

# Consultation on Heathrow market power assessment: Summary

CAP 1026





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## Purpose of this document

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1. This document summarises the CAA's provisional analysis of whether the market power test (MPT) is met in relation to Heathrow airport (Heathrow). Under the "deeming provision" in the Civil Aviation Act 2012 (the Act) the test is currently treated as being met in relation to the areas of Heathrow, for which Heathrow Airport Limited (HAL) has overall responsibility. The full consultation document that accompanies this summary will be published by the end of May 2013.
2. The CAA is minded to find, consistent with its section 1 duties in the Act, that the MPT is met, at least, in relation to the core area of Heathrow.
3. This document sets out the CAA's reasons for this provisional view. The CAA wishes to consider representations and reach a final decision later in 2013. The CAA especially welcomes views on how the CAA should weigh evidence that has so far been provided.
4. The CAA requests views on the full consultation document by no later than 26 July 2013.

## Potential implications for the regulation of Heathrow

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5. The practical consequence of the MPT being met is that HAL, the main operator of Heathrow, would be unable to charge for most services from April 2014, unless it has a licence granted by the CAA.<sup>1</sup> The Act sets out the primary duty of the CAA as being to further users' (which is to say, passengers' and cargo owners') interests in the provision of airport operation services; and, where appropriate, to do this by promoting competition.<sup>2</sup> It also sets out the provisions for the grant of a licence and what a licence may contain.<sup>3</sup> A licence may include such conditions as the CAA considers necessary or expedient in relation to risks of abuse of market power. This may include price control conditions. Any regulatory intervention must be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed.<sup>4</sup>
6. The CAA has consulted in general terms about options for the form of future regulation for HAL. Specific proposals for the regulation of HAL

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1 Section 3 of the Act.

2 Sections 1(1) and (2) of the Act.

3 Chapter 1 of the Act.

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

have been published on 30 April 2013, available here: [www.caa.co.uk/CAP1027](http://www.caa.co.uk/CAP1027)

## The Market Power Test

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7. The CAA has applied the MPT to the relevant airport operator (HAL). The MPT has three parts:
  - Test A is that HAL has, or is likely to acquire, substantial market power (SMP). This must be in a market for, or including, one or more types of airport operation services provided in the airport area and that market must include geographically all or part of the airport area.
  - Test B is that competition law does not provide sufficient protection against the risk that HAL may engage in conduct that amounts to an abuse of that SMP. Such conduct may, in particular, include behaviour defined under UK competition law as abuse of a dominant position.
  - Test C is that, for users of air transport services, the benefits of regulating HAL by means of a licence are likely to outweigh the adverse effects.
8. The CAA's assessment has focused broadly on the current position and the Q6 period, 2014 to 2019, although some of the trends reviewed seem likely to extend beyond that period.

## Test A

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### Market definition

9. The CAA has adopted the standard approach used by regulators and competition authorities in assessing HAL's market power and has sought, as a starting point for its analysis, to define the relevant markets in which HAL operates. This provides the framework for analysing competitive constraints, whether they come from within or outside the market.
10. Combining the product and geographic dimensions of market definition, the CAA is minded to take the view that HAL currently operates in the market for airport operation services for full service carriers (FSCs) and associated feeder traffic that is limited to Heathrow. This market is referred to as the Heathrow FSC and feeder market.
11. This market was identified on the basis of the infrastructural demands of FSC and associated feeder traffic, as well as evidence on the

substitutability of other airports for Heathrow. The market definition was informed by the views of airlines and airport operators, evidence on airline switching behaviour and the analysis of passenger preferences and behaviour.

12. The methodology for analysing the substitutability of airports usually assumes that airport charges are at the competitive level. The CAA recognises that HAL's airport charges may be below those that would be considered as a market clearing price. This situation has arisen, in part, because current government policy restricts the development of runway capacity at Heathrow, Gatwick and Stansted. However, the CAA considers that the current, regulated price is above the long-run price that would be achieved in the absence of capacity constraints. This position is supported by evidence that HAL's current charges are significantly above those of comparator airports. The CAA considers that its SMP analysis for HAL is robust and would not be overturned if airport charges were different.

### The product market

13. The CAA considers that airlines using Heathrow purchase a bundle of services<sup>5</sup> taking into account the total charge of this bundle rather than focusing on any one individual charge in their purchasing decision. Given the prevalence of the FSC business model at Heathrow the CAA considers that the focal bundle includes, in particular, the provision of infrastructure and facilities for services to premium passengers and the provision of the infrastructure and facilities to allow for the integrated transfer of passengers and associated baggage.
14. The CAA has considered whether the product should be differentiated by: based and inbound airlines; route destination; and cargo operations. In its Initial Views for Heathrow<sup>6</sup> the CAA stated that it did not consider it was appropriate to segregate the market on the basis of based and inbound airlines and route destination of passengers. The CAA remains of this view. With regards to cargo operations, 99 per cent of cargo by weight at Heathrow is bellyhold cargo carried by FSCs and associated feeder traffic. The CAA considers that cargo infrastructural services are

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

6 Heathrow Market Power Assessment Initial Views, CAA, February 2012: <http://www.caa.co.uk/docs/5/HeathrowMarketPowerAssessment.pdf>



part of the bundle of services that FSCs and feeder traffic demand and there is no need to define a separate market for cargo at Heathrow.

## The geographical market

### Airlines

15. In the Heathrow FSC and associated feeder market, airlines require a number of key inputs to ensure the efficient and profitable running of their networks, including sufficient demand from premium passengers, the provision of feeder traffic mainly from short-haul networks and the provision of bellyhold cargo. Apart from Heathrow, the only other London airports where FSC airlines can currently access the facilities and infrastructure they require for connecting traffic are Gatwick and Stansted.
16. Gatwick has been, or is, used for some services by airlines that are present at Heathrow. However, evidence from these airlines suggests that they consider these airports as serving different markets. The evidence suggests that Heathrow is key to the airlines' networks as:
  - almost all Heathrow's passengers are carried by FSCs, compared to 35 per cent at Gatwick;
  - of the FSCs present at each airport, approximately 75 per cent are members of an airline alliance at Heathrow compared to 55 per cent at Gatwick;
  - approximately 34 per cent of Heathrow's passengers connect at the airport compared with 8 per cent at Gatwick;
  - Heathrow benefits from strong demand from business/premium passengers (approximately 5 per cent of Heathrow passengers are carried in First and Business class compared with 1 per cent at Gatwick). Gatwick is an airport that is more usually associated with leisure travel by airlines; and
  - average airline fares and average yields are higher at Heathrow than at Gatwick.
17. The factors that the airlines cited as key to their business model at Heathrow suggest that it would not be constrained by Gatwick or other London airports. The evidence presented to the CAA shows significant differentiation such that it points to Heathrow being a market in itself. If HAL's airport charges were to increase by a small but non-transitory amount of 10 per cent few, if any, airlines would switch capacity to Gatwick or other UK airports.

18. Although Stansted has the required facilities for the FSC and feeder market and spare capacity, it does not operate with them at present, though potentially this could change over time depending on the business strategy adopted by Stansted's new owners. Currently, Stansted lacks a suitable feed of connecting traffic and it is difficult to see this changing appreciably over the short to medium term. FSC airlines stated that Stansted was not a substitute for Heathrow and the CAA has not included it in the relevant market.

### **Passengers**

19. The CAA considers that the majority of Heathrow's passengers, including connecting passengers, are unlikely to be sensitive to a small but significant increase in HAL's charges because airport charges form a small proportion of the cost of their ticket price.
20. The CAA notes that airlines may not pass on an increase in HAL's charges or may only do so after some time. Passenger switching will only occur to the extent that any increase in HAL's charges are passed on by the airlines.
21. The evidence from HAL shows that it considers that Origin & Destination (O&D) and transfer passengers represent different markets for the purposes of airport operation services, highlighting the currently differentiated charging.
22. The CAA considered whether switching by either O&D or transfer passengers might suggest that other airports should be included in the same geographical market as Heathrow. Surface passengers at Heathrow are drawn from a wide catchment. Heathrow's catchment overlaps with other London airports suggesting that some passengers could switch to other London airports if Heathrow were to increase its prices. Only 6 per cent of passengers at Heathrow come from districts not served by Luton, Stansted or Gatwick airports.
23. If passengers who wish to travel to a specific destination want to use a different airport, the destination must be available at an alternative airport. The great majority of short-haul destinations available at Heathrow were also available at one other London airport. However, looking at long-haul city pairs, only 17 per cent of cities served from Heathrow were served by other London airports.<sup>7</sup>

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<sup>7</sup> Table 14 "Initial Views", CAA February 2012.

24. Many passengers exhibit a strong preference for Heathrow over other London airports. For short-haul flights; 67 per cent of passengers flying from Heathrow expressed a first preference for flying from that airport<sup>8</sup>. Connecting passengers expressed a strong (62 per cent) first preference for connecting at Heathrow.
25. Connecting passengers could reach their final destination by connecting via an alternative hub airport. However, the evidence available to the CAA is not sufficient for the CAA to consider widening the market. The CAA considers that there are a number of factors that would make passengers less sensitive to hub airport pricing.
- The hub airport's charges are likely to be a low proportion of the total fare.
  - Passengers may have a preference for particular airlines. Further, airline alliance frequent flyer programmes, are likely to influence the hub a passenger will use, as alliances tend to be linked to specific hub airports.
  - To some extent airlines specialise in serving specific markets, often driven by history. Passengers flying to certain destinations may therefore opt for the airline offering the greatest frequency in service. Similarly the time preference of passengers may override cost and therefore lead them to choose the shortest flying times.
26. The CAA has been unable to find significant evidence to lead it to define a hub-based market that is wider than Heathrow. In recent years, HAL's charges have increased substantially relative to alternative European hubs, which indicates that they have not provided an effective constraint.

### **Provisional conclusion on the relevant geographical market**

27. The CAA's provisional conclusion is that passenger switching in response to a small but significant, non-transitory increase in price would be insufficient to justify a market that is wider than Heathrow.

### **Framework for analysing competitive constraints**

28. In the Heathrow FSC and feeder market, the CAA has sought to identify how much of the capacity at the airport is marginal in the sense that it would be likely to switch away if HAL's airport charges were to increase

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<sup>8</sup> Source: CAA Passenger Survey Working paper November 2011.

by a small but significant and non-transitory amount of 10 per cent. This analysis considered:

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

### **Current competitive constraints on HAL: Heathrow FSC and feeder market**

29. The CAA notes that HAL's charges are a low proportion of FSCs' operating costs. Many airlines indicated that they would absorb an increase in airport charges in the first instance and seek to pass it on to passengers in the longer term. Reducing the frequency of services was considered to be the most feasible means by which both based and inbound airlines could seek to reduce their use of Heathrow in response to an increase in airport charges.
30. BA and Virgin are the main based FSC carriers at Heathrow. Both also have bases at Gatwick. However, carriers operating at Heathrow have consistently maintained that Heathrow is their preferred option when operating from London. This is supported by evidence that there are very few instances of switching services from Heathrow to Gatwick.
31. Both based and inbound airlines at Heathrow tend to operate hub-and-spoke services, either using the airport as their hub or operating spoke services to their domestic hub at another airport. The resulting network of airlines, serving different destinations from Heathrow, means that there are significant network effects at this airport. The principal factors creating these network benefits are the demand from connecting passenger and, related to this, the presence of strategic partner airlines.

32. When an airline has strategic partners at an airport, for example as part of an airline alliance or with airlines with which it has a code sharing, interlining or similar type of agreement, removing routes or reducing the frequency of services may reduce an airline's profits by the loss of revenue:
- from operating the route itself;
  - from the contribution of the route to the network; and
  - from the profits of its partner airlines, as it may share in some of their revenue under a code sharing or interlining agreement.
33. As Heathrow is the only hub airport in the UK, losing network benefits could constitute a significant switching cost if an airline were to switch away from the airport. For the above reasons, the CAA considers that airlines with a significant proportion of connecting passengers or a reliance on partner airlines are unlikely to switch in response to an increase in HAL's charges.
34. An additional benefit of operating from Heathrow is the availability of significant air cargo demand. This means that airlines can increase their revenue by carrying it in the bellyhold of passenger aircraft. Since there would not be the same quantity of air cargo feed at another London or UK airport, the potential loss of cargo revenue can constitute an additional switching cost.
35. Another cost of switching away from Heathrow is the loss of the valuable contribution that serving the airport makes to airlines' viability and commercial strategy. Overall, the CAA considers that operating to London is strategically important to the operation of both based and inbound carriers. This is due to a number of factors, including the network benefits, strong passenger demand from a large and relatively wealthy catchment in London, and strong demand from inbound passengers to travel to London either to connect or to terminate their journey.
36. The CAA found no evidence in the commercial arrangements between HAL and the airlines to indicate that FSCs were able to exercise buyer power. Although BA accounts for a high proportion of HAL's business it appeared to lack credible alternative airports to which to switch.
37. From the above the CAA considers that the majority of airlines would be unlikely to switch away from Heathrow in response to an increase in airport charges. Inbound airlines with less than 10 per cent of connecting passengers are considered by the CAA as the most likely to

be marginal, especially if they also are not part of an alliance. The CAA estimates that the number of passengers carried by marginal airlines is unlikely to be sufficient to make a price increase unprofitable for HAL as, even if they were all to switch in response to such a price increase, it would be insufficient to constrain HAL's pricing.

### Indicators of market power

38. In addition to competitive constraints, the CAA considered a number of indicators that it considers to be relevant to its assessment of HAL's market power. The CAA recognises that relatively more weight can be given to some indicators compared to others.
39. The CAA's provisional view is that HAL is the only operator in the relevant market suggesting that it has SMP. In the market for airport operation services the CAA considers that there are a number of reasons why market share data may not be a reliable indicator of market power. These include:
  - the importance of geographical location for airport competition means that there is a continuum of substitution possibilities depending on distance and other airport characteristic; and
  - any market definition beyond a single airport is, to an extent, arbitrary and assessment of market shares is unlikely to be a useful tool in itself for measuring airport market power.
40. With respect to HAL's financial performance, the CAA notes that Heathrow is a regulated airport. As such, the CAA considers that its financial performance is unlikely to provide particularly strong evidence about the airport operator's market power.
41. Similarly, on service quality, the CAA notes that Heathrow is a regulated airport that is subject to a service quality scheme. Therefore, quality outcomes are unlikely to provide particularly strong evidence about HAL's market power. That said, the CAA notes that HAL's performance appears to be at or slightly above the target levels for the measure of service quality. The relatively high levels of service quality experienced at the airport may also, in part, reflect the efficiency of the capital expenditure (capex) and operating expenditure (opex) incurred at the airport.
42. The CAA notes that independent studies have identified several areas where inefficiency at the airport is present. This might indicate market

power, as an airport operator with SMP is likely to face insufficient competitive pressures to drive up operating efficiency.

43. HAL's negotiations with the airlines indicate whether they are able to secure advantageous terms and conditions. This may suggest whether or not the airlines consider that they have alternatives to Heathrow. The CAA considers that the evidence suggests that HAL appears to select which airline it wishes to operate at the airport in line with its commercial strategy. The scope for negotiation appears to be relatively limited, with new and existing airlines rarely able to achieve terms that are different from those set out in the Conditions of Use (with prices usually at the price cap).
44. While the individual indicators may each suggest slightly different conclusions, when considered as a whole, the CAA considers that they suggest HAL has SMP.

### **The CAA's 'minded to' assessment for the Heathrow FSC and feeder market**

45. The most likely source of any SMP that HAL has would appear to stem from its position as the operator of the UK's only hub airport and the combined package that it offers of strong demand, including premium passengers, cargo and connecting passengers. This makes it attractive for both based and inbound airlines. The CAA considers that the importance of network effects means that very few airlines would be able and willing to switch sufficient capacity to constrain an increase in HAL's charges.
46. Heathrow's good surface access options, the inherent attractiveness of the London market, and its strategic importance to airlines in general combined with constraints in the London system that act to reduce the number and size of available alternatives are also important.
47. The CAA notes that the government has currently put a hold on the expansion of the main London airports and that the Davies' Commission is not expected to bring out an interim report until the end of 2013, with a full report in summer 2015. The CAA considers that any change in government policy after the release of the Davies' Commission's final report may take some time to be implemented and that any significant capacity expansion would not be expected until 2025. Over the Q6 period, due to improving economic conditions and tightening capacity across the London airports, the CAA considers that HAL's SMP will endure over the Q6 period.

48. The CAA is minded to conclude that HAL has SMP in this market and will continue to do so over the Q6 period, but will consider carefully any further submissions that might indicate that it is constrained by competition, in particular by the credible possibility of switching by FSC and associated feeder carriers, or passengers, to other hub airports.

## Test B

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49. Test B requires that the CAA is satisfied that competition law does not provide sufficient protection against the risk of abuse of SMP. Further, as with all of the CAA's regulatory functions, the assessment of Test B must be conducted in accordance with the CAA's "general duty" in section 1(1) of the Act. The CAA must apply Test B "in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services". Further, in so doing, the CAA must, where appropriate, seek where appropriate to "promote competition in the provision of airport operation services".
50. Importantly, for Test B, the CAA has to assess the adequacy of competition law from the perspective of "users of air transport services", which are defined in section 69(1) of the Act as passengers carried by the air transport service or a person who has a right in property carried by the service. Accordingly, when assessing the merits of competition law, the CAA has to further the interests of passengers and cargo owners, and not the interests of commercial passenger or cargo airlines or other intermediary service providers, such as groundhandling providers, car parking or retail concessionaires.
51. Under competition law, a dominant company has a special responsibility not to allow its conduct to impair or distort competition in the relevant market. It is not the position of dominance or SMP itself that is prohibited but rather the undertaking using that position to prevent or distort the effective competition in the market.
52. However, it is the CAA's view that there are clear and distinct aims for *ex-ante* regulation and *ex-post* competition law. The former is to foster the development of competition correcting for known impediments to the competitive process. The latter is to protect the current state of competition (as a minimum) within the market.
53. The CAA considers that there is adequate competition case law, on which it would be able to rely in order to tackle vertical abuses where



an airport operator has an interest in a downstream market or horizontal abuses where the airport operator is seeking to foreclose the market for a competing airport operator.

54. It is the CAA's view, however, that for vertical abuses of an exploitative nature, where the airport operator does not have an interest in the downstream market, the CAA has insufficient comfort that it would be able to successfully discipline behaviour through the use of competition law. Such abuses might include excessive pricing and service quality based abuses.

### **Potential detriment from relying on competition law**

55. The CAA considers that the consumer detriment for users from HAL's market power is likely to have effects in a number of areas.
56. Excessive prices are likely to have a direct impact on passengers' ability to travel where these are passed straight through in the fare paid. Although individually the amounts involved are likely to be limited over the passenger group as a whole these are likely to lead to significant sums.
57. Where the prices are not directly passed through, this will have a direct impact on the profitability of the airline sector. This is in turn likely to have an effect on the incentive and ability of airlines to invest and innovate, for example, in new routes and also affect the viability of existing routes offered. This is likely to affect air transport users, ultimately by reducing their choice in airlines and direct destinations available from the airport.
58. Likewise, it is expected that HAL's ability to charge excessive prices may lead it to have less incentive to deliver the level of service that air transport users demand from the airport.
59. Given the nature of the detriment that could affect users of air transport services and the difficulties in pursuing potential exploitative vertical abuses, in light of the case law, the CAA is minded to consider that, in the case of HAL, competition law is likely to be insufficient to curtail abusive behaviour.

### **Test C**

60. Given the level of market power identified in Test A it is unlikely that HAL would face significant competitive pressure following deregulation.

Although the Airport Charges Regulations (ACR) and Airport Groundhandling Regulations provide some measure of protection to users, it is the CAA's consideration that neither of these regulations is adequate to tackle the level of market power present.

61. The CAA notes on the indirect costs of regulation that:
  - evidence on opex efficiency at Heathrow shows that areas of HAL's operation are inefficient. Opex is higher on a per passenger basis at Heathrow than most benchmark airports;
  - on service quality, research indicates that passengers are broadly content with the current level of performance at the airport and that there have been some improvements over Q5. However the improvements that have been observed in some areas appear to have been at the expense of others;
  - the history of regulation at Heathrow shows that it clearly has sufficient incentive under the regulation to invest; and
  - Heathrow has performed poorly during periods of disruption.
62. The CAA considers that there would be limited incentive on HAL to improve its efficiency or improve its service quality in the failing areas if it were deregulated. The CAA is less certain as to what the impact on investment would be. The CAA considers that, absent regulation, HAL would be likely to have an incentive to develop additional runway capacity should the opportunity become available. There is some uncertainty over whether it would face sufficient incentive to invest or innovate in other areas of airport infrastructure. Given the structure of the legislation, a licence would allow the CAA to regulate to improve HAL's performance during disruption.
63. The evidence that the CAA has been able to obtain on the direct cost of regulation suggests that these are around £12m a year. These include the costs associated with the CAA of £2m a year, £8m net costs for the airport operator and £2m for the engagement of airlines within the regulatory process. The CAA's initial proposals for the price cap are £4.21 per passenger lower than those in HAL's business plan. This equates to a saving for air transport users of an estimated £295m per year for services from Heathrow.
64. It is the CAA's consideration that the benefits of licence regulation outweigh the costs to air transport users.

