

# Response to CAA's Market Power Assessment

CAA/Q6/80

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# 1 Executive Summary and Conclusions

1.1.1 The CAA's market power assessment (MPA) is an important part of the application of the new regulatory framework. While the process can be interpreted as the means by which the CAA sets out its case for imposing regulation (through a License), Heathrow Airport Limited ("Heathrow") considers the process fundamental to the development of the regulatory framework for the airport. The process, the evidence base and the rationale for decisions made by the CAA are all of fundamental importance to confidence in the regulatory framework. Heathrow has significant concerns in relation to the CAA's MPA

1.1.2 Heathrow's main concerns in relation to the CAA's decisions in respect of the market power tests ("MPT") are summarised below:

- (a) On Test A, the CAA has based its conclusions on flawed analysis:
  - (i) The proposed market definition is inconsistent with extensive precedent from other competition authorities and inconsistent with its own views expressed previously. It is not supported by robust evidence, and therefore inconsistent with evidence on the different competitive conditions facing different market segments. Finally, the market definition appears to be inconsistent with the legal framework established within the Civil Aviation Act 2012;
  - (ii) The analysis of competitive constraints analysis considerably understates the cumulative effect of potential switching options available to airlines and passengers and overstates airlines' potential switching costs. The CAA also fails to consider the wider dimensions of competition such as service quality;
  - (iii) The CAA's critical loss analysis is subject to significant limitations, particularly the lack of direct price elasticity evidence to estimate "actual" loss, the arbitrary alternative approach to estimating likely lost passengers, and the use of potentially skewed commercial income and cost elasticity assumptions with no sensitivity analysis; and
  - (iv) The CAA's review of market power indicators adds little to the analysis.
- (b) On Test B, the CAA has failed to provide sufficient evidence of harm to air transport users in the absence of ex-ante regulation, and has clearly understated the protection (and dissuasive incentives) that ex-post competition law does provide.
- (c) On Test C, the CAA has failed to undertake a sufficient evaluation of the direct and indirect benefits and costs of its regulation, as well as the counterfactual by which it should be measured.

1.1.3 As a consequence, Heathrow is concerned that the CAA's MPA is insufficiently robust to support the CAA's conclusions. Many of the concerns expressed above suggest that the CAA may have fallen into the trap of "confirmation bias". Given this, it is important that the CAA has fully explored the important issues in this MPA in order to offset any real or perceived influence of confirmation bias in the CAA's decision.

## 2 Market Definition and assessment of market power (Test A)

### 2.1 Introduction

2.1.1 CAA is minded to find that Heathrow has Substantial Market Power (SMP) in a market for aeronautical services. The CAA's preliminary decision rests on four pillars:

- (a) The proposed relevant market definition is for full service carriers (FSCs) and associated feeder traffic (at Heathrow Airport);
- (b) Heathrow faces limited competitive constraints from airline or passenger switching to alternative airports;
- (c) A critical loss analysis which suggests that it would be profitable for Heathrow to raise prices by 5-10%; and
- (d) A review of market power indicators which the CAA considers supports a finding of SMP.

2.1.2 Each of the CAA's 'pillars' is addressed below.

### 2.2 Market Definition

2.2.1 The CAA's proposed market definition is as follows:

- (a) The product market consists of the provision of aeronautical services to FSCs and associated feeder traffic; and
- (b) The geographic market is defined as Heathrow airport itself i.e. a separate market from other London airports and from other hub airports in Europe and globally.<sup>1</sup>

2.2.2 Heathrow has significant concerns about the CAA's approach to market definition. In particular, the CAA's approach is:

- (a) Inconsistent with extensive precedent in the analysis of the airport sector (including in the London area) by competition authorities;
- (b) Inconsistent with its own views as expressed in earlier market power assessment documents and in other contexts;
- (c) Not supported by robust evidence;
- (d) Inconsistent with the variation in competitive conditions facing different market segments; and

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<sup>1</sup> CAA, "Consultation on Heathrow market power assessment" (CAP 1051) ("Heathrow MPA Consultation"), May 2013, §4.173 – 4.174

- (e) Appears to be inconsistent with the legal framework within the Civil Aviation Act 2012.

### **Inconsistent with extensive precedent**

2.2.3 The CAA's approach to market definition appears to be inconsistent with extensive precedent where other airport and competition regulators have had to address similar issues. Contrary to the CAA's MPA, these precedents recognise the potential for: (i) identifying a separate segment for connecting passengers from origin and destination (O/D) passengers, where different competitive conditions may apply to each segment within the airport sector; and (ii) widening the geographical market definition.<sup>2</sup> While it may be appropriate for the CAA to consider the evidence in any particular assessment on its merits, the failure to explain how it has reached such a different approach to other competition regulators is of significant concern. These precedents are summarised in Table 1 below.

2.2.4 Precedent where competition authorities recognise the potential for segmenting the market by type of passenger includes:

- (a) In a number of merger cases, the European Commission ("the Commission") found that airport product markets could be segmented. For example, the Commission analysed the appropriate market definition in relation to London airports when it reviewed the acquisition of BAA plc by Ferrovial (and other financial partners) in 2006. In this case, the Commission left open the possibility of further sub-segmenting the product market on the basis of type of customer (e.g. FSCs and low cost carriers) or short-haul versus long-haul routes (as suggested by some of the airlines).<sup>3</sup>
- (b) NMA (the Dutch competition authority) commissioned a study from German Airport Performance (GAP) as part of conducting a market power assessment for Amsterdam Schiphol Airport. The study found four markets for the provision of infrastructure: airlines serving O/D passengers; airlines serving connecting passengers; cargo services; and local and instruction flights.<sup>4</sup> In particular, subdividing passengers between O/D and connecting passengers was based on observing Schiphol's price discrimination between O/D and connecting passengers, and then testing whether there is any substitution between these two types of passengers when the "Air Passenger Tax" was introduced at Schiphol in July 2008. This tax was levied on O/D but not connecting passengers (thus approximating a small but significant price increase on O/D passengers), but after its introduction there was no apparent substitution between these markets.<sup>5</sup>

2.2.5 Precedent that recognises the potential for a wider geographic market definition includes:

- (a) The Competition Commission (CC) in its investigation into BAA airports:

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<sup>2</sup> We cover the CAA's own previous statements in the next section.

<sup>3</sup> European Commission, Ferrovial / Quebec / GIC / BAA decision, §13

<sup>4</sup> GAP, "The economic market power of Amsterdam Airport Schiphol", April 2010, §233.

<sup>5</sup> GAP, "The economic market power of Amsterdam Airport Schiphol", April 2010, §193

- (i) The CC avoided narrow geographic market definitions in this investigation due to a number of issues, including the difficulty in assessing the competitive price of an individual airport<sup>6</sup> and the existence of binding price caps.<sup>7</sup> We comment further on the CAA's treatment of the competitive price level in [section 2.3] below.
  - (ii) The CC also noted that defining the narrowest possible geographic market is important mainly where market power can be accurately approximated by market shares. This is not the case in assessing an individual airport where geographical location is so important for competition.<sup>8</sup> The CAA agrees with this in the Heathrow MPA Consultation, citing the same observation from the CC.<sup>9</sup> As such, it is unclear why the CAA has sought to define a rigidly narrow geographic market in this case.
  - (iii) We note that the CC referred to airports in "south-east England" throughout its findings<sup>10</sup>, which the CAA acknowledged in its Initial Views<sup>11</sup> but does not address this in the current consultation.
  - (iv) In the appeals process of the market investigation, the Court of Appeal made clear that the CC had concluded there was strong substitutability between Heathrow, Stansted and Gatwick, where: "*If the Commission had not been satisfied that there was, at the very least, a significant degree of substitutability, it would have made no sense for it to have required BAA to divest itself of Stansted*"<sup>12</sup>, clearly indicating that a wider geographic market definition would enable a more appropriate assessment of competitive constraints.
- (b) In its review of the Ferrovial acquisition of BAA, the Commission notes that leaving open the exact geographic market definition on airport infrastructure services is in line with previous decisions.<sup>13</sup>

<sup>6</sup> CC, "BAA airports market Investigation: A report on the supply of airport services by BAA in the UK" ("BAA Market Investigation Final Report"), 19 Mar 2009, §2.44(a)

<sup>7</sup> CC, BAA Market Investigation Final Report, §2.44(b)

<sup>8</sup> CC, BAA Market Investigation Final Report, §2.46

<sup>9</sup> Heathrow MPA Consultation, §3.55 – 3.56

<sup>10</sup> For example, CC, BAA Market Investigation Final Report, Summary §1. We note this is despite the CC's observation that "...there is a continuum of substitution possibilities depending on distance and other airport characteristics. Hence any market definition beyond a single airport is, to an extent, arbitrary...". CC, BAA Market Investigation Final Report, §2.46

<sup>11</sup> CAA, "Heathrow: Market Power Assessment non-confidential version – The CAA's Initial Views" ("the CAA's Initial Views", Feb 2012, §2.128

<sup>12</sup> Court of Appeal Judgment, BAA Limited v Competition Commission, handed down 26 Jul 2012, §11. The Court of Appeal also notes that the Tribunal concluded the CC's report had found: "... strong substitutability of Heathrow and Stansted (when looking at the scope for bilateral competition between them) and ... strong substitutability of Heathrow, Gatwick and Stansted (when looking at the scope for development of a trilateral competitive dynamic between them all) ..." (§9, emphasis added), implying that the constraint is symmetric.

<sup>13</sup> European Commission, BAA / Ferrovial decision, §15. In this particular case, the Commission observes that it can leave open whether a wider area including some or all of the London airports is not necessary, given no competition concerns arise under either geographic market definition (European Commission, BAA / Ferrovial decision, §18 – 21)

- (c) The GAP study for NMA also left open the exact geographic market definition, stating that *“the definition of the geographic markets should not predetermine the assessment of market power too early”*, further noting that this is in line with European case law.<sup>14</sup>
- (d) However, the GAP study for NMA did highlight the Commission’s approach for defining catchment areas in the acquisition of Flughafen Berlin. In this case, the Commission considered the main European hub airports as belonging to the same catchment area, where these can be reached within a two-hour flight.<sup>15</sup> Application of such a rule would imply that several European hub airports would present reasonable alternatives to Heathrow, including (but not necessarily limited to) Paris CDG, Amsterdam Schiphol and Frankfurt Main. We note the CAA has not attempted to undertake any catchment analysis for connecting traffic in its MPA. We provide further comments on the CAA’s route overlap and catchment analysis below.

2.2.6 As a consequence, the CAA appears to have failed to take into account these precedents, where other competition authorities have considered market definition for airports and have recognised the potential for:

- (a) Segmenting the product market by passenger type. In particular, GAP on behalf of NMA had undertaken considerable analysis of whether connecting and O/D passengers should be separate market segments in assessing Amsterdam Schiphol’s market power; and
- (b) A wider geographic market definition beyond including just the airport in question. The other competition authorities in these precedents have also had to assess the substitutability of other airports, and have reached a considerably different view to the CAA.

2.2.7 Given the CAA does not appear to have received significant evidence or carried out quantitative analysis which contradict these precedents, we encourage the CAA to review its reasons for coming to such different conclusions.

#### **Inconsistent with the CAA’s own views**

2.2.8 The CAA’s current approach also appears to contradict its own views as expressed:

- (a) In the earlier stages of its assessment of Heathrow’s market power; and
- (b) In other contexts, specifically during the CC’s market investigation into BAA airports and in the subsequent appeals.

2.2.9 In particular, the CAA acknowledges both London-wide and (at least) European airport substitutes for Heathrow’s passengers on these occasions. These views are also summarised in Table 1 further below.

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<sup>14</sup> GAP, “The economic market power of Amsterdam Airport Schiphol”, April 2010, §224

<sup>15</sup> Cited in GAP, “The economic market power of Amsterdam Airport Schiphol”, April 2010, §226

## Views expressed earlier in this market power assessment

- 2.2.10 The CAA appears to have considered both segmenting the product market and a wider geographic market in its working papers from 2011, its Initial Views in February 2012 and its stakeholder presentation in March 2012.
- 2.2.11 In its “UK Airports Market – General Context” Working Paper (Sep 2011), the CAA observed that different passenger segments can have different preferences and requirements, and so may view different airports as substitutes for their journeys<sup>16</sup>. From its Passenger Survey findings, more than one-third of Heathrow’s passengers are connecting passengers, for whom *“the local catchment area is not relevant”*.<sup>17</sup> Rather, their substitutes for Heathrow are *“likely to include other hub airports within the EU, such as Paris CDG, Amsterdam or Frankfurt, but might also include, depending on the journey in question, hubs in other geographic regions, including North America and the Middle East.”*<sup>18</sup> Given the CAA refers to the same Passenger Survey working paper (Nov 2011) in its Consultation Document market definition analysis as in this working paper, and the CAA has no route overlap evidence that contradicts this observation, it is unclear why the CAA has deviated from its previous views.
- 2.2.12 The CAA’s views on the potential relevance of market segmentation were expanded on in its 2012 Initial Views. In this document, the CAA separately analysed the market for the supply of infrastructure to airlines and that to passengers, where the CAA noted that:
- (a) *“This passenger product market needs to be segregated into the services provided to connecting and surface passengers”*.<sup>19</sup> This finding appears to be mainly based on finding that airports can (and do) distinguish between connecting and O/D passengers, considering the different parts of airport infrastructure used by these passengers, as well as findings from the CAA’s Passenger Survey on which airports these passengers view as alternatives to Heathrow.<sup>20</sup> On the basis of this analysis, the CAA clearly stated that it is useful to treat these two passenger groups as being in separate economic markets<sup>21</sup>; and
  - (b) In relation to the geographic market, Heathrow operates in overlapping geographic markets in relation to both airlines and passengers. The CAA noted that the passenger markets appear to be relatively broad, mainly based on considering the CAA’s catchment area analysis and Passenger Survey. In particular, when considering passengers’ airport preferences the CAA noted, *“for a significant proportion of connecting passengers, this choice set includes at least the three other major European hub airports: Amsterdam Schiphol, Frankfurt am Main and Paris Charles de Gaulle.”*<sup>22</sup>
  - (c) In contrast, the CAA noted that from an airline perspective Heathrow’s geographic market is *“no wider than Heathrow and, for some services, Gatwick when based*

<sup>16</sup> CAA, “Airport market power assessments: UK Airports Market – General Context”, Working Paper, (“UK Airports Market – General Context Working Paper”) Sep 2011, §7.4 onwards

<sup>17</sup> CAA, UK Airport Market – General Context Working Paper, §8.9

<sup>18</sup> CAA, UK Airport Market – General Context Working Paper, §8.9

<sup>19</sup> The CAA’s Initial Views, §2.153

<sup>20</sup> The CAA’s Initial Views, §2.97 – 2.99

<sup>21</sup> The CAA’s Initial Views, §2.100

<sup>22</sup> The CAA’s Initial Views, §2.135

*network carriers are considered but further afield when considering Heathrow's inbound carriers*".<sup>23</sup>

2.2.13 The CAA also appeared to adopt a wider geographic market definition in its stakeholder presentation of March 2012, where this is a consequence of separating airlines into based, inbound, short-haul and long-haul segments, stating:

- “• *Based network airlines: market is no wider than LHR and, for some services, LGW*
- *Inbound airlines operating short-haul services: market extends broadly to Europe*
- *Inbound airlines operating long-haul services: market extends further afield*”<sup>24</sup>

2.2.14 Given that the evidence underpinning these conclusions has not changed, it is difficult to understand why the CAA has now reached different conclusions. While the CAA's Consultation Document acknowledges its Initial Views on the substitution possibilities available to surface and connecting passengers<sup>25</sup>, it then goes on to reverse its view based on making a series of qualitative points.<sup>26</sup> In general, the CAA observes that its thinking has “evolved” in relation to market definition<sup>27</sup>, stating:

*“Since the publication of the Initial Views, the CAA has strengthened its evidence base by undertaking additional analysis on the existing evidence as well as considering new material, including material submitted in response to the Initial Views and material obtained from further stakeholder engagement.”*<sup>28</sup>

2.2.15 This additional analysis appears to mainly consist of (re)consulting airlines on their views, and undertaking a critical loss analysis. In Heathrow's view, these do not provide a robust basis on which to conclude a rigid and narrow market definition. Moreover, Heathrow is not able to identify any material differences in the existing or new evidence that merits an entirely different interpretation or new approach. We provide more detailed comments on the CAA's evidence base below.

### **Views expressed in other contexts**

2.2.16 The CAA's current approach to market definition also appears to reverse a number of views expressed in other contexts, particularly in relation to its geographic market definition. We present examples of the CAA's views on potential geographic markets: (i) during the CC's market investigation into BAA airports and subsequent appeal; and (ii) in other contexts outside of the CC investigation.

2.2.17 While we have not reviewed every single representation the CAA has made to the CC in this context, we present a considerable number of examples below that suggest the CAA considered Heathrow to be in a wider geographic market when making submissions to the investigation, including:

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<sup>23</sup> The CAA's Initial Views, §2.156

<sup>24</sup> CAA, “The CAA's Initial Views on Market Power: Heathrow – Stakeholder workshop”, 9 Mar 2012, slide 6

<sup>25</sup> Heathrow MPA Consultation, §4.149

<sup>26</sup> Heathrow MPA Consultation, §4.155 – 4.156

<sup>27</sup> Heathrow MPA Consultation, §1.9

<sup>28</sup> Heathrow MPA Consultation, §1.8

- (a) The CAA's submission on economic regulation to the CC in Feb 2008, where the CAA stated that "*Heathrow's position is not equally strong across all of the markets it serves...a significant proportion of passengers at Heathrow are connecting between two international flights. In this market segment it is likely that Heathrow faces a degree of competitive constraint from other hub airports.*"<sup>29</sup>;
- (b) The CAA's response to the CC's Provisional Findings and Remedies Notification in September 2008, where the CAA stated:
- "The CAA is aware that this market definition is narrower than that adopted by the CAA in its advice to the DfT on Stansted de-designation. Nevertheless, it is suitable for the CC's market inquiry because it comprehensively captures the potential interactions between BAA's airports, which is the key question in hand. A broader assessment would, however, be necessary to determine the risk of abuse of market power and/or the appropriate regulatory response for any given individual airport"* (emphasis added)<sup>30</sup>;
- (c) The CAA's response to the CC's Provisional Decision on Remedies in Jan 2009, where the CAA included Professor Yarrow's report arguing the "*even in the short-to medium-term, the competition between Heathrow and divested Gatwick and Stansted airports could be expected to be much more than 'marginal' in its intensity, significance and effectiveness*".<sup>31</sup> The CAA current proposals are inconsistent, in having previously believed the three London airports competed to some degree in the same market;
- (d) On a similar point, in upholding the CC's decision to divest Stansted, the Competition Appeals Tribunal (CAT) also made the CAA's representation to the CC very clear, which was that "*the CC had up to that point correctly identified scope for competition between the three London airports if separately owned, but had underestimated that competitive effect*".<sup>32</sup> This was reiterated in the European Commission's decision on the IAG/bmi merger, which noted that "*previous Commission decisions determined that a certain degree of substitutability exists between the London airports, at least for NTS [non-time sensitive] passengers*", as well as substitutability between Heathrow and at least Gatwick on certain routes for time-sensitive passengers as well<sup>33</sup>;
- (e) The CAA's response to the CC's Provisional Determination of No Material Changes in Circumstance in April 2011, where despite it being relatively early after Gatwick's divestment, the CAA cited Gatwick and Heathrow taking different approaches to their operations, which "*potentially creates a degree of competition and innovation that was not observed under common ownership*".<sup>34</sup> The CAA then

<sup>29</sup> CAA, "The CC's Market Investigation of BAA Ltd: A submission by the Civil Aviation Authority on Economic Regulation of UK airports", Feb 2008, §3.26

<sup>30</sup> CAA, "Response to the Competition Commission's Provisional Findings and Remedies Notification", Sep 2008, §3.4

<sup>31</sup> CAA, "Response to the Provisional Decision on Remedies", Jan 2009, Annex B, last point of §19

<sup>32</sup> BAA Limited vs Competition Commission and Ryanair Limited, heard at Victoria House on 5-7 Dec 2011, Judgment §66

<sup>33</sup> European Commission, IAG/bmi decision, Mar 2012 §46

<sup>34</sup> CAA, "Provisional consideration of possible material changes of circumstances", letter to the CC 26 Apr 2011

goes on to state that there is no reason to believe that Stansted would act differently if separately owned, and *“indeed, it might even have more scope for competing in the short run than Gatwick given it currently has more spare capacity”*<sup>35</sup>.

2.2.18 In contexts outside of the CC investigation, the CAA has also made a number of comments that appear to consider Heathrow in a wider geographic market, including in:

- (a) The CAA’s response to the Department for Transport’s consultation on the Sustainable Aviation Framework, where the CAA commented that *“for routes where no direct service is available...consumers are likely to be relatively less guided by whether they hub through a UK or foreign airport, although the Government may be interested in the employment implications of such hub-to-hub competition”*<sup>36</sup> (emphasis added); and
- (b) A 2011 presentation at the Global Airport Development conference, where the CAA demonstrated that UK passengers use various European hubs including Schiphol and Paris CDG.<sup>37</sup>

2.2.19 The CAA’s Consultation Document makes no reference to these views, and provides no reasons for why the CAA has reversed its approach to the geographic market definition for Heathrow. The inconsistencies of the CAA’s current approach as compared with precedents and key examples of its previous views are summarised in the table below.

**Table 1: Summary of previous CAA positions and precedents on market definition**

	CC	Precedents		CC / CAT	CAA’s views		
		EC	NMA		2011 working papers	2012 initial views	2013 current consultation
<b>Product</b> Further segmentation? Aero-nautical and commercial <sup>38</sup>		<ul style="list-style-type: none"> <li>• Infrastructure, ground-handling and commercial<sup>39</sup></li> <li>• Left open possibility of further sub-segments</li> </ul>	Split by O/D, ,cargo, other	Considered less important <sup>40</sup>	Potentially segment e.g. connecting passengers	Segment O/D and connecting passengers	Bundle is the same regardless of user

<sup>35</sup> CAA, “Provisional consideration of possible material changes of circumstances”, letter to the CC 26 Apr 2011

<sup>36</sup> CAA, “Department for Transport consultation: Developing a Sustainable Framework for UK Aviation – Response by the CAA”, response to question 5.10 p.24

<sup>37</sup> “Considerations for the UK CAA in Today’s Aviation Climate”, presentation given by the Group Director for Regulatory Policy (Iain Osborne), 9 Nov 2011

<sup>38</sup> CC, “BAA airports market investigation: A report on the supply of airport services by BAA in the UK”, March 2009, §2.41

<sup>39</sup> European Commission, Ferrovial / Quebec / GIC / BAA decision, May 2006 (COMP/M.4164), §10 – 11

<sup>40</sup> We note that the CAA commented: *“Whether or not aeronautical and commercial services are combined for the purposes of arriving at a product market definition is less important than whether the interactions between aeronautical and commercial services are taken into account in the analysis.”* §3.5, “The Civil Aviation Authority’s response to the Provisional Findings and Remedies Notification”, Sep 2008.

<b>Geographic</b>	Include regional?	"South east" airports	Left open	Left open	"South east" airports	Potentially include	For O/D passengers	No
	Include other hubs?	Considered <sup>41</sup>	Left open	Left open	Yes (Feb 2008 submission)	Potentially include	For connecting passengers	No

### Not supported by robust evidence

2.2.20 The CAA's evidence base and reasoning do not stand up to detailed review. While this response does not seek to examine each and every piece of evidence the CAA has used in its reasoning to reach conclusions on market definition, we highlight some key examples below (the omission of further examples does not signify that we agree with the CAA on all other points).

2.2.21 In particular, in reaching its conclusions on market definition, the CAA refers to, and in some cases relies heavily on:

- (a) An assumption that current airport charges are above the long-run competitive level, in absence of capacity constraints, to assess substitutability;
- (b) Selective references to Heathrow's marketing activities to demonstrate markets are not two-sided;
- (c) Selective evidence from airlines on their ability to switch hubs, when this is not the only constraint on Heathrow; and
- (d) Effectively disregarding route overlap and catchment area analysis in assessing connecting passengers' alternatives.

2.2.22 We examine each of these in turn below. The CAA also cites airport charges benchmarking in its Executive Summary as evidence that European hubs have not provided an effective constraint on Heathrow<sup>42</sup>. We include our comments on benchmarking in considering the CAA's assumption on the long-run competitive price level (item (a) above).

### Current airport charges versus the competitive level

2.2.23 As the CAA has set out, determining the relevant competitive price benchmark (rather than just considering the prevailing prices by default) is critical to analysing market definition, since if the prevailing prices are above the competitive level, the analysis may result in overly-wide market definitions ("the Cellophane Fallacy"). Similarly, if prevailing prices are below the competitive level, an overly-narrow market definition may result ("Reverse Cellophane Fallacy").<sup>43</sup>

<sup>41</sup> The CC considered all constraints on airports to be potentially relevant, including "where...there might also be a constraint from alternative hub airports". CC, BAA Market Investigation Final Report, §2.48(b)

<sup>42</sup> Heathrow MPA Consultation, §26

<sup>43</sup> Heathrow MPA Consultation, §4.3

2.2.24 In Heathrow's case, a key factor that complicates the analysis are capacity constraints. As the CAA itself notes in its market assessment guidelines:

*5.8 "...Although barriers to entry and expansion are one way in which scarcity can be created, scarcity could also be a normal and/or transitory feature of a generally competitive market. In the context of a competition assessment, it is important to distinguish carefully between different causes of scarcity."<sup>44</sup> (emphasis added)*

2.2.25 However, for the purposes of market definition in this MPA, the CAA does not appear to have sufficiently considered the causes of Heathrow's capacity constraints. As a consequence, the CAA has not thoroughly assessed the potential counterfactuals (i.e. alternative "states of the world") that are relevant to this analysis. We summarise the CAA's approach, and then include our comments on the potential counterfactuals.

2.2.26 The CAA appears to distinguish between:

- (i) The current regulated price, which is cost-based;
- (ii) What the CAA terms the current "market-clearing price". The CAA considers this is likely to be higher than (i) given excess demand and capacity constraints at Heathrow<sup>45</sup>; and
- (iii) The long-run price that would be achieved in the absence of capacity constraints, which the CAA considers to be lower than (i) and (ii).<sup>46</sup>

2.2.27 The CAA appears to have deduced (iii) based on Leigh Fisher's benchmarking analysis. The CAA then justifies using the current regulated price in its analysis because it "*is likely to be a fairer indication of the price in a non-constrained (hypothetically competitive) context*"<sup>47</sup>, i.e., a fairer indication of price (iii).

2.2.28 In actual fact, the CAA has not sufficiently considered the different counterfactuals on which to base its analysis, where:

- (a) The current "market-clearing price" could be a result of either: (i) an "endogenous" reduction in capacity by a monopolist; or (ii) an "exogenous" capacity constraint caused by other factors. However, the CAA has not conducted any analysis of the corresponding price levels, and so cannot distinguish between the two. The CAA did previously submit to the CC that "*it is questionable whether the observed shortage of runway capacity in the SE [South East] has arisen as a consequence of artificial constraints on investment in new runway capacity*".<sup>48</sup> In the current MPA, the CAA acknowledges that the current capacity constraints have resulted from public policy<sup>49</sup>, implying this is not as a result of "endogenous" shortage. Therefore, at the very least the CAA cannot discount the possibility that the

<sup>44</sup> CAA, "Guidance on the assessment of airport market power", Apr 2011

<sup>45</sup> Heathrow MPA Consultation, §4.22

<sup>46</sup> This point appears to be clearest in the Executive Summary – Heathrow MPA Consultation, §12

<sup>47</sup> Heathrow MPA Consultation, §4.22

<sup>48</sup> CAA, "Response to the Competition Commission's Provisional Findings and Remedies Notification", §4.45

<sup>49</sup> Heathrow MPA Consultation, §4.21.

“market-clearing price” is the price which would arise from an otherwise competitive market, subject to exogenous capacity constraints in the medium term.

- (b) In considering the longer-run competitive price absent capacity constraints, the CAA has failed to account for the forward-looking cost of adding capacity. Forward-looking costs would be consistent with a cost-based approach<sup>50</sup>, as well as being the minimum price level that would incentivise the investment required to alleviate capacity constraints in the first place (absent government planning). However, the CAA has not carried out any analysis of forward-looking costs at Heathrow.
- (c) We do not consider the Leigh Fisher benchmarking analysis to be appropriate for the CAA’s intended purpose.<sup>51</sup> The CAA’s statement implies a narrow range of “competitive” prices for one type of product/service, where in actuality, a market can often have a range of products/services with differing attributes and thus differing prices that are seen as potential substitutes, and any price benchmarking would need to take sufficient account of such attributes. Given this, the CAA fails to account for a number of limits on the price benchmarking analysis, including: the comparability of the airports included in the benchmarking analysis (particularly given the methodology by which they were chosen); the use of an average benchmark, when Leigh Fisher itself acknowledged that “the available basket of comparators is polarized into two groups” of high and low revenue per passenger<sup>52</sup>; and failing to account for service quality, input cost and investment cycles in understanding differences in prices.<sup>53</sup> Leigh Fisher itself acknowledges that “*it is not possible to make comparisons between Heathrow and airports subject to light-handed regulation as there are none with appropriate revenue data in the comparator basket*”<sup>54</sup>, implying it is not a “competitive market” price benchmark.

2.2.29 Therefore, given the uncertainties involved in determining the competitive price benchmark, and the bearing this has on how wide the market may be defined, we do not consider that the CAA has sufficient grounds to conclude “its SMP analysis for HAL [Heathrow] is robust and would not be overturned if airport charges were different”.<sup>55</sup>

### **Selective use of Heathrow’s marketing activities to demonstrate markets are not two-sided**

2.2.30 Despite the evidence presented to the CAA on the multi-sided market characteristics of airports (including a paper by Starkie and Yarrow<sup>56</sup>), and the CAA’s previous statements

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<sup>50</sup> See for example Ofcom, “A new pricing framework for Openreach”, Annex 4

<http://stakeholders.ofcom.org.uk/binaries/consultations/openreachframework/statement/annexes.pdf>

<sup>51</sup> This is “*to further inform its understanding of the potential range of prices that might be considered competitive*”. Heathrow MPA Consultation, §4.13

<sup>52</sup> Leigh Fisher, “Comparing and Capping Airport Charges at Regulated Airports – Updated Final Report”, April 2013, p.30

<sup>53</sup> We would be happy to provide more detailed comments on the CAA’s request. See also our previous submission for a more detailed critique: “Heathrow initial comments on Leigh Fisher’s draft report: Comparing and Capping Airport Charges”, Sep 2012.

<sup>54</sup> Leigh Fisher, “Comparing and Capping Airport Charges at Regulated Airports – Updated Final Report”, April 2013, p.30

<sup>55</sup> Heathrow MPA Consultation, §12

<sup>56</sup> Summarised by the CAA in Heathrow MPA Consultation, §3.15

in its Initial Views (e.g. “...the interactions and interdependences between passenger airlines [sic] and airlines provide “two-sided” competitive constraints”<sup>57</sup>), the CAA currently considers that Heathrow is in a vertical derived demand relationship with passengers through airlines. One piece of evidence for this cited by the CAA is Heathrow’s approach to marketing, which the CAA considers focuses on airlines and “already booked to fly” passengers. For example, the CAA observed that “Heathrow does not appear to advertise specifically to attract new passengers to the airport”.<sup>58</sup>

- 2.2.31 This appears to selectively disregard further evidence from Heathrow’s internal documents and marketing, which clearly demonstrate the fact that Heathrow markets directly to potential passengers. For instance,  $\asymp$ <sup>59</sup>. This includes spend on Easter marketing tailored to families travelling for the first holiday season after the Christmas disruption last year, and advertising for Heathrow’s Family Lanes when passengers go through security in the summer, both of which are aimed at attracting potential passengers to fly through Heathrow.
- 2.2.32 Furthermore, this marketing approach demonstrates the other important non-price dimensions of competition that Heathrow faces, including service quality and innovation in facilities, on which Heathrow does more directly compete for potential passengers and which the CAA appears to have neglected in its market definition analysis.
- 2.2.33 The CAA also notes that there is no evidence of Heathrow’s pricing decisions for aeronautical services being made taking account of non-aeronautical revenue. However, this fails to recognise the clear interrelationship between passenger numbers and non-aeronautical revenues, most of which are sensitive to the volume and mix of passengers at the airport. The fact that Heathrow currently prices at the level of the cap is not inconsistent with maximising revenue across both aeronautical and non-aeronautical income given capacity constraints which exist at the airport.
- 2.2.34 Given these concerns, the CAA’s decision to treat airports as a pure vertical relationship rather than a multi-sided market may not be robust, and in doing so potentially places too little emphasis on the competitive constraints posed by the connecting and O/D passenger “sides” of the market.

### Selective evidence from airlines on their ability to switch hubs

- 2.2.35 The CAA places undue reliance on certain airline evidence in order to identify a “Heathrow” geographic market. The evidence presented to support the market definition focuses on whether airlines would wish to (or be able to) close their operations at Heathrow and set up at alternative airports such as Gatwick. However, this is not required to reach a wider market definition.
- 2.2.36 As the CAA is aware, the relevant consideration is the extent of “marginal” capacity that may switch away from the airport if Heathrow were to increase its airport charges above

<sup>57</sup> The CAA’s Initial Views, §2.157

<sup>58</sup> Heathrow MPA Consultation, §3.21

<sup>59</sup> This underestimates the total amount that Heathrow spends marketing to passengers, since it excludes other channels through which Heathrow markets to passengers, such as public relations costs and digital marketing (e.g. “How to use Heathrow” films on the Heathrow website), as well as the actual staff costs of Heathrow’s passenger marketing team.

competitive levels.<sup>60</sup> This is less likely to take the form of airlines relocating their entire operations to an alternative airport, which the CAA appears to focus on, e.g., in citing British Airways (BA)'s statement that "*we do not believe that there is an airport suitable for our services and passengers with the capacity to absorb this size of operation in the London market area*"<sup>61</sup>, or in switching operations to airports that the airlines do not currently operate in (as presumed by the CAA in footnote 185 of the Heathrow MPA Consultation). Rather, as the CAA acknowledges later in the Heathrow MPA Consultation<sup>62</sup>, airports are more likely to be affected by airline decisions to allocate growth at alternative hubs (most likely at hubs where airlines do already operate, since this would entail lower switching costs) and change frequencies, or passengers' decisions to connect via alternative hubs (potentially using different airlines) in response to price increases.

2.2.37 Furthermore, the CAA appears to have made selective use of airline evidence, disregarding statements where airlines do consider other airports to be in the same market e.g. even though it notes that its premium customers are not equally distributed, BA states that "...British Airways regards the London area as a single market..."<sup>63</sup>

2.2.38 As a consequence, the CAA is likely to have understated the evidence supporting a wider geographic market definition. We include further comments on the CAA's analysis of airline switching options in [section 2.3] below.

### **Disregarding route overlap and catchment area analysis**

2.2.39 The CAA acknowledges that "*route overlaps may provide an indication of the possible substitute airports available for passengers*"<sup>64</sup>, and the CAA's existing analysis suggests at least a regional (e.g. "south-east" airports) geographic market definition. For example, the CAA cites its earlier finding that 86 per cent of cities on short-haul city pairs served from Heathrow in 2010 were also served from another London airport.<sup>65</sup> The CAA also appears to disregard its own catchment area analysis, which suggests that only 6% of Heathrow's passengers are drawn from districts served solely by Heathrow.<sup>66</sup>

2.2.40 Furthermore, the CAA's route overlap analysis fails to consider long-haul city pairs that use alternative hub airports. Rather than conduct its own analysis based on the extensive data to which it has access, the CAA offers only a critique of Heathrow's illustrative analysis (that was based on the limited CAA data available to Heathrow). In considering passengers' ability to switch, the CAA relies on qualitative points about how changes in airport charges are unlikely to be passed through<sup>67</sup>, and some potential

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<sup>60</sup> In analysing competitive constraints, "...the CAA has sought to identify how much of the capacity at the airport is marginal...". Heathrow MPA Consultation, §28

<sup>61</sup> Heathrow MPA Consultation, §4.108

<sup>62</sup> See Heathrow MPA Consultation, §5.11 onwards

<sup>63</sup> Heathrow MPA Consultation, §4.109

<sup>64</sup> Heathrow MPA Consultation, §4.129

<sup>65</sup> Heathrow MPA Consultation, §4.129

<sup>66</sup> CAA, Heathrow MPA Consultation, Figure 4.6. Although the CAA cites a greater passenger preference to fly from Heathrow than other London airports (Heathrow MPA Consultation, §4.147), the CAA also acknowledges that this is difficult to disentangle from other passenger preferences e.g. to fly with particular airlines (Heathrow MPA Consultation, §4.413). In any case, the stated passenger preferences do not indicate how close passengers consider their second or other alternatives are to Heathrow, particularly if faced with a rise in airport charges.

<sup>67</sup> Heathrow MPA Consultation, §4.155 point 3

reasons for why passengers may have a preference to travel through an airport.<sup>68</sup> The CAA does not carry out any quantitative analysis to test these hypotheses.

- 2.2.41 This contradicts with academic evidence available on hub competition, which suggests that there are significant overlaps in the availability of alternative hub options for connecting flights. For example, based on an analysis of Innovata data, *Redondi et al (2011)* suggests that over 75% of Heathrow's worldwide O&D route pairs have overlaps with those at each of Frankfurt, CDG and Schiphol airports.<sup>69</sup>
- 2.2.42 The type of analysis carried out in the *Redondi et al* paper could have featured in any comprehensive assessment of the market in which Heathrow operates, and could have led to the CAA reaching more robust conclusions. For example, this type of analysis could have helped the CAA to assess the extent to which connecting passengers constrain Heathrow's transfer charges, and therefore its relevance for the geographic market definition.
- 2.2.43 In the absence of quantitative evidence relating to alternative hub competition, the CAA's finding on geographic market definition is not robust. Where the CAA does seek to provide some quantitative evidence through its critical loss analysis, the work does not properly address the question of whether a separate market segment for connecting passengers should be defined. We include further comments on the CAA's critical loss analysis in [section 2.3] below.

#### **Inconsistent with the variation in competitive conditions facing different market segments**

- 2.2.44 Market definition typically also recognises distinct segments or customer groups within a market, where each segment faces different competitive conditions to another. For example, in its Market Investigation guidelines, the CC notes that:

*150 "One set of customers may be more affected than others by any particular feature. Where such diversity exists, and where suppliers can charge different prices to different groups (ie price discriminate), the CC will recognize these differences."<sup>70</sup> (emphasis added)*

- 2.2.45 The CAA's approach therefore appears to be inconsistent with the evidence it has received on the variation in competitive conditions in different market segments, for example in relation to: (i) the surface or origin and destination (O&D) segment; versus (ii) the connecting/transfer segment. There would appear to be sufficient available evidence to segment the product market and widen the geographic market definition.

- 2.2.46 For example, in relation to the O&D segment:

- (a) As outlined above, the CAA's own passenger survey analysis clearly identifies extensive overlaps across the catchment areas of the main London airports.

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<sup>68</sup> Heathrow MPA Consultation, §4.155 point 4

<sup>69</sup> *Redondi et al*, "Hub Competition and travel times in the world-wide airport network", *Journal of Transport Geography* (Vol 19, 6)

<sup>70</sup> CC, Guidelines for market investigations: their role, procedures, assessment and remedies, April 2013

- (b) The pricing behaviour of airlines at Heathrow indicates that the connecting and O&D markets are treated differently. Furthermore, certain statements by airlines are consistent with a London market for point to point services, for example BA's statement that it "*regards the London area as a single market*".<sup>71</sup>

2.2.47 In relation to the market for connecting passengers:

- (a) The CAA takes no account of the fact that Heathrow's pricing strategy clearly recognises the different conditions facing O&D as opposed to connecting traffic. It introduced a discount of 25% in 2011/12, which clearly demonstrates both the ability and the incentive to maintain competitiveness in the connecting market.
- (b) As the CAA itself recognises, the likely alternative options for this passenger segment are very different, with connecting passengers in the CAA's passenger survey having considered other European hubs including Amsterdam Schiphol, Frankfurt am Main, Paris Charles De Gaulle, Dublin and New York JFK<sup>72</sup>.
- (c) Heathrow has repeatedly demonstrated that it considers European hubs to be its main competitors. While CAA may wish to consider such evidence on its merits, it does not provide any analysis to suggest why the clear market segmentation suggested by Heathrow's strategy, marketing and communications is not relevant to its decision. Furthermore, as already mentioned the CAA appears to rely selectively on Heathrow internal documentation in other respects.
- (d) Publicly available evidence also suggests that hub airports in Europe consider themselves rivals to Heathrow. For example, Schiphol launched an aggressive advertising campaign last year to become the UK's hub airport, which was noted by the UK press.<sup>73</sup> Aer Lingus has also recently announced the expansion of its long haul transatlantic services from Dublin, with the airline reportedly claiming that Dublin has overtaken Schiphol as the preferred alternative hub to Heathrow for UK passengers.<sup>74</sup>
- (e) It is also not appropriate to simply compare Heathrow's charges with other European hubs in trying to assess whether the latter exert any competitive constraint. Setting aside flaws in the price benchmarking and how the CAA has interpreted this data (see our comments above on the competitive price level), the CAA has also neglected to account for the other non-price dimensions on which Heathrow competes, including on quality and service innovation dimensions.

2.2.48 Given the CAA's approach appears to be inconsistent with the considerable evidence on competitive conditions facing different market segments, we urge the CAA to reconsider its conclusions on market definition. In particular, the serious issues we have identified in the CAA's current market definition could:

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<sup>71</sup> Heathrow MPA Consultation, §4.109

<sup>72</sup> Heathrow MPA Consultation, Figure 4.8

<sup>73</sup> The Telegraph, "Schiphol claims to operate Heathrow's third runway", 7 Nov 2012 <http://www.telegraph.co.uk/news/aviation/9337349/Schiphol-claims-to-operate-Heathrows-third-runway.html>. See also: <http://www.standard.co.uk/incoming/article8293464.ece/ALTERNATES/w620/amsterdam.jpg>

<sup>74</sup> The Telegraph, "Dublin airport 'an alternative hub to Heathrow', says Aer Lingus", 3 Jul 2013 <http://www.telegraph.co.uk/finance/newsbysector/transport/10158483/Dublin-airport-an-alternative-hub-to-Heathrow-says-Aer-Lingus.html>

- (a) Lead to inaccurate analysis of the competitive constraints on Heathrow, particularly in understating the competitive constraints exerted by airlines and connecting passengers and therefore that exerted by European and other global hubs for connecting traffic;
- (b) Set a flawed precedent for how markets are defined in future market power assessments in the sector; and, as a consequence;
- (c) Create the risk of inappropriate regulatory interventions, particularly in the future when competitive constraints in different market segments may evolve and reach a point where previous regulatory interventions are no longer suitable.

### **Inconsistent with Civil Aviation Act 2012**

2.2.49 The CAA states that it has considered “*what the focal product or service for the market definition should consist of*”<sup>75</sup> by using the new Civil Aviation Act (2012, “the Act”) as a starting point.<sup>76</sup> The CAA cites Section 5(4) of the Act in defining the “core area” of the airport<sup>77</sup>, and Section 68 of the Act in what consists of “airport operations services”<sup>78</sup>, concluding in the next section that given the way the Act sets out the market power test:

*4.29 “...the CAA considers that the airport operation services provided in the core area of the airport is the most logical place from which to start defining the product market.”*<sup>79</sup>

2.2.50 The CAA then considers that “*it is therefore appropriate to treat the basket of services outlined in paragraphs 4.34 to 4.35 [of the Heathrow MPA Consultation] as a single product*”.<sup>80</sup> In doing so, the CAA has mistakenly identified a number of airport operational services which Heathrow does not provide as being (either) directly or indirectly provided by Heathrow. For example, in the case of groundhandling services the CAA has incorrectly asserted that “*...groundhandlers pay fees to the airport operator relating to the use of and access to infrastructure. In these cases charges would still affect the airline through the charges levied on the groundhandlers*”.<sup>81</sup> With the exception of a small annual licence fee (the 2013/14 fee is £3,248) to cover safety reviews and licence administration, groundhandlers are not charged by Heathrow for access to infrastructure.

2.2.51 The basket of services considered by the CAA as a single market also lists services that are not provided by Heathrow, and services over which Heathrow has little or no influence. The fact that these services are provided at the airport does not support the CAA’s conclusion that Heathrow operates in a market for those services. It is apparent that the CAA has not assessed the market (basket of services) in which it asserts Heathrow operates in order to determine if in fact Heathrow provides those services. Heathrow is only present in a sub-set of the market as defined by the CAA.

<sup>75</sup> Heathrow MPA Consultation, §3.42

<sup>76</sup> Heathrow MPA Consultation, §3.43

<sup>77</sup> Heathrow MPA Consultation, §3.50. This draws on Section 66 of the Act in defining what consists of an airport.

<sup>78</sup> Heathrow MPA Consultation, §3.46

<sup>79</sup> Heathrow MPA Consultation

<sup>80</sup> Heathrow MPA Consultation, §4.33

<sup>81</sup> Heathrow MPA Consultation, footnote 140

- 2.2.52 In order to meet Test A, it is incumbent on the CAA to determine if “the relevant operator” has market power and if the market is “*for one or more types of airport operation service provided in the airport area (or for services that include one or more of those types of service)*”.<sup>82</sup> In carrying out its MPA, the CAA has not specifically identified Heathrow as “the relevant operator” having market power for one or more types of airport operational services. Instead the CAA has listed a basket of services which it has defined as a single market and which it considers Heathrow operates in. Noting that Heathrow is only present in a limited sub-set of the market, it is apparent that the CAA has had regard to markets that are not relevant.
- 2.2.53 Section 7(7) of the Civil Aviation Act 2012 requires the CAA to have regard to the market or markets that are relevant for the purpose of Test A and section 7(8) provides the CAA with the power to make market power determinations in respect of different areas located at the same airport that have the same “relevant operator”. There is no direct power to make market power determinations on markets that are not relevant for purposes of Test A (i.e. because the proposed licence holder is not the relevant operator of the airport area). The CAA has defined a market which consists of a number of services which are not provided by Heathrow in airport areas in which Heathrow is not the relevant operator given Heathrow’s lack of overall responsibility for the management of those areas.
- 2.2.54 In setting licence conditions the CAA must have regard to the risk that the holder of the licence may engage in conduct that amounts to an abuse of substantial market power in a market for airport operational services. With this in mind, Heathrow questions the CAA’s ability to apply licence conditions on Heathrow that concern airport operational services not undertaken by Heathrow.
- 2.2.55 Furthermore, this approach appears to be inconsistent with the CAA’s Guidelines, which the CAA itself notes in the Heathrow MPA Consultation proposes that “*wherever feasible, the hypothetical monopolist test should be adopted as a useful starting point for defining the relevant market*”.<sup>83</sup> As an illustration, if the CAA had truly adopted the hypothetical monopolist framework in defining the product market, it is likely to have defined passenger and cargo markets separately, given these are intuitively not substitutable. Instead, the CAA appears to have started with what it perceives are the requirements for finding market power under the Act, and then made qualitative comments to justify this approach.
- 2.2.56 Similarly, it is unclear how the CAA’s reading of the Act and what constitutes the “core area” of an airport has influenced its rigid and narrow geographic market definition.

### **2.3 Competitive Constraints on Heathrow**

2.3.1 The CAA considers that there is insufficient constraint on Heathrow to prevent a (profitable) small but significant price increase (SSNIP) e.g. by 10%. This is mainly based on its assessment of:

- (a) Airlines’ switching options and switching costs;
- (b) Airlines’ countervailing buyer power; and

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<sup>82</sup> The Act, Section 6(6) part (a)

<sup>83</sup> Heathrow MPA Consultation, §3.8

(c) How these interact with the capacity constraints at Heathrow.

- 2.3.2 We comment on the CAA's analysis of these factors below. The CAA also compares its critical loss analysis to its estimates of potential loss, which we comment on in [section 2.4] below.
- 2.3.3 We note that the CAA has disregarded passenger switching options in its analysis of competitive constraints. As already outlined, the CAA has not produced quantitative evidence to justify taking this approach, in particular, not undertaking an adequate analysis of route overlaps with alternative hub airports.

### **Airlines' switching options are understated and switching costs are overstated**

- 2.3.4 The CAA does acknowledge that airlines have wider switching options than relocating its entire operations to another hub. However, although the CAA considers a list of such options (including allocating new growth to other airports, reducing frequencies on existing services and switching based aircraft to other bases<sup>84</sup>), it appears to discount these on the basis of: (i) the impact of each option on its own; and (ii) network benefits.<sup>85</sup>
- 2.3.5 Firstly, the CAA appears to assess the constraints of potential switching options based on whether each is sufficient on its own to offset a price increase.<sup>86</sup> However, as the CAA sets out in its own guidelines, the aim is to "*establish the smallest set of substitutes to the product (or product group)*" (emphasis on plural added) where a SSNIP could be profitably sustained.<sup>87</sup> This would require considering the combined effect of the options. In any case, the CAA does not appear to have any quantitative evidence to test its hypotheses on this issue.
- 2.3.6 Secondly, the CAA cites network benefits that would prevent airlines from switching, particularly in relation to switching based aircraft to other bases.<sup>88</sup> It considers that only routes on which a very low proportion of connecting traffic exists could be "marginal". While it is clear that the possibility of carrying connecting traffic will enhance the potential profitability of a route, this does not imply that "marginal" routes with higher proportions of connecting traffic will not exist. Examples of this would include such cases where a standalone route would be loss-making, and only becomes viable once the contribution to connecting flights is taken into account (the CAA itself gave an example of a "marginal" route in describing the viability of flying from Hyderabad via London to New York<sup>89</sup>).
- 2.3.7 If airlines were to switch such routes to alternative hubs that also have high connecting traffic (e.g. KLM switching flights to Schiphol), it may be possible that some (if not most) of the network benefits can be retained. The CAA appears to acknowledge this point in its Initial Views, where it states:

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<sup>84</sup> Heathrow MPA Consultation, §5.11 onwards

<sup>85</sup> The CAA also cites the of impact capacity constraints, which we discuss further below.

<sup>86</sup> For example Heathrow MPA Consultation, §5.36 and §5.53

<sup>87</sup> CAA, "Guidance on the assessment of airport market power", Apr 2011, §3.10

<sup>88</sup> Heathrow MPA Consultation, §5.51

<sup>89</sup> Heathrow MPA Consultation, §3.18

“...inbound carriers are likely to have more ways to redeploy their aircraft away from Heathrow whilst avoiding a large adverse impact on their networks. In particular, a service operating between Heathrow and their network hub can be redeployed on a number of alternative services out of that hub. This alternative service might be expected to deliver similar (if, on average, not as significant) network benefits to the airline...However, based on inbound carriers’ responses to the CC’s airline survey, these carriers seem to be more likely to switch to an airport more distant than the south east of England, which may include Europe and further afield depending on their particular business model.”<sup>90</sup>

2.3.8 However, the point has subsequently been dropped in the Heathrow MPA Consultation. The CAA has not produced any comparative analysis of network effects at alternative hubs which justifies its approach.

2.3.9 The CAA then considers airlines’ switching costs.<sup>91</sup> In addition to emphasising the loss of network (and strategic) benefits, the CAA cites the illiquidity of the secondary slot market as a potential switching cost.<sup>92</sup> However, Heathrow considers this unlikely to be a serious concern. Airlines seeking to enter will most likely need to find a willing seller of slots, but this should not be insurmountable as airlines seeking to sell slots are able to recoup the lost expected profit from operating at Heathrow in the slot sale price. Any value placed on liquidity would also be incorporated into the sale price as well, allowing the seller to additionally recover any perceived risk of not being able to re-enter Heathrow. In actuality, transactions do take place with relative frequency: from summer 2008 onwards at least 10 transactions have occurred every six months (except in winter 2011), as demonstrated in the data from Airport Co-ordination Limited (ACL) below.

**Table 2: ACL slot trading data for London Heathrow, summer 2001 to summer 2012**

	Number of transactions	Slots-per-week traded	Total slots-per-week allocated
S01	5	74	9223
W01	9	330	8992
S02	13	398	9318
W02	19	357	8977
S03	8	236	9268
W03	7	172	9042
S04	9	262	9338
W04	5	109	9098
S05	3	68	9371
W05	8	130	9174
S06	11	139	9435
W06	6	109	9210
S07	10	235	9462
W07	9	182	9235
S08	17	220	9482
W08	17	244	9271
S09	15	313	9512

<sup>90</sup> The CAA’s Initial Views, §2.79

<sup>91</sup> However, it is unclear how these have affected the CAA’s decision-making, given they are presented after apparent conclusions on the viability of the options discussed above.

<sup>92</sup> Heathrow MPA Consultation, §5.100

	Number of transactions	Slots-per-week traded	Total slots-per-week allocated
W09	10	409	9280
S10	18	435	9524
W10	18	265	9280
S11	11	156	9524
W11	6	248	9305
S12	23	122	9524

Source: ACL website <http://www.slottrade.aero/slot-trading-volumes.asp>

2.3.10 The CAA also acknowledges that the ability to lease slots would significantly reduce any slot-related switching costs.<sup>93</sup> As such, the CAA may have otherwise overstated the role of illiquidity in the slot market, which would likely be mitigated by a liquidity premium on any slot sale price.

2.3.11 Given this, the CAA appears to have underestimated the potential switching options available to airlines, and overestimated the slot-related switching costs that airlines are likely to face.

#### **Airlines' relative bargaining power is understated**

2.3.12 As noted in the CAA's own guidelines, buyer power is "*most commonly found in industries where buyers and suppliers negotiate, in which case buyer power can be thought of as the degree of bargaining strength*"<sup>94</sup>. To assess this would require the CAA to consider the relative negotiating strength of both parties, and as the CAA noted the evidence that may be considered could include "*indicators for the importance of a given airline to the airport in question*"<sup>95</sup>.

2.3.13 Given this, the CAA's assessment of airlines' buyer power is surprisingly one-sided, only focusing on airlines' submissions without considering any evidence from Heathrow. As the CAA has observed, British Airways (BA) accounts for 45 per cent of Heathrow's passengers, with the share rising to 53 per cent for the Oneworld alliance. The CAA appears to discount the significance of this due to BA's apparent lack of substitutes.<sup>96</sup>

2.3.14 However, the CAA has not considered Heathrow's corresponding lack of substitute airline to replace BA's substantial passenger volumes if it were to switch away. This corresponds to 53% landing slots, as well as the near exclusive use of Terminal 5.

2.3.15 As a consequence, the CAA may have considerably understated BA's relative bargaining power in relation to Heathrow. Moreover, to the extent that the CAA finds airlines derive strategic benefits such as higher yields – and hence profits – from operating out of Heathrow (which may reduce their ability to exert buyer power), this finding needs to be reconciled with the CAA's assessment of Test B.

<sup>93</sup> Heathrow MPA Consultation, §5.157

<sup>94</sup> CAA, "Guidance on the assessment of airport market power", Apr 2011, §6.2

<sup>95</sup> CAA, "Guidance on the assessment of airport market power", Apr 2011, §6.4

<sup>96</sup> Heathrow MPA Consultation, §5.167

## Capacity constraints should not rule out marginal capacity

2.3.16 Because of Heathrow's capacity constraints, the CAA appears to discount airlines' ability to allocate new growth to other airports<sup>97</sup>, as well as other airports' ability to exercise competitive constraint<sup>98</sup>. In doing so, the CAA has failed to consider: its previous views on this subject in other contexts; the effect of marginal capacity; and the opportunity cost to Heathrow if such growth did not materialise.

2.3.17 The CAA sets out its views on the potential for competition even under capacity constraints in its submissions to the CC. For example, the CAA clearly states:

*5.6 "Airports can lose custom – or attract new custom – in a market that is characterised by continually changing airline and passenger requirements as business models and demand conditions evolve. It follows that an airport would still have strong incentives to compete with other airports through price and/or service quality so as to retain and attract what it sees as the most valuable custom, even when it (and rival airports) might be regarded as 'full'."<sup>99</sup> (emphasis added)*

2.3.18 As the CAA previously set out, airports do not serve a static stock of customers even in the face of capacity constraints. Rather, airports gain and lose capacity on the margin as the mix and demands of airlines and passengers evolve over time. For example:

- (a) In the last year (winter 2011 / summer 2012), there were 29 slot trades approved by ACL leading to 370 slots-per-week changing hands out of approximately 9414 total slots-per-week available;
- (b) The CAA's data demonstrates some differences in the mix of revenue per passenger realised from different airlines, which varies over time. For example, the lowest-yielding airline in 2011 (Aer Lingus) realised £18.16 per pax, which is around 35% lower than the highest-yielding airline (Virgin at £27.73)<sup>100</sup>; and
- (c) Changes in the mix of other factors such as aircraft type and load factor, which together would have volume effects for Heathrow over time, are missing in the CAA's analysis.

2.3.19 As such, the CAA's analysis fails to consider the competitive constraint posed by the potential churn and changes in the mix of airlines on the margin, even under capacity constraints.

2.3.20 Furthermore, the CAA appears to underestimate the substantial opportunity cost to Heathrow if such growth did not materialise, resulting in reductions in load factors or aircraft sizes on existing routes. For example, in the Heathrow MPA Consultation the CAA cites Aer Lingus in stating that "...it has had to downsize aircraft (A321 to A319s)

<sup>97</sup> Heathrow MPA Consultation, §5.13

<sup>98</sup> Heathrow MPA Consultation, §5.215

<sup>99</sup> CAA, "The Civil Aviation Authority's response to the Provisional Findings and Remedies Notification", Sep 2008. While this statement used Gatwick's changing airline and passenger mix as illustration, the CAA appeared to be making a more general point about the competitive constraint of "full" airports, which we consider would also apply to Heathrow.

<sup>100</sup> Heathrow MPA Consultation, Figure 5.8

as it is transporting few pax per slots<sup>101</sup>, which would have a direct financial impact for Heathrow as well.

## 2.4 Critical Loss Analysis

2.4.1 The CAA's critical loss analysis appears to be hampered by a number of issues, including: whether a critical loss analysis is appropriate in the situation; the CAA's lack of direct elasticity evidence and the estimate it has used to replace this; and the use of assumptions that may lead to the critical loss estimate being overstated with no sensitivity analysis carried out on these.

### It is unclear that critical loss analysis is appropriate in this situation

2.4.2 In order to assess Heathrow's critical loss, it is necessary to take into account: (i) the derived demand structure through which the CAA has chosen to examine the market; and (ii) the effect of capacity constraints on the analysis

2.4.3 Ofcom notes in its recent Wholesale Local Access consultation that:

*7.48 "We consider that carrying out a critical loss analysis is of limited use when assessing indirect constraints on the provision of wholesale local access. Such analysis depends on a number of parameters:*

- *The elasticity of demand for the downstream products that use wholesale local access and an input;*
- *The extent to which retail prices change (ie. the strength of the dilution effect);*
- *The margin earned on the provision of wholesale local access.*

*We consider that there is insufficient data to reliably estimate these parameters.*<sup>102</sup>

2.4.4 Similarly, in order to carry out a robust critical loss analysis, the CAA would need reliable estimates of (among other inputs) passengers' elasticity of demand, and the extent to which retail airfares change in response to changes in airport charges. The CAA has not included these parameters in its analysis.

2.4.5 Furthermore, the CAA's analysis appears to be inconsistent in its treatment of capacity constraints. The CAA contends that the relevant price benchmark should be the long-run competitive price in the absence of capacity constraints (with the current regulated price to be used as an approximation – see discussion above in [section 2.3]). However, the CAA otherwise carries out the analysis assuming the existence of capacity constraints, using assumptions about the current costs of the business and what the CAA perceives to be the current scope of switching.

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<sup>101</sup> Heathrow MPA Consultation, §5.178

<sup>102</sup> Ofcom, "Fixed Access Market Reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30 – Consultation on the proposed markets, market power determinations and remedies", 3 Jul 2013

### The CAA's lack of direct elasticity evidence

- 2.4.6 The CAA does not appear to have direct elasticity evidence to compare with its estimate of the required scale of switching. Given this, the CAA then appears to adopt a number of artificial criteria, which serves to restrict potential switching to airlines that are:
- (a) Not based at Heathrow. However, as already discussed, this disregards marginal switching by airlines through allocating growth to other airports (e.g. through changing load factors or aircraft sizing); reducing flight frequencies; and switching based aircraft to other bases. In particular, the CAA has not considered what advantages available to airlines at Heathrow could be replicated at other airports (especially where the airlines and/or their alliance partners already operate);
  - (b) Have less than 10% of connecting passengers, which appears to be an entirely arbitrary cut-off point, with no indication that airlines with more than 10% of connecting passengers in particular hubs would not operate marginal routes and potentially switch these to alternative hubs with similar levels of connectivity; and
  - (c) Not aligned to any alliance. A key purpose of alliances is to take advantage of improved connectivity, and the CAA has already placed a constraint on the level of connecting passengers. Given this, an additional criterion on connectivity is unnecessary and may unduly restrict the scope of potential switching by airlines.

### The CAA's use of assumptions

- 2.4.7 As a related point, given that the CAA has no direct elasticity evidence with which to compare its critical loss calculations, it is surprising that the CAA has performed very little sensitivity analysis on its assumptions, relying instead on point estimates in its calculations.
- 2.4.8 This is particularly concerning as we consider the CAA has made a number of poorly-evidenced assumptions, particularly relating to:
- (a) Opex variability, where the CAA has used the Steer Davies Gleave (SDG) opex elasticity estimate, which was originally calculated for Stansted's mid-quinquennium review.<sup>103</sup> The CAA uses the CC's analysis as an alternative estimate<sup>104</sup>, which is based on data from 2001 to 2006 and is actually the starting point for the SDG analysis.<sup>105</sup> Given its original purpose, we have concerns about the relevance of the comparator airports chosen for the CC's and SDG's analyses.<sup>106</sup> However, as illustrated by SDG's own data, Heathrow had almost twice as many flights and passengers as the next largest airport in the sample (Gatwick) in 2010, and around the same number of flights (but a considerably higher number of passengers) than the six smallest airports in the sample

<sup>103</sup> Heathrow MPA Consultation, §5.62

<sup>104</sup> Heathrow MPA Consultation, §5.62

<sup>105</sup> SDG, "Stansted Airport: Review of operating expenditure and investment consultation (Annex D): Mid-term Q5" ("SDG's review of Stansted Airport opex and investment"), May 2012, p.57

<sup>106</sup> The CC's analysis was based on the seven BAA airports at the time (Aberdeen, Edinburgh, Gatwick, Glasgow, Heathrow, Southampton and Stansted), whereas SDG expands its sample to include Manchester, Luton and Birmingham airports in the analysis. SDG's review of Stansted Airport opex and investment, p.57.

combined.<sup>107</sup> Given this, it is likely that Heathrow's cost structure is considerably different, particularly as compared to the smaller airports in the sample; and

- (b) Non-aeronautical revenue variability, where the CAA appears to have assumed that almost 30% of this does not vary with passenger traffic without adequate justification or sensitivity analysis.

2.4.9 As a consequence of these issues, we view the CAA's critical loss analysis to be deeply flawed, and not sufficiently robust to support a conclusion on Heathrow's market power.

## 2.5 Indicators of Market Power

2.5.1 The CAA's analysis of the indicators of market power adds very little to its overall analysis. It seeks to identify a number of indicators that may be relevant to its assessment, but acknowledges that several of these indicators are of limited relevance to Heathrow. For example:

- (a) Market shares. As already discussed in [section 2.2], the CC and the CAA agree that these may be of limited use in determining market power where the geographic market definition is difficult to determine precisely;
- (b) Profitability. The CAA has discounted profitability measures on the basis that Heathrow is subject to price cap regulation, designed to prevent the airport from earning a super-normal profit in the longer term<sup>108</sup>; and
- (c) Service quality. This is usually considered a parameter of competition<sup>109</sup>, but the CAA considers that it cannot differentiate between the effects of regulatory incentives and competitive pressures, and so puts little weight on Heathrow's strong performance. This appears to be a further selective use of evidence on the CAA's part, given that pricing and operating expenses are heavily influenced by regulatory incentives as well.

2.5.2 Therefore, the CAA's reliance on any evidence that Heathrow has market power is restricted to two indicators: (i) operating expenses (opex) efficiency; and (ii) pricing. We comment on each below.

### Opex efficiency

2.5.3 The CAA claims to have found evidence of opex inefficiency in several areas based on consultancy reports<sup>110</sup>. While we include more detailed comments on this finding in our response to the CAA's Q6 proposals<sup>111</sup>, we believe both the evidence collected and how the CAA has interpreted it is flawed:

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<sup>107</sup> SDG's review of Stansted Airport opex and investment, p.51

<sup>108</sup> Heathrow MPA Consultation, set out in Initial Views (§6.14) and confirmed in current analysis (§6.16)

<sup>109</sup> As cited in the CAA's own guidance. CAA, "Guidance on the assessment of airport market power", Apr 2011, §2.8. Quoting the European Commission, "*Market power is the power to influence market prices, output, innovation, the variety or quality of goods and services, or other parameters of competition on the market for a significant period of time.*" (emphasis added)

<sup>110</sup> Heathrow MPA Consultation, §6.38

<sup>111</sup> See Chapter 2 of our response to the CAA's Q6 proposals

- (a) The analysis undertaken fails to take account of a number of key factors, including:
  - (i) Whether the comparator airports chosen were suitable, in terms of size, location and/or complexity. For example, the CAA's own benchmarking appears to take the ATRS sample average, which includes 141 worldwide airports that handle from 1 million to 88 million passengers, without any adjustments to the data;
  - (ii) Appropriate comparators for Heathrow's labour costs, and the context of Heathrow's legacy pension arrangements. For example, the IDS study appears to compare Heathrow security guards with retail security jobs; and
  - (iii) Appropriate evidence and substantiation of supposed efficiencies identified (e.g. Heathrow has yet to receive an explanation from Steer Davis Gleave on its proposed efficiency for Heathrow Connect costs).<sup>112</sup>
- (b) Furthermore, the CAA has not assessed increases in opex relative to improved outcomes, for example initiatives that contributed to ASQ scores reaching their highest levels and security waiting times continuing to improve.

## Pricing

2.5.4 Our comments on pricing have mostly been set out in [section 2.3] above. However, we do note that although the CAA acknowledges prices have been regulated on a cost-based approach<sup>113</sup>, the CAA also observes that: (i) Heathrow has set its tariffs close to the cap over the last 8 years<sup>114</sup>; and (ii) Heathrow does not offer discounts on charges in the context of relative bargaining power with airlines.<sup>115</sup>

2.5.5 However, these observations are not indicative of Heathrow exercising its market power. Since the price limits have been set to allow Heathrow to recover on average no more than the cost of capital, any reduction in the price level below the limit set by the CAA, whether through setting published charges at a level below those implied by the price limit, or through discounting relative to the standard charges, would simply have led to (further) sub-normal returns and under-recovery relative to the respective settlements.

## 2.6 Conclusions on test A

2.6.1 Therefore, based on the discussion above, we have demonstrated that for each of the "Pillars" on which the CAA has built its conclusions on Test A:

- (a) The CAA's market definition is:

<sup>112</sup> The CAA also appears to have misinterpreted the conclusions of the Booz & Company 2012 European benchmarking report. For example, the residual productivity differential found between Gatwick and Heathrow is actually positive for Heathrow i.e. Heathrow operates at a higher level of productivity than Gatwick.

<sup>113</sup> Heathrow MPA Consultation, §4.22

<sup>114</sup> Heathrow MPA Consultation, §6.47

<sup>115</sup> Heathrow MPA Consultation, §5.186. As noted above, Heathrow does offer discounted charges for transfer passengers. Heathrow also offers discounts for passengers with reduced mobility.

- (i) Inconsistent with extensive precedent in the airport sector (including in the London area) by competition authorities;
  - (ii) Inconsistent with its own views as expressed earlier in the market power assessment and in other contexts;
  - (iii) Not supported by robust evidence;
  - (iv) Inconsistent with the variation in competitive conditions facing different market segments; and
  - (v) Appears to be inconsistent with the legal framework established in the Civil Aviation Act 2012.
- (b) The CAA's competitive constraints analysis considerably understates airlines' switching options and relative bargaining power in relation to Heathrow, and overstates their potential switching costs as well as the impact of Heathrow's capacity constraints;
- (c) The CAA's critical loss analysis raises some serious concerns, including:
- (i) A critical loss analysis may not even be appropriate in the situation;
  - (ii) The lack of direct price elasticity of demand evidence with which to compare the analysis, and the arbitrary alternative approach to estimating likely lost passengers; and
  - (iii) The CAA's use of potentially skewed assumptions with no sensitivity analysis; and
- (d) The CAA's review of market power indicators adds little to the analysis.

2.6.2 As a consequence, Heathrow is concerned that the CAA's MPA is insufficiently robust to support the conclusions that it has reached. Many of the concerns expressed above suggest that the CAA may have fallen into the trap of "confirmation bias", a well-known feature of policy-making where investigations, assessments and decisions are made within a single organisation.<sup>116</sup> Given this, it is important that the CAA fully explore the important issues in this MPA in order to offset any real or perceived influence of confirmation bias in the CAA's decision. Heathrow does not consider that the CAA has achieved this.

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<sup>116</sup> For example, a recent report by the Regulatory Policy Institute identifies a number of the factors that can lead to confirmation bias. These include premature closing (i.e. restricting analysis to that which is supportive of the original hypothesis), which is consistent with some of the concerns identified in this report. Decker and Yarrow, Regulatory Policy Institute, "Studies in regulation: On the discovery and assessment of economic evidence in competition law", 2011 [http://www.rpieurope.org/Publications/Studies New Series/Economic Evidence in Competition Law.pdf](http://www.rpieurope.org/Publications/Studies%20New%20Series/Economic%20Evidence%20in%20Competition%20Law.pdf)  
The OFT also acknowledges that: "*Finally, it is worth noting that although this paper only discusses consumer and firm behavioural biases, this does not preclude the possibility of authorities having behavioural biases as well!*" OFT, "What does Behavioural Economics mean for Competition Policy?", March 2010, p.34

## 3 Application of Competition Law (Test B)

### 3.1 Introduction

3.1.1 The CAA considers that competition law alone is unlikely to be sufficient in preventing the risk of Heathrow abusing the market power that the CAA has found under Test A.<sup>117</sup> The CAA asserts that it must assess the merits of competition law from the point of view of “users of air transport services”.<sup>118</sup> We consider that in doing so, the CAA has:

- (a) A lack of evidence demonstrating the potential harm to passengers (and other users of air transport services) in the absence of ex-ante regulation; and
- (b) Failed to take into account recent case law, draft legislation and deterrence effects that strengthen the position of airport users from a competition law perspective.

### 3.2 Lack of evidence of harm to passengers

3.2.1 Although the CAA emphasises its duty to passengers (and other users of air transport services), it provides very little analysis assessing the detriment to these users of not implementing ex-ante regulation. Instead, the CAA contends that:

- (a) Excessive prices are likely to be passed through to users in the long term<sup>119</sup>; and
- (b) Where prices are not directly passed through, it will still have a direct impact on the airlines’ ability to innovate and the viability of routes offered.<sup>120</sup>

3.2.2 We provide our comments on these points below.

#### Whether excessive prices are likely to be passed through to users

3.2.3 The CAA’s assertion that excessive prices are likely to be passed through to users is inconsistent with: (i) its own analysis in Test A; (ii) airlines’ own statements on how they price to passengers; and (iii) its own views in other contexts.

3.2.4 In its analysis of passengers’ ability to constrain Heathrow’s pricing, the CAA argues that “airport charges are less likely to be directly passed through to the passenger in the overall fare”<sup>121</sup>, which underpins the CAA’s conclusion that competitive constraints through passenger choice are likely to be limited. If this were the case, however, the extent of passenger harm that may be caused by the absence of ex-ante regulation through excessive pricing is unclear.

3.2.5 This is confirmed by comments from airlines that the CAA cites in support of its arguments under Test A. For example, BA decides whether to pass through a pricing increase in part based on what the market could bear<sup>122</sup>, and Lufthansa has also stated

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<sup>117</sup> Heathrow MPA Consultation, §8.82

<sup>118</sup> Heathrow MPA Consultation, §8.4

<sup>119</sup> Heathrow MPA Consultation, §8.79

<sup>120</sup> Heathrow MPA Consultation, §8.80

<sup>121</sup> Heathrow MPA Consultation, §4.155

<sup>122</sup> Heathrow MPA Consultation, §4.155

that its pricing “is based on the prices the market will bear”<sup>123</sup>. As the CAA itself observes, “FSC [full service carrier] airlines tend to price to the market rather than on a simple cost plus basis”<sup>124</sup>. Therefore, it is unclear whether the airlines would pass on any price increases directly to passengers.

- 3.2.6 The CAA’s assertion on excessive price pass-through is also inconsistent with its own views in other contexts. In particular, in its submission to the CC in relation to the BAA market investigation, the CAA points out that:

*4.36 “It is largely undisputed that incumbent airlines – particularly those operating on long haul routes – enjoy valuable slot rights at Heathrow. Much of the value of these rights derives from airlines having the freedom to set airfares according to a market clearing price (in circumstances in which demand may exceed supply) whilst paying airport charges which – as a result of tight economic regulation – are substantially below the market clearing price.”<sup>125</sup>*

- 3.2.7 As such, ex-ante regulation may simply be benefiting airlines by increasing the value of the slots they hold, and/or conferring strategic benefits in relation to higher yields (and hence higher profits – see our comments on airlines’ relative bargaining power in Test A [section 2.3]), rather than preventing any passenger harm.

### **Whether airlines’ ability to innovate and route viability would be affected**

- 3.2.8 The CAA also suggests that even where prices are not directly passed through to passengers, excessive airport charges could cause harm in the form of reduced innovation as well as reduced choice in airlines and destinations. However, the CAA offers no evidence for these conclusions, which seem to be entirely speculative. The CAA also does not consider that the reverse may actually apply, where higher charges could force airlines to take greater account for the scarcity value of slots, and doing so improve passenger service.

## **3.3 The CAA has failed to take into account recent case law and draft legislation**

- 3.3.1 Furthermore, in making this assessment, the CAA has failed to take into account recent case law, draft legislation and general deterrence effects which strengthen the position of airport users from a competition law perspective.
- 3.3.2 Legal developments indicate that competition law offers appropriate protection for “users of air transport services” and that Test B is not met for the purposes of the market power assessment. Examples of this include: (i) the Purple Parking Ltd v Heathrow Airport Ltd case (2011); and (ii) the draft Consumer Rights Bill.

### **Purple Parking Ltd v Heathrow Airport Ltd**

- 3.3.3 In Purple Parking Ltd v Heathrow Airport Ltd [2011] EWHC 987 (Ch), a private company operating valet parking at Heathrow brought a claim against Heathrow in relation to the

<sup>123</sup> Heathrow MPA Consultation, §5.180

<sup>124</sup> Heathrow MPA Consultation, §4.155

<sup>125</sup> CAA, “The Civil Aviation Authority’s response to the Provisional Findings and Remedies Notification”, Sep 2008

provision of “meet and greet” parking services at the airport. Purple Parking argued that HAL had abused its dominant position by excluding all “meet and greet” parking operators from the terminal forecourts, while at the same time operating Heathrow’s own “meet and greet” service from the same forecourts. Heathrow had required third party providers of the services to operate from airport car parks (for which they were charged a fee) on grounds of congestion, safety and security.

- 3.3.4 The court found in favour of Purple Parking. It was decided that there were significant differences between operating “meet and greet” services from the terminal forecourts, and operating the same services from the airport car-parks. Requiring Purple Parking to operate from the car parks, while Heathrow continued to operate from the forecourt, imposed practical obstacles on “meet and greet” parking operators. Heathrow’s congestion and safety considerations were not deemed to be sufficient justification for excluding third party operators from the forecourts.
- 3.3.5 The decision in this case demonstrates how competition law has enabled a relatively small airport user to use ex-post competition law in relation to exploitative abuses, and is a clear precedent under existing competition law that provides demonstrable and tested means for airport users to obtain redress in the event of competition issues arising at the airport.

### **Consumer Rights Bill**

- 3.3.6 The draft Consumer Rights Bill, which implements the EU Consumer Rights Directive, is currently before Parliament and is likely to come into force in 2014. The Bill consolidates and strengthens consumer law generally and Schedule 7 makes amendments to the Competition Act 1998 and Enterprise Act 2002 in light of this objective. The stated intention of the sections relating to competition law is to “...*make it easier for consumers and businesses to gain access to redress where there has been an infringement of antitrust provisions*”.<sup>126</sup>
- 3.3.7 There are three elements to the competition law provisions in the draft bill: (i) wider scope of cases heard by the CAT; (ii) collective actions; and (iii) voluntary redress schemes. We outline the key points under each of these in Appendix [1].

### **General deterrence**

- 3.3.8 Furthermore, the CAA appears to have significantly understated the general deterrence effect resulting from the enforcement interventions already available to competition authorities. For example, the OFT published a study in 2011 based on a survey of UK businesses (with 501 responses from large firms), which suggested that for every abuse of dominance investigation conducted by the OFT, an estimated 12 cases are deterred.<sup>127</sup>

## **3.4 Conclusions on Test B**

- 3.4.1 It is clear that competition law currently provides sufficient protection for individuals or smaller businesses who use Heathrow Airport, as demonstrated in *Purple Parking v.*

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<sup>126</sup> Consumer Rights Bill – Explanatory Notes

<sup>127</sup> OFT, “The impact of competition interventions on compliance and deterrence: Final Report”, Dec 2011, §1.35

*Heathrow Airport Ltd.* The draft Consumer Rights Bill will make obtaining redress for losses as a result of a breach of competition law even more accessible. In failing to take into account recent case law, a key piece of draft legislation and the general deterrence effect of competition law, the CAA have failed to properly apply Test B.

3.4.2 Therefore, we submit that the requirements for Test B (under section 6 of the Civil Aviation Act 2012) are not met, as the CAA has:

- (a) Provided insufficient evidence of potential harm to airport users in the absence of ex-ante regulation; and
- (b) Clearly understated the protection and deterrence effect that ex-post competition law does provide against the risk that an airport operator may abuse any substantial market power.

## 4 Proportionality of Regulation (Test C)

4.1.1 Heathrow's response to the CAA's Initial Proposals set out Heathrow's views on proportionality, and argued that the regulator must assess, in a way that the Initial Proposals appeared not to, the extent to which passengers' interests would be better served by investments and improvements in service, as opposed to reductions in airport charges that may not be passed onto passengers.

4.1.2 The CAA's Initial Proposals prioritise a marginal "price" benefit, in the context of the overall ticket price, without assessing the direct benefit to airlines, and passengers, flowing from Heathrow's investments. The same standard of robustness and proportionality must apply to the CAA's MPA; regulation must be targeted, and both reasonable and proportionate to the users' interests. Indeed, this is consistent with the CAA's own views as expressed in the CAA's response to the CC's provisional decision on remedies:

*"However, care needs to be taken that any short-term regulatory intervention is properly justified. Merely regulating because there is, or might be, a capacity shortage – and doing so in a way that holds prices below competitive levels or by implementing remedies that determine particular investment and/or service quality outcomes – will significantly 'crowd out' the very competition that will provide a long-term, sustainable, solution. In other words, without full and rigorous justification that there is a short-term abuse that needs to be addressed, regulation in the short-term may mean that the market never achieves the long-term competitive outcome that the Commission supports."<sup>128</sup>*

4.1.3 The CAA's MPA assessment effectively assumes the CAA's Initial Proposals will be implemented (without change) and this forms the basis of the CAA's assertion on direct costs.<sup>129</sup> The CAA suggests that the "direct benefits" of the proposed regulation are in the order of ~£295m per annum and that these outweigh the "direct costs" of the proposed regulation (estimated by the CAA to be ~£12m per annum). Notwithstanding Heathrow's comments on the CAA's Initial Proposals and that the CAA's assessment assumes the CAA's proposed price profile including a £3bn capital investment, if the CAA's analysis adopted the five year average price from Heathrow's RBP of £21.93 the CAA's estimate of "direct benefits" would be considerably lower at ~£125m.

4.1.4 While this still yields a difference between the assumed direct costs and benefits, it actually represents little more than the difference in respective price profiles as opposed to an estimate of the direct benefits of regulation.

4.1.5 Moreover, given that the CAA has not sought to quantify any of the other potential costs of regulation or potential distortive effects, it is difficult to properly assess the relative balance (as between costs and benefits).

4.1.6 Relatedly, the CAA's qualitative cost-benefit exercise provides little, if any, assessment of the potential benefit of avoiding passenger harm. This is arguably the key issue in determining whether to impose ex-ante regulation. The CAA's assumption that Test B is "passed" implies a risk of some form of abuse by Heathrow, for which the proposed mitigation is regulation.

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<sup>128</sup> CAA, "Response to the Provisional Decision on Remedies", §2.32

<sup>129</sup> Heathrow MPA Consultation, §9.94

- 4.1.7 Firstly, we note that the CAA considers the most likely forms of abuse are excessive pricing or abuses through service quality.<sup>130</sup> While Heathrow acknowledges the potential difficulties in assessing (excessive) pricing cases, presumably the CAA now has sufficient knowledge and experience of Heathrow's operations, costs, prices and otherwise to conduct such an exercise. Indeed, this would of course involve similar work, information and processes to the current (and previous) regulatory price reviews.
- 4.1.8 In the context of passenger harm, the CAA state that:
- “Excessive prices are likely to be passed through to users in the long-term and are likely to have a direct impact on consumers’ ability to travel ... passengers will either take the hit of the higher prices or decide not to fly at all”.*<sup>131</sup>
- 4.1.9 Heathrow is not able to reconcile this assertion with statements elsewhere in the CAA's MPA, or the CAA's Initial Proposals where it is understood that the airport charge is a “small fraction” of the airfare, and relatedly, a relatively small proportion of the airline opex cost-stack.<sup>132</sup> Absent further analysis of this particular issue, we do not consider that the CAA has properly established the potential for, or the cost of, passenger harm. Clear evidence is required on the likely and additional costs to passengers absent economic regulation. Heathrow believes this is fundamental to a robust cost-benefit analysis on ex-ante regulation.
- 4.1.10 In terms of the CAA's view that even where prices are not directly passed through to the passenger price increases will have a direct impact on the profitability of the airline sector; this appears to be an unsubstantiated qualitative assertion. Heathrow would welcome further detailed analysis from the CAA on this point such that the CAA is able to more accurately measure the potential costs to passengers absent regulation.<sup>133</sup>
- 4.1.11 More generally, on service quality and otherwise, the CAA has conducted little meaningful analysis of the counterfactual absent ex-ante regulation. For example, Heathrow's continuing improved performance in service quality cannot be solely explained by regulatory incentives, but we agree that it may be difficult for the CAA to isolate the various incentive effects. That being the case however, it is even more important that the CAA attempt to analyse these, and related matters, in order that the CAA is then able to more accurately determine the “benefits”, if any, of regulation.
- 4.1.12 In summary, Heathrow is not persuaded by the CAA's analysis on Test C and suggests the CAA also give further consideration to each of the key issues. We also encourage the CAA to give consideration to the Government's Better Regulation Framework and other regulators' Impact Assessments.<sup>134</sup>

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<sup>130</sup> Heathrow MPA Consultation, §8.75

<sup>131</sup> Heathrow MPA Consultation, §8.79

<sup>132</sup> The CAA's Initial Views, Figure 4

<sup>133</sup> If the CAA's working assumption is that the £4 difference in relative price profiles is the potential 'cost' of passenger harm absent regulation, it should be noted that Heathrow's price profile also assumes regulation.

<sup>134</sup> For example, the Better Regulation Framework Manual

<https://www.gov.uk/government/publications/better-regulation-framework-manual>

## **5 Appendix 1: further information on the draft consumer rights bill**

### **Wider scope of cases heard by the CAT**

- A1.1.1 The first key change that the bill will bring about is the ability of the CAT to hear stand-alone claims in addition to follow-on proceedings. It is also proposed that the CAT will be able to grant injunctions, together with the existing power to award damages. This will make it easier for individual claimants to bring private actions before the CAT and to obtain appropriate remedies. Furthermore, the bill proposes that any injunctions granted by the CAT will be able to be enforced as if they had been issued in a court – for example, through contempt of court proceedings.
- A1.1.2 Under the draft bill, simple claims can be brought in the CAT under the “fast-track” procedure, to enable them to be resolved more quickly and at a lower cost. This will undoubtedly be to the benefit of individuals and smaller companies who have been disadvantaged as a result of a breach of competition law. In addition, the limitation period for claims brought in the CAT (currently 2 years) is to be extended to 6 years to bring it more in line with the limitation period in the High Court.
- A1.1.3 The draft bill will increase the CAT’s flexibility to elect whether to be bound by OFT rulings. The CAT will therefore be in the same position as a court hearing competition cases.
- A1.1.4 Therefore, there is a clear focus on improving access to justice for individuals and smaller companies in the draft bill. It amends the Enterprise Act to allow for the CAT to make payments to legal advisers acting on a pro bono basis.

### **Collective actions**

- A1.1.5 Currently the CAT can only hear “opt-in” collective actions, where claimants have to expressly opt in to the action in order to obtain any damages. The second major change to the law that the draft bill brings about is the introduction of the CAT’s ability to hear “opt-out” collective actions, where claimant are automatically added to a collective action unless they opt out. This will mean obtaining redress for losses as a result of competition law breaches will be even easier, as claimants will not have to take an active role in bringing claims in order to benefit from them.

### **Voluntary redress schemes**

- A1.1.6 The third way in which the draft bill will change the operation of private actions in competition law is the introduction of voluntary redress schemes, which will be a form of alternative dispute resolution. A voluntary redress scheme will enable parties who have been found liable for breaches of competition law to enter into negotiations with consumers or businesses that have been disadvantaged as a result. The draft bill envisages that the Competition and Markets Authority will take these settlement negotiations into account when determining fines.

