹ This is an approach that GAL has put forward based on the expectation that the CAA does not find that it has SMP and that the CAA does not set a licence for GAL.

³⁰ [redacted].

³¹ Source: GAL, [redacted].

³² Source: GAL, [redacted].

G67 In relation to the pricing behaviour of GAL, the CAA also noted that, in the absence of regulation, GAL's prices were likely to be raised above the current regulated price.

Stakeholders' views

G68 Stakeholders' views on what should be the competitive price (and the starting point for any analysis) are explored in detail in appendix D. However, in summary:

- GAL did not agree with the CAA's view of price and considered that the competitive price was much higher than that suggested by the CAA.
- The GACC and easyJet agreed with the CAA that the current price cap is not significantly below the competitive price.³³
- At a broader level, the four non-GAL respondents suggested that there was a clear indication that GAL would increase prices if regulation was removed (as they considered it had SMP).³⁴

CAA views and conclusion on price

G69 As outlined above, the issue of what price should be used as the starting point for any analysis is discussed in appendix D. However, in summary, the evidence suggests that GAL's pricing is broadly consistent with what would be found in a market subject to conditions of effective competition.

G70 EE's LRAIC modelling and LF's benchmarking study also suggest that the current regulated price at Gatwick is reasonable. In addition, under true conditions of effective competition, competing firms:

- Tend to 'compete away' their fixed costs.
- Do not earn a guaranteed ex-ante return on their assets.
- Face competitive pressures which force them to maximise their efficiency.
- Efficiency adjustments are imposed overnight without any gradual adjustments considered by regulators.
- Return on assets (weighted average cost of capital) tend to be competed away while regulators tend to err towards setting a higher weighted average cost of capital instead of a lower one to incentivise long-term investment.

³³ GACC, ACC Response to CAA document: Consultation on Gatwick market power assessment, paragraph 1.28 and easyJet response to CAA consultation on Gatwick airport market power, p.1.

³⁴ The submissions of the four non-GAL respondents are available on the CAA's website.

- Impose fierce competitive conditions without considering the financial viability of the competing firms.
- G71 On the basis of the above, the CAA is confident that the current regulated price is not below competitive price levels. In addition, the CAA does not accept GAL's view that the competitive price is well above current regulated prices. GAL's view suggests that in the absence of regulation that prices at Gatwick would rise. However, this is inconsistent with the latest evidence in relation to the recent deals proposed by GAL offering discounts to the airlines on their airport charges.
- G72 Going forward, the CAA considers that in the absence of regulation GAL's prices are likely to be raised significantly above current regulated levels (which are broadly consistent with the prices that would result under competitive conditions). This forward-looking assessment is based on:
- GAL's view that the competitive price is substantially above the current regulated price.
 - The evidence from the four non-GAL respondents to the Consultation that suggested that there was a clear indication that GAL would increase prices if regulation was removed (as they considered it had SMP).³⁵
 - The evidence by GACC and easyJet, which both considered that the current price cap is not significantly below the competitive price.³⁶
 - GAL consistently pricing to the (regulatory price) cap for over a decade.³⁷
 - GAL's approach to commercial negotiations with the airlines – an issue discussed in the next section.
- G73 Based on the above discussion, as a result, the CAA considers that the pricing analysis does appear to rebut the presumption of SMP of the market share analysis.

Engagement with airlines and commercial negotiations

- G74 This section considers the behaviour of the airport operator with respect to its engagement with its airline customers. The behaviour in its decision making and its conduct in relation to commercial negotiations can provide

³⁵ The submissions of the four non-GAL respondents are available on the CAA's website.

³⁶ GACC, ACC Response to CAA document: Consultation on Gatwick market power assessment, paragraph 1.28 and easyJet response to CAA consultation on Gatwick airport market power, p.1.

³⁷ See appendix C for more information.

useful insight into how the airport's management views the degree to which it is constrained by competition and consequently the degree to which it may be possible to exercise market power.

- G75 However, an airport operator can choose not to exercise its market power by, for example, entering into genuine engagement of its customers into its decision making process on matters such as quality of services, prices and efficiency. Furthermore, the airport operator may also consider bilateral negotiations with the airlines and achieve deals with them on prices and other commercial issues.
- G76 Since the publication of the Consultation the CAA was made aware in November 2013 that GAL had been in commercial negotiation with its airlines. The CAA broadly consider that these negotiations have been motivated by the proposed regulatory settlement set out in the Q6 Initial Proposals which was aimed specifically at fostering a more commercial focus between the airlines and the airport. The CAA requested information on the proposed deals from GAL as well as the airlines with which the airport operates had been negotiating. The CAA consider this evidence in its discussion below.

Consultation view

- G77 The CAA has considered a range of information to gain insight into what GAL's behaviour says about the degree to which it is constrained by competition and to which it may exercise any market power that it may hold. The material that the CAA considered includes:
- Responses to the Initial Views.
 - Strategy documents, including board papers and executive committee papers and papers discussing potential and actual strategies for encouraging passenger growth.
 - Marketing and promotional material.
 - Offers made to incumbent airlines in response to a threat of switching or actual switching.
 - Offers made to airlines considering launching new routes.
 - Discussions / teleconferences with a range of airlines, including those who have been present at Gatwick for some time and those that are relatively new.³⁸

³⁸ Airlines that the CAA engaged with include short-haul and long-haul carriers, FSCs, LCCs and charters.

G78 Given the complexity of assessing behavioural issues, the CAA has tried to simplify the analysis by examining the evidence as it pertains to scheduled short-haul airlines, scheduled long-haul airlines and charters.³⁹ There is, however, limitations associated with this evidence, as records of negotiations are often incomplete as discussions often occur face-to-face/on the telephone and recordings and/or minutes are not kept.

Short haul airlines

G79 With respect to GAL's engagement and commercial negotiations with short-haul airlines, several airlines were critical of LGW's approach by stating *inter alia* that::

- LGW doesn't offer any support in terms of discounts and that it is unlikely to receive in the future.⁴⁰
- LGW has a monopolistic behaviour since it is not listening and is making decisions unilaterally without consulting.⁴¹
- Limited face to face meetings and GAL not willing to negotiate its charging scheme.⁴²

G80 The non-short-haul airlines had suggested that GAL had 'take-it or leave-it' approach in the ACC meetings.

G81 The CAA considered that the evidence suggested that the majority of short-haul operators do not receive any discounts to aeronautical charges and there is little scope for negotiation. However, the CAA also suggested that inbound LCCs, or those that are proposing to expand their operations significantly at the airport, may be relatively well placed to exercise their bargaining power as they have flexibility as to which London airport they are willing to operate from.

G82 The CAA also examined a number of presentations that GAL offered to airlines to encourage them to operate at Gatwick.⁴³ The CAA considered that this evidence indicated [redacted].

³⁹ The CAA recognises that this grouping is different to how it has defined the markets that GAL operates in. However, the CAA has separated this discussion in this manner as this facilitated the grouping of similar themes identified through discussions with stakeholders.

⁴⁰ Source: Air Malta, [redacted].

⁴¹ Source: easyJet, [redacted].

⁴² Source: Flybe, [redacted].

⁴³ Source: GAL, [redacted].

G83 Based on the above evidence, the CAA considered that the majority of short-haul airlines have limited scope to negotiate with GAL on aeronautical charges.⁴⁴

Long haul airlines

G84 With respect to the evidence on long-haul airlines, the CAA found that the evidence suggested that GAL has been relatively active in looking to establish new long-haul carriers (or new routes from existing long haul carriers) at the airport.⁴⁵

G85 The CAA also considered that:

- The incentives that may be made available to these airlines tend to be very similar, although public relations and marketing support varies case by case.
- The evidence suggested that the incentive a new long haul operator will typically be offered by Gatwick will be a 3 year declining incentive.
- Incentives of a similar duration and scale may also be offered to long haul airlines that are currently at the airport and which are considering expanding their services at the airport.⁴⁶
- The evidence also outlined that not all long haul operators receive incentives (discounts or marketing support).
- Similar to the discussion on short-haul, airlines may be eligible for marketing support, although the size (and scope) of this incentive varied on a case by case basis.⁴⁷
- The evidence suggested that there was relatively more scope for negotiations around marketing support, the evidence on this is limited.

G86 Based on the available evidence the CAA therefore considered that:

⁴⁴ Approximately 85 per cent of Gatwick's traffic is made up of short haul traffic.

⁴⁵ While GAL has been relatively successful in attracting new long haul airlines it has also lost a number of such airlines.

⁴⁶ Airlines that have been offered this incentive include [redacted].

⁴⁷ Some of the marketing promotions that tend to be included in an incentive package include: Cash marketing support; Welcome Home E-mail; Mention in an E newsletter; Skyscraper advertising; A network pack of posters / Pillar wraps; and Adverts on digital screens in terminals. Assistance of this sort was, for example, offered to Monarch, for long haul services, Lufthansa, Turkish Airlines, Hong Kong Airlines, Air Asia X and Vietnam Airlines.

- While discounts to aeronautical charges are possible for new long haul traffic, the scope for airlines to actively negotiate with GAL and change the size of these discounts is limited.⁴⁸
- The scope for discounts to aeronautical charges for long-haul airlines already at the airport and not planning on incremental growth is much more limited relative to new long-haul traffic.
- There appears to be some scope for negotiations around marketing support for all long-haul services.

Charters (short and long haul)

G87 The evidence on negotiations with charters suggested that, due to the maturity of its business model, there is limited scope for charters to effectively negotiate with GAL as levels of incremental growth are limited. Charters' position is also potentially affected by the limited scope for them to operate at other London airports.

G88 Views expressed by some charters on how GAL negotiates with them can be summarised as follows:

- Gatwick focuses on business passengers rather than leisure passengers, thus there is less incentive to keep Thomas Cook there and seems quite happy for it to leave.⁴⁹
- At other airports decisions to expand operations at an airport arise from negotiation with the airport. ...[and] LGW and STN would be less likely to offer discount for operators with TUI's type of business model, as it would only bring incremental growth due to its level of maturity.⁵⁰
- Gatwick does not offer any long haul incentive discounts.⁵¹
- Other airports are forthcoming and it is much easier to discuss and work collaboratively at these airports than it is with GAL.⁵²
- GAL negotiations are markedly different and notably more difficult than those with these other airports.⁵³

⁴⁸ The CAA has seen incentives offered for [redacted].

⁴⁹ Source: Thomas Cook, [redacted].

⁵⁰ Source: Thomson Airways, [redacted].

⁵¹ Source: Monarch, [redacted].

⁵² Source: Monarch, [redacted].

⁵³ Source: Monarch, [redacted].

- GAL is not receptive to any joint initiatives suggested by Monarch.⁵⁴
- GAL's strategy is to focus on attracting new carriers and then once they start operating, it focuses its attention on another new carrier, without maintaining its incumbents.⁵⁵

Other issues

G89 The CAA also noted that it received some evidence that suggested that GAL is reluctant to move issues forward when they have been identified by airlines.⁵⁶ Furthermore, the issue of airlines failing to gain any traction with GAL with respect to a service level agreement was raised by a number of airlines during discussions with the CAA's board.

G90 Having analysed all the material above, the CAA concluded that GAL largely sets the terms that an airline will receive and that the scope for negotiation is relatively limited. In particular, the CAA found that there appeared to be:

- Limited scope for short haul airlines to negotiate any discounts to aeronautical charges, [X], and the scope for charters to effectively negotiate with GAL on other issues appears limited.
- Some scope for short haul carriers to enter into joint ventures and for some negotiation on marketing activities. In addition, it appears that short-haul carriers that consider flying from Gatwick or others considering expansion in Gatwick, will have some, albeit limited, ability to negotiate with GAL.

G91 The CAA also considered that GAL appeared to have adopted a strategy that was largely focused on building the number of long haul services operating at Gatwick. In addition, the CAA considered that GAL appeared to be willing to provide [X] incentives to airlines to operate at Gatwick, although the structure and scope of those incentives are set by GAL and deviation from that appeared limited.

Stakeholders' views

G92 GAL considered that the CAA's assessment of its pricing policy and engagement with airlines did not take proper account of the strict cost-

⁵⁴ Source: Monarch, [X].

⁵⁵ Source: Monarch, [X].

⁵⁶ Source: BA, [X].

based price cap regulatory environment within which it is operating, and is not indicative of market power. In particular, GAL highlighted that:⁵⁷

- The CAA appears to criticise it for not providing aeronautical discounts to all airlines and for focusing those on new airlines.
- The CAA had failed to acknowledge that GAL's current price cap is not simply about 'preventing excessive returns' and that:
 - The current price cap sets a cost-derived price limit based on a 'reasonable return' (the weighted average cost of capital).
 - Not achieving this would mean that the airport operator would, in effect, be loss making.
- GAL is severely restricted in its pricing flexibility and if it were to make available widespread discounts, this would likely lead to an underperformance against the cost of capital (a possibility which was a source of concern to the CAA in its Q6 Policy Update document).

- G93 GACC indicated that GAL's lack of engagement, particularly in relation to discussions on Commitments, lack of information disclosure during the Constructive Engagement (CE) process and behaviour in relation to the delivery of major capital projects (such as Atlantic House and runway re-surfacing) illustrates GAL's market power.⁵⁸
- G94 easyJet indicated that its submission should be read alongside that of the GACC's submission. It also considered that without regulation Gatwick would use its market power to unreasonably increase prices.⁵⁹
- G95 VAA indicated that GAL's lack of engagement particularly in relation to discussions on Commitments and the lack of information disclosure during the CE process illustrated GAL's market dominance. It also noted that this was not the behaviour that would take place if GAL was operating in a competitive market.⁶⁰
- G96 A number of submissions made it in response to the Initial Proposals were also of relevance to the CAA's assessment so the CAA drew on this material too.

⁵⁷ GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Reference Q5-050-LGW60, pp. 29 to 30.

⁵⁸ GACC, ACC Response to CAA document: Consultation on Gatwick market power assessment, paragraph 1.11.

⁵⁹ easyJet, easyJet response to CAA consultation on Gatwick airport market power, p. 1.

⁶⁰ VAA, Virgin Atlantic Airways Response to CAA Consultation on Gatwick Market Power Assessment, p. 4.

CAA views

- G97 As outlined at the start of this section, the behaviour of an airport operator can provide useful insight into how an airport's management view the degree to which it can be constrained by competition (and the degree to which it may be possible to exercise market power). In addition, an airport operator with SMP can choose not to exercise this market power by, for example, entering into genuine engagement on commercial issues.
- G98 While the CAA's analysis on engagement and commercial negotiations covered a number of issues, GAL's response focused on the offering of discounts only to new airlines, its return on capital and the lack of flexibility it has in relation to price.
- G99 In relation to GAL's comment on cost-based prices set by the regulatory regime, a price cap is set to allow the maximum levels of opex, capex and return on assets. However, a regulated firm has the flexibility and discretion to promote efficiency, innovation and better processes and practices to drive costs down and charge lower prices as it would do if it operated within a dynamic market environment driven by effective competition. For example, consistent with a view expressed by GAL (below), an airport operator may be able to set a lower (cost reflective) price that would allow it to operate successfully if it increased its efficiency (see earlier discussion):
- Competitive companies need to maximise returns on investment also [and that] competitive companies maximise returns through innovation, better understanding of customers' needs and efficient operations etc.*⁶¹
- G100 The CAA also considers the expected traffic flow through an airport when setting the price cap for an airport operator. GAL therefore has the scope to determine the price (up to the cap) that it considers will help bring people to the airport, including lowering prices which may facilitate increased passenger flow through the airport.
- G101 In addition, an airport operator may be able to reduce its prices through increasing retail revenue (due to the single till). Thus, similar to the point above on efficiency, by facilitating increased retail spending, directly or indirectly, an airport operator such as GAL may be able to reduce prices (and increase revenue).
- G102 Taken together, the CAA considers that there is a high degree of flexibility that is permitted by the current regulatory regime and that an airport

⁶¹ Source: GAL, [3<].

operator has a number of tools at its disposal, that it can use individually or together, to maximise its performance.

G103 With respect to the other concerns raised by stakeholders, the CAA considers that they can be summarised as the lack of effective engagement around capex and the Commitments – an outcome that these stakeholders considered reflected SMP.

G104 While capex and the Commitments (among other issues) are examined in the Initial Proposals and the Final Proposals, the CAA considers that a brief examination of these issues has merit.

G105 GAL has, for example, released revised Commitments but various stakeholders have expressed concern with GALs approach to this issue. For example, the GACC (in response to the Initial Proposals) noted:

*GAL shared an updated version of its commitments on the 7th June. As this came relatively late in the consultation period, the ACC has not been able to provide full comments on this updated proposal.*⁶²

G106 In addition, as per the Consultation, the CAA has received evidence that suggests that the airport operator is reluctant to move issues forward when they have been identified by airlines in various forums. The GACC has noted:

*... the ACC and its member airlines have debated with GAL the prospect of commitments However, these debates progress slowly as the airlines learn more of what GAL proposes. This is complicated by GAL volunteering minimum supporting data of such commitments and a general belief that the terms of these commitments are currently inadequate.*⁶³

G107 Further submission⁶⁴ made to CAA by both the airlines and the GAL to the CAA's Final Proposals consultations and the further response provided by both the airline community and the airport show that there is still considerable debate over varying issues relating to the regulatory settlement. The CAA has been made aware of a number of bilateral negotiations some of which have resulted in signed agreements between GAL and its airlines that have resulted from the regulatory process. The airlines have advised that these highlight GAL strong market position and

⁶² GACC, Response to CAA document: Economic regulation at Gatwick from April 2014: Initial Proposals, p. 52.

⁶³ GACC, Response to CAA document: Economic regulation at Gatwick from April 2014: Initial Proposals, p. 4.

⁶⁴ See: <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15408>

they have entered negotiations due to the regulatory incentives. These agreements are discussed in detail below.

Conclusion on engagement and commercial negotiations

- G108 Having analysed evidence from a range of sources, the CAA concludes that GAL largely sets the terms that an airline will receive and that the scope for negotiation is relatively limited. In particular:
- There appears to be limited scope for short-haul airlines to negotiate any discounts to aeronautical charges, [§<], and the scope for charters to effectively negotiate with GAL on other issues appears limited.
 - There appears to be some scope for short-haul carriers to enter into joint ventures with GAL and for some negotiation on marketing activities. In addition, it appears that short-haul carriers that consider flying from Gatwick or others that consider expansion in Gatwick will have some, albeit limited, ability to negotiate with GAL.
- G109 The CAA also considers that GAL appears to have adopted a strategy that it is largely focused on building the number of long haul services operating at Gatwick. As part of this, GAL appears to be willing to provide [§<] incentives to airlines to operate at the airport, although the structure and scope of those incentives are set by GAL and deviation from them appears limited.
- G110 The evidence also suggests that GAL's approach to the Commitments, consistent with the discussion outlined in the Consultation, is that it is not being constrained by competition. In particular, the CAA considers that the evidence suggests that GAL has been slow to release information, that the information that is released is often limited and that meaningful engagement is often absent.
- G111 While GAL may have started experiencing some initial competitive pressure since it was sold⁶⁵ and these competitive pressures may strengthen, potentially due to new ownership at Stansted, as GAL is the sole operator in the relevant market, the CAA considers that the present and future competitive pressures are not sufficient to impose a competitive constraint on GAL. This situation, a firm enjoying a position of SMP while facing some degree of competition, is described in the Hoffmann-La Roche v Commission [1979]:

⁶⁵ For example Air Moldova has switched away from Gatwick to Stansted. Delta Airlines, Qatar Airways and US Airways have also left Gatwick and now concentrate all their flights at Heathrow, where they already had a significant presence.

*As the Court has stressed, a finding of a dominant position does not preclude some competition in the market. It only enables the undertaking that enjoys such a position, if not to determine, at least to have an appreciable effect on the conditions under which that competition will develop, and in any case to act in disregard of any such competitive constraint so long as such conduct does not operate to its detriment.*⁶⁶

- G112 Based on the material outlined above, the CAA considers that GAL's overall behaviour suggests that GAL has SMP in the relevant market.

Quality of service

- G113 Airport operators operating in a competitive market may face significant pressure to maintain or improve their service quality to prevent airlines and passengers switching to other airports. The level of service quality could, therefore, provide evidence about whether an airport faces significant competitive pressures. Where an airport operator has SMP, in addition to increasing prices and/or reducing levels of investment, it might be able to reduce the quality of its service offering.

- G114 In Q4, in response to a public interest finding made by the Competition Commission (CC), regulation of service quality under the Service Quality Rebate (SQR) scheme was introduced by the CAA at Gatwick. Under this scheme, where airport operator's performance falls below certain pre-determined standards, the airport operator is liable to repay a portion of the charges levied to the airlines. The scheme was expanded for Q5 to include a total of 17 measures⁶⁷, some of which relate directly to passenger satisfaction and some which relate to the quality of services to airlines which, in turn, are passed onto passengers.

Consultation view

- G115 In the Consultation, the CAA noted, having considered evidence from a range of sources, including passenger surveys, direct measurement⁶⁸ and evidence from stakeholders, that it considered:

⁶⁶ Case 85/76, Hoffmann-La Roche v Commission [1979] ECR461, paragraph 39.

See also: EC's SMP Guidelines, Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services, (2002/C 165/03), footnote (74): *It should be stressed here that for the purposes of ex-ante regulation, if an undertaking has already been imposed regulatory obligations, the fact that competition may have been restored in the relevant market as a result precisely of the obligations thus imposed, this does not mean that that undertaking is no longer in a dominant position and that it should no longer continue being designated as having SMP.*

⁶⁷ 16 at the South Terminal, 17 at the North Terminal.

⁶⁸ The working paper on empirical methods discussed the two main methods by which service quality

- Since the introduction of the SQR scheme at Gatwick, there has been an improvement in the service quality at the airport.
- Since the change of ownership, there had been a further increase in the service quality at the airport. For example, GAL has gone beyond the regulatory targets that were set in a number of areas.
- Increased competitive pressures may be being felt by GAL, but it remains unclear if the improvements seen at Gatwick are due to competition or regulatory incentives. Furthermore, the CAA noted that irrespective of the source of improvement seen at Gatwick, an airport operator that is behaving more competitively does not automatically mean that it currently faces, or will face, a level of competition that is seen in an effectively competitive market.

Stakeholders' views

- G116 GAL indicated that the CAA's consideration of service quality is notable for the absence of any assessment of the requirements and desires of passengers. For example, there is no reference to the ACI ASQ survey data and how Gatwick's performance compares to the performance of other potentially comparator airports.⁶⁹
- G117 GACC highlighted that despite a somewhat positive change in behaviour since the sale in terms of improved delivery of service targets, that it did not attribute this to increased competition. Rather, it considered that this change was due to the beneficial effect of new owners.⁷⁰ It also noted that, given GAL's market power, it will face limited incentives to provide good service levels to either passengers or airlines.⁷¹
- G118 easyJet indicated that its submission should be read alongside the GACC's submission. It also noted that it considered that GAL has SMP

could be measured: through passenger surveys and direct measurement. It identified the various surveys that are carried out at airports, in particular: ACI's Airport Service Quality Ranking (the ASQ survey); BAA's own passenger surveys called the Quality of Service Monitor (QSM) and surveys carried out by the CAA. However, the surveys that the CAA undertakes are not designed to collect information about service quality although a question on passenger satisfaction with the airport experience has been included since July 2012.

⁶⁹ GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Reference Q5-050-LGW60, p. 30.

⁷⁰ GACC, ACC Response to CAA document: Consultation on Gatwick market power assessment, paragraph 1.11.

⁷¹ GACC, ACC Response to CAA document: Consultation on Gatwick market power assessment, paragraph 1.35.

and that as a result there would be a significant risk of service quality failures.⁷²

- G119 VAA noted that: *‘despite a change in behaviour since the change in ownership, particularly in regards to service quality; we are not be able to directly attribute this solely to increased competition in the market.’*⁷³

CAA views

- G120 A number of stakeholders shared the view that the improvement in service quality seen at Gatwick has not been solely due to increased competition and that this change was also due to the beneficial effect of new owners. New owners do appear to have made a difference at Gatwick but it remains unclear if all the improvements seen at Gatwick are due to GAL facing increased competition, better management focus and/or regulation.
- G121 In relation to GAL’s concern that there was no reference to the ACI ASQ survey data and how Gatwick’s performance compares to the performance of other potentially comparator airports, service quality was examined in both Test A and Test C of the Consultation. Indeed, a large amount of information on service quality was only outlined in the document explaining Test C. While this information was not repeated in the document explaining Test A, this material was considered by the CAA in the final consideration as part of Test A.
- G122 For the sake of completeness, in the discussion on Test C in the Consultation, the CAA outlined that it had considered GAL’s service quality performance against both direct objective measurement, using the Q5 service quality incentive scheme, and qualitative assessment through passenger satisfaction surveys such as the ASQ and QSM.⁷⁴
- G123 The analysis of these different approaches highlighted that:⁷⁵
- During Q5, GAL had been successful in reducing the level of rebates paid and increasing the bonuses awarded under the SQR at Gatwick.⁷⁶

⁷² easyJet, easyJet response to CAA consultation on Gatwick airport market power, p. 1.

⁷³ VAA, Virgin Atlantic Airways Response to CAA Consultation on Gatwick Market Power Assessment, p. 4.

⁷⁴ QSM is the Quality of Service Monitor which is customer satisfaction survey data collected by the airport. ASQ is an international customer satisfaction survey overseen by the Airports Council International which enables the benchmarking of STAL’s performance with other airports.

⁷⁵ For the full details of the CAA’s Test C discussion on service quality see pp. 487 to 496 of the Consultation.

⁷⁶ The Q5 regime incorporates a service quality rebate scheme, with targets and rebates paid, set at

- GAL's QSM survey, which includes the question *'how would you rate your overall experience in the airport terminal today?'* and the CAA's Passenger Survey, which asks the same question, both showed that there has been a steady increase in the level of passenger satisfaction since early 2008.
- The ASQ survey, which has a smaller sample size but is based on an independent passenger survey of overall satisfaction with the airport, showed a similar profile, showing increasing passenger satisfaction during Q5. As with the QSM survey results, passenger satisfaction had improved throughout Q5, and not simply after the airport ceased to be under BAA control in December 2009.
- GAL's ASQ ranking compared to other airports that participate in the survey has tended to fall as more airports have joined the sample. That said, the CAA notes that it has moved from being in the fourth quartile to the third quartile of reporting airports.

G124 In the Consultation it was also highlighted that there was little doubt that GAL's service quality performance had improved during Q5. However, the discussion had also noted that it was difficult to judge whether the improved performance seen at Gatwick reflected the impact of regulation or competitive pressures – a view consistent with that which the CAA outlined in Test A.

Conclusion on quality of service

G125 Having considered evidence from a range of sources, including from responses to the Consultation, the CAA considers that the view it outlined in the Consultation remains appropriate. In particular, the CAA considers that:

- Since the introduction of the SQR scheme at Gatwick, there has been an improvement in the service quality at the airport.
- Since the change of ownership, there had been a further increase in the service quality at the airport. For example, GAL has gone beyond the regulatory targets that were set in a number of areas.
- Increased competitive pressures may be being felt by GAL (and that this may increase again with Stansted's sale), but it remains unclear if the improvements seen at Gatwick are due to competition or regulatory incentives.

a maximum of 7 per cent of airport charges, for underperformance across 17 passenger and airline facing metrics, and a service quality bonus scheme, with bonuses paid, set at a maximum of 2.24 per cent of airport charges, for outperformance across 6 passenger facing measures.

- Irrespective of the source of improvement seen at Gatwick, an airport operator that is behaving more competitively does not automatically mean that it currently faces, or will face, a level of competition that might be expected from a company in a well functioning market.

G126 GAL also did not provide any evidence (such as strategy documents, specific quality of service actions and own initiatives to outperform the targets set by the CAA) to support its view that the improvements seen with respect to service quality reflected competitive dynamics and not merely regulatory incentives.

Profitability

G127 In the absence of regulation, an airport operator holding SMP can act to an appreciable extent independently of its competitors and its customers, due to insufficient competitive pressure. As a result, an airport operator may increase prices above the competitive level, compromise service quality and enjoy supernormal profits.

Consultation view

G128 In the Consultation, the CAA indicated that analysis of the financial performance of regulated airport operators is unlikely to provide particularly strong evidence about an airport operator's market position.⁷⁷ This is particularly true if an airport operator chooses to set its prices at, or near to, the allowed price cap (which GAL has done), as economic regulation is designed to prevent excessive returns being achieved.⁷⁸

G129 In coming to this view the CAA noted that:

- The financial performance and pricing of a company can often provide evidence regarding the airport operator's level of market power. However, due to the economic regulation of GAL, the level of profits cannot be used as a reliable indicator as to whether GAL would enjoy a high level of market power.
- In 2009, BAA (now Heathrow Airport Holdings Limited) disposed of Gatwick but the separation process was not completed until February 2011 and this affected GAL's results, particularly its cost base.
- In light of the limited reliance that can be placed on these aspects of behavioural evidence, it did not assess in detail the costs, revenues and profitability of GAL.

⁷⁷ CAA, Empirical methods for assessing behaviour, performance and profitability of airports.

⁷⁸ CAA, Empirical methods for assessing behaviour, performance and profitability of airports, paragraph 4.3.

G130 The CAA also noted that there are a number of issues associated with profitability, namely efficiency, service quality and pricing, which, if examined, could help inform an assessment of market power.

Stakeholders' views

G131 In relation to profitability, GAL noted:

[T]he current price cap sets a cost-derived price limit based on a 'reasonable return' (the weighted average cost of capital). Failure to achieve the reasonable return would mean that the airport is effectively loss making.⁷⁹

CAA views and conclusion on profitability

G132 In relation to GAL's single concern on profitability, the CAA notes:

- The regulated price cap sets the maximum allowed yield per passenger on the basis of recovering the allowed opex and capex including a reasonable return on capital which is designed to prevent excessive returns.
- A regulated firm may decide to promote economy and efficiency by (among many things) putting downward pressure on operating and capital costs including financing costs. For example, a firm may consider various options to reduce its financing costs such as altering its capital structure, identifying sources of cheaper debt and equity capital.

G133 Neither GAL nor any other stakeholder has raised any specific concerns in relation to the CAA's views on profitability. On this basis, the CAA considers that since GAL is a regulated airport operator the analysis of its profitability cannot be considered as a useful indicator of SMP. This view is consistent with that outlined in the Consultation.

GAL's bilateral negotiations under the proposed regulatory framework

G134 In November 2013⁸⁰, the CAA was made aware that pursuant to the proposed commitments framework GAL has been in negotiations with a number of airlines in order to sign bi-lateral agreements. Agreements between GAL and three airlines (Emirates,⁸¹ Norwegian Air⁸² and

⁷⁹ GAL, CAA's Gatwick Market Power Assessment: Response from Gatwick Airport Limited, Reference Q5-050-LGW60, p. 30.

⁸⁰ Source: GAL, [§<].

⁸¹ See: <http://centreforaviation.com/members/direct-news/gatwick-set-to-welcome-the-emirates-a380->

Thomson⁸³) have been publically announced. The CAA has been notified by GAL of agreed heads of terms with a further two airlines.⁸⁴ Other proposed bilateral agreements while not formally agreed yet appeared to be at an advanced stage of negotiation. The CAA requested from GAL the proposals it has made for these bi-lateral arrangements and also asked the airlines how the proposed bi-lateral agreements might effect on their prior considerations and the evidence submitted about GAL's level of market power.⁸⁵

G135 GAL provided evidence on the status of negotiations on bi-lateral agreements with the following airlines:

- [redacted];
- [redacted];
- [redacted];
- [redacted];
- Emirates;
- [redacted];
- Norwegian Air;
- [redacted];
- Thomson Airways;
- [redacted]; and
- [redacted].

Main provisions of the agreements

G136 On the basis of the available evidence (at this late stage) the CAA identified a number of main conditions to the bi-lateral agreements:

[146125](#)

⁸² See: <http://www.mediacentre.gatwickairport.com/News/Norwegian-and-London-Gatwick-sign-landmark-long-term-commercial-partnership-87a.aspx>

⁸³ See: <http://www.mediacentre.gatwickairport.com/News/Thomson-agrees-long-term-commercial-partnership-with-London-Gatwick-887.aspx>

⁸⁴ [redacted] and [redacted]. GAL, Email to Iain Osborne from Kyran Hanks, 12 December 2013 at 11:58, Email to Iain Osborne from Kyran Hanks, 10 December 2013 at 11:07

⁸⁵ The CAA also questioned the airlines on the impact that these bi-lateral arrangements have for the proposed regulation.

- The bi-lateral agreements are effectively conditional upon GAL being licensed in respect of the Commitments Framework under a licence, as set out by the CAA in its final proposals.
- The foreseen discounts calculated from one or more charges set out in GAL's published conditions of use. GAL retains the ability to flex the structure of its charging scheme and the price of the agreement can be varied unilaterally by GAL.
- The agreements focus on discounts offered to charges levied on winter traffic volumes (off-peak discounts), where the majority of traffic at the airport is in the summer months.
- The airlines are required to support the inclusion of Gatwick in any consideration by the Airports Commission for a second runway, and to agree lines on this issue with the airport.
- The agreements almost universally require the airlines to agree the following GAL commercial initiatives:
 - [X].
 - [X].
 - [X].
 - [X].
 - [X].

G137 A number of airlines do have more bespoke arrangements within the bi-lateral agreements; however these are in addition to the main conditions set out above. Indicatively, the CAA notes that in one agreement in particular the airline is required to support the Commitment regime in writing to the CAA⁸⁶

G138 As noted above the CAA has as a result of the submission of details of these bi-lateral agreements contacted the airlines involved asking them:

- the latest state of these discussions, and
- in the light of these discussions do you wish to provide the CAA with any further views on whether GAL has substantial market power.

G139 Given the stage of these commercial negotiations a number of airlines did not feel able to comment in time for the CAA to take account of their

⁸⁶ GAL, [X]

response for the purpose of this determination. However, a number of airlines did respond stating::

- [REDACTED]:
- [REDACTED].
- [REDACTED].
- [REDACTED].
- [REDACTED].
- [REDACTED]:
 - [REDACTED].
 - [REDACTED].
- [REDACTED]
- [REDACTED]:
 - [REDACTED].
 - [REDACTED].
- [REDACTED].
- [REDACTED].
- [REDACTED].

G140 In summary the airlines consider that the negotiation do not affect their position on GAL having SMP the negotiations are the result of the regulatory process. The airlines consider that they have had to enter negotiation to remain competitive given the regulatory settlement, which they do not consider provides adequate protection. They also raised concern over the nature of the negotiations being one sided.

G141 Norwegian Air did not respond to our call for evidence and therefore limited comment can be made on its view in line with that of the other airlines presented above. Norwegian Air is quoted in the GAL press release for the agreement as saying:⁸⁷

Norwegian [Air] is delighted to have agreed a long term commercial partnership with London Gatwick. As one of the fastest growing airlines at

⁸⁷ 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>

the airport, Norwegian [Air] will continue offering our passengers at Gatwick an increasing route network and a high quality product at reasonable fares. We are particularly excited about the potential to serve long haul routes, and we have already announced the first three routes from London Gatwick to the US. Norwegian [Air] is very supportive of Gatwick's runway expansion plan which would mean that the airport could offer even better operating facilities in the future.

CAA's assessment of the GAL bi-lateral agreements

G142 One of the objectives of the proposed regulation for GAL was promote commercialisation of the airport with a view to enhance its competitive pressures and outcome in terms of quality and price to its customers. As such, the CAA welcomes any steps that the airport operator would be prepared to make in this area.

G143 The CAA considers that the deals and proposals stem from the regulatory settlement. As [X] noted in their response:⁸⁸

[X].

G144 It is explicit in the terms of the deals that, should the regulatory settlement not be as proposed within the Final Proposals, then the bi-lateral agreements fall away. The agreements themselves would therefore form part of the overall regulatory settlement for GAL but would not have legal force outside a licence.

G145 Furthermore, as set out above, some of the general and specific terms of these deals explicitly interact with elements of the regulatory settlement – for example, requiring support for a second runway at the airport and in at least one case making the agreement conditional on the airline to responding in a particular way to CAA's regulatory consultation process.

G146 The CAA is therefore mindful in its consideration of the effect that these deals may have on its analysis of any SMP that GAL might have SMP being apparently mitigated by regulatory actions or events contingent on regulatory intervention. The CAA considers that this would be a circular argument. The Court of Appeal has given clear guidance on the risks of circularity:⁸⁹

A question as to how an undertaking would operate on a market cannot be answered, in this context, by saying that it would behave in a way that would comply with the regulatory controls that might be imposed on it if it

⁸⁸ [X].

⁸⁹ Hutchinson 3G UK LTD vs. The Office of Communications [2009] EWCA Civ 683 paragraphs 61 and 66.

did not. That would result in a regulatory system being self-defeating. Its existence would mean that the mischief which it exists to deal with would be found not to be present because of the very existence of the system, thereby negating, in theory, the conditions for the application of regulatory control but leaving it open to the undertaking, in practice, to operate (for a time at least) uncontrolled by regulation.

...

A regulatory provision which, if used, would have an effect on the freedom of an operator to act independently of its customers cannot be allowed to provide an a priori answer to the question whether that operator does or does not have SMP. It does not seem to me to matter whether the provision is one which affects, directly, the operator in question or a third party dealing with it, such as BT in the present case, the extent of whose CBP is in issue and would affect the operator's freedom in relation to its customers. Accordingly it does not seem to me helpful or relevant to consider whether the dispute resolution powers are to be seen, in this context, as affecting BT or H3G or both. Either way, in the present situation, if it were taken into account in the way Miss Rose submitted is correct, it would provide an automatic answer to the question, and would not allow a finding of SMP in any such case. That cannot be a correct application of the legislation.

- G147 The response from the airlines community supports the CAA assessment of the deals in that they clearly stem from and are conditional upon the regulatory framework and in particular the Q6 Final Proposals. The evidence from the airlines strongly suggests that the negotiation of these agreements is effectively a result of the regulatory process and not an indication of buyer power that would be sufficient to rebut GAL's SMP. The CAA therefore risks circularity in argument in consideration of these negotiation and agreements as a change in commercial strategy by the airport or an improvement in the negotiating position of the airlines.
- G148 The CAA therefore concludes that the GAL bilateral negotiations do not justify altering its assessment under Test A. In taking making this decision, the CAA has only been able to consider in the round what appear to be the key common elements of the agreements: for example, the linkage with any regulatory licensing settlement under the CA Act. It has not had sufficient time to analysis the possible affect of each individual term may have on the market position or conduct of GAL in any market(s) that it operates or holds significant interest. It has also taken into account the fact that the deals do not cover all airlines and some are still in the process of negotiation

Conclusion on indicators of market power

- G149 The examination of indicators of market power can provide insight into the performance and behaviour of an airport operator. The CAA recognises that while individual indicators of market power on their own may not be determinative of market power (and may each suggest slightly different assessments), when considered as a whole, they help to determine whether an airport operator has SMP. However, the CAA's overall assessment of SMP, presented in chapter 5 draws on the evidence in this appendix and that in the other appendices.
- G150 In light of the representations from stakeholders as part of the Consultation, the CAA has re-evaluated the evidence available on indicators of market power. While the individual indicators of market power may each suggest slightly different outcomes, the CAA considers that GAL has SMP and that this will continue going forward, not least due to improving economic conditions and tightening capacity across the London airports.
- G151 In coming to this view, the CAA recognises that more weight can be given to some indicators relative to others. In particular, GAL's performance with respect to efficiency and its behaviour in relation to commercial negotiations do not only appear to rebut but also corroborate the presumption of SMP suggested by the market share analysis. For example, the evidence suggests that:
- There are a number of areas of inefficiency at Gatwick. In particular, the evidence from a number of benchmarking and efficiency studies, carried out by different independent consultants using different approaches, indicate several areas of inefficiency at Gatwick – staff costs and pensions being the most significant.
 - There appears to be limited scope for short-haul airlines to negotiate any discounts to aeronautical charges, [X], and the scope for charters to effectively negotiate with GAL on other issues appears limited.
 - GAL is often slow to release information, that the information that is released is often limited and that meaningful engagement is often absent.
 - The recent deals proposed by GAL to the airlines clearly stem from and are conditional upon the regulatory framework and in particular the CAA's final Q6 proposals.

- In relation to those bilateral deals the evidence from the airlines strongly suggests that the negotiation of these agreements is effectively a result of the regulatory process and not an indication of buyer power that would be sufficient to rebut GAL's SMP.
- G152 The evidence on price also suggests that, contrary to GAL's view that the competitive price is substantially above the current regulated price, that GAL's current price is broadly consistent with the price that would arise in a market facing competitive conditions. However, going forward, the evidence suggests that in the absence of regulation GAL's prices are likely to be raised significantly above current levels. This consideration does not rebut the presumption of GAL having SMP in the relevant market suggest by the market shares and suggests that going forward GAL's SMP will to be maintained.
- G153 Consistent with the above, evidence on efficiency also suggests that GAL has SMP in the relevant market as it is able to maintain levels of inefficiency which could not be maintained if there was effective competition.
- G154 While, at first glance, the market share analysis suggests that Gatwick has a relatively strong market presence, there are a number of limitations associated with market shares analysis.
- G155 In addition:
- Since GAL is a regulated airport operator that is subject to a quality scheme, the quality outcomes are unlikely to provide particularly strong evidence about the airport operator's market power. However:
 - GAL's performance has improved in a number of areas and while this was encouraging, it has only been occurring for a relatively short time period.
 - While the improvements seen at Gatwick may reflect greater competitive pressures, the airport operator might still have sufficient market power to require economic regulation.
 - While it appears that greater focus has been placed on improving efficiency at the airport since its sale, several independent studies have identified areas of inefficiency. In addition, since the initial reduction in costs following new ownership, there has been limited subsequent improvement.
 - GAL's financial performance is unlikely to provide particularly strong evidence about the level of market power, as Gatwick is a regulated airport and it only changed owners recently.