

# Consultation on Gatwick market power assessment

**CAP 1052**





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### Annexes (which are published as separate documents)

Annex 1 – Procedure and Chronology, and chronology of published documents for the Gatwick Market Power Assessment

Annex 2 – Gatwick Airport: draft conditions of use including proposed commitments (March 2013)

Annex 3 – “Assessing the adverse effects and benefits of regulation”, GAL, October 2012

# SUMMARY

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

## Potential implications for regulation of Gatwick

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5. The practical consequence of the MPT being met is that GAL, the main operator of Gatwick, would be unable to charge for airport operation services from April 2014 unless it has a licence granted by the CAA.<sup>1</sup> The Act sets out the primary duty of the CAA as being to further users<sup>2</sup> interests regarding the range, availability, continuity, cost and quality of airport operation services; and, where appropriate, to do this by promoting competition.<sup>3</sup> A licence may include such conditions as the CAA considers necessary or expedient in relation to risks of the airport operator abusing its substantial market power (SMP). This may include price control conditions. Any regulatory intervention must be transparent, accountable, proportionate, consistent and targeted where it is needed.<sup>4</sup>
6. The CAA published on 30 April 2013 specific proposals for the future regulation of GAL.

### The Market Power Test

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

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<sup>1</sup> Section 3 of the Act.

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

<sup>3</sup> Section 1 of the Act.

<sup>4</sup> Sections 1(3)(g) and (4) of the Act.

- Test A is that the relevant airport operator has, or is likely to acquire, SMP. This must be in a market for, or including, one or more types of airport operation services provided in the airport area and that market must include geographically all or part of the airport area.
  - Test B is that competition law does not provide sufficient protection against the risk that the airport operator may engage in conduct that amounts to an abuse of that SMP.
  - Test C is that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.
8. The CAA's assessment has focused broadly on the current position and the Q6 period, 2014 to 2019, although some of the trends reviewed seem likely to extend beyond that period. The evidence that the CAA has considered in making its market power assessment for GAL post-dates the sale of the business in 2009. Evidence from the airlines is current and statistical evidence is the latest available.

## Test A

### Market definition

9. The CAA has adopted a standard approach of regulators and competition authorities engaged in assessing market power and has sought, as a starting point for its analysis, to define the relevant markets in which GAL operates. This provides the framework for analysing competitive constraints, whether they come from within or outside the market.
10. The CAA is minded to take the view that GAL currently operates in two distinct markets, combining the product and geographic dimensions of market definition:
- Airport operation services<sup>5</sup> for low cost carriers (LCCs) and charter airlines covering a geographic market that is limited to Gatwick but may include Luton and Stansted. This market is referred to as the Gatwick LCC and charter market.
  - Airport operation services<sup>6</sup> for full service carriers (FSCs) and associated feeder traffic. The CAA's current view is that this market includes

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<sup>5</sup> For LCCs and charter airlines these activities include facilitating the use of runway and taxi-ways, aerodrome ATC, aircraft parking, ramp handling services, fuel and oil handling, and aircraft maintenance, as well as the minimum activities required for the processing of passengers at the airport, the provision of a terminal and the facilities for check-in, baggage handling, security screening and the transit of passengers to and from the aircraft.

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



Heathrow<sup>7</sup>. This market is referred to as the Gatwick FSC and feeder market.

11. These markets were identified on the basis of the distinct infrastructural demands of LCC and charter airlines and FSC and associated feeder traffic as well as evidence on the substitutability of other airports for Gatwick. The market definitions were informed by the views of airlines and airport operators, evidence on airline switching behaviour and the analysis of passenger preferences and behaviour.
12. In its Initial Views<sup>8</sup> document published in February 2012, the CAA explored whether a seasonal market definition might be relevant i.e. whether there were separate summer and winter markets. This was considered because of the importance of charter airlines, whose business is seasonal, at Gatwick. Information gathered subsequently has suggested that the total demand for GAL's airport operation services is not markedly more seasonal than at other London airports. Furthermore, the CAA considers that defining a seasonal market would not lead to different findings on market definition or the strength of competitive constraints at Gatwick.

### The Gatwick LCC and charter market

13. Overall, the evidence suggested that LCCs do not view the north London airports, Luton and Stansted, as substitutes for Gatwick.
14. The CAA's "Initial Views" on GAL's market power discussed whether Gatwick should be considered as part of a Europe-wide market. GAL has argued that LCCs enjoy considerable flexibility in allocating their assets and may be able to switch either based aircraft or allocate growth to other EU airports. Information gathered by the CAA since then has shown that the competitive constraints posed by airline switching (or threat of switching) to European airports from UK airports including Gatwick appears to be relatively weak. Little evidence has come to light of actual switching of established airline capacity from London airports to European airports.
15. Charter airlines indicated to the CAA that passengers tend not to associate other south east England airports with package holiday travel and alternatives to Gatwick do not have as extensive a catchment or "pull".
16. The evidence from LCCs and charter airlines suggest that Gatwick may be a market within itself, with a number of airlines considering that there is a north/south split across London. However, a number of airlines have considered

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<sup>7</sup> The key consideration the strength of the competitive constraint from Heathrow rather than whether it is, or is not, included in the relevant market.

<sup>8</sup> ["Gatwick Market Power Assessment Initial Views", CAA, February 2012](#)

and currently operate some services from other London airports. The CAA considers that there may be a geographical market limited to Gatwick itself, but the market may possibly include Luton and Stansted.

### The Gatwick FSC and associated feeder market

17. In the FSC and associated feeder market, airlines require a number of key elements to ensure the efficient and profitable running of their route networks, including the provision of feeder traffic and the provision of bellyhold cargo. If FSCs offer the facility to connect at an airport, then they will demand the infrastructure that allows them to do so, even if the number of connecting passengers is low. Apart from Gatwick, the only other London airports where FSCs can access the facilities and infrastructure they require for connecting traffic are Heathrow and Stansted. A number of airlines indicated that Heathrow would be substitutable for Gatwick if sufficient capacity were available. Some of these carriers operate in full or in part from Gatwick as they cannot gain slot access at suitable times at Heathrow.
18. Although Stansted has the required facilities and spare capacity, it does not operate with them at present. Currently, Stansted lacks a suitable feed of connecting traffic and it is difficult to see this changing appreciably over the short-to-medium term. FSCs stated that Stansted was not a substitute for Gatwick.

#### *Current competitive constraints on GAL*

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

The means available to an airline to switch away capacity, and how reasonable and effective different strategies would be in constraining GAL's pricing. For example, airlines might allocate future growth to other airports; reduce the frequency of their service(s); ground marginal aircraft; or switch away their marginal based aircraft.

The types and size of switching costs airlines might incur. These costs range from the costs of relocating aircraft, crew and facilities to costs from lost revenue if an airline has to switch away from a preferred market. The integration of services within a carrier's network and the benefits derived from the presence of alliance partners were also considered in relation to airline switching.

The constraints to airline switching imposed by the availability of spare capacity at competing airports.

Whether airlines could exercise buyer power to counteract any SMP that GAL might have.

### Current competitive constraints on GAL: LCC and charter market

20. Airport charges are a higher proportion of LCC airlines' costs than FSCs', suggesting that LCCs might be more sensitive to an increase in GAL's airport charges.
21. The CAA has examined whether there are sufficiently strong competitive constraints (from within and outside the relevant market defined above) such that GAL cannot profitably raise its charges above the competitive price. The CAA has carefully considered evidence on the possibility of airline and passenger switching and the constraints they face in doing so.
22. Based LCCs, especially those with alternative London bases, have the facility to switch some of their services to those bases or further afield. Inbound LCCs have more potential to be mobile as they tend not to have significant sunk costs at Gatwick.
23. The CAA has found that direct costs of switching aircraft operations and crew are relatively low. However, there are a number of strategic costs to airlines associated with switching away from Gatwick. These costs include establishing a market position at a substitute London airport, particularly the cost of marketing new routes. Evidence suggests that, while new routes are being established, it typically takes some time for airline yields to build up to their long-run potential, which represents a switching cost. Also, if an airline were to switch to another airport, there is the possibility that it may face increased competition on its routes if a rival airline were to take up a vacated slot.
24. Substitution possibilities for LCCs are also constrained by the limited stand capacity at Luton, which would make it difficult to base significant numbers of additional aircraft there.
25. The CAA has found that charter airlines tend to regard each airport on a case-by-case basis rather than looking at a route as a city-pair. In particular, the CAA considers that the evidence suggests that charters look to serve the core catchment associated with the airport that they operate from and often look to consolidate their scheduled and chartered holiday flights from one 'leisure hub'. Charter airlines told the CAA that they are attracted by Gatwick's wide catchment and good surface links compared to the north London airports, Luton and Stansted. Gatwick has a predominant position as the main airport for holiday departures in the south east of England. Charter airlines told the CAA that it had a good brand image as a holiday airport making Gatwick flights easy to sell.
26. The CAA found no evidence in the commercial arrangements between GAL and the airlines to indicate that LCCs and charter airlines were able to exercise buyer

power. This appears to be because the airlines lack credible alternatives to switch away to discipline GAL's pricing behaviour.

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

### **Current competitive constraints on GAL: FSC and feeder market**

28. GAL's airport charges are a lower proportion of FSCs' operating costs relative to LCCs', suggesting that they might be less sensitive to an increase in airport charges. The CAA considers that FSC and feeder airlines at Gatwick, of which BA and Virgin are the largest, are likely to find reducing the frequency of services to be the most feasible means of constraining a price increase by GAL.
29. In the FSC and feeder traffic market, the costs of relocating aircraft and crew are unlikely to be material for most based or inbound airlines at Gatwick. The strategic costs of switching from Gatwick to Heathrow also appear to be low (with the exception of slot acquisition which could be a material expense). Carriers might actually gain from switching to Heathrow. FSCs and associated feeder traffic at Gatwick have consistently told the CAA that Heathrow is their preferred option when operating from London.
30. There is evidence of some switching between Gatwick and Heathrow, but this has often been airlines that have been operating at Gatwick while they were waiting for suitable Heathrow slots to become available. The CAA considers that these instances of switching were driven by factors other than GAL's airport charges and are therefore not evidence of a competitive constraint on GAL in the normal meaning of the term.
31. The main reason why the CAA considers that Heathrow may not exercise an effective constraint on GAL's pricing is the lack of suitably timed slots at Heathrow. GAL has submitted that there is spare capacity in the London system and that even if capacity is scarce, slots can be bought to facilitate switching to other airports (Heathrow). However, the airlines told the CAA that the cost and availability of slots at Heathrow creates a high barrier to entry and expansion at that airport. As slots appear to be difficult to obtain at Heathrow, the CAA considers that the competitive constraint that Heathrow poses to Gatwick is very limited. It may be possible for some airlines to obtain slots but the CAA's provisional view is that this would be insufficient to constrain GAL's airport pricing.
32. Stansted has the capacity to accommodate additional traffic, but its lack of connecting passengers means that it is unlikely to be able to attract a significant scale of FSCs or their associated feeder traffic.

33. The CAA found no evidence to indicate that FSCs were able to exercise countervailing buyer power. Individually they do not account for a high proportion of GAL's airline business and they appeared to lack credible alternatives to which to switch. GAL has offered discounts to some new airlines to Gatwick but not to the incumbent airlines.

### Current competitive constraints on GAL: passengers

34. With regards to passenger switching, airlines may not pass on an increase in GAL's charges or may only do so after some time. Passenger switching will only occur to the extent to that any increase in GAL's charges are passed on by the airlines.
35. GAL has stressed the significant overlaps between passenger catchment areas in the London system, which might suggest that passengers have significant choice. The CAA recognises that there are significant overlaps. However, passengers have preferences that must be taken into account when trying to assess their propensity to switch in response to an increase in GAL's airport charges. Also, in order to exercise that choice some passengers require equivalent flights (sometimes to the same destinations) to be available at other airports. There appears to be more choice available to passengers seeking to fly on a short-haul service than for long-haul flights.
36. Connecting passengers represent around 8 per cent of Gatwick passengers. The CAA considers that connecting passengers will also have relatively low passenger sensitivity to increases in GAL's airport charges (as opposed to increases in airfares). Therefore, the CAA considers that the proportion of connecting passengers that might switch in response to an increase in GAL's airport charges appears to be insufficient to widen the geographical market or, when combined with surface passenger switching, to constrain GAL.
37. Passengers' preferences for a particular destination, limited route availability at other airports, and the lack of full substitutability of different types of service suggest that fewer passengers may be able, or willing, to change the airport they use than that suggested by catchment overlaps. The CAA found that route availability at other airports was relatively high for short-haul services but for long-haul, the overlap was less and much of it was accounted for by services that would not normally be considered to be substitutes, e.g. charter flights and scheduled services.
38. Analysis suggests that, at most, a 10 per cent increase in airport charges would equate to around 3 per cent on an airfare. The airfare may itself be purchased as part of a bundled product (e.g. a holiday). Therefore, passengers' sensitivity to increases in airport charges is likely to be relatively low.

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

*Indicators of GAL's market power*

40. If Luton and Stansted are included in the LCC product market, GAL has a 46 per cent share of the relevant market by passenger numbers. In the FSC product market, GAL has a 14 per cent share of the relevant market by passenger numbers.
41. The CAA considers that there are a number of reasons why market share data may not be a reliable indicator of market power.
- Long-term capacity constraints at Heathrow and to a lesser extent at Gatwick may render the market share misrepresentative.
  - The importance of geographical location for airport competition means that there is a continuum of substitution possibilities depending on distance and other airport characteristic.
  - Any market definition beyond a single airport is, to an extent, arbitrary and assessment of market shares is unlikely to be a useful tool in itself for measuring the airport operator's market power.
42. Given these limitations, the CAA does not draw strong conclusions from this analysis on its own and has therefore sought to review other relevant evidence. Nevertheless, the CAA notes the GAL share of the LCC and charter market is above a level where dominance has been found. If Luton and Stansted are not considered to be in the market, it is above a level where dominance is presumed. Although GAL's share of the FSC market is low and below that used for a presumption of dominance, it is still of concern owing to the difficulty of switching to Heathrow. Therefore, the CAA considers that the Heathrow constraint is relatively ineffective.
43. The CAA has commissioned an independent benchmarking study which shows that prices at Gatwick are likely to be close to the level of comparator airports. Taken together with a study of long-run average costs, commissioned by the CAA, this suggests that current prices at GAL are close to the competitive level. At present GAL is pricing to its regulatory price cap and has indicated that it believes that its prices are too low. This may suggest that GAL would increase prices if it were to be deregulated.
44. GAL has argued that it has introduced a number of service level initiatives at Gatwick since its change of ownership in 2009 and is now exceeding many

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

45. Similarly, GAL maintained that improvements in efficiency since the change of ownership indicate competitive pressures. The CAA considers that GAL's efficiency has improved under new ownership. However, the evidence suggests that there remain a number of areas of inefficiency. The CAA therefore considers that the evidence on efficiency is open to interpretation. Businesses with SMP may also benefit from making efficiency improvements so this factor does not clearly point to the existence of a competitive market.
46. How an airport operator engages in negotiations with the airlines that use it can be informative as to the degree of its market power. The CAA considers that GAL largely sets the terms that an airline will receive and that the scope for negotiation is relatively limited. The CAA considers that there appears to be limited scope for short-haul airlines to negotiate any discounts to airport charges and the scope for charters to effectively negotiate with GAL on other issues appears limited.
47. Some of the indicators are open to interpretation and the indicators have to be weighed against the evidence that the CAA obtained from the airlines, which indicated that the competitive constraints from within and outside the relevant markets are weak.

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

48. The CAA appreciates that the evidence does not all point in one direction and a judgement is therefore needed on the balance of the evidence it has reviewed. On this basis, the CAA is minded to conclude that, in relation to the LCC and charter market, GAL has SMP, which is unlikely to be eroded over the period 2014 to 2019.

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

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

substantial part of the market supplied by Heathrow, an airport that is severely capacity constrained.

50. A contrary finding that GAL does not have SMP appears to be inconsistent with the evidence the CAA has obtained from the airlines and its analysis of passenger switching. In particular, the airlines indicated that they lacked substitution possibilities if GAL were to increase its airport charges or reduce the quality of its offer to the airlines.
51. The CAA is minded to conclude that GAL has SMP in this market, but will consider carefully any further submissions that might indicate that GAL is sufficiently constrained by competition in the Gatwick FSC and associated feeder market, in particular by the credible possibility of FSC and associated feeder carriers switching to Heathrow.

### **Factors contributing to GAL's market power and future developments**

52. In both the FSC and associated feeder market as well as in the LCC and charter market, the CAA considers that the likely underlying source of GAL's market power is the inherent attractiveness of the London market and its strategic importance to airlines, combined with capacity constraints in the London system, which limit the number and size of available alternatives.
53. The CAA notes that the government has currently put a hold on the expansion of the main London airports and that the Davies' Commission is not expected to bring out an interim report until the end of 2013, with a full report in summer 2015. The CAA considers that any change in government policy following the release of the Davies' Commission final report may take some time to be implemented and that any significant capacity expansion would not be expected until 2025.
54. Gatwick is likely to benefit from the expected tightening of capacity constraints across the South East. Larger aircraft and better utilisation of slots may help to address capacity constraints. However, based on the Department for Transport's (DfT) and GAL's passenger forecasts, the CAA is minded to conclude that capacity constraints are expected to tighten further over the Q6 period. This tightening can be expected to reduce GAL's incentive to price to the competitive level.
55. The CAA acknowledges there are some uncertainties and that in the future its analysis could change over the longer term. For example, the change of ownership of Stansted could result in it posing a greater competitive constraint on GAL. The outlook for the economy is uncertain and future government policy in relation to new capacity in the South East could change. Moreover, the airlines operate in a market that is characterised by change and hence the business models operating at Gatwick could change, as could passenger preferences.



## Test B

56. Test B requires that the CAA is satisfied that competition law does not provide sufficient protection against the risk of abuse of SMP. Further, as with all of the CAA's regulatory functions, the assessment of Test B must be conducted in accordance with the CAA's primary duty. The CAA must apply Test B "in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services". Further, in so doing, the CAA must, where appropriate, seek to "promote competition in the provision of airport operation services".
57. Importantly, for Test B, the CAA has to assess the adequacy of competition law from the perspective of "users of air transport services". Accordingly, when assessing the merits of competition law, the CAA has to further the interests of passengers and cargo owners, and not the interests of commercial passenger or cargo airlines or other intermediary service providers, such as groundhandling providers, car parking or retail concessionaires.
58. Under competition law, a dominant company has a special responsibility not to allow its conduct to impair or distorted competition in the relevant market. It is not the position of dominance or SMP itself that is prohibited, but rather the undertaking using that position to prevent or distort the effective competition in the market.
59. The CAA considers that there are clear and distinct aims for *ex-ante* regulation and *ex-post* competition. The former is to foster the development of competition correcting for known impediments to the competitive process. The latter is to protect the current state of competition (as a minimum) within the market.
60. The CAA considers that there is adequate competition case law, on which it would be able to rely in order tackle vertical abuses where an airport operator has an interest in a downstream market or horizontal abuses where the airport operator is seeking to foreclose the market for a competing airport operator.
61. The CAA considers that for vertical abuses of an exploitative nature where the airport operator does not have an interest in the downstream market the CAA has insufficient comfort that it would be able to successfully discipline behaviour through the use of competition law. These include abuse of excessive pricing and service quality based abuses.

## Potential detriment from relying on competition law

62. The CAA considers that the detriment to air transport users from the potential abuse of GAL's market power is likely to have effects in a number of areas.
63. Excessive prices are likely to have a direct impact on passengers'/users' ability to travel where these are passed straight through to the fare paid in the case of the

Gatwick LCC and charter market. Although individually the amounts involved are likely to be limited, over the passenger group as a whole, these are likely to lead to significant sums.

64. Where the airport price rises are not directly passed through to passengers/users, this will have the direct impact on the profitability of the airline sector. This is likely to have an effect on airlines' incentive and ability to invest and innovate, for example, in new routes and also affect the viability of existing routes offered. This would be likely to affect users' interests, for example, by restricting their choice of airlines and destinations available from the airport.
65. Likewise, the CAA expects that GAL's ability to charge excessive prices may lead it to have less incentive to deliver the level of service quality demanded by users.
66. Given the nature of the detriment to the users and the difficulties that result in pursuing potential exploitative vertical abuses, the CAA is minded to consider that, in the case of GAL, competition law is unlikely to be sufficient to curtail abusive behaviour. Therefore, this part of the MPT is met.

### **Test C**

67. Test C requires the CAA to assess whether the benefits of a licence regime are likely to outweigh the adverse effects. It is not necessary, in assessing whether Test C is met, to define precisely the type of regulation that would apply; only whether the benefits of some form of licence-based regulation are likely to outweigh the adverse effects. The CAA has a duty to perform its functions having regard to good regulatory principles, including the proportionality of any licensing proposals and targeting them only where action is needed. In order to assess the potential benefits of a licence, it is necessary to form a view of the counterfactual to a licence regime i.e. what conditions of regulation would exist in the absence of a licence.

### **The regulatory counterfactual**

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

### Enforcement risks of commitments

69. The CAA has considered whether GAL's commitments are sufficient and that the incremental benefits of licence regulation are likely to be outweighed by the adverse effects and so Test C would not be met. In undertaking this assessment the CAA has been mindful of the lack of explicit statutory provision for the acceptance of commitments in lieu of licence regulation. Consequently, the CAA considers that it should exercise caution and would want to consider whether commitments would provide material benefits over licence regulation, in particular in relation to the CAA's statutory duties.
70. For commitments to be an effective substitute for licence regulation they must be clear and enforceable so that airlines and other stakeholders have confidence that the benefits GAL say would accrue from the commitments would be delivered in practice, and would accrue to passengers and cargo owners.
71. The CAA considers that GAL's current proposal to include commitments in the Conditions of Use raises a number of concerns about the substance and enforceability of the provisions. In particular, the CAA is concerned that the Conditions of Use (including the commitments) would be unbalanced with insufficient clarity over the facilities that GAL would provide. It would allow GAL to undertake unilateral variation or contracting out. As they would be enforced by airlines they may not offer the same protection to passengers and cargo owners as compared to a licence enforceable by CAA which has a statutory duty to protect their interests. Furthermore, the commitments commit parties to dispute resolution which could unduly delay airlines from taking enforcement action, and they provide no explicit protection from repeated failure against service quality standards.
72. In addition, the CAA is concerned that in the absence of a licence, if there are repeated failures to comply with the commitments, then while this may constitute a material change in circumstances, the process of re-introducing licence regulation may take two to three years, allowing significant passenger detriment to occur during this time. These issues could be avoided under licence regulation.

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

#### Benefits

73. **Price:** As highlighted earlier, the CAA considers that the current cap is not significantly below the competitive price. Consequently the CAA is concerned that GAL's commitments propose to increase the price cap by an equivalent of RPI+4

per cent per year over seven years. This is in excess of a reasonable price as judged by a RAB-based comparator, which gives a price of RPI+0 per cent, over the period. Consequently licence regulation is likely to provide additional benefits in this area.

74. **Efficiency:** The impact on efficiency of the commitments is likely to be mixed, with potential benefits from retaining the benefits from efficiency improvements for longer (at least seven years, compared to typically five years from licence regulation), offset to some extent by the looser price cap providing less of an incentive to be efficient, and the pass through of full operational costs.
75. **Service quality:** The commitments include much the same service quality regime as used for Q5. However, the extension and the increased money at risk for bonuses could provide gains to GAL, and the inclusion of airline facing service quality targets has the potential to distort competition to the detriment of passengers. Again it may be possible to avoid these issues under a licensing regime.
76. **Investment:** The commitments do not include capital expenditure commitments or triggers. Instead, investment would be driven by the service quality regime and GAL's vision for the airport in the future. Given the position of the SMP of the airport operator there is a risk that some beneficial enhancements for users would not be taken forward. The consultation arrangements under the commitments would be based on those under the ACR. While this may save costs and speed processes, for an airport operator with SMP this means that users' interests may not be fully taken into account.

### Adverse effects

77. The commitments would have benefits over a licence approach, in that they would avoid the direct costs of staff and consultancy associated with a regulatory review. GAL estimates that these costs of the existing regulatory regime are around £8m per year, mainly around consultation. In addition there would be CAA costs, estimated to be around £1m per year, and airline costs of up to £1m per year. These costs may be reduced under alternative forms of regulation. Commitments themselves are unlikely to be costless and potential cost savings would be significantly reduced but perhaps not eliminated if there is not effective partnership working between GAL and airlines, and if there were numerous complaints to the CAA under competition law or ACR. Airline feedback on the commitments has been mixed.
78. The commitments would also have benefits in terms of avoiding the potential distortions from licence regulation: avoiding management distraction, as the enforcement of the commitments would be linked to commercial negotiations; and removing some perverse incentives that may occur under a regulatory regime, for example potential distortions to capital expenditure incentives under a

RAB-based framework, or the potential for regulatory “gaming”. Commitments could also avoid potential distortions to competition, for example a price cap set too low could distort charges and investment at other airports and bilateral contracts could be more likely under commitments, although GAL would be free to pursue these under licence regulation.

### Assessment

79. In addition to the concerns highlighted above, the CAA has reviewed whether the provisions in the commitments would provide sufficient protection against the potential abuse of SMP, across the focuses on the topics most commonly addressed by economic regulation.
80. Overall the CAA welcomes GAL's commitment proposals. However the CAA is not sufficiently convinced that the enforceability of and the terms within the current commitment proposals provide sufficient protection to passengers and cargo owners. Overall, the CAA is minded to find that Test C is met and that some form of licence regulation should apply to GAL. Consequently the CAA considers that there would be significant incremental benefits from licence regulation, which are likely to outweigh the adverse effects and that Test C is met.

# FIRST PART: TEST A

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## CHAPTER 1

# Introduction

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### Purpose of this document

- 1.1 This document sets out the CAA's 'minded to' views on whether Gatwick Airport Limited (GAL) has or is likely to acquire substantial market power (test A).<sup>9</sup> It also sets out the CAA's 'minded to' view on:
- test B – whether competition law provide sufficient protection against the risk of abuse of substantial market power (SMP); and
  - test C – which requires the CAA to be satisfied with the benefits of licence regulation against its potential adverse effects.
- 1.2 This is the non-confidential version of this document and excisions from the text are marked with [§].
- 1.3 The CAA notes that the Civil Aviation Act 2012 (the Act) commenced on 1 April 2013 and that this 'minded to' decision is consistent with the CAA's new primary duty to further passengers' and cargo owners' interests in the provision of airport operation services, where appropriate, by promoting competition and the market power test under the Act.
- 1.4 The CAA is seeking stakeholders' views on the information and conclusions presented in this 'minded to' document. Those wishing to respond to this consultation should do so in writing, by no later than **5 pm on 26 July 2013**. Responses should be emailed to: [economicregulation@caa.co.uk](mailto:economicregulation@caa.co.uk).

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<sup>9</sup> The Civil Aviation Act 2012 (CA Act) only permits economic regulation of an airport operator and the granting of a licence by the CAA if three tests set out in section 6 (market power test) are met. The tests are: (1) test A, which requires the CAA to establish whether "the relevant operator has, or is likely to acquire, substantial market power in a market either alone or taken with such other persons as the CAA considers appropriate"; (2) test B is that competition law does not provide sufficient protection against the risk of abuse of substantial market power; and (3) test C requires the CAA to be satisfied with the benefits of licence regulation against its potential adverse effects.

- 1.5 The CAA intends to publish responses to this consultation on its website shortly after the close of the consultation period. If there are parts of your response that you consider commercially confidential, please mark them clearly as such. Please note that the CAA has powers and duties with respect to information disclosure that can be found in section 59 and Schedule 6 of the Act and in the Freedom of Information Act 2000.

### Background and structure of this document

- 1.6 In 2011, the CAA commenced a project to understand the extent and nature of market power held by the operators of the airports that are currently 'designated' under the Airports Act 1986 (the Airports Act) and that are subject to price regulation, i.e. Gatwick, Heathrow and Stansted.
- 1.7 In February 2012, the CAA published "Gatwick – Market Power Assessment: the CAA's Initial Views" (the Initial Views). In the Initial Views, the CAA indicated that GAL enjoyed a particularly strong market position in some market segments. For example, the CAA indicated that GAL has a relatively strong market position when competing for point-to-point (no frills and charter) services serving passengers in the South East of England, as well as outbound holiday passengers.
- 1.8 Since the publication of the Initial Views, the CAA has strengthened its evidence base by undertaking additional analysis on the existing evidence and considering new material, including material submitted in response to the Initial Views and material obtained from further stakeholder engagement.
- 1.9 In particular, since the publication of the Initial Views the CAA's thinking has evolved with respect to defining the market(s) that GAL operates in (see chapter 5) – a key step in any competition assessment – and competitive constraints (see chapters 6 and 7). The CAA has also further developed its thinking on price and the other indicators of market power (see chapters 4 and 9).
- 1.10 This document is structured so that material and analysis associated with test A is initially examined. An examination of tests B and C then occurs. An overall conclusion is then presented. In particular:



- Chapter 2 describes GAL's business and operations;
- Chapter 3 describes the analytical framework for market definition;
- Chapter 4 considers the competitive price for aeronautical services at Gatwick;
- Chapter 5 defines the market(s) within which GAL operates;
- Chapter 6 assesses competitive constraints for low cost carriers and charter airlines, including airport users' ability to discipline the airport operator through switching or the threat of switching, buyer power and potential entry and expansion;
- Chapter 7 assesses competitive constraints for full service carriers and associated traffic, including airport users' ability to discipline the airport operator through switching or the threat of switching, buyer power and potential entry and expansion;
- Chapter 8 assesses competitive constraints from passengers' ability to discipline the airport operator through switching or the threat of switching;
- Chapter 9 investigates indicators of market power, including pricing, profitability, efficiency and service quality;
- Chapter 10 outlines the CAA's 'minded to' conclusion on test A for GAL;
- Chapter 11 considers test B;
- Chapter 12 considers test C; and
- Chapter 13 outlines the CAA's 'minded to' conclusion for the market power test and the market power determination.

### **CAA's approach to consultation and evidence gathering**

- 1.11 In coming to its 'minded to' view, the CAA has undertaken extensive evidence gathering, including through stakeholder engagement (see Annex 1 for details). Stakeholders that the CAA has engaged with include GAL, unregulated airport operators and airlines operating at Gatwick. This engagement has taken a variety of forms, including:

- one-to-one meetings with GAL and its airlines to discuss relevant evidence;
- stakeholder feedback and discussion on work in progress;
- a CAA Board Gatwick stakeholder engagement day (16 January 2013);
- the submission of evidence by stakeholders (including reports commissioned from economic consultancies);
- questionnaires issued by the CAA to both airport operators and airlines and gathered documentary evidence from both; and
- consultants' studies commissioned by the CAA.

1.12 The CAA notes that in 2011 it also published a number of working papers (all of which are available on its website), including:

- empirical methods relating to geographical market definition and updates focusing on competitive constraints between neighbouring airports;
- empirical methods for assessing behaviour, performance and profitability of airports;
- general market context;
- catchment area analysis; and
- passengers' airport preferences.

### Contact details

1.13 If you would like to discuss the contents of this paper, or the CAA's work on assessing airport competition more generally, please contact the CAA on 0207 379 7311.

### Next steps

1.14 The CAA intends to publish its formal decision under the Act on the market power determination for GAL before the end of 2013.

## CHAPTER 2

# The business of Gatwick Airport Limited

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- 2.1 This section provides an overview of the current ownership and history of Gatwick and business of Gatwick Airport Limited (GAL). In particular, it looks at the services the airport provides to different users, as well as the different sources of revenue for GAL.

## The ownership of Gatwick

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- 2.2 GAL is the company licensed by the CAA to operate Gatwick. It is wholly-owned by Ivy Bidco Limited (Ivy), a company formed to undertake the acquisition of Gatwick. Ivy is ultimately controlled by funds managed by Global Infrastructure Management, part of Global Infrastructure Partners (GIP).<sup>10, 11</sup>
- 2.3 Following an equity syndication process, GIP retains a 42 per cent controlling stake in Gatwick. The other shareholders are the Abu Dhabi Investment Authority, National Pension Service of Korea, California Public Employees' Retirement System and the Future Fund of Australia.<sup>12</sup>
- 2.4 Other UK airports held within the GIP portfolio include London City (75 per cent ownership)<sup>13</sup> and Edinburgh (100 per cent).<sup>14</sup>

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<sup>10</sup> GIP is an independent investment fund manager that invests worldwide in infrastructure assets. It targets investments in air transport infrastructure, ports, freight rail, power and utilities, natural resources infrastructure, water distribution and treatment, and waste management.

<sup>11</sup> GAL, Ownership, <http://www.gatwickairport.com/business/about/ownership/>, (accessed 11 December 2012).

<sup>12</sup> GAL, Ownership, <http://www.gatwickairport.com/business/about/ownership/>, (accessed 11 December 2012).

<sup>13</sup> GIP, <http://global-infra.com/investment/london-city-airport/>, (accessed 11 December 2012).

<sup>14</sup> GIP, <http://global-infra.com/investment/london-city-airport/>, (accessed 11 December 2012).

## The historical development of Gatwick

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- 2.5 Gatwick is a single runway airport and is located approximately 25 miles south of central London.
- 2.6 The airport began life in 1930 when a small flying club was formed<sup>15</sup>, largely to allow owners, trainers, race-goers and jockeys to travel to and from racing meetings by air.<sup>16</sup>
- 2.7 In 1934, the airport was issued with its first public licence<sup>17</sup> but it was not until 1953, when the Government determined that Gatwick would be London's second airport, that Gatwick attracted major investment.
- 2.8 By 1956, Gatwick had been transformed into a modern facility with a 610 metres runway, a terminal incorporating a rail station and a covered pier linking terminal with aircraft, the first of its kind in the UK.<sup>18</sup>
- 2.9 Gatwick underwent further development<sup>19</sup> in the years leading up to 1965, when the British Airports Authority (which later became BAA) was established and assumed ownership of Heathrow, Gatwick, Stansted and Prestwick.<sup>20</sup>
- 2.10 In 1979, an agreement between BAA and West Sussex County Council was reached which prevented the construction of a second runway at Gatwick before 2019.<sup>21</sup>

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<sup>15</sup> GAL, <http://www.gatwickairport.com/business/about/history/>, (accessed 11 December 2012).

<sup>16</sup> Gatwick Airport Consultative Committee (GACC), <http://www.ukacccs.info/gatwick/profile.htm> (accessed 11 December 2012).

<sup>17</sup> GAL, <http://www.gatwickairport.com/business/about/history/>, (accessed 11 December 2012).

<sup>18</sup> GAL, <http://www.gatwick-airport-guide.co.uk/history.html>, (accessed 11 December 2012).

<sup>19</sup> In particular, in 1962, two new piers were construction which doubled the size of the terminal, and, in 1964, the runway was extended to 2,500 metres (and was further extended in 1970 and again in 1973).

<sup>20</sup> GAL, <http://www.gatwickairport.com/business/about/history/>, (accessed 11 December 2012).

<sup>21</sup> GACC, <http://www.ukacccs.info/gatwick/profile.htm>, (accessed 11 December 2012).

- 2.11 Gatwick has been regulated by the CAA in accordance with the Airports Act 1986 (AA86), under which an airport with an annual turnover of at least £1 million requires a '*permission to levy airport charges*' from the CAA. Specifically, AA86 requires the CAA to impose conditions on airports designated by the Secretary of State for Transport for regulating the maximum amounts that may be levied by an airport operator by way of airport charges during a specified five-year period. In November 1986, the Secretary of State for Transport granted permission to Gatwick to levy airport charges, and the airport has been subject to this form of regulation since. While the CAA sets a maximum level of charges that an airport can set, an airport can enter into bilateral agreements with airlines to agree terms, which means that the charges incurred by an airline can be lower than the cap that has been set.
- 2.12 The CAA notes that the Civil Aviation Act 2012 replaces the framework for airport regulation under the Airports Act 1986 (AA86).
- 2.13 Under BAA, Gatwick was further developed and by 2005 it had broadly reached the configuration that is observed today. In particular:
- In 1983, work began on the North Terminal. This work was completed in 1988, and in 1991 a second pier was added.<sup>22</sup>
  - In 1994, the new North Terminal International Departures Lounge and the first phase of the new South Terminal International Departures Lounge were opened.<sup>23</sup>
  - In 2000, an extension to the international departure lounge in the South Terminal was opened. A further extension was developed for the North Terminal departure lounge in 2001.<sup>24</sup>
- 2.14 In 2003, the Government issued 'The Future of Air Transport' (the White paper), which set out a strategic framework for the development of airport capacity in the UK over the next 30 years. Among other issues, this document examined current and future capacity requirements and found that there was a need to make the best possible use of existing runways at the major South East airports. It also recognised that new runway capacity in the South East was

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<sup>22</sup> GAL, <http://www.gatwickairport.com/business/about/history/>, (accessed 11 December 2012).

<sup>23</sup> GAL, <http://www.gatwickairport.com/business/about/history/>, (accessed 11 December 2012).

<sup>24</sup> GAL, <http://www.gatwickairport.com/business/about/history/>, (accessed 11 December 2012).

required and indicated that land should be safeguarded for a possible second wide-spaced runway at Gatwick after 2019.

- 2.15 In May 2005, in response to the White Paper, GAL published for consultation its Outline Airport Master Plan, a potential blueprint for Gatwick in 2015 and 2030.<sup>25</sup>
- 2.16 In 2006, BAA was acquired by Airport Development and Investment Ltd, a consortium led by Grupo Ferrovial.<sup>26</sup>
- 2.17 In 2008, the European Union – United States of America (EU-US) Open Skies Agreement came into effect, which allowed any airline of the EU and US to fly between any point in the EU and any point in the US. As a consequence, a number of US airlines relocated from Gatwick to Heathrow.<sup>27</sup>
- 2.18 In March 2007, the Competition Commission (CC) launched an investigation into BAA's ownership of airports within the UK.<sup>28</sup>
- 2.19 In 2008, ahead of the CC's decision, BAA announced that Gatwick would be sold and in December 2009 GIP became the owners of the airport.<sup>29</sup>
- 2.20 In 2009, the CC concluded that BAA's common ownership of airports in south-east England and lowland Scotland gave rise to adverse effects on competition.<sup>30</sup> The CC concluded that a package of remedies that would be effective in remedying this included the divestiture of both Stansted and Gatwick to different purchasers and the divestiture of either Edinburgh or Glasgow airport.<sup>31</sup>
- 2.21 In June/July 2010, GAL revealed Gatwick's new brand identify, re-

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<sup>25</sup> GACC, <http://www.ukaccs.info/gatwick/profile.htm>, (accessed 11 December 2011).

<sup>26</sup> GAL, <http://www.gatwickairport.com/business/about/history/>, (accessed 11 December 2012).

<sup>27</sup> Airline network news and analysis, <http://www.anna.aero/2009/01/30/open-skies-shifts-demand-from-gatwick-to-heathrow/>, (accessed 18 December 2012).

<sup>28</sup> Competition Commission (CC), [http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/core\\_term\\_s\\_of\\_reference.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/core_term_s_of_reference.pdf), (accessed 6 March 2013).

<sup>29</sup> GAL, <http://www.gatwickairport.com/business/about/history/>, (accessed 11 December 2012).

<sup>30</sup> CC, [http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep\\_pub/reports/2009/fulltext/545.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/545.pdf), p. 4 (accessed 6 March 2013).

<sup>31</sup> CC, [http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep\\_pub/reports/2009/fulltext/545.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/545.pdf), (accessed 6 March 2013).

opened the refurbished inter-terminal shuttle and outlined its plans for the airport. In 2011, the North Terminal extension was opened.<sup>32</sup>

2.22 In 2010, following a change in government, the Government indicated that it would not permit further runway expansion at the designated airports<sup>33</sup>, including development of a new runway at Gatwick, until its new aviation strategy had been developed.

## Gatwick's facilities

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2.23 This section describes the scale and disposition of some of the facilities at Gatwick.

### The runway

2.24 The primary runway is an instrument runway (suitable for operations in low visibility conditions) with a pavement length of 3,316 metres by 45 metres wide.<sup>34</sup> There is also a parallel standby runway that is used when the primary runway is closed for planned maintenance or for an unplanned closure. This is a visual runway (it cannot be used in low visibility conditions) with a pavement length of 2,565 metres.<sup>35</sup>

### The terminals

2.25 Gatwick has two passenger terminals:

- The South Terminal, which opened in 1958, has a gross floor area of approximately 160,000 square metres, of which 14,768 square metres is retail facilities.<sup>36</sup>
- The North Terminal, which opened in 1988, has a gross floor area of approximately 98,000 square metres, of which 12,530 square metres is retail facilities.

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<sup>32</sup> GACC, <http://www.ukaccs.info/gatwick/profile.htm>, (accessed 11 December 2012).

<sup>33</sup> Department for Transport (DfT), <http://www.dft.gov.uk/news/speeches/villiers-20101214/>, (accessed 8 November 2012).

<sup>34</sup> GAL, <http://www.gatwickairport.com/business/about/facts-figures/>, (accessed 11 December 2012).

<sup>35</sup> GAL, Gatwick Master Plan, July 2012, page 42.

<sup>36</sup> GAL, <http://www.gatwickairport.com/business/about/facts-figures/>, (accessed 11 December 2012).

- The two terminals are connected by an automated people mover system known as ‘the shuttle’.<sup>37</sup>
- 2.26 Gatwick also has 348 check-in desks, 187 in South Terminal and 161 in North Terminal. In addition, there are 88 self-service kiosks.<sup>38</sup>
- 2.27 The CAA notes that GAL has recently redeveloped the South Terminal security area, introduced family-friendly security lanes and changed the way it looks after passengers with reduced mobility.<sup>39</sup> According to GAL, this involves:
 

*19 new security lanes that allow almost 5,000 people per hour to pass through into the departure lounge. This large, high-tech security area includes 15 standard lanes for passengers, two dedicated lanes for families with young children and passengers with reduced mobility, and two lanes for premium travellers.*<sup>40</sup>
- 2.28 Associated facilities within the passenger terminals include office buildings, baggage handling facilities, boilers and chillers and air/cabin crew reporting facilities.<sup>41</sup>
- 2.29 Taking all these things together, the terminals occupy approximately 18 ha of airport land.<sup>42</sup>

## Aprons and piers

- 2.30 Gatwick’s apron area currently extends to 161 ha comprising aircraft parking stands (37 per cent), taxiways (52 per cent), fuel farm

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<sup>37</sup> GAL, Gatwick Master Plan, July 2012, p. 42.

<sup>38</sup> The CAA notes that GAL indicated that reducing queues and delivering a smoother check-in experience was one of its early priorities and that as a result, working with Norwegian Air Shuttle, it created a check-in ‘test lab’ in the South Terminal which allows passengers to use self-service kiosks to check in and tag their own bags. Source: GAL, Airport competition: Competing to grow and become London’s airport of choice, An initial submission from Gatwick Airport to inform the CAA’s review of airport competition, November 2011, Q5-050-LGW05, p. 63.

<sup>39</sup> GAL, Airport competition: Competing to grow and become London’s airport of choice, An initial submission from Gatwick Airport to inform the CAA’s review of airport competition, November 2011 Q5-050-LGW05, page 6.

<sup>40</sup> GAL, Airport competition: Competing to grow and become London’s airport of choice, An initial submission from Gatwick Airport to inform the CAA’s review of airport competition, November 2011 Q5-050-LGW05, page 58.

<sup>41</sup> GAL, Gatwick Master Plan, July 2012, page 42.

<sup>42</sup> GAL, Gatwick Master Plan, July 2012, page 42.



(6 per cent) and piers, fire station, control tower, etc (5 per cent).<sup>43</sup>

## Aircraft stands

2.31 Aircraft stands at Gatwick can be used flexibly for a range of different aircraft sizes, including the A380 on one pier served stand.<sup>44</sup> GAL has indicated that it could accommodate up to 150 smaller aircraft or 115 aircraft if all its stands were used for large aircraft.<sup>45</sup>

2.32 Assuming the stands are all used for large aircraft, the airport's 67 pier served stands (stands that allow passengers to walk (via piers) between the aircraft and the terminal) are split roughly equally between each terminal. Its 48 remote stands are serviced by coaches.<sup>46</sup>

## Surface transport facilities and car parks

2.33 Key components of Gatwick's surface access infrastructure include:

- A rail station, which is located at the South Terminal, that provides access to central London and a range of other destinations.<sup>47</sup>
- The motorway system, in particular, the M23 and M25 road networks which connect the airport to London and the rest of the UK.<sup>48</sup>
- Car rental pick-up, drop-off and valet facilities, waiting areas for taxis and coaches, the main bus and coach stations serving both terminals, and the terminal forecourt road systems.<sup>49</sup>
- GAL's own car parks at Gatwick, which provide around 34,000 spaces<sup>50</sup>, including for short, long stay, holiday parking and valet parking.<sup>51</sup>

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<sup>43</sup> GAL, Gatwick Master Plan, July 2012, page 43.

<sup>44</sup> GAL, <http://www.gatwickairport.com/business/about/facts-figures/>, (accessed 11 December 2012).

<sup>45</sup> GAL, Gatwick Master Plan, July 2012, page 43.

<sup>46</sup> GAL, <http://www.gatwickairport.com/business/about/facts-figures/>, (accessed 11 December 2012).

<sup>47</sup> GAL, <http://www.gatwickairport.com/transport/trains/>, (accessed 11 December 2012).

<sup>48</sup> GAL, Gatwick Master Plan, July 2012, page 45.

<sup>49</sup> GAL, Gatwick Master Plan, July 2012, page 46.

<sup>50</sup> In addition to the spaces that it provides, GAL has indicated that other car park operators

## Cargo facilities

2.34 The cargo centre covers some 11 ha. This is made up of 23,000 square meters of cargo shed, office accommodation, areas for HGV loading, unloading and parking, and open equipment parking areas. The cargo sheds are not owned by GAL but are owned by a third party with a long term ground lease.<sup>52</sup>

## Aircraft maintenance

2.35 Over recent years, GAL has reduced the hangar provision available at Gatwick through the demolition of some facilities south of the runway. British Airways (BA) now operates the one remaining hangar in this location on a 5 ha site. There is a second maintenance hangar (approximately 4 ha) to the north of the runway. This hangar is currently operated by Virgin Atlantic Airways.<sup>53</sup>

## Other facilities

2.36 At Gatwick there are also a number of other ancillary facilities that help support GAL's operations, including hotels, offices, vehicle and equipment maintenance, contractor's compounds, filling stations and a police station. A number of separate on-airport sites of approximately 33 ha accommodate these activities.<sup>54</sup>

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provide approximately 23 000 spaces.

<sup>51</sup> GAL, Gatwick Master Plan, July 2012, page 46.

<sup>52</sup> GAL, Gatwick Master Plan, July 2012, page 44.

<sup>53</sup> GAL, Gatwick Master Plan, July 2012, page 45.

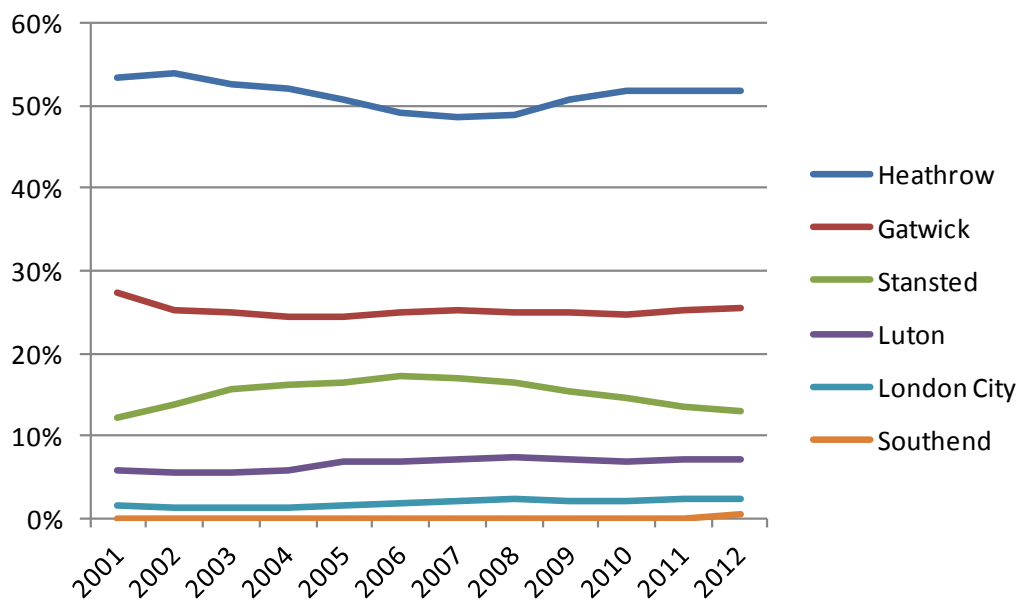
<sup>54</sup> GAL, Gatwick Master Plan, July 2012, page 45.

## Gatwick's traffic and customers

### Traffic trends

2.37 In 2012, Gatwick had 53 airlines each serving more than 10 000 passengers a year and was the second busiest London airport in terms of passenger numbers.<sup>55</sup> This is illustrated in Figure 2.1 below.

**Figure 2.1: London airports' share of passengers of London airports**



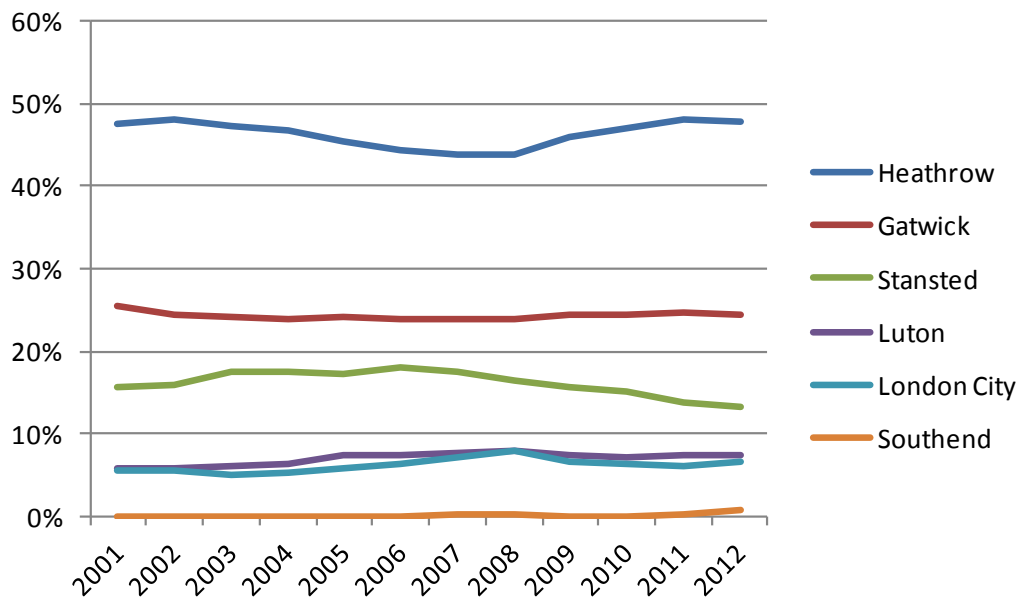
Source: CAA airport statistics.

2.38 Figure 2.1 shows that in 2012, Gatwick accommodated around 25 per cent of passengers from the six London airports – this compares to the 52 per cent accommodated by Heathrow and the 13 per cent accommodated by Stansted.

In 2012, Gatwick was also the second largest London airport when measured by air traffic movements (ATMs) – see

2.39 Figure 2.2 below.

<sup>55</sup> CAA data.

**Figure 2.2: London airports' share of ATMs of London airports**

Source: CAA airport statistics.

2.40 Figure 2.2 shows that in 2012, Gatwick accounted for around 24 per cent of ATMs from the six London airports – this compares to the 48 per cent accounted for by Heathrow and the 13 per cent accounted for by Stansted.

### Passenger airlines

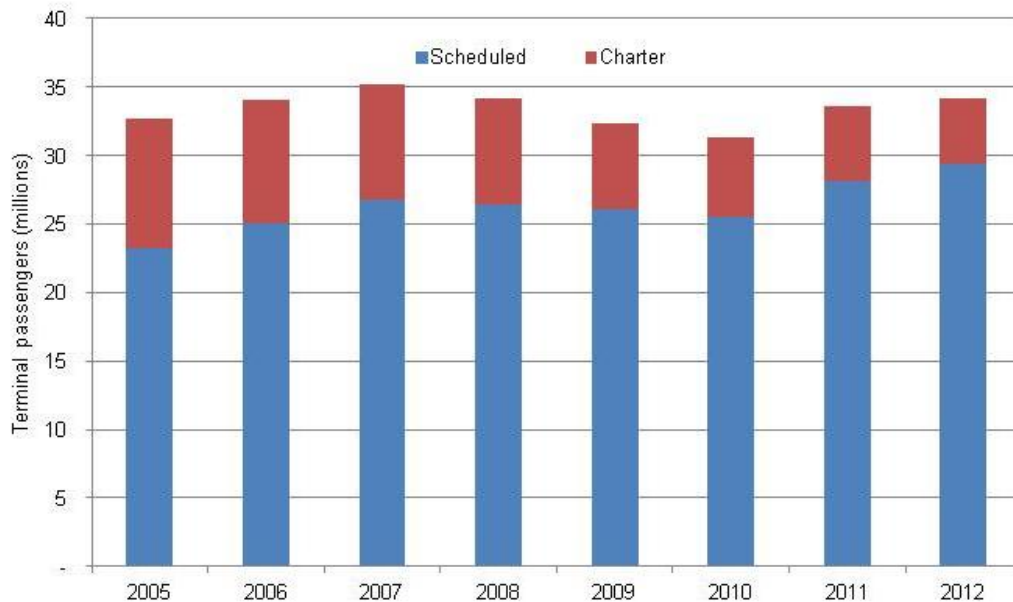
2.41 In 2012, Gatwick served 34.2 million passengers. The major passenger airlines operated at Gatwick and the airlines' share of traffic is outlined in Figure 2.3 below.

**Figure 2.3: Number of passengers by major airlines, 2012**

Airline	Terminal passengers (in thousands) in 2012	% of scheduled / charter traffic
easyJet Airline Company Ltd	13,122	44.7%
British Airways Plc	5,153	17.6%
Monarch Airlines	1,681	5.7%
Virgin Atlantic Airways Ltd	1,398	4.8%
Norwegian Air Shuttle	1,278	4.4%
Flybe Ltd	1,146	3.9%
Ryanair	1,042	3.6%
Other airlines	4,516	15.4%
<b>All scheduled services</b>	<b>29,336</b>	<b>100.0%</b>
Thomson Airways Ltd	2,447	51.7%
Thomas Cook Airlines Ltd	1,500	31.7%
Monarch Airlines	495	10.5%
Small Planet Airlines	76	1.6%
Strategic Airlines (Luxembourg)	65	1.4%
Aer Lingus	34	0.7%
Strategic Airlines (France)	34	0.7%
Other airlines	80	1.7%
<b>All charter services</b>	<b>4,732</b>	<b>100.0%</b>

Source: CAA airport statistics.

2.42 Figure 2.4 (below) also shows growth of passenger traffic at Gatwick from 2005 to 2012.

**Figure 2.4: Growth of passenger traffic at Gatwick, 2005-2**

Source: CAA airport statistics

2.43 The CAA notes that over the last five years, a period covering challenging macroeconomic conditions, GAL has been relatively successful at attracting new passenger airlines, although it has also lost a number of airlines. Some of the airline changes that have occurred since 2009 are listed below:<sup>56,57</sup>

- Mid 2009, Norwegian Air Shuttle moved its entire operation from Stansted to Gatwick;
- October 2009, BA closed a number of services from Gatwick and switches some further services back to Heathrow;
- February 2011, Air Berlin moved two of its five Stansted routes to Gatwick;
- May 2011, Qatar Airways pulled out of Gatwick for Heathrow;
- October 2011, AirAsia X switched from Stansted to Gatwick. The service was subsequently cancelled in April 2012;

<sup>56</sup> Source: GAL, 'Airport competition: Competing to grow and become London's airport of choice'. An initial submission from Gatwick airport to inform the CAA's review of airport competition, Q5-050-LGW05, November 2011.

<sup>57</sup> The CAA has amended and extended the initial list submitted by GAL to reflect changes since its submission.

- October 2011, Lufthansa opened operations at Gatwick;
- November 2011, SAS ceased operations from Gatwick in favour of services at Manchester;<sup>58</sup>
- December 2011, Turkish Airlines opened operations from Gatwick;
- December 2011, Vietnam Airlines opened operation from Gatwick;
- March 2012, Hong Kong Airlines opened operations from Gatwick. However, the route was cancelled in September 2012;<sup>59</sup>
- April 2012, Air Nigeria opened operations from Gatwick. The service was, however, cancelled in September 2012;
- April 2012, Korean Air opened operations from Gatwick, but withdrew its operations in the winter season;
- April 2012, Delta closed its operations at Gatwick;
- May 2012, Air China opened operations at Gatwick;
- March 2013, Vueling opened operation at Gatwick;<sup>60</sup>
- From March 2013, US Airways switching Charlotte service from Gatwick to Heathrow,

2.44 The CAA's 'minded to' view on GAL's approach to attracting airlines through its negotiations is explored in more detail in chapter 9.

## Cargo airlines

2.45 The CAA notes that the London Air Traffic Distribution Rules (TDRs) essentially prevent cargo and general aviation operations from Gatwick at peak times (extending to a considerable period of the day),

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<sup>58</sup> SAS ceased its Gatwick-Bergen service from November 2011, in January 2012 SAS launched Manchester-Bergen. It has been reported that this new route is effectively a replacement for the Gatwick service. See: <http://www.breakingtravelnews.com/news/article/sas-to-move-bergen-flight-from-london-to-manchester/>, (accessed 6 March 2013).

<sup>59</sup> The CAA has note that Hong Kong Airlines departure from Gatwick was reported within the media as being due to weak overall economic outlook in Europe and the company refocusing on its regional business. See: <http://www.travelweekly.co.uk/Articles/Details/41319>, (accessed 22 May 2013).

<sup>60</sup> Vueling, Press release, October 2012, available at: <http://www.vueling.com/en/we-are-vueling/press-room/press-releases/corporate/vueling-network-to-expand-to-100-destinations-from-barcelona-el-prat-airport-in-2013/>, (accessed 26 February 2013).

subject to exemptions granted by the airport operator.

- 2.46 The CAA also notes that in the provisional findings and provisional remedies of the CC's March 2009 BAA airports market investigation final report, that the CC:

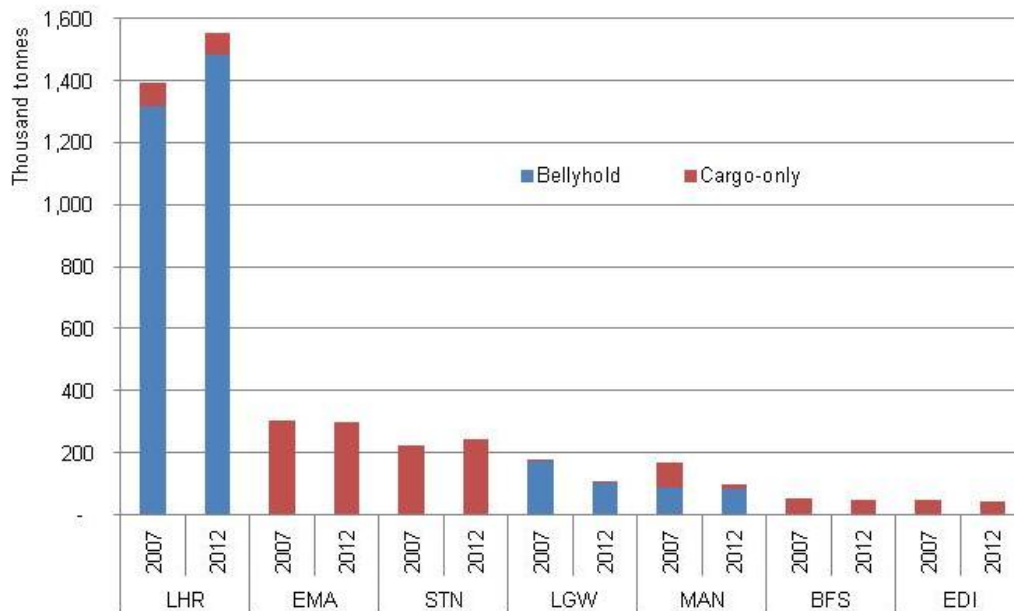
*considered that the TDRs restricted, prevented or distorted competition, by limiting large cargo aircraft wishing to serve the London area to Stansted, as other airports were either full, too far away, or had runways which were too short, thereby imposing additional costs on some operators who had as a result to split their operation between Stansted and Heathrow and/or Gatwick which they used for belly-hold cargo carried on passenger flights.*

- 2.47 Notwithstanding the above, according to CAA airport statistics, Gatwick is, in terms of air cargo tonnage, the fourth most important airport in the UK with 4 per cent of the volume. This compares with Heathrow's 61 per cent, East Midlands' 12 per cent and Stansted's 9 per cent.

- 2.48 The CAA notes, however, that Gatwick has no scheduled cargo-only airlines and that in 2012 almost all (99.9 per cent) cargo at Gatwick was carried in the bellyhold of, principally long-haul, passenger flights. The relative dominance of bellyhold cargo at Gatwick is reflected in the small number of cargo-only ATMs annually (8 ATMs in 2012). Figure 2.5 (below) shows bellyhold and cargo-only flights tonnage at selected airports.



**Figure 2.5: Cargo tonnage by types of flights at major cargo airports, 2007 and 2012**

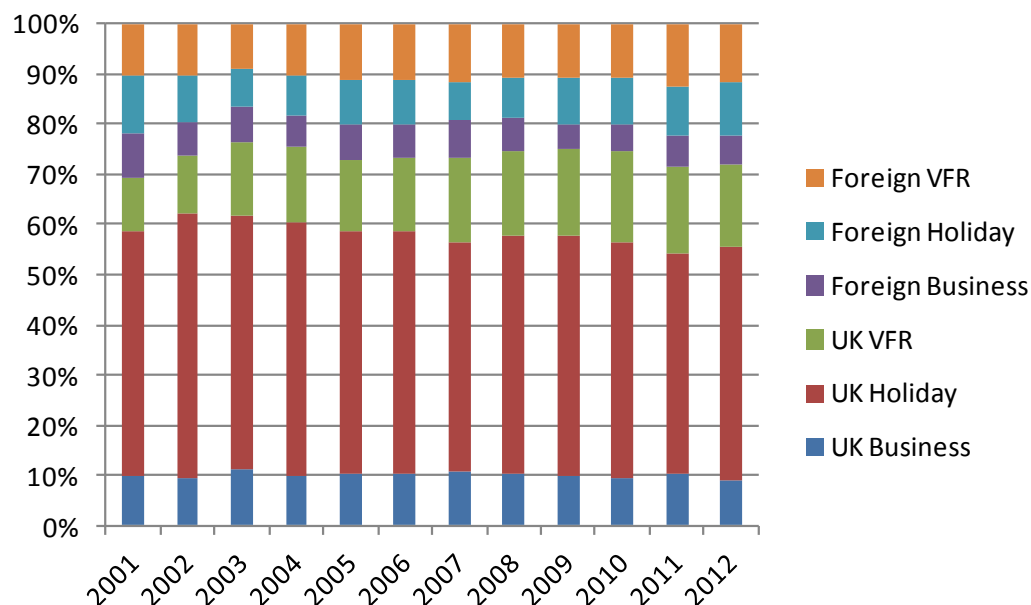


Source: CAA airport statistics

2.49 The CAA notes that, with the exception of a small number of carriers who hold grandfather rights on operating cargo-only movements at Gatwick and Heathrow, the significant majority of cargo-only movements at London airports have been consistently flown from Stansted.

### Passenger types

2.50 Gatwick caters to all passenger types. However, Gatwick has a smaller proportion for business traffic than Heathrow and a higher proportion of passengers travelling for holidays and to visit friends and relatives (VFR) – see Figure 2.6 below.

**Figure 2.6: Gatwick passenger types (2001-2012)**

Source: CAA Passenger Survey.

2.51 Figure 2.6 shows that in 2012, 84 per cent of the passengers at Gatwick were using the airport for holidays and VFR, with business passengers accounting for only 16 per cent of all passengers.

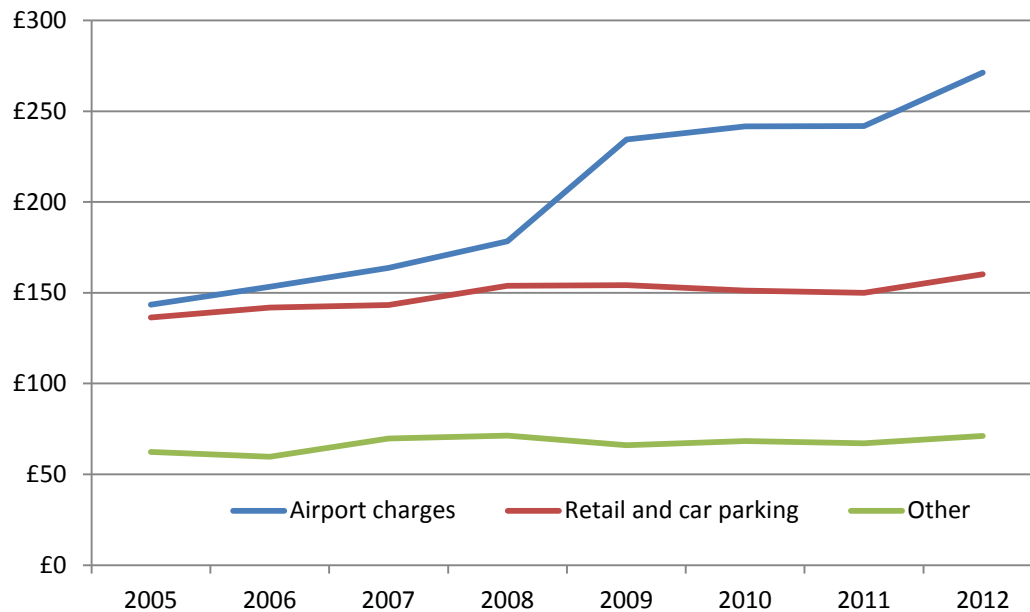
## GAL's business model

2.52 GAL generates revenue from three main sources:

- airport charges, including charges on landing, charges on departing passengers and aircraft parking charges;
- commercial income, such as revenue from retail concessions (and associated retail revenue sharing arrangements), car parking and property; and
- other income, specifically income from non-regulated aeronautical charges (i.e. revenue from charges levied on airlines for other services, including the servicing of aircraft and the use of airport property and fuel).

2.53 Figure 2.7 (below) shows the various revenues that GAL has received for year ending 31 March 2005 to the year ending 31 March 2012.<sup>61</sup>

**Figure 2.7: GAL's revenues (2005-2012, £m)**



Source: GAL, Statutory accounts

2.54 The CAA notes that Gatwick is a designated airport that is subject to price controls and that the maximum average aeronautical charge per passenger that it is permitted to charge is based on the CAA's:

- assessment of an efficient level of costs;
- view on the appropriate return of capital to be allowed; and
- view on how the resulting price cap would facilitate competition between airports.

2.55 The CAA also notes that:

- each airport is separately regulated, with price controls closely linked to the specific circumstances of the airport and the needs of the airlines and passengers at that airport; and

<sup>61</sup> This information has been taken from GAL's statutory accounts, which can be found at: <http://www.gatwickairport.com/business/investor/this-is-the-investor-page/annual-reports/> (accessed 20 May 2013).

- through the 'single till' approach to the regulation of aeronautical charges, commercial revenues generated by the airport operator from the airport infrastructure reduce the aeronautical charges. This is in contrast to a 'dual till' approach in which the regulator would set separate price caps for aeronautical and other revenues.

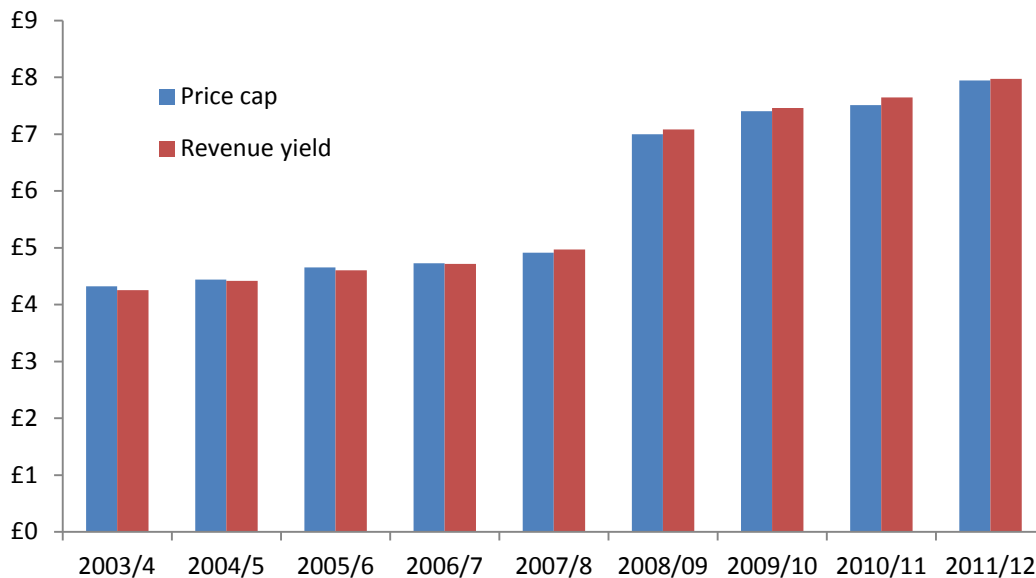
2.56 The actual airport charges (tariffs) that GAL sets are published in its 'Conditions of Use', which are available on its website.<sup>62</sup> By considering these charges and passenger numbers (and the weight of planes, noise levels etc), an estimate of GAL's revenue can be calculated.

2.57 The CAA notes, however, that the charges outlined in GAL's 'Conditions of Use' may not represent the charges that are actually paid by an airline at Gatwick. Airlines can enter into bilateral agreements with the airport which can result in lower charges being incurred.

2.58 Figure 2.8 (below) illustrates the regulated price caps (or maximum airport charge) that were set at Gatwick as well as the revenue yields that GAL has achieved over the period 2003/04 – 2011/12.

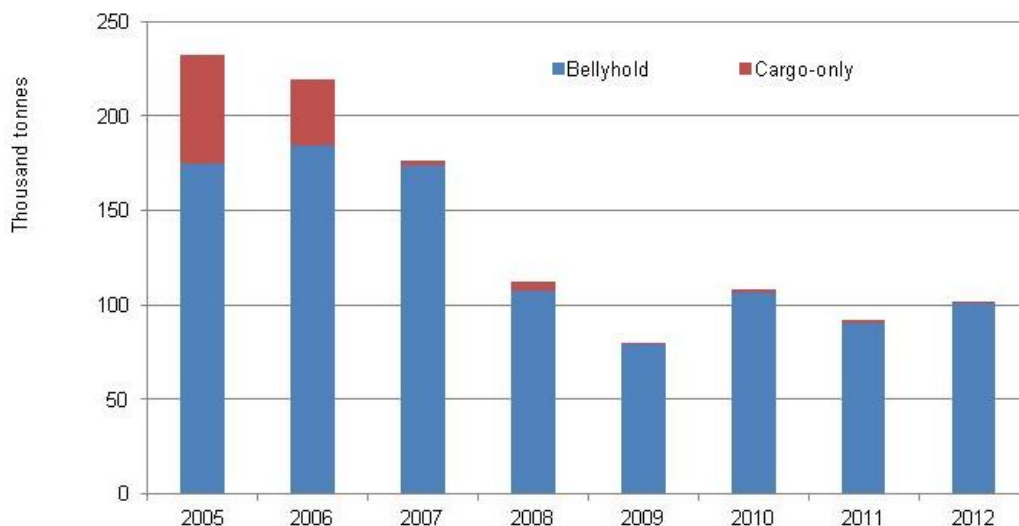
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<sup>62</sup> The Conditions of Use can be found at: <http://www.gatwickairport.com/cou/>, (accessed 20 May 2013).

**Figure 2.8: GAL's aeronautical revenues and revenue yields**

Source: CAA analysis of regulatory returns

- 2.59 The CAA considers that Figure 2.8 shows that since, at least, 2009/10 GAL has sought to set the airport charges for GAL at the regulated price cap (with any over recovery in one year being automatically paid back the following year). The CAA notes that evidence submitted by GAL and other stakeholders on the negotiations that occur on charges are outlined in more detail in chapter 9.
- 2.60 The CAA also notes that GAL generates revenue from its cargo operations. Figure 2.9 (below) shows the cargo tonnage handled by Gatwick over the period 2005–2012, which as noted earlier, is largely bellyhold.

**Figure 2.9: Cargo tonnage at Gatwick, 2005 – 2012**

Source: CAA airport statistics.

## Airport charges

2.61 As outlined in paragraph 2.52, the main aeronautical charges at Gatwick are charges on landing, departing passengers and aircraft parking. Each of these issues is explored below.

### Charges on landing

2.62 The charge on landing is a charge for the landing of an aircraft that is typically based on the weight of the aircraft, including its contents, and noise – with aircraft failing to meet set noise standards subject to a higher charge. At Gatwick, a higher charge is also imposed on aircraft landing at the peak period (6 am to 11:59 am and 5 pm to 6:59 pm, 1 April to 31 October) and for landing in summer as compared to winter.<sup>63</sup> For example, in 2012/13, an aircraft that weighs over 50 metric tonnes (and has a chapter 3 base noise certificate), would face landing charges of:

- £1,689.72 during the peak period;

<sup>63</sup> This information is taken from GAL's 2012 Conditions of Use. This document also highlights that the summer off peak period is '1 April to 31 October, all times other than those designated as peak' and that winter is 1 November to March 31.

- £554.61 during the summer off peak period; and
- £0.00 during the winter off peak period.

2.63 The CAA notes that the setting of a zero landing charge for aircraft that meet the above listed criteria (and for other criteria) during the winter off peak period was introduced by GAL in 2011.

### Charges on departing passengers

2.64 The charge on departing passengers is a charge that GAL imposes for each departing passenger. It is a charge that a passenger does not face directly as it is paid by the airline. The level of this charge is often not visible to the customer and can be bundled in the overall airfare, although this is not always the case.

2.65 As of 2009, GAL applied three different departing passenger charges based on the destination (and therefore the infrastructure and services) that the passenger was going to use. A rebate on these charges was offered if the passenger left from a remote stand. The level of passenger charges at Gatwick over the past four years has remained unchanged (see Figure 2.10 below).

**Figure 2.10: Charges on departing passengers 2009/10 – 2012/13**

£ per passenger	Domestic	International	International (Republic of Ireland)	Remote stand rebate
2009/10	7.35	11.21	9.03	2.52
2010/11	7.35	11.21	9.03	2.52
2011/12	7.35	11.21	9.03	2.52
2012/13	7.35	11.21	9.03	2.52

Source: Gatwick, Conditions of Use 2009/10–2012/13.

### Aircraft parking charges

2.66 Aircraft parking charges are the charges that GAL imposes for the parking of aircraft at Gatwick. In general, these charges are based on an aircraft's weight and the duration of stay.<sup>64</sup> Figure 2.11 (below) highlights the charges that GAL has imposed over the period 2009/10–2011/12.

<sup>64</sup> See footnote 53.

**Figure 2.11: Airport parking charges 2009/10 – 2011/12**

	Charges per quarter hour or part thereof (£)	
	Fixed element	Per metric tonne
2009/10	4.82	0.075
2010/11	4.82	0.075
2011/12	4.82	0.075

Source: Gatwick, Conditions of Use.

- 2.67 Figure 2.11 shows that airport parking charges have remained static over the three years 2009/10 to 2011/12.
- 2.68 However, in 2012/13, GAL modified its approach to airport parking charges and introduced a fixed charge per five minutes, which was set in reference to the weight of the aircraft, with all aircraft fitting into three categories.<sup>65</sup> In addition, a peak period multiplier of three is applicable.<sup>66</sup>

### Commercial income

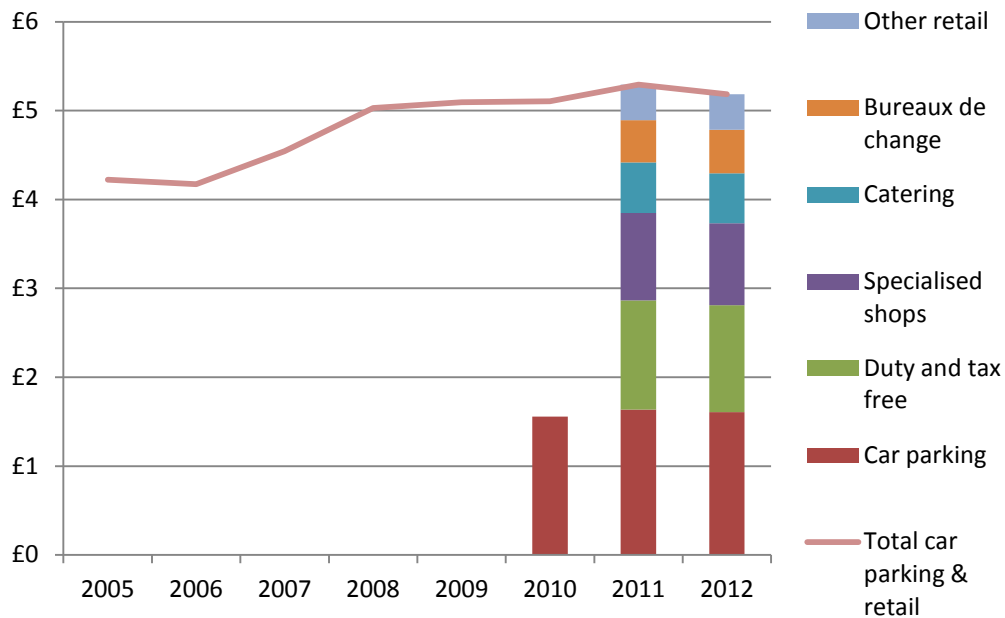
- 2.69 GAL also generates revenue from a number of commercial activities including car parking, various (airside and landside) retail outlets and catering. Figure 2.12 (below) shows the revenue per passenger that GAL has achieved over the period 2005–2012.<sup>67</sup>

<sup>65</sup> The charge per five minutes for the different weight categories are: £2.413 for aircraft below 50 metric tonnes, £4.826 for aircraft greater than or equal to 50 metric tonnes but less than or equal to 200 metric tonnes and £7.238 for aircraft greater than 200 metric tonnes. Source: GAL, Conditions of Use 2012/13.

<sup>66</sup> GAL, Conditions of Use 2012/13.

<sup>67</sup> When considering this figure it is important to note that the granularity of information contained within the accounts changed over time. While the granularity of information increased in 2010, the information that was available changed again in 2011. The CAA also notes that there was no information available for the 2009 total retail figure and that it estimated a total retail figure for the year 2009 by taking a simple average of the total retail in 2008 and 2010.



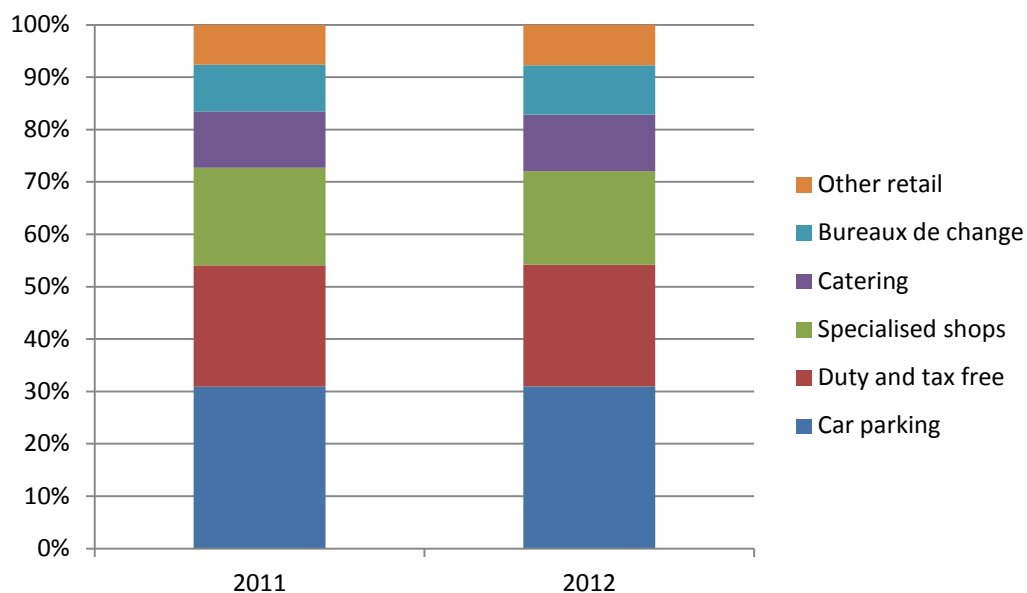
**Figure 2.12: Commercial revenue(s) per passenger**

Source: GAL, Financial Statements.

2.70 Figure 2.12 suggests that:

- Total retail revenue per passenger has, in general, increased over 2005–2012, with an increase of over 20 per cent seen in that period;
- Car park revenue is relatively stable, with the available data suggesting that GAL achieves, on average, £1.60 per passenger for parking.
- Non food shopping also appears to be relatively stable, although there is insufficient data to suggest anything more than this.

2.71 Another way to examine the sources of commercial revenue that GAL has generated can be seen by reference to Figure 2.13 (below).

**Figure 2.13: GAL's sources of commercial income**

Source: GAL, Financial Statements.

2.72 Figure 2.13 shows, on a percentage basis, the various sources of GAL's commercial revenue. In particular, this figure shows (among other things) that:

- revenue from duty free, air-side and specialised shops, and bureaux de change represent around 58 per cent of the commercial revenue currently generated at the airport;
- parking revenue represents around 30 per cent of the commercial revenue currently generated at the airport; and
- catering revenues represents around 10 per cent of the commercial revenue currently generated at the airport.

2.73 The CAA notes, however, that there is limited scope to infer any specific trends and/or patterns in the sources of GAL's commercial revenue at this stage.<sup>68</sup> Over time, with more data becoming available, the CAA expects to be able to draw more robust conclusions on the different sources of GAL's commercial income.

<sup>68</sup> The CAA notes that Gatwick was sold in late 2009 and therefore there is a limited set of post sale accounts that it can draw on to examine these issues.

## CHAPTER 3

# Analytical framework for the GAL market power assessment

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## Introduction

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- 3.1 This chapter sets out the approach that the CAA has taken in its analysis, under sections 6 and 7 of the Civil Aviation Act 2012 (the Act), for the determination of GAL's market power and the application of the market power test to the airport area at Gatwick.
- 3.2 The CAA notes that a key component of this is the market definition. This is relevant, not just for assessing whether GAL, as the operator of Gatwick, has SMP for the purposes of test A, but also for assessing under test B whether there is a risk of abuse of such a position. Both of those tests are applied by reference to the relevant market, i.e. a market for one or more types of airport operation services within the airport area.
- 3.3 This chapter does not repeat the guidance that the CAA has developed for the assessment of market power of airports (the Guidelines)<sup>69</sup> nor the applicable OFT and European Commission guidance, to which the CAA must have regard under section 1(10) of the Act.<sup>70</sup> Rather, it highlights, as appropriate, key propositions that apply specifically within the context of the GAL market power assessment.
- 3.4 This chapter is structured as follows:
- Section 1: considers issues relating to market definition; and
  - Section 2: considers issues relating assessing market power.

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<sup>69</sup> The CAA's April 2011 "Guidance on the assessment of airport market power" (the "Guidelines"), can be accessed via the CAA's website at:

<http://www.caa.co.uk/docs/5/Final%20Competition%20Assessment%20Guidelines%20-%20FINAL.pdf>.

<sup>70</sup> See the OFT's Competition Law Guideline on Market Definition, dated December 2004 ("OFT 403") and the European Commission's Notice on the definition of relevant market for the purposes of Community competition law (OJ 97 C 372 p.3) ("EC Market Definition Notice").

## Section 1: Market definition

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- 3.5 The Guidelines outline, broadly, the assumptions and approach taken in the process of market definition. In particular, and similarly to the OFT and the European Commission (EC), the CAA does not regard market definition as an end in itself, but rather as an economic framework within which to analyse the competitive effects of market definition in order to support and inform the CAA's regulatory policy.<sup>71</sup>
- 3.6 Market definition is a useful tool for identifying, in a systematic way, the competitive constraints which the relevant operator faces in the market and whether those constraints prevent it from operating independently of effective competitive pressure.<sup>72</sup> There may, however, be characteristics of the airport sector that make it difficult to define the market precisely. As explained in the Guidelines, the market power assessment should seek to analyse all the competitive constraints faced by GAL in the round, regardless of whether they arise from within or outside the relevant market or markets, as defined in Chapter 5.<sup>73</sup>
- 3.7 The exercise of market definition consists, in essence, of identifying the effective alternative sources of supply for the customers of the relevant operator in terms of the products or services supplied and their geographical location.<sup>74</sup>
- 3.8 The Guidelines state that, wherever feasible, the hypothetical monopolist test should be adopted as a useful starting point for defining the relevant market.<sup>75</sup> This involves starting with the narrowest possible bundle of products or services and the smallest geographical area (normally those supplied by the operator in question) and assessing customers' switching reactions to a small but sustainable non-transitory increase in price (SSNIP), generally

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<sup>71</sup> CAA, Guidelines, paragraphs 1.4, 3.3 and 3.4. See also OFT 403, paragraphs 2.1 and 2.6 and the EC Market Definition Notice, paragraph 2.

<sup>72</sup> EC Market Definition Notice, paragraph 2.

<sup>73</sup> CAA, Guidelines, paragraph 3.5. This is consistent with the approach adopted in the Competition Commission's report on the supply of airport services by BAA in the UK 19 March 2009 ("CC's 2009 BAA Report"), paragraphs 2.48-2.49.

<sup>74</sup> EC Market Definition Notice, paragraphs 7-9 and 13 and Guidelines, paragraphs 3.6-3.9.

<sup>75</sup> CAA, Guidelines, paragraphs 3.10 to 3.12; OFT 403, paragraphs 2.5 - 2.13 and EC Market Definition Notice, paragraphs 15-19.

considered as being 5 to 10 per cent. If the price increase is unprofitable due to customers switching away to substitute products/services and areas, the test is repeated by widening the set of products/services and geographic area to include additional substitutes until the price increase is profitable. What is then left is the narrowest set of products/services and geographic area over which a hypothetical monopolist could profitably sustain prices 5 to 10 per cent above competitive levels.

### Limitations of the SSNIP test

- 3.9 Although the SSNIP test is a useful starting point, the CAA notes that it is not infallible. As the OFT observes, the test assumes that the hypothetical monopolist is not subject to economic regulation that might affect its pricing behaviour. The test also assumes that competitors' pricing strategies are competitive. In addition, there may be other external considerations that might affect the uniformity and/or the profitability of the price increase.<sup>76</sup>
- 3.10 The SSNIP test is also less than ideal for assessing the current level of competition in some markets, since it is intended to be carried out by reference to the competitive price level. Its utility is limited where the prevailing price levels observed in the market are not reflective of the competitive price. For example:
- It may be that the current price level is already above the competitive price level due to market distortions, such as the presence of a profit maximising monopolist or regulation. In such cases, it would appear that the company could not viably sustain a SSNIP over the relevant timeframe as its customers would switch to alternative products/services. In such circumstances, however, it would be wrong to argue that the comparator products/services limit GAL's ability to exercise market power. The comparator products should not be included in the relevant market otherwise the application of the SSNIP test, in circumstances where normal competitive conditions do not apply, would lead to an erroneously wide market definition.<sup>77</sup>

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<sup>76</sup> OFT 403, paragraph 2.10-2.11 and 5.4-5.6. See also Guidelines, paragraphs 3.24-3.25.

<sup>77</sup> The Cellophane fallacy is referred to in OFT 403, paragraph 5.5.

- Likewise, the prevailing prices could be below the competitive level leading to a narrower market being defined.<sup>78</sup> Caution must therefore be exercised, for example, when considering evidence of switching patterns as this may not be a reliable guide as to what would happen in an effectively competitive market.<sup>79</sup> The possibility that the market analysis may be distorted by certain factors will need to be accounted for when the evidence is considered in the round.

- 3.11 As such, and as noted in the Guidelines, it is rarely possible to apply the SSNIP test in a precise manner due to data and evidential restrictions.<sup>80</sup>
- 3.12 Given the particular circumstances relating to the historical regulation of GAL and Gatwick, the CAA has been unable to carry out a formal SSNIP test. However, it has gathered a range of evidence, including catchment area analysis, passenger surveys, documentary evidence and the views of airlines and relevant airport operators on substitutability. This has been interpreted within the hypothetical monopolist framework.

### Interdependence of demand from different user groups

- 3.13 The Guidelines state that airports can be viewed as platforms in a multi-sided market. It recommends that, where there is good evidence that airport operators take account of the interdependent demands of different user groups and levy different charges for different services to different users, account should be taken of any interactions and interdependencies between the various activities that the airport operator undertakes. The extent to which common (one-sided) market definition methods need amending will depend on the strength of the interrelationships between the various activities and whether these form a genuine platform that brings together consumers and other service providers as different "sides" of the market.<sup>81</sup>
- 3.14 In the Initial Views, the CAA considered the interaction between

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<sup>78</sup> The CAA considers the competitive price in chapter 4.

<sup>79</sup> CAA, Guidelines, paragraphs 3.15-3.16.

<sup>80</sup> CAA, Guidelines, paragraph 3.13. See also the CC's 2009 BAA Report, paragraph 2.1.

<sup>81</sup> CAA, Guidelines, paragraphs 3.18-3.26.

passengers and airlines and their impact on pricing incentives<sup>82</sup>.

- 3.15 The CAA notes that in the past, GAL has accepted that it operates as a multi-sided platform and that the assessment of market power has to take account of the additional competitive constraints on the airport that result from interdependent demands. However, GAL criticised the CAA's Initial Views for placing too little emphasis on the vertical constraints emanating from the supply chain.

*"We agree that it is appropriate to include in its assessment of Gatwick's market power any additional constraints emanating from the fact that the airport is a multi-sided platform. However, in doing so the CAA focuses on the dual-sided nature of the relationship between the airport and passengers and the airport and airlines and largely ignores the much more dominant vertical relationships and constraints between airport, airline and passengers. We consider that a more appropriate approach to considering the competitive constraints between airports, which form one level in a supply chain, would be to adopt the approach that the CAA has taken in its previous assessments of airport competition.*

*...The CAA appears to be departing from its previous approach to analysing the vertical constraints, instead focussing on the inter-relationships between the two sides of the market without first having understood the vertical constraints that exist."<sup>83</sup>*

- 3.16 The CAA accepts the criticism levelled by GAL with respect to the Initial Views. For clarity, the discussion below sets out more precisely the CAA's consideration of the possible multi-sided nature of airports as part of its definition of the relevant market and assessment of GAL's market power.
- 3.17 There are a number of issues that the CAA considers relevant to whether the process of market definition for GAL can be carried out primarily using conventional market definition methods. In particular, it must be determined whether treating the relationship between airlines and their passengers and cargo as a vertical one is appropriate, or whether such methods should be modified significantly to take into account the possible role of an airport as a multi-sided platform.

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<sup>82</sup> CAA, Initial Views, paragraphs 2.191-2.199.

<sup>83</sup> Source: GAL.

- 3.18 The key characteristics of a multi-sided market, in the context of airports, has been set out in a paper prepared by David Starkie and George Yarrow for the CAA in 2010:<sup>84</sup>
- the airport is the platform and it can be viewed as having multiple revenue (and associated cost) streams, some of which are highly inter-related, including via network effects;
  - airlines and passengers are the two main groups that use the platform;
  - an airport is more attractive to passengers the greater the number of airline services (more routes, greater frequencies, better connections) offered to and from that airport;
  - an airport is more attractive to airlines the greater the number of passengers who might use that airport;
  - in matching airlines to passengers, the airport takes account of the different demand conditions – on the one hand, the airline’s demand for access to the airport and its facilities and, on the other, the demand of the passenger for services from the airport; and
  - if the airport operator is itself the provider of commercial services to passengers (retailing, car parks etc.), or has revenue sharing agreements included in its leases with commercial services providers, then the airport operator has a revenue stream from each of these two groups, and has to consider two sets of prices.
- 3.19 The CAA considers that, broadly, the arguments outlined above fall into three categories:
- the existence of network effects;
  - marketing activities carried out by the airport operator to attract passengers and airlines separately to the airport; and
  - the existence of a stream of commercial revenue driven by passenger volumes.
- 3.20 With respect to the existence of network effects, the CAA considers that the available evidence suggests that, although present, network

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<sup>84</sup> Starkie and Yarrow (2010), ‘Market definition in the airports sector’, available at: <http://www.caa.co.uk/docs/5/ergdocs/MarketDefAirports.pdf>, page 13.



effects at Gatwick are low across the airport as a whole. In particular, the CAA notes that airlines currently at Gatwick do not operate hub-and-spoke operations associated with the need for inter-connectivity between services. GAL does, however, provide services to a number of full service carriers (FSCs) and airlines that provide feeder traffic.<sup>85</sup>

3.21 A number of airlines have also commented on the interlining opportunities at Gatwick as part of its relative attractiveness, compared to other airports.<sup>86</sup> However, the CAA notes:

- CAA survey shows that only circa 10 per cent of passengers transfer at Gatwick, a figure which includes passengers self-connecting between flights.
- The majority of FSCs have noted that Gatwick is an origin and destination (O&D) leisure airport with sufficient demand from the local catchment from which to operate services.
- Gatwick's main airline, easyJet, is a low cost carrier (LCC) providing short-haul O&D routes without allowing for passenger interlining with other carriers.

3.22 Overall, the CAA considers that, while there appears to be some degree of network benefits for certain carriers at Gatwick, they do not appear to be particularly pronounced.<sup>87</sup>

3.23 The CAA also notes that GAL does not appear to directly approach passengers and airlines as two separate, parallel user groups. For example, GAL has provided the CAA with evidence, in the form of a number of strategy papers, that are concerned with the development of GAL through the airlines that currently operate from Gatwick and through airlines it can potentially attract.<sup>88</sup> A more recent strategy

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<sup>85</sup> The CAA notes that the provision of bellyhold cargo is a key part of the FSC revenue stream. The arguments within this paragraph apply equally to the transportation of bellyhold cargo. Given that bellyhold cargo is by its nature carried on passenger flights there is a clear dependency from cargo at the airport on the provision of passenger operations. However, the CAA notes that, as per chapter 5, that cargo is a very small operation from Gatwick and the CAA is not considering it in isolation at this stage.

<sup>86</sup> Source: [redacted]; Virgin; and Flybe.

<sup>87</sup> Although there is no integrated interlining at between LCCs, a small proportion of passengers may self connect between flights by purchasing two separate tickets.

<sup>88</sup> Source: GAL.

document has, however, focussed on direct market to business clients through relevant business media, and promotion of GAL's retail offer.<sup>89</sup>

3.24 In addition, the CAA notes that Heathrow Airports Group Limited (formerly BAA), the largest airport operating company in the UK, has stated that:

*“we win business by persuading airlines to put routes from our airports. There is very, very little leverage, or encouragement or incentive, that we can put directly on a customer. What we do is to persuade airlines to base their aircraft at our airports rather than someone else’s airport. That is the nature of the competition that we live running an airport...There is not much that we can do to incentivise a passenger to choose one airport versus another. The landing charge is a relatively small proportion of the total. Probably his transport costs from wherever he lives to the airport are going to be far bigger than any differences. What we do is to compete [for] airlines to have them fly from our airports.”<sup>90</sup>*

3.25 Stansted Airport Limited (STAL) has also told the CAA that it does not tend to market itself to passengers as a brand, but concentrates on supporting airlines in their marketing to passengers.<sup>91</sup>

3.26 The CAA also notes that the airport operator has a limited direct commercial relationship with passengers, other than through charges for its car parks or access to the operator’s forecourt. In addition, to the extent that an airline decides to pass on any increase in airport charges, this is only visible to the passenger through an increase in airfares imposed by the airline.

3.27 These points suggest that GAL currently does little in the way of matching airlines to passengers. Its focus appears to be on gaining airlines which then generate passengers and there are currently limited network effects at Gatwick. Although, as noted above, it appears that GAL's strategy may be changing.

3.28 Notwithstanding the above, the CAA recognises the existence of 'complementarities' between aeronautical and non-aeronautical

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<sup>89</sup> Source: GAL.

<sup>90</sup> Source: HAL.

<sup>91</sup> Source: STAL.

revenue of the type identified by Yarrow and Starkie. In particular, by reducing passenger volumes, an increase in aeronautical charges may reduce revenues derived from commercial services. The CAA notes that, in principle, an airport operator may take this into account in its pricing decisions for aeronautical services.<sup>92</sup>

3.29 The strength of these 'complementarities' will, however, depend on the extent to which the non-aeronautical revenue generated by the airport operator is linked to passenger volume and on the amount of revenue the airport operator generates from aeronautical services relative to non-aeronautical services. It will also depend on the extent to which the airport operator's pricing decisions in relation to aeronautical services take account of the revenue potential for non-aeronautical services.

3.30 The CAA notes that these factors will be taken into account when assessing the impact on profitability of a small price rise later. However, the CAA notes:

- Historically, GAL has priced up to its regulatory price cap, and has recently stated that it considers its prices are too low.<sup>93</sup>
- GAL operates a two-tier pricing structure in that its commercial revenue stems from both a flat concession fee and a percentage of sales. As such, regardless of the passenger throughput, a certain level of income is earned.
- The 'one bag rule' imposed by easyJet on its passengers may, other things being equal, act to suppress demand for non-aeronautical services as it limits the purchases that passengers can take onboard.<sup>94</sup>
- It has seen no evidence that the airport operator's pricing decisions for aeronautical services are made taking into account the potential impact on commercial income.

3.31 Taking the evidence in the round, the CAA considers that GAL

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<sup>92</sup> The CAA is aware that competitive airports typically behave in this way.

<sup>93</sup> See chapter 4 for the CAA's discussion of GAL's price levels.

<sup>94</sup> easyJet levy additional charges for passengers that wish to board with more than one piece of hand baggage, additional baggage has to be checked into the hold for a minimum of £25. See: <http://www.easyjet.com/planning/baggage>, (accessed 7 March 2013).

exhibits some of the characteristics of a multi-sided platform. However, the CAA also considers that the evidence suggests the main relationship is vertical in nature whereby the airport in the upstream market provides a key facilities input to airlines operating in the downstream air transport market. Accordingly, the CAA proposes to adopt a conventional approach based on derived demand in a vertical relationship.<sup>95</sup>

### The role of airline and passenger switching in vertical derived demand analysis

- 3.32 As is explained in chapter 5, the relevant product market comprises all those products or services that are interchangeable or substitutable by the customer by reason of their characteristics, price and intended use.<sup>96</sup> The CAA will look at demand side substitutability for each user group individually, while accounting for interactions between the different groups, to see whether services to each group constitute a distinct product market.<sup>97</sup>
- 3.33 To assess derived demand, the CAA will consider both the direct and indirect impacts on the demand for airport services. The derived demand process is illustrated as follows:
- Following an increase in airport charges an airline makes the initial response to, broadly, either absorb the cost increase or to pass it on to its passengers and/or to switch some services to another airport. Should an airline remove some capacity, there will be a direct effect on the volume of passengers travelling through the airport, provided that the removal of this capacity does not trigger entry or expansion by another airline. Assuming that the airline maintains the same level of capacity at the airport, and passes the price increase onto its passengers, the passenger becomes indirectly exposed to the airport operator's pricing decision. To the extent that a similar flight is available at another airport, the passenger may then decide to switch to that airport in response to the price rise thus affecting the level of derived demand.
- 3.34 The CAA considers that its market definition analysis should start with

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<sup>95</sup> This is consistent with the approach adopted in the CC's 2009 BAA Report, paragraph 2.2.

<sup>96</sup> CAA, Guidelines, paragraphs 3.7 and 3.27.

<sup>97</sup> CAA, Guidelines, paragraph 3.29-3.33.

the evaluation of airlines' views of the substitutability of other airports for Gatwick and, where possible, evidence on airlines' actual switching behaviour.

- 3.35 Airlines' requirements regarding an airport's infrastructure are likely to differ according to their business model and the type of services they offer. In turn, the business model and services may dictate the type of aircraft used which might require special airport facilities.<sup>98</sup> The Guidelines emphasise that the nature and magnitude of airlines' switching costs will depend upon a number of factors and are an important aspect of the overall competition assessment.<sup>99</sup> An airline's ability to switch is not just relevant for the product market definition but also the definition of the relevant geographic market.<sup>100</sup>
- 3.36 The product market definition will be affected by the ability and willingness of passengers to switch between airports. The ability of passengers to respond to a price increase imposed by the airport operator is only derived if they are exposed to the airport's price increase after the airline's initial response. The ability and willingness of passengers to switch will depend, in part, on the extent to which they regard services at different airports as reasonably close substitutes and the costs they face in switching demand to the next best alternative.<sup>101</sup> An important factor will be the availability of suitable alternative flights to the same destination as well as the willingness of passengers to follow an airline to an alternative airport.
- 3.37 The Guidelines also highlight the importance of passenger switching for geographic market definition stating:

*"The CAA considers that passenger switching is likely to be a significant focus of geographic market definition. However, it may also be important to consider the interdependencies with, or feedback effects from, the airport's other user groups.*

*Whilst geographic market definition might be focused on the potential for passengers to switch between airports, it will also be important to ensure that the ability of airlines to switch away from an airport –*

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<sup>98</sup> CAA, Guidelines, paragraph 3.41.

<sup>99</sup> CAA, Guidelines, paragraph 3.42.

<sup>100</sup> CAA, Guidelines, paragraph 3.65.

<sup>101</sup> CAA, Guidelines, paragraphs 3.34.

*potentially to a relatively distant airport – is included within the wider assessment of competitive constraints... Assessing the likelihood that airlines and passengers take these choices, and the impact this would have on the airport in question, is at the core not only of the market definition but also of the assessment of the strength of competitive constraints an airport is facing."*<sup>102</sup>

- 3.38 In common with other authorities carrying out such analysis,<sup>103</sup> the CAA has sought to understand passengers' likelihood to switch in response to a price rise. It has done this using passenger surveys and catchment area analysis.
- 3.39 However, as part of the analysis of derived demand, the CAA considers that in making decisions as to whether to switch or discontinue a service in response to a price rise at an airport, an airline could be expected to have taken account of the likely behaviour of their passengers in the downstream market and, in particular, their willingness to use other airports. The CAA therefore considers that it is possible to assume that passengers' propensity to switch in response to a price rise by the airport operator has, to some extent, been internalised in the airline's decision-making process.
- 3.40 Consequently, where airlines' decision-making processes are supported with primary evidence, e.g. an analysis of catchment overlaps developed for airports' and airlines' internal purposes, the CAA has attached weight to that evidence when delineating the boundaries of the geographic market. The CAA has complemented such evidence with interviews with a number of airlines and airport operators.
- 3.41 The CAA notes, however, that airlines' propensity to switch may not be fully aligned with that of passengers, as they face different switching costs and constraints. Further, relying solely on existing airlines' views and evidence may provide too static a view of the market. The CAA has therefore complemented airline and airport evidence with findings from its own research and analysis of passenger behaviour.
- 3.42 Analysis in the Initial Views on the cost structure of airlines suggests

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<sup>102</sup> CAA, Guidelines, paragraphs 3.60 and 3.61.

<sup>103</sup> See for example the CC's 2009 report into BAA.

that, for LCCs, the airport charges make up around 30 per cent of their cost base.<sup>104</sup> For long-haul carriers, airport charges account for around 10 per cent of their cost base. The CAA considers that this suggests that a 5 to 10 per cent increase in airport charges, if passed on fully to passengers, may only translate, at most (in the case of a LCC), into a 3 per cent increase in charges to the passenger.<sup>105</sup>

- 3.43 In addition, considering that passengers' choice of airports is part of a wider decision-making process of air transportation services, whether for business or leisure. The impact of airport pricing on passengers is likely to be significantly lessened as it forms one component of a bundle of goods.<sup>106</sup> The CAA's 'minded to' view is, therefore, that passenger responses to an airport SSNIP are likely to be muted.

### Supply side substitution

- 3.44 As noted in the Guidelines<sup>107</sup> (and the OFT Guidelines<sup>108</sup>), supply side substitution is a key part of the market definition analysis. The EC summarises supply side substitution in the following:

*"Supply-side substitutability may also be taken into account when the definition market, in those situations in which its effects are equivalent to those of demand substitution in terms of effectiveness and immediacy. This means that suppliers are able to switch production to the relevant products and market them in the short-term without incurring significant permanent changes in relative prices. When these conditions are met, the additional production that is put on the market will have a disciplinary effect on the behaviour of the companies involved. Such an impact in terms of effectiveness and immediacy is equivalent to the demand substitution effect."*<sup>109</sup>

- 3.45 The CAA considers that supply side substitution in the airports sector is likely to be limited. Although the CAA recognises that airport development may be motivated by competition or prospective

<sup>104</sup> Initial Views, Figure 19 and Initial Views STAL paragraph 2.70 and Figure 3.

<sup>105</sup> For a long haul full service carrier an airport SSNIP could represent less than a 1 per cent change in the ticket price.

<sup>106</sup> In this context a list, by no means exhaustive, that may be purchased includes surface access charges, flights, and hotels.

<sup>107</sup> CAA, Guidelines paragraphs 3.27, 3.56-3.58.

<sup>108</sup> OFT 403 paragraphs 3.12-3.18 and 4.5.

<sup>109</sup> EC market definition notice, paragraph 20.

competition between airports, the CAA considers this to be part of a long-term market dynamic rather than a short to medium term competitive response. Both new entry and expansion are unlikely to be sufficiently timely market responses to a SSNIP by an incumbent airport due to planning legislation and the time required for the construction of facilities.

### Competition with other modes of transport

3.46 In its November 2011 submission to the CAA, GAL noted:

*"We recognise that for most routes other forms of transport will not be viewed as good substitutes by passengers. However, rail (and in some cases road and ferry) services will be viewed as substitutes by some passengers for domestic UK flights and flights to nearby continental destinations (especially those where access is offered by the Eurostar). Gatwick notes that its domestic UK routes (not including Ireland) accounted for 2 million passengers in 2010."<sup>110</sup>*

3.47 The CAA accepts GAL's consideration of the substitutability of other transport modes. However, the CAA refers to the finding of the CC111 which considered that the substitution opportunities were too weak to justify expanding the airport market to include surface access alternatives.

3.48 Given the limited number of passengers that fly on services from Gatwick that may be substitutable with surface journeys, and considering the CC's finding the CAA did not consider it expeditious to the current investigation to consider this issue further. The markets considered within this document reflect this thinking and are not widened to include surface journey alternatives.

### The focal product for market definition purposes

3.49 It is important to identify the focal product, or service, for the market definition. However, an airport is a complex organisation with a number of products and service which may be linked. Therefore, it may be more appropriate to analyse the focal product market in terms

<sup>110</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, Q5-050-LGW05, November 2011, page 83.

<sup>111</sup> CC, BAA airports market investigation: A report on the supply of airport services by BAA in the UK, March 2009. Paragraphs 2.5-2.12.



of a service bundle rather than individual products or services.

3.50 The Act provides a logical starting point for the process of product market definition. Section 3 of the Act prohibits an operator in a dominant airport area at a dominant airport from requiring the payment of charges in respect of airport operation services unless it has a licence. An airport area will be dominant if the CAA has made a determination that the market power test in section 6 the Act is met in relation to that area.<sup>112</sup>

3.51 Section 66 of the Act states that an airport:

*“means an aerodrome within the meaning of the Civil Aviation Act 1982<sup>113</sup> together with other land, buildings and structures used for the purposes of—*

*(a) the landing and taking off of aircraft at the aerodrome,*

*(b) the manoeuvring, parking or servicing<sup>114</sup> of aircraft between landing and take-off at the aerodrome,*

*(c) the arrival or departure of persons carried or to be carried as passengers by air transport services operating to or from the aerodrome, together with their baggage,*

*(d) the arrival or departure of cargo carried or to be carried by such service(s) the processing of such persons, baggage and cargo between their arrival and departure, and*

*(f) the arrival or departure of persons who work at the airport.”<sup>115</sup>*

3.52 Supplementary provisions concerning the precise facilities included as

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<sup>112</sup> Section 5(1) of the Act. An airport will be dominant if all or part of its "core area" is in a dominant area.

<sup>113</sup> At section 105 of the Civil Aviation Act 1982 "aerodrome" means any area of land or water designed, equipped, set apart or commonly used for affording facilities for the landing and departure of aircraft and includes any area or space, whether on the ground, on the roof of a building or elsewhere, which is designed, equipped or set apart for affording facilities for the landing and departure of aircraft capable of descending or climbing vertically". In its narrowest interpretation an aerodrome can be consider as the runway.

<sup>114</sup> Section 67 defines servicing as the supply of fuel and the repair, maintenance and overhaul of aircraft that land at the aerodrome.

<sup>115</sup> The definition of airport specifically excludes hotels (except those situated in a passenger terminal that is part of an airport), bus, trams and railway stations.

part of the airport for performing those activities are contained in section 67.

- 3.53 The Act, defines "airport operations services" in section 68 as:
- "services provided at an airport [as defined in section 66] for the purposes of –*
- (a) the landing and taking off of aircraft,*
  - (b) the manoeuvring, parking or servicing of aircraft,*
  - (c) the arrival or departure of passengers and their baggage,*
  - (d) the arrival or departure of cargo,*
  - (e) the processing of passengers, baggage or cargo between their arrival and departure, or*
  - (f) the arrival or departure of persons who work at the airport."*
- 3.54 The definition of airport operations services does not include air transport services, air traffic services or services provided in shops and other retail businesses.<sup>116</sup>
- 3.55 These definitions feed into Section 6(1) of the Act which sets out the market power test that must be applied to the airport area. Under section 5(3) an airport area is defined as "*an area that consists of or forms part of an airport*".
- 3.56 The market power test will be met by the airport area if the three cumulative tests, A to C, are met by the relevant operator of the airport area at that time (the market power test). In particular, section 6(3) sets out test A, i.e. whether the relevant operator has, or is likely to acquire, substantial market power. Section 6(3), read in conjunction with sections 6(6) and 6(7), requires that that assessment must be made by reference to a market for one or more airport operations services which are provided in the airport area or, where appropriate, the "*core area*"<sup>117</sup>.
- 3.57 The core area is defined in section 5(4) as follows:

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<sup>116</sup> Section 68(4).

<sup>117</sup> Section 6(7) provides that, where the airport area includes all or part of the core area, the SMP test will be applied by reference to a market for airport operation services provided in the core area.

*“(a) the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft at the airport,*

*(b) the passenger terminals, and*

*(c) the cargo processing areas.”*

- 3.58 Based on the above, the CAA considers that the initial focal product is, therefore, likely to consist of one or more of the airport operations services defined in section 68, supplied in the area defined in section 5(4).

## Section 2: Market power

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- 3.59 Market power is the ability, profitably, to sustain prices above the competitive level or restrict output or quality below competitive levels. The assessment of market power involves an analysis of the competitive constraints faced by the operator to see whether they are strong enough to prevent it from harming the process of competition<sup>118</sup>. Market power is not an absolute term but a matter of degree which varies according to the individual circumstances of the case.
- 3.60 The CAA notes that market shares are one of several indicators of market power (see chapter 9 for other indicators that the CAA has examined).
- 3.61 The Guidelines indicate that evidence on the market structure and market shares is commonly used in competition assessments. The CAA would expect to undertake such analysis.<sup>119</sup> Market power is more likely to exist if an operator has a persistently high market share over time compared to its nearest rivals.<sup>120</sup>
- 3.62 However, the Guidelines also note that market shares are not sufficient in isolation to determine the intensity of competition in the relevant market as they are too static to shed light on the dynamics of

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<sup>118</sup> The OFT's Competition Law Guideline on Assessment of Market Power December 2004 ("OFT 415"), paragraphs 3.1-3.3.

<sup>119</sup> CAA, Guidelines, paragraph 4.1.

<sup>120</sup> CAA, Guidelines, paragraph 4.2 and OFT 415, paragraphs 4.2-4.3.

the market. In particular:

- The difficulties in defining the market precisely might limit the reliance that could be placed on any given measure of market shares as an indicator of market power. It may be necessary to take account of constraints from outside the relevant market.
- There are aspects of airport markets that may reduce the reliability of market shares as an indicator of market power. In particular, the differentiated nature of airports, both in terms of their facilities and services, but also in terms of their location and the differing degrees of their interdependent demand, can reduce the reliability of market shares as an indicator of market power.<sup>121</sup>

3.63 In the CC's 2009 BAA Report, the CC recognised the limitations of market share calculations in the context of the supply of airport services. Specifically, the CC noted:

- 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.<sup>122</sup>

3.64 In the case of London airports, there are additional reasons why market shares may not be a reliable measure of the level of market power of airports, including:

- Long-term capacity constraints at Heathrow airport and, to a lesser extent, at Gatwick airport. As stated by the OFT in its guidance, where competitors are unable to increase output substantially because of capacity constraints, "*the undertaking would be in a stronger position to increase prices above competitive levels than an otherwise identical undertaking with a similar market share operating in a market where its competitors were not close to full capacity*".<sup>123</sup>

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<sup>121</sup> CAA, Guidance on the assessment of airport market power, April 2011, paragraphs 4.5- 4.7.

<sup>122</sup> CC, BAA 2009 Report, page 36.

<sup>123</sup> OFT, Assessment of market power, Understanding competition law, paragraph 4.4.

- Common ownership of the three largest airports (Heathrow, Gatwick and Stansted) for a considerable period of time under BAA. For example, BAA might not have operated or marketed its airports as substitutes for one another. Instead, it may have marketed its airports as complementary to one another to prevent growth at one airport cannibalising growth at another. While the sale of Gatwick airport may have reduced this concern, the sale of Stansted airport has completed only recently in January 2012 and it is not expected that the airport will be able to sufficiently change its proposition in the short-term to mitigate the possible rigidities that arose from the historic joint ownership.
- The level of substitutability of airports for different airlines can be influenced by (among other issues) infrastructure requirements, capacity constraints, strategic reasons and costs.
- The London Air Traffic Distribution Rules (TDR) that came into effect in 1991. Under the Airports Act, the Secretary of State for Transport has the power to make such rules, which distribute traffic between airports in a 'system'.<sup>124</sup> In 2009, the CC noted that BAA considered that the original purpose of the TDRs was to ensure priority was given in peak hour slots to passenger services at Heathrow and Gatwick.<sup>125</sup>

3.65 Notwithstanding these concerns, the CAA has calculated market shares for GAL by reference to the market definition that the CAA adopted based on the evidence available. In addition, the CAA has had regard to other market features, including buyer power, barriers to entry and expansion<sup>126</sup>. It has also supplemented that analysis with other indicators of market power relating to the operator's behaviour and performance, including profitability measures, quality of service, efficiency and engagement with airlines and the impact of regulation to date<sup>127</sup>. The market definition is presented in chapter 5, with the CAA's analysis of market share data following in chapter 9.

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<sup>124</sup> Article 19 of Regulation (EC) 1008/2008 gives member states the power to put in place TDRs, provided they do not discriminate on grounds of nationality.

<sup>125</sup> CC 2009, The London Air Traffic Distribution Rules, available at: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep\\_pub/reports/2009/fulltext/545\\_6\\_2.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/545_6_2.pdf), p. A6(2)-1.

<sup>126</sup> See CAA, Guidelines, paragraph 4.4 and chapters 5-7, and OFT 415, chapter 5.

<sup>127</sup> See CAA, Guidelines, paragraphs 7.4-7.10 and OFT 415, paragraphs 6.5-6.7.

## CHAPTER 4

# The competitive price at Gatwick

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## Introduction

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4.1 When undertaking a market power assessment, the CAA considers it important to understand whether there is evidence that the prevailing and historical price levels at an airport are reasonably close to or significantly above or below the competitive level. This is important for several reasons:

- as explained in chapter 3, the hypothetical monopolist or 'SSNIP' test for market definition is predicated on an assumption that the airport operator is charging a competitive price;
- the purpose of the market power assessment is to determine whether the operator can profitably sustain prices above the competitive level over time; and
- the risk of supra-competitive prices being imposed in the absence of a licence is relevant for assessing the effectiveness of competition law under test B as well as the cost/benefit analysis of regulation via a licence in test C.

4.2 The Guidelines explain that caution must be exercised in determining the relevant market and assessing market power where prevailing prices, for some reason, are not in line with the competitive price. For example:

- if prices are above the competitive level there is scope that an overly wide market definition results ('the Cellophane Fallacy'<sup>128</sup>); and
- if prices are below the competitive price ('Reverse Cellophane Fallacy'<sup>129</sup>):

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<sup>128</sup> *United States v E.I. du Pont de Nemours & Co.* (1956) 351 U.S.377; 76 S. Ct. 994; L.Ed 1264.

<sup>129</sup> For a good example, see the Aberdeen Journals case (CAT case no. 1009/1/1/02 and OFT case CE/1217-02).

- Airports that may otherwise be considered as substitutes for Gatwick at the competitive price might not be considered as alternatives by airlines and passengers. For example, if Gatwick was under-priced relative its competitors, airlines (and consequently passengers) may be less likely to switch away in light of a 5 to 10 per cent price increase as Gatwick may still represent good value. This might lead to the relevant market being defined too narrowly.
- GAL's pricing behaviour (and other behaviour, such as that related to service quality or investment), may suggest that it has a greater degree of market power than it actually does. For example, under this scenario, an airport may be less inclined to negotiate with airlines or to respond to switching threats by lowering prices because it can easily "backfill" vacated slots.<sup>130</sup>

4.3 The CAA notes that with respect to the airport sector, there are particular difficulties with identifying the competitive price:

- Gatwick is a designated airport that is subject to price regulation. In principle, this means that the regulated price might be above, below or approximately equal to the competitive level.<sup>131</sup>
- Gatwick (like the other designated airports), is currently subject to government policy restrictions that limit runway expansion. The resulting excess demand for airport services may therefore inflate the market clearing prices beyond that which would be seen in the absence of this restriction (as extra runway capacity could be built).
- The potential for airport prices to vary over time may limit the ability to determine the competitive price level with a significant degree of accuracy. Therefore, the CAA expects to analyse the long-term average price level using measures of long-run, forward-looking, cost such as depreciated replacement or incremental cost.<sup>132</sup>

4.4 Given the difficulties involved in establishing a competitive price level, the CAA notes that it may not always be possible to derive an accurate measure. However, where sufficient and robust evidence is available to determine a reasonable estimate, the CAA expects to

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<sup>130</sup> CAA, Initial Views, paragraphs 3.56–3.59.

<sup>131</sup> See the Guidelines for more information on this issue.

<sup>132</sup> Guidelines, paragraph 3.17.

take full account of it.<sup>133</sup>

- 4.5 The CAA also notes that there is no specific additional guidance provided from the relevant authorities on issues regarding the pricing of airports. However, telecoms operators throughout Europe face a significant degree of price regulation on the services that they provide and the European Commission (EC) has indicated (with respect to telecoms) that:

*In principle, the ‘hypothetical monopolist test’ is relevant only with regard to products or services, the price of which is freely determined and not subject to regulation. Thus, the working assumption will be that current prevailing prices are set at competitive levels. If, however, a service or product is offered at a regulated, cost-based price, then such price is presumed, in the absence of indications to the contrary, to be set at what would otherwise be a competitive level and should therefore be taken as the starting point for applying the ‘hypothetical monopolist test.’*<sup>134</sup>

- 4.6 The CAA therefore considers that it is reasonable to treat the regulated price, which is cost-based, as the competitive price level and hence as the benchmark for the SSNIP test.
- 4.7 The remainder of this chapter outlines the CAA’s assessment of the competitive price level at Gatwick and considers:
- the regulated “RAB” price,<sup>135</sup>
  - long-run average incremental costs (LRAIC); and
  - price benchmarking.
- 4.8 The chapter then concludes by outlining the CAA’s ‘minded to’ views, drawing on the evidence it has outlined in this chapter.

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<sup>133</sup> Guidelines, paragraph 3.19.

<sup>134</sup> EC, Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services, 2002/C 165/03, 11-7-2002, paragraph 42.

<sup>135</sup> A regulated RAB price is a price based on a Regulated Asset Base (RAB), which is a proxy for the value of (in this context) the airport’s regulated operating assets upon which the owners of the airport earn a return.



## The regulated "RAB" price

- 4.9 In the Initial Views, the CAA's coverage of the regulated price was relatively limited, with its analysis focussing more on the discussion around the long run incremental costs and price benchmarking.<sup>136</sup>
- 4.10 For completeness, the CAA notes that as part of the Q5 decision (March 2008), it concluded that price caps set out in Figure 4.1 (below) would fall within the range of price caps that could be reasonably recommended by a regulatory authority applying a 'building block' methodology.

**Figure 4.1: CAA's final decision on the maximum level of airport charges per passenger for Gatwick in Q5**

Items	
<b>2007/08 price cap</b>	4.91
<b>Reclassification of costs into airport charges*</b>	0.70
<b>Adjusted 2007/08 price cap</b>	5.61
<b>% real increase in airport charge price cap from adj. 2007/08 to 2008/09 price cap</b>	21.0%
<b>2008/09 price cap</b>	6.79
<b>Price cap increase 2007/08 – 2008/09</b>	1.18
<b>% real annual increase in airport charge price cap from 2008/09 to 2012/13</b>	2%
<b>2012/13 price cap</b>	7.34

Source: CAA, [http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision\\_mar08.pdf](http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision_mar08.pdf), p. vi

\* offset by reductions in air navigation service direct charges and in other BAA service charges

- 4.11 In setting these charges, the CAA based its decision on an assessment of the efficient level of costs, while strengthening the array of financial incentives on GAL to improve further its service performance across a broader suite of activities, and to invest in a timely fashion.<sup>137</sup>
- 4.12 While (as noted earlier), it is reasonable to treat the regulated price, which is cost-based, as the competitive price level<sup>138</sup>, the CAA

<sup>136</sup> CAA, Initial Views, paragraphs 3.60-3.100.

<sup>137</sup> CAA, [http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision\\_mar08.pdf](http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision_mar08.pdf), p. v.

<sup>138</sup> The CAA notes, for example, that some competition authorities have treated the regulated price as a reasonable proxy for the competitive price for the purposes of assessing complaints of

acknowledges that the price cap a regulator sets for an airport is a reflection of the objectives, process and effectiveness of the regulatory regime under which it operates. As such, the regulated price may vary from the competitive price for significant periods of time.

4.13 Reasons why the CAA considers that the regulated price may not represent the competitive price for Gatwick over significant periods of time include:

- The scope for the misalignment of proposed capital expenditure (capex) and current market requirements, due to the long term and 'lumpy' nature of the capex.
- Difference in the valuation of assets, which will affect the calculation of the competitive price. For example, an airport operator that depreciates its assets more quickly will have a lower value of capital employed than an airport operator that depreciates its assets over a longer period.
- The potential for operational expenditure (opex) inefficiencies which a regulator may be only partially able to mitigate due to insufficient information and/or the implementation of insufficiently strong incentives to address an issue.
- The bias towards increased use of capital created by RAB-based price regulation may have the undesirable effect of encouraging inefficient investment.
- Common ownership of airports which can result in less favourable regulatory outcomes if efficient capacity expansion at one airport impacts passenger numbers, airline performance and airport performance at another. In addition, common ownership can impinge on the incentive under the RPI approach for an airport to outperform the forecasts used in the price determination so far as passenger numbers are concerned. This is because such outperformance at one airport may, to some extent, come at the expense of the others.<sup>139</sup>

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excessive pricing. Source: Michele Giannino, Enforcement of excessive price competition provisions in the airport sector: An overview, June 2012.

<sup>139</sup> These concerns were set out in paragraph 6.62 of the CC's 2009 report. The CAA notes that

- 4.14 The CAA notes that GAL has indicated that it does not consider that the regulated price at Gatwick is a reasonable proxy for the competitive price level. Specifically, GAL noted (among other issues), that:
- *the CAA has erroneously concluded that the prevailing regulated price is similar to the competitive price level;*<sup>140</sup>
  - *it is GAL's strongly held view, supported by analysis presented to the CAA, that the current aeronautical charges levied at Gatwick (under the regulated price cap) are below the level that would be expected in a competitive market;*<sup>141</sup> and
  - *[the higher yields available at Gatwick] was more likely prima facie evidence that the regulated price at Gatwick was below the competitive price level [rather than a barrier to switching].*<sup>142</sup>
- 4.15 To help address the concerns that have been raised concerning price, the next sections explore the analysis that the CAA has undertaken, along with stakeholder's concerns, with respect to both LRAIC and price benchmarking.

## Long run average incremental cost

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- 4.16 Price caps based on LRAIC have been used by some regulators as part of their regulatory duties.<sup>143</sup> The primary conceptual benefit of this approach is that it proxies the long-term average price that might emerge from a competitive market.<sup>144</sup>

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while Gatwick was sold by BAA in late 2009, this is still a relatively recent event. It also notes that Stansted is in the process of being sold. See: <http://www.bbc.co.uk/news/business-21093783>, (accessed 16 April 2013).

<sup>140</sup> Source: GAL.

<sup>141</sup> Source: GAL.

<sup>142</sup> Source: GAL.

<sup>143</sup> For example, in the telecommunications sector Ofcom uses a long run incremental cost approach to inform the likely level of efficient costs in the context of its price-cap regulation of mobile termination rates (MTRs). This approach is also used in a slightly different form in the regulation of fixed access charges.

<sup>144</sup> CAA, Review of price regulation at Heathrow, Gatwick and Stansted airports ("Q6") policy update, May 2012, page 56.

- 4.17 In the Initial Views, the CAA noted that:<sup>145</sup>
- it had drawn on a number of different sources of evidence to assess whether there was a significant divergence between historical prices and the competitive price level at Gatwick; and
  - different approaches to determining the competitive price provided a range of different answers.
- 4.18 With respect to estimates of the competitive price derived through the use of LRAIC, the CAA also indicated that:<sup>146</sup>
- LRAIC estimates suggest that the current charges are somewhat below the competitive level. However, it also noted that:
    - while the calculation of LRAIC is relatively straight forward in methodological terms, any estimate is highly sensitive to the assumptions that are used;<sup>147</sup> and
    - there was significant uncertainty around the cost and passenger volume assumptions used by FTI (a consultant GAL engaged to estimate LRAIC for it);<sup>148</sup> and
  - the estimates produced by FTI were based on information about the cost of expanding Gatwick, which might not represent the next expansion project to occur in a well-functioning market. The CAA also noted that while FTI was clear that its approach was designed to make best use of the most accurate information available; namely, cost information from Gatwick, the relevant price benchmark might be the (lower) cost of expanding a competing airport.<sup>149</sup>
- 4.19 The CAA concluded that the combination of the uncertainty attached to the input assumptions, and the reliance on cost estimates that were based on expansion (only) at Gatwick, meant that it was difficult to place much weight on FTI's estimates.<sup>150</sup>

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<sup>145</sup> CAA, Initial Views, pages 78-79.

<sup>146</sup> CAA, Initial Views, pages 68-69.

<sup>147</sup> CAA, Initial Views, page 71, paragraph 3.65.

<sup>148</sup> CAA, Initial Views, paragraph 3.69.

<sup>149</sup> CAA, Initial Views, page 72.

<sup>150</sup> CAA, Initial Views, page 72.

- 4.20 In response to the Initial Views, GAL indicated (among other things), that:
- it was concerned with the analysis that the CAA had undertaken with respect to determining the competitive price;
  - it had conducted further work on the competitive price, including with respect to long run average incremental costs; and
  - its further analysis, combined with the analysis that it presented in earlier submissions, pointed to the current regulated price level at Gatwick being below the competitive price level.<sup>151</sup>
- 4.21 GAL also noted that:
- the CAA had failed to conduct any substantive analysis regarding the competitive price level at Gatwick and that it was incumbent on the CAA to conduct its own analysis;<sup>152</sup> and
  - its own further analysis of LRAIC, based on the CAA's methodology used to estimate LRAIC in Stansted in 2008, showed that capacity additions at Gatwick have been associated with a LRAIC above the current regulated price.<sup>153</sup>
- 4.22 The CAA notes that other stakeholders have suggested that the accuracy of a LRAIC approach to determining price could be adversely affected by the history of common ownership and regulation of the London airports. In particular, it has been argued that the current specification of the airports was set by BAA (as the common owner of Heathrow, Gatwick and Stansted), which means that the estimates of the incremental costs may be higher than the costs of expanding an efficient airport. The CAA notes that while it is difficult to assess the strength of this argument, it is true that the current configuration of an airport may not reflect that which would result from a well-functioning airport market – albeit that it is not clear whether this would increase or reduce the incremental costs.<sup>154</sup>
- 4.23 easyJet also highlighted that there are '*practical problems*' with using a such an approach to set a price cap, which means that it does not

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<sup>151</sup> Source: GAL.

<sup>152</sup> Source: GAL.

<sup>153</sup> Source: GAL.

<sup>154</sup> CAA, Initial Views, paragraph 3.69.

see any real alternative to the use of a RAB based approach to setting prices.<sup>155</sup>

- 4.24 Looking to address the conflicting views on the merits of using LRAIC to help inform our 'minded to' decision, the CAA engaged Europe Economics (EE) to (among other issues):
- estimate a LRAIC for Gatwick; and
  - identify the advantages and disadvantages of using a LRAIC based approach to inform estimates of the competitive price for Gatwick (and to set price caps).<sup>156, 157</sup>
- 4.25 EE examined three<sup>158</sup> increments for Gatwick and considered that the most appropriate increment to use for LRAIC was complete airport replacement. Under this increment, two scenarios were examined, with the CAA considering that the most relevant increment being the one where the costs to replace Gatwick were benchmarked against the replacement cost for Stansted (the basis for this being that the current configuration at Gatwick reflects the historic development of Gatwick and not necessarily the most efficient configuration). Using this increment, EE determined that the LRAIC for Gatwick was £8.40 per passenger.
- 4.26 EE indicated that estimating the LRAIC was one way of assessing price in a normally competitive market. However, it also identified a number of practical disadvantages of using this approach, including:

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<sup>155</sup> Source: easyJet.

<sup>156</sup> Europe Economics (EE) was engaged to review the various approaches taken to calculate LRAIC and examine these issues as they applied to Stansted and Gatwick.

<sup>157</sup> A non-confidential version of EE's report is available on the CAA's website: <http://www.caa.co.uk/docs/1350/Europe%20Economics,%20Advice%20on%20the%20application%20of%20long%20run%20incremental%20cost%20estimates%20for%20Gatwick%20and%20Stansted%20-%20nonconfidential%20version.pdf>.

<sup>158</sup> Four increments were examined if you consider the two scenarios were considered as part of one increment.

- Difficulties in determining the appropriate increment to use – as noted above, EE considered that the most credible increment would be the replacement of an airport (rather than, for example, a small amount of incremental capex or a new runway). However, it noted that since Stansted was a relatively new airport, these problems may be less severe.<sup>159</sup>
- Greater uncertainty (and loss of accuracy) due to the need to make a judgement as to the efficient levels and types of investment required rather than using historic values that were spent.
- The potential for greater uncertainty of remuneration of investment. For example, a historic cost-based RAB system would offer greater certainty since once an investment cost has been approved for inclusion in the RAB it would be part of the calculation for future price limits.

4.27 EE's analysis also identified that any model that is used to estimate LRAIC would be sensitive to the inputs and the assumptions that underpin it. In particular, EE's sensitivity analysis indicated that changes to the inputs and assumptions could lead to quite significant changes in a LRAIC estimate. EE also questioned the relevance of an estimate of the competitive price obtained through LRAIC given the level of government involvement in planning of airport capacity, particularly in the south east of England.<sup>160</sup> Specifically, EE noted:

*The specific nature of the airports sector in the South East of England means that entry and expansion is restricted and controlled by government planning procedures, and this substantially reduces the importance of setting regulated prices to approximate those that would be found in a competitive market...*<sup>161</sup>

4.28 The CAA notes that as part of its recent 'minded to' decision on

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<sup>159</sup> As noted earlier, in determining an appropriate replacement cost for Gatwick, EE has used the replacement cost of (the relatively new) Stansted to determine the replacement cost for Gatwick, which has a configuration that reflects the historic development of the airport and not necessarily the most efficient configuration.

<sup>160</sup> EE, Advice on the application of long run incremental cost estimates for Gatwick and Stansted, page 9.

<sup>161</sup> EE, Advice on the application of long run incremental cost estimates for Gatwick and Stansted, page 65.

Stansted<sup>162</sup> that it released a non-confidential version of the EE report on its website, which included EE's calculation for a LRAIC for Gatwick.<sup>163</sup>

- 4.29 In March 2013, following the publication of EE's initial study, GAL identified a number of concerns – from conceptual points to issues of principle and approach – that it considered would have a material effect on EE's estimates.<sup>164</sup> At the broadest level, GAL indicated that:
- too much emphasis was placed on how government policy (on setting overall airport capacity in London) reduced the usefulness of this approach to determine prices for airports; and
  - the estimates produced were '*materially understated*', particularly for the airport replacement option – the most preferred option – as various inputs (utility and transport connections, planning and pre-construction activity costs, depreciation and land indexation) had either been omitted or had been set inappropriately.
- 4.30 In particular, GAL's concerns with the material that it had considered included:
- The dismissal of Increment 2 (additional runway capacity). Specifically, GAL was concerned that:
    - EE relied on the estimates of Increment 3 (a modern equivalent asset valuation of Gatwick) in coming to its preferred estimates; and
    - EE's main argument against the use of an additional runway as a relevant increment was that capacity expansion is determined by government policy and as such is not indicative of market signals as to the need for, or costs of, expansion.

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<sup>162</sup> This document is available at:

[http://www.caa.co.uk/docs/78/FINAL%20STAL%20Market%20Power%20Assessment%20\(Summary,Tests%20A,B,C\).pdf](http://www.caa.co.uk/docs/78/FINAL%20STAL%20Market%20Power%20Assessment%20(Summary,Tests%20A,B,C).pdf).

<sup>163</sup> This document is available at:

<http://www.caa.co.uk/docs/1350/Europe%20Economics,%20Advice%20on%20the%20application%20of%20long%20run%20incremental%20cost%20estimates%20for%20Gatwick%20and%20Stansted%20-%20nonconfidential%20version.pdf>.

<sup>164</sup> Source: GAL. The CAA notes that GAL also indicated that it would respond to the CAA's analysis of Stansted's market power and the associated Annexes by 26 April 2013.



- Inappropriate assumptions about passenger throughput. In particular, GAL was concerned that, in estimating the forward-looking costs of an efficient new entrant, EE's models assumed an airport would be full from the first day of its operation.
- The exclusion of material cost categories from cost estimates, which would result in systematic downward bias in the estimates. As part of this, GAL indicated that any new build costs should have quality uplift included.
- Various assumptions associated with the modelling, including factors such as asset life and indexing needed reconsideration.<sup>165</sup>

4.31 As a result, GAL noted that '*considerable caution needs to be applied when interpreting its [the study's] results*'.<sup>166</sup>

4.32 To assess the merit (or otherwise) of GAL's concerns, the CAA engaged EE to reconsider its approach to LRAIC and its model.<sup>167</sup>

4.33 EE considered GAL's concerns and (amongst other issues):

- re-iterated its view that the value of LRAIC was reduced if entry and expansion is driven more by government planning and less by price signals; and
- determined that the model could be improved by more fully addressing how depreciation was captured in the model.

4.34 In particular, EE noted (amongst other issues) that:<sup>168</sup>

- The dismissal of increment 2 was based on a concern about the relationship between the incremental cost of additional capacity and assessing the competitive price level for an airport as a whole.<sup>169</sup>

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<sup>165</sup> Source: GAL.

<sup>166</sup> Source: GAL.

<sup>167</sup> EE's report on this issue, '*Advice on the application of long run incremental cost estimates for Gatwick and Stansted; Response to comments by Gatwick Airport Limited*', is available from the CAA's website: <http://www.caa.co.uk/docs/78/Q6EELRICResponseGatwick.pdf>.

<sup>168</sup> EE, '*Advice on the application of long run incremental cost estimates for Gatwick and Stansted; Response to comments by Gatwick Airport Limited*', pp. 1-18.

<sup>169</sup> It also noted that its LRAIC estimate for Increment 2 of £17.0 was the upper estimate and that this should be lower as the construction of the runway would most properly be phased over more time in line with demand. Source: EE, '*Advice on the application of long run incremental cost*

- Its assumption that a replacement airport would be full from day one was based on the premise that this new airport would replace Gatwick, with all existing traffic migrating to the new airport.
- Its approach did not include 'quality uplift' as part of any new build as a hypothetical entrant would offer exactly the same experience as the exiting airport and its inclusion would not be appropriate.
- Its LRAIC calculations were based on a 'brownfield site', which assumes that the land is already set up for an airport, including all planning permission, land acquisition and connection utilities – an approach consistent with the approach adopted by GAL's consultant (FTI).
- The costs associated with transport links are already included in the accounts of Gatwick, upon which the airport replacement costs are based (and only where the airport incurs these costs can they be reimbursed via the RAB).
- The index that GAL proposed to increase land values by was quite high and was not appropriate. Furthermore, EE indicated that a more appropriate index may be lower than the one that it used in its modelling (but which it had retained in the revised version of its model).

4.35 The CAA has examined EE's analysis and considers that the revised approach that it has put forward is reasonable. The CAA notes GAL's concerns but agrees with the EE analysis outlined above and considers that the various concerns have been addressed or do not require addressing.

4.36 The CAA notes that under EE's revised model that the LRAIC estimate for a replacement airport (Increment 3a) increased to £11.05, up from the £10.60 originally stated. However, the CAA also notes that EE's model was built using a cost of capital assumption of 6.5 per cent. If EE's model is updated to reflect the CAA's current view on the cost of capital for GAL (5.65 per cent), the appropriate LRAIC estimate would be £9.99. The CAA notes that this is well below the level that GAL has suggested and remains broadly consistent with the findings from the first EE study.

- 4.37 The CAA notes, however, that it continues to consider that there are numerous drawbacks associated with using this approach to set a competitive price for an airport, including:
- As LRAIC is a long-term forward-looking measure, there is a risk of over and under recovery in a particular period. This means LRAIC may not be well-suited as a benchmark to indicate whether a particular price is proximate to the 'competitive' price at any given time. Charging a flat LRAIC price over time also raises similar issues as any other 'smoothing' effect, which is that existing passengers may resist being asked to pay for future improvements where they may not benefit.
  - A LRAIC approach is data intensive and requires regulatory judgement to define the increment (although this might be less for a replacement cost approach). This can lead to significant uncertainty over future price profiles and it may be possible to generate large price increases or decreases depending on the assumptions used, limiting the protection to users and introducing variability owing to regulatory judgements.
  - It has also been argued that it is not an effective proxy for competitive airport prices where investments are very 'lumpy' for example it may not reflect the capacity cycle which, in a competitive market, could produce significant price volatility.<sup>170</sup> Indeed, the Guidelines<sup>171</sup> state that when considering prices it is important to take account of the effects of the capital-intensive nature of airports and of the 'lumpiness' of capacity increments.<sup>172</sup>
- 4.38 Connected to the third point above, the fluctuation of a price around the competitive price as a result of 'lumpy' investments assumes that the development of new airport capacity is largely driven by market

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<sup>170</sup> CAA, Review of price regulation at Heathrow, Gatwick and Stansted airports, ("Q6") Policy update, May 2012.

<sup>171</sup> See paragraph 3.17 of the Guidelines.

<sup>172</sup> In principle, short-run prices in a well-functioning airport market would be expected to fluctuate around a long-term average, depending on the level of spare capacity available in the market: when capacity tightens, prices could be expected to increase with the resulting high prices triggering the development of new capacity by competing airports and subsequent fall in prices. Under such circumstances, pricing above the competitive price for a period of time might be considered a normal feature of a well functioning market.

forces. Evidence suggests that this is not the case for airports in the South East, where the decision to develop significant new capacity is largely driven by government policy.<sup>173</sup> The CAA notes that government policy in this respect changed in 2010 and is currently not expected to be settled until 2015. Under such circumstances, pricing above the competitive level is unlikely to result in significant new airport capacity (or new entry) being brought forward.

## Price benchmarking

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- 4.39 An alternative way of estimating the level of the competitive price is to consider evidence on pricing at comparable airports. As airports are relatively differentiated, there are, however, some difficulties in identifying reasonably equivalent comparators. In addition, many airports are subject to economic regulation and their pricing is likely to be a reflection of the effectiveness of the regulatory regime under which they operate and may therefore bear little resemblance to prices that would be established under competitive conditions.
- 4.40 In the Initial Views, the CAA noted that:
- the price comparison information that it examined suggested that Gatwick is one of the more expensive airports to operate from, albeit that it is not obviously out of line with larger airports serving major metropolitan areas; and
  - the CAA's analysis does provide evidence to support the view that GAL's current charges are not significantly below the competitive price level.<sup>174</sup>
- 4.41 In response to the Initial Views, GAL indicated that:
- it had further developed its price benchmarking analysis and that this analysis continued to demonstrate that its airport charges were relatively low compared to other appropriate benchmark airports;
  - it questioned the validity of the comparator airports used by the CAA in its Initial Views document; and

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<sup>173</sup> For a description of this, see paragraphs 96-174 of Volume 2: Appendices of the CC's 2009 BAA report.

<sup>174</sup> CAA, Initial Views, paragraphs 3.77-3.94.

- all its analysis, combined with the analysis that it presented in earlier submissions, pointed to the current regulated price level at Gatwick being below the competitive price level.<sup>175</sup>

4.42 The CAA also notes that easyJet provided the CAA with information on the costs of operating at various airports within the UK and internationally. This information highlights that GAL's costs per pax £([<]) is [<] the majority of its entire (UK and overseas) network.<sup>176</sup> Specifically, the costs that easyJet incurs at Gatwick is [<] the costs it incurs at Stansted £([<]). Luton airport £([<]) and significantly [<] the costs at Southend airport £([<]).<sup>177</sup>

4.43 The CAA notes that other stakeholders have also expressed views on the relative price of Gatwick:

- Air Asia X noted that overall airport pricing at Stansted and Gatwick is not that different. Gatwick is only marginally more expensive than Stansted;<sup>178</sup>
- Ryanair noted that Gatwick is a relatively high cost airport;<sup>179</sup> and
- Thomson Airways noted:
  - In terms of price, Gatwick is becoming one of the most expensive airport for Thomson Airways to operate from, it used to be lower cost before Q5<sup>180</sup>; and
  - that while charges at Gatwick are lower compared to charges at Amsterdam Schiphol, Frankfurt am Main etc, they are not when compared to most airports in Spain (with the exception of Barcelona and Madrid where prices have recently increased), Italy, Greece and the USA.<sup>181</sup>

4.44 To further inform the CAA's understanding on price it commissioned Leigh Fisher to undertake work on benchmarking airport charges at Heathrow, Gatwick and Stansted, against suitable comparator

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<sup>175</sup> Source: GAL.

<sup>176</sup> Source: easyJet.

<sup>177</sup> Source: easyJet. The charge is [<].

<sup>178</sup> Source: Air Asia X.

<sup>179</sup> Source: Ryanair.

<sup>180</sup> Source Thomson Airways.

<sup>181</sup> Source: Thomson Airways.

airports, which where possible, were operating in a competitive market.<sup>182</sup>

- 4.45 The CAA considers that the benchmarks used in this analysis are appropriate and can help inform the discussion of the competitive price at Gatwick.<sup>183</sup> Leigh Fisher's approach was to identify a set of suitable comparators for each airport based on a set of criteria (such as catchment size and traffic mix) which were important in determining similarities across airports. Suitable criteria and comparators were discussed with airline and airport stakeholders.
- 4.46 Leigh Fisher's analysis shows, as illustrated by Figure 4.2, that the aeronautical revenue per passenger at Gatwick is marginally above the average of comparable airports and about £2 above the subset of airport operators that are subject to lighter regulation.<sup>184</sup>

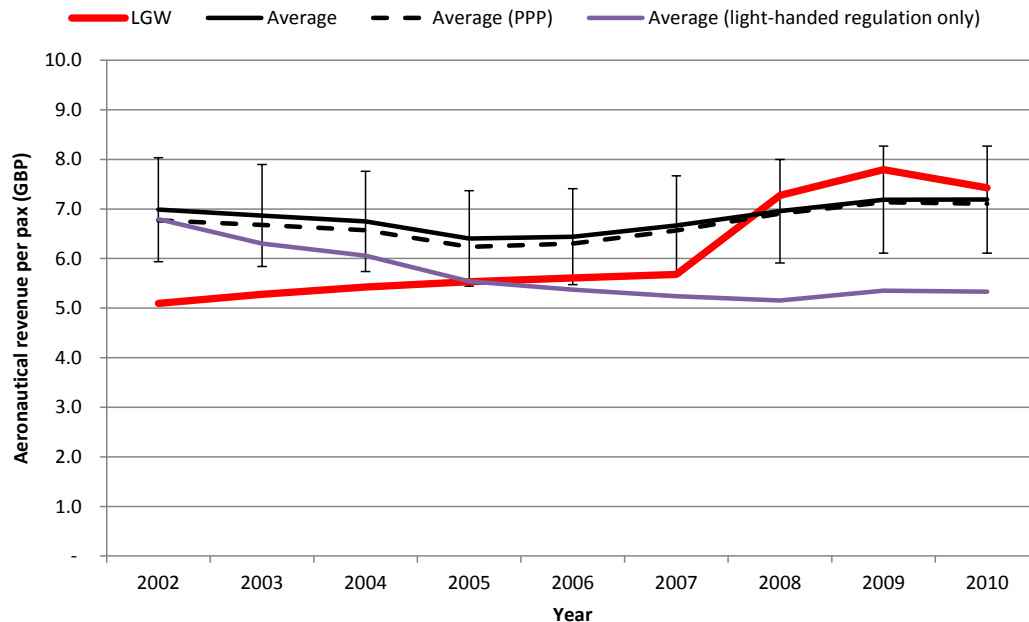
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<sup>182</sup> The CAA notes that the report that was released with the Stansted minded to decision has been revised and that the report dated 19 April 2013 supersedes the previous version. The revised Leigh Fisher study is available on the CAA's website.

<sup>183</sup> The CAA notes that the Hypothetical Monopolist (HM) test is hypothetical and the correct benchmark for the competitive price is a hypothetical competitive market.

<sup>184</sup> There were 11 airports in Gatwick's comparator group – Birmingham, London Stansted, London Luton, Edinburgh, Newcastle International, Barcelona, Milan Malpensa, Vienna International, London Heathrow, Madrid Barajas and Glasgow International. The CAA also notes that the analysis shows that GAL's aeronautical revenue per passenger were below the average of comparable airports over the period 2002 to 2008.

**Figure 4.2: Aeronautical revenue per passenger compared to the basket average**



Source: Leigh Fisher

Note: An error bar of 15 per cent is attached to the average value to reflect the uncertainties associated with the statistical techniques applied and the range that might be expected if different averaging techniques were used.

4.47 Leigh Fisher also undertook comparisons of total revenues and aeronautical tariffs. Based on the analysis undertaken, tariffs do not appear to be very informative of the competitive price of airports due to the widespread discounts available to published tariffs, particularly for airport operators that compete with GAL. Total revenue per passenger at Gatwick has also changed over the period, with Gatwick moving (up) to the middle of its comparator set. This may be informative given that charges at Gatwick are regulated on a single till, however, the substitutability between aeronautical and non-aeronautical charges may be limited (for example there is likely to be little substitution between retail income and landing charges).

- 4.48 The CAA notes that in a competitive environment, airport operators will have an incentive to maximise non aeronautical revenues as this will allow them to maximise the overall revenues and profits of the airport. In a RAB based framework, the airport operator will also have a strong incentive to outperform regulatory non-aeronautical revenue assumptions during the control period. However, these incentives may be muted compared to a competitive environment as the regulator will remove any outperformance at the end of the control period and thus reduce incentives for outperformance in the latter years of a control period.
- 4.49 In addition, the regulated company might have an incentive to underperform towards the end of the control period on non-aeronautical revenues, as this would maximise the scope for outperformance and reduce the pressure placed on management in the following price control period. Given these potential distortions to incentives under regulation, the CAA considers that comparing aeronautical revenues at Gatwick with other airport is more informative as both regulated and non regulated airports have similar incentives to maximise aeronautical revenues.
- 4.50 The CAA notes that GAL indicated, following a workshop on comparators at the CAA, that '*this exercise is difficult in nature*'<sup>185</sup> but that it sees '*some merit in a comparator based approach as a possible way of providing backstop protection or [to] inform a price monitoring regime*'.<sup>186</sup> However, GAL also identified a number of concerns with the analysis that was presented and suggested that the analysis '*would appear to need to be significantly amended*'.<sup>187</sup>
- 4.51 At the highest level, the key concerns that GAL identified were that:
- establishing, selecting and weighting comparators means that subjective judgements need to be made; and
  - when subjective judgements are made it is important to consider the aggregate impacts of these as they could otherwise result in spuriously accurate results.<sup>188</sup>

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<sup>185</sup> Source: GAL.

<sup>186</sup> Source: GAL.

<sup>187</sup> Source: GAL.

<sup>188</sup> Source: GAL.



- 4.52 In addition, GAL highlighted that the Leigh Fisher analysis could be improved by:<sup>189</sup>
- *...a discussion about the purpose, limitations and risks of using comparators and then letting the methodology be derived from that purpose;*
  - *[t]hat the set of comparators [for GAL] should include other London airports;*
  - improving the application of judgement, in particular in relation to outliers and balance – for example, GAL indicated that Leigh Fisher should ‘*consider further the impact of this excluding airports without proper justification*’;
  - *[t]hat the methodology should recognise price and service quality are both specification of product output, and removing one of these means no valid comparison can be made of the other;*
  - consideration of macro-economic factors, particularly regional GDP per capita and changes in exchange rates; and
  - by addressing a number of ‘*more specific technical points relating to the methodology, including the selection criteria and weighting factors*’.
- 4.53 The CAA notes that GAL, having had an opportunity to consider Leigh Fisher's report, submitted additional material that outlined its concerns with the report.<sup>190</sup> The material that was submitted covered a number of issues, including the comparison sample, the methodology used, the exclusion of significant variables and issues relating to data accuracy. Overall, GAL considered that the study represented a ‘*missed opportunity*’.<sup>191</sup>
- 4.54 The CAA has considered GAL's concerns and notes that a revised Leigh Fisher study – taking into account feedback from the CAA and other stakeholders – has been released.<sup>192</sup> The CAA notes that this revised study has sought to address a number of issues, including the method used to derive weighting criteria for the selection of

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<sup>189</sup> Source: GAL.

<sup>190</sup> Source: GAL.

<sup>191</sup> Source: GAL.

<sup>192</sup> See footnote 56.

comparator airports and inconsistencies/errors in input data.<sup>193</sup>

4.55 The CAA notes that in its revised study, Leigh Fisher has sought to address a number of the issues that the CAA (and other stakeholders) identified. In particular, the CAA notes that Leigh Fisher highlighted:

- In relation to the list of comparator airports used, GAL provided its own list of 23 airports with which regular comparisons were made. Of these, 20 were included in the long list of comparators that were used, with the exceptions being those that lacked sufficient data to enable the chosen comparison approach.<sup>194</sup>
- The choice of criteria used for the assessment took account of stakeholder feedback but did not necessarily adopt every suggestion.<sup>195</sup> It noted, for example, that with respect to service quality that:
  - *... service quality has not been included on the basis that it is the match of service quality to the customer's requirements that is more properly assessed rather than the absolute comparison between different service levels delivered in potentially different market segments.*
  - *While a secondary consideration, the absence of publicly available data on comparable service standards for the vast majority of airports on the long list would also have prevented its inclusion.*<sup>196</sup>

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<sup>193</sup> Leigh Fisher, Comparing and capping airport charges at regulated airports, 19 April 2013, page 4.

<sup>194</sup> Leigh Fisher, Comparing and capping airport charges at regulated airports, 19 April 2013, pages 6-7.

<sup>195</sup> Leigh Fisher, Comparing and capping airport charges at regulated airports, 19 April 2013, pages 8-9.

<sup>196</sup> Leigh Fisher, Comparing and capping airport charges at regulated airports, 19 April 2013, p. 9.

- In relation to the assessment criteria that were used to construct the comparability index, that weightings were derived from regression analysis to reflect the degree of significance that each criteria is likely to have on the drivers for the difference between charges at airports. It also noted that it aimed to ensure that *'each criteria has the appropriate influence on the overall selection process, reflecting its significance and avoiding bias.'*<sup>197</sup>
- To provide a reasonable basket (sample size) of airports for comparison, that the qualifying limit – or cut of point – was based on the variance of difference rather than an absolute score, and that this was modified, following feedback on the initial results. It also noted that this approach (which was consistently applied for the airports it was considering), ensured a reasonable sample size while excluding airports that were widely different.<sup>198</sup>
- With respect to correcting for currency and inflation, that it tested a number of possible approaches and determined that the most appropriate approach was using own-country inflation data, converted to £GB at the 2011 exchange rate.<sup>199</sup>

4.56 The CAA therefore considers that the evidence suggests that GAL's aeronautical charges are broadly competitive compared to comparator airport operators, notwithstanding there being a margin of error in the analysis that makes it difficult to be definitive on this.

### **Assessment on the competitive price at Gatwick**

4.57 The CAA considers that the evidence outlined above suggests:

- the current prices at Gatwick are close to the LRAIC, which is an approximate measure of LRMC; and
- aeronautical revenue per passenger is marginally above the average of comparable airports, and about £2 above the average for the subset of airport operators that are subject to lighter regulation average of comparable airports.

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<sup>197</sup> Leigh Fisher, Comparing and capping airport charges at regulated airports, 19 April 2013, p. 15.

<sup>198</sup> Leigh Fisher, Comparing and capping airport charges at regulated airports, 19 April 2013, p. 17.

<sup>199</sup> Leigh Fisher, Comparing and capping airport charges at regulated airports, 19 April 2013, pp. 20-21.

- 4.58 The CAA also considers that this suggests:
- GAL's current cap is not significantly below the competitive price;
  - the current prices provide a reasonable rate of return to GAL through the RAB approach;<sup>200</sup> and
  - GAL's prices are close to what could be considered as the competitive price benchmark for Gatwick.
- 4.59 The CAA also considers that the evidence outlined above, including material from the EC guidance, is sufficient for it to define markets and analyse GAL's behaviour on the basis that current prices are sufficiently close to the competitive level.
- 4.60 The CAA notes that the issue of price is also examined in chapter 9.

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<sup>200</sup> The CAA notes that it has not seen any evidence to suggest that under the current RAB based approach GAL does not have an incentive to invest, which suggests that under current arrangements it is able to earn a return commensurate with the risk of its investments.

## CHAPTER 5

# Market Definition

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### Introduction

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- 5.1 This chapter considers the market definition for services provided by GAL applying the analytical framework discussed in chapter 3.<sup>201</sup>
- 5.2 This chapter builds on the analysis that was undertaken in the Initial Views and is structured as follows:
- Section 1 considers the product market definition;
  - Section 2 considers the geographic market definition;
  - Section 3 considers the relevance of temporal markets; and
  - Section 4 draws together the analysis that has been undertaken and outlines the CAA's views on the market(s) that GAL operates in.

### Section 1: Product market

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- 5.3 This section considers the product market definition for services supplied by GAL. First, it considers the product bundle for the assessment. Second, it considers appropriate market segmentations for the product market(s) in which GAL operates.
- 5.4 As defined in both European Commission<sup>202</sup> and the OFT<sup>203</sup> guidance, a relevant product market comprises all those products and/or services that are regarded as interchangeable or substitutable by the consumer by reason of the products' characteristics, their prices and their intended use.
- 5.5 This section employs the framework set out in chapter 3. It first

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<sup>201</sup> The CAA notes that chapter 4 discusses the CAA's consideration of the competitive price level at Gatwick and concludes that the current charges at Gatwick are near the competitive level.

<sup>202</sup> Commission Market Definition Notice, paragraph 7.

<sup>203</sup> OFT 403, paragraph 2.5.

examines what is an appropriate bundle of services with a focus on services provided in the 'core area' of the airport as defined in the Act.<sup>204</sup>

### The service bundle

- 5.6 GAL provides a number of services to airlines, passengers, freight operators and a range of other companies (groundhandlers, retail concessionaires etc) for the use of the infrastructure at Gatwick.<sup>205</sup> However, GAL's primary function is to provide access to the infrastructure of Gatwick for the landing, parking and departure of aircraft and the processing of passengers and cargo.
- 5.7 Given how the Act sets out the market power test by reference to a market for airport operation services in the airport area or its core area, and given that an airport can only be found to be dominant if the market power test is met for services provided within the core area, 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 (as per the discussion in chapter 3).
- 5.8 By adopting this approach, the product market would cover airport operation services that could be generally described as aeronautical services. It would, however, exclude the provision of facilities for retail, car parking and other commercial activities such as the provision of office space to airlines.
- 5.9 The CAA therefore considers that the aeronautical services provided by GAL at Gatwick are likely to consist of at least:
- the use of the runway and taxiways;
  - aerodrome Air Traffic Control ("ATC")<sup>206</sup>;

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<sup>204</sup> Section 5(4).

<sup>205</sup> Details on the services that GAL provides can be found in chapter 2.

<sup>206</sup> Aircraft landing at Heathrow will only face charges from the airport operator for the aerodrome element of ATC. The approach service is provided by NERL Plc as part of the London terminal manoeuvring area (LTMA) and charged directly to airlines operating in this space. At airports outside of the LTMA, the approach service would be included within this bundle of activities. It should be noted, however, that the CA Act formally excludes ATS as defined in the Transport Act 2000 from airport operations services. The CAA also notes that the ability to land and manoeuvre aircraft at and around an airport is a key service that airport operators are required to provide as part of its services to airlines. In the UK these services are currently contracted by the airport

- aircraft parking;
- ramp handling services;
- fuel and oil handling;
- the provision of facilities for aircraft maintenance; and
- the provision of infrastructure needed for the provision of other airside and landside groundhandling services.<sup>207</sup>

5.10 In addition, the CAA considers that aeronautical services will include:

- the provision of facilities for check-in;
- baggage handling;
- security screening;
- facilities for holding passengers between arriving at the airport and departure ("Holding passenger facilities");
- facilities for the processing of airline staff arriving and departing the airport<sup>208</sup> ("Airline staff processing facilities"); and
- the transit of passengers to and from the aircraft (in the case of a passenger airline) ("passenger transit facilities") and the provision of facilities for the processing of cargo (in the case of an aircraft carrying cargo, either in bellyhold or as a cargo-only flight) ("Cargo processing facilities").

5.11 The CAA considers that:

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operator with an air navigation service provider in a liberalised market. It is then up to the airport operator how they recover this cost in a similar manner to any other costs incurred, it is not a 'pass through' cost.

<sup>207</sup> The CAA notes that ramp handling services, fuel and oil handling, and aircraft maintenance are groundhandling services as defined in Directive 96/67/EC. Groundhandling services are often provided by the airlines or to the airlines by third parties. However, the groundhandlers pay fees to the airport operator relating to use and access to infrastructure. In these cases the airport charges would still affect the airline through the charges levied on the groundhandlers.

<sup>208</sup> The CAA notes that that given the legislative definitions, staff may never "arrive" at an airport if they do not enter through a passenger terminal, pass the forecourt of such a terminal, or use a qualifying car park. Nevertheless, the CAA considers that staff access costs would be a consideration as part of an airline's decision to operate from an airport.

- these services are likely to form the key bundle of services that an airline would require to operate from an airport;
- an airline would be required to bear the costs of all of these services to provide air transport services;<sup>209</sup> and
- in deciding whether to land at an airport, an airline would take account of the total bundle of charges rather than focusing on any one charge in isolation (even though services may be priced individually by the airport operator to reflect different cost drivers).

5.12 Given the above, the CAA considers that it is therefore appropriate to treat the basket of services outlined in paragraphs 5.9 to 5.10 as a single product. The CAA notes this is consistent with information provided by airlines regarding the factors taken into account in making their initial choice of airport. For example, Wizz Air stated that it considers costs holistically including aeronautical charges, the charges of groundhandling agencies, and, more widely, opportunities for commercial agreements with travel agents.<sup>210</sup>

5.13 The CAA notes that this bundled approach is consistent with the approach adopted by the OFT and the CC in their consideration of market definition for the BAA airports market reference.<sup>211</sup>

## Market segments

5.14 This section considers the available evidence on whether it is appropriate to segregate the product set out in paragraphs 5.9 and 5.10 and define separate markets based on the supply and demand of airport operations services by the following:

- airline business models;
- based and inbound carriers;

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<sup>209</sup> Air transport services are defined in the CA Act as “a service for the carriage by air of passengers or cargo to or from an airport”.

<sup>210</sup> Source: Wizz Air.

<sup>211</sup> OFT's reference to the Competition Commission in relation to BAA April 2007 (“OFT's BAA market reference”), paragraphs 4.5 and 4.19 and the CC's 2009 BAA Report, paragraphs 2.13-2.41. Indeed the CC's analysis highlights that where secondary products (i.e. aircraft parking fees and check-in) are constrained by the interaction with a primary product (i.e. landing of aircraft at the airport), it is generally accepted that they should be treated as a single product market. At this point, the CAA does not consider that it is analytically necessary to define primary and secondary products, as the CC did. For clarity, the CAA considers them as a whole.



- cargo operations; and
- passenger segmentations.

5.15 GAL, in its formal representations to the CAA through its initial submission in November 2011 and in its responses to the CAA's Initial Views, stated that:

*"...there is little evidence to support a view defining markets to be narrower than previously defined by the CAA and the CC i.e. separate markets for surface passengers and connecting passengers. And separate markets for LCC and FSC airlines".<sup>212</sup>*

5.16 GAL also objected to the approach the CAA outlined, in the Initial Views, which focussed on particular market segments to support a finding that Gatwick has SMP.<sup>213</sup> GAL also considered that the CAA *"appears to misuse the concept of market segments, by using a segment effectively as the relevant economic market within its conclusions".<sup>214</sup>* According to GAL, this constituted a *"major departure from normal approaches to market analysis".<sup>215</sup>*

5.17 The CAA notes that in the analysis below, where market segmentation is considered, it has sought to substantiate and clarify its approach to market segmentation and the evidence on which this is constructed. As will be seen in the evidence below, the CAA considers that, contrary to GAL's consideration, the product market could and should be segmented further.

### **Airline business models**

5.18 In the Initial Views, the CAA considered segregating the market for airport operation services by the provision of service to long-haul and short-haul operations. In particular, the CAA noted :

*"...long-haul routes are more likely to be served by larger aircraft – requiring a higher specification of runway – and they are more likely to carry bellyhold cargo, which can add to the requirements of long-haul operations, relative to those operating short-haul. Furthermore, airlines tend to require a larger catchment area and a degree of*

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<sup>212</sup> Source: GAL.

<sup>213</sup> Source: GAL .

<sup>214</sup> Source: GAL.

<sup>215</sup> Source: GAL .

*connecting traffic to sustain the more expensive long haul operations.*<sup>216</sup>

- 5.19 However, the Initial Views also indicated that a distinction is more likely to be linked to differentiation in airline business models. This section considers this aspect further and also brings together the discussion of long-haul and short-haul with the business model approach.
- 5.20 The Low Cost Carrier (LCC) business model has a number of key features, including:
- LCCs require quick turnaround times and minimal use of airport facilities.
  - The LCC model is based on all customers using the same basic service without differentiation and the airline maximising the usage of its assets through high rotations.
  - There is no ability to interline in an integrated manner.<sup>217</sup>
- 5.21 Given the above, the CAA considers that for LCCs there is no reliance on additional traffic at the airport or sophisticated transfer baggage systems (a position not shared with their full service counterparts). Given the fleet types employed by the LCCs and the focus on short haul destinations,<sup>218</sup> some may also have lower requirements on airport infrastructure in terms of runway length. The CC made similar observations with regards to LCCs' use of airport infrastructure:
- "The requirement of such carriers for airport facilities is also significantly different from that of the more traditional carriers; in particular, a need for rapid and reliable turnaround times (of no more than 25 minutes) to allow three or more rotations of aircraft each day; and no requirement for facilities such as airbridges or facilities for*

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<sup>216</sup> CAA, Initial Views, paragraph 2.67.

<sup>217</sup> It is possible to self connect with LCCs (as with FSCs) by buying an extra ticket. However, this requires no additional airport infrastructure as the passenger arrives at the airport to go through the entire departure process again. This takes place in the same manner as a passenger arriving at the airport by car or train.

<sup>218</sup> Just over half of short-haul services in the UK are provided by LCCs. In 2011, CAA airport statistics show that 54 per cent of passenger flew short-haul with a LCC.

*transfer passengers or their baggage.*"<sup>219</sup>

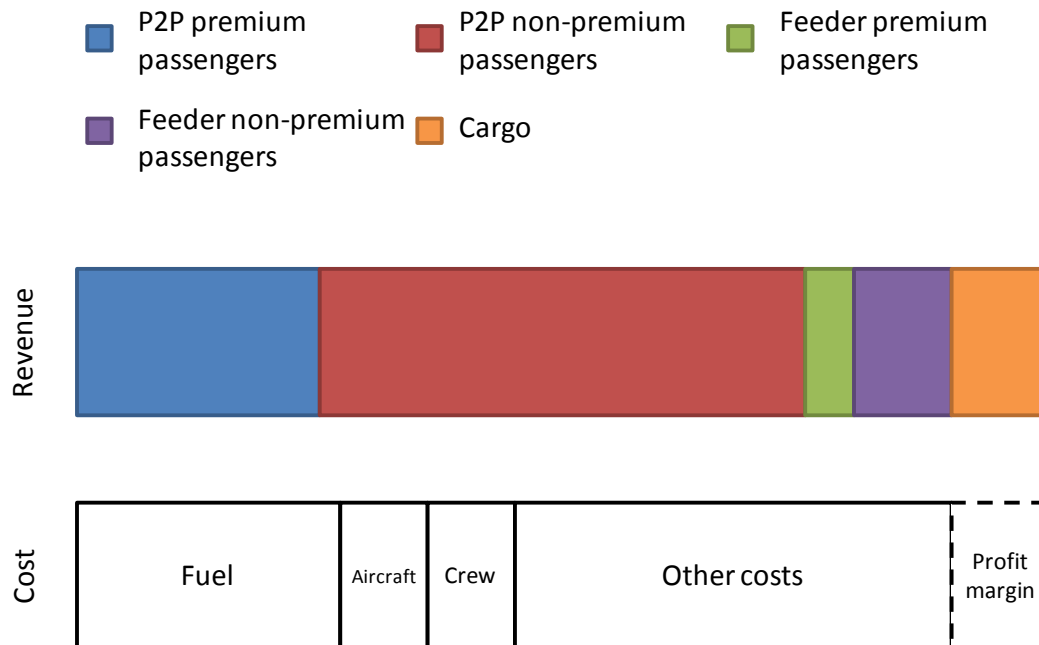
- 5.22 The CAA considers that charter airlines are similar in many respects to the LCCs, in terms of their demand for airport operation services from an airport, as they also deal with a single passenger class operating point-to-point services without the requirement for interlining. However, the CAA does recognise that charter airlines provide a number of long-haul services, especially from Gatwick.
- 5.23 A number of Full Service Carriers (FSCs) have submitted evidence which suggest a significantly differentiated demand for airport operation services. For example, Cathay Pacific has described the broader service requirements that its FSC model needs to operate profitably. In particular, noting that:
- 5.24 [§].<sup>220</sup>
- 5.25 Cathay Pacific , on transfer passengers, has also indicated:
- "Connecting passengers do contribute to CP's load factors at LHR. Though the destinations of the connecting passengers vary, but as a hub carrier what works for CP at HKG also works at LHR. In terms of infrastructure for connecting passengers, CP notes that it is important to transfer passengers through an airport as quickly as possible, ideally within an hour. An effective baggage transfer mechanism between terminals is also required. Additional operations within a terminal itself can assist the flow of transfer passenger traffic. A hub partner airline would also be required at the airport".*<sup>221</sup>
- 5.26 In presentations to the CAA, British Airways (BA) also highlighted the role of the three elements of the FSC business model. This is shown in the figure below, which shows illustrative revenues and costs faced by long haul FSC operations.

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219 CC, BA Report (2009), paragraph 3.10.

220 Source: Cathay Pacific.

221 Source: Cathay Pacific.

**Figure 5.1: Illustrative costs and revenues faced by a long haul flight**

Source: CAA adapted from BA presentation

- 5.27 Delta, a FSC, has also highlighted the importance of each revenue element for the viability of its services.<sup>222</sup>
- 5.28 The CAA also considers that the evidence above suggests that by comparison to LCCs, FSCs have significantly greater price and service differentiation between passengers with at least two distinct groupings; economy, and premium (business and first) class. To meet the needs of certain classes, FSCs may require access to additional airport facilities, such as lounges and priority security lanes for premium class passengers.
- 5.29 To operate long-haul services, FSCs may also require an extensive short-haul network from which to feed their long-haul services, to ensure sufficient load factors on these flights. Some airlines, such as BA or Lufthansa, provide the majority of their own network. Other airlines such as Virgin Atlantic Airlines Ltd. (Virgin) operate using code share agreements allowing passengers to transfer from other carriers. The use of feeder traffic requires additional airport facility to transfer passengers between aircraft without the passengers leaving the airport, such as a transfer baggage system.

<sup>222</sup> Source: Delta.

- 5.30 Flybe, a regional airline, has stated that it considers the product market at LGW to be for the provision of airport services to airlines. Further it considers that a narrower definition may be more relevant based on services to long and short haul carriers.<sup>223</sup> Flybe has a number of arrangements in place with FSCs at LGW to allow interlining. It has stated, for example, that it:
- "...seeks actively to tailor its schedules so as to maximise the interline possibilities without sacrificing the integrity of its regional timetable"*<sup>224</sup>
- 5.31 The CAA considers that this highlights the key interdependence between feeder and long haul operations. Regardless of whether individual routes require connecting traffic for viability, FSCs offer this service across their product range and therefore demand these services be available at the airports they serve.
- 5.32 Based on the evidence provided by Cathay, BA and Delta outlined above, the CAA considers that:
- there appears to be a need for the provision of bellyhold cargo facilities by the airport for the success of the FSC model.
  - there also appears to be significant differences in airlines' demand for airport operations services.
- 5.33 The CAA is therefore minded to consider that the market may be segregated on provision of services to LCC and charter airlines, on the one hand, and the services provided to FSC and airlines providing feeder traffic on the other.
- 5.34 The CAA also considers, based on the evidence available, that to meet FSCs and feeder airlines' operational needs, airports are likely to require:
- access to additional airport infrastructure to allow for facilities such as lounges and priority security lanes for premium passengers ("Premium passenger facilities"); and

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<sup>223</sup> Source: Flybe, Complaint to the Civil Aviation Authority under section 41 Airports Act 1986 paragraph 3.8, March 2011.

<sup>224</sup> Source: Flybe, Complaint to the Civil Aviation Authority under section 41 Airports Act 1986 paragraph 4.11, March 2011.

- airport facilities to transfer connecting passengers and their baggage between aircraft without the passengers leaving the airport, such as a transfer baggage system ("Integrated transfer facilities").

### **Based and inbound carrier**

- 5.35 In the Initial Views, the CAA considered whether there were separate markets for based and inbound carriers, but it did not conclude on that issue.<sup>225</sup>
- 5.36 The CAA considers that inbound carriers' demand for airport operation services are similar to those of a based carrier. This is highlighted in the discussion of the airline business model (above) and the geographic market below,<sup>226</sup> where both based and inbound airlines appear to face similar demand conditions.
- 5.37 The CAA has considered whether a lack of a requirement for access to the morning peak may also have differentiated inbound from based carriers. As noted below, in the discussion on temporal markets, the CAA does not consider that this is the case. The CAA notes that inbound operators still require access to inbound peak slots to allow them to provide early morning services for their inbound passengers. Setting aside those carriers that operate a low weekly frequency, inbound carriers offering daily flights are also likely to require access to the airport facilities throughout the day to operate an efficient flying schedule.
- 5.38 Based on the above, the CAA is therefore minded to conclude that it is not appropriate to segregate the product market between inbound and based carriers.

### **Cargo Operations**

- 5.39 The Guidelines highlight the need to consider the different demands of passengers and cargo for airport facilities.<sup>227</sup> In assessing the evidence from both a supply and demand perspective, the CAA considers that it appears there is good reason to segregate the market in terms of facilities required for passenger airlines and those required for cargo-only airlines.

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<sup>225</sup> CAA, Initial Views, paragraphs 2.85-2.88.

<sup>226</sup> section 3.

<sup>227</sup> CAA, Guidelines, paragraphs 3.30 and 3.43-47.

- 5.40 As set out in the Initial Views<sup>228</sup>, cargo is a relatively small activity at Gatwick and is focussed mainly on bellyhold provision via FSC passenger operations. For example, in 2012, 97,567 tonnes of cargo passed through Gatwick of which over 99 per cent was via bellyhold operations.<sup>229</sup>
- 5.41 The CAA does not, therefore, consider that there is merit in developing an independent market definition for cargo at Gatwick. Consequently, the CAA does not consider further cargo separately within the analysis presented in this document.

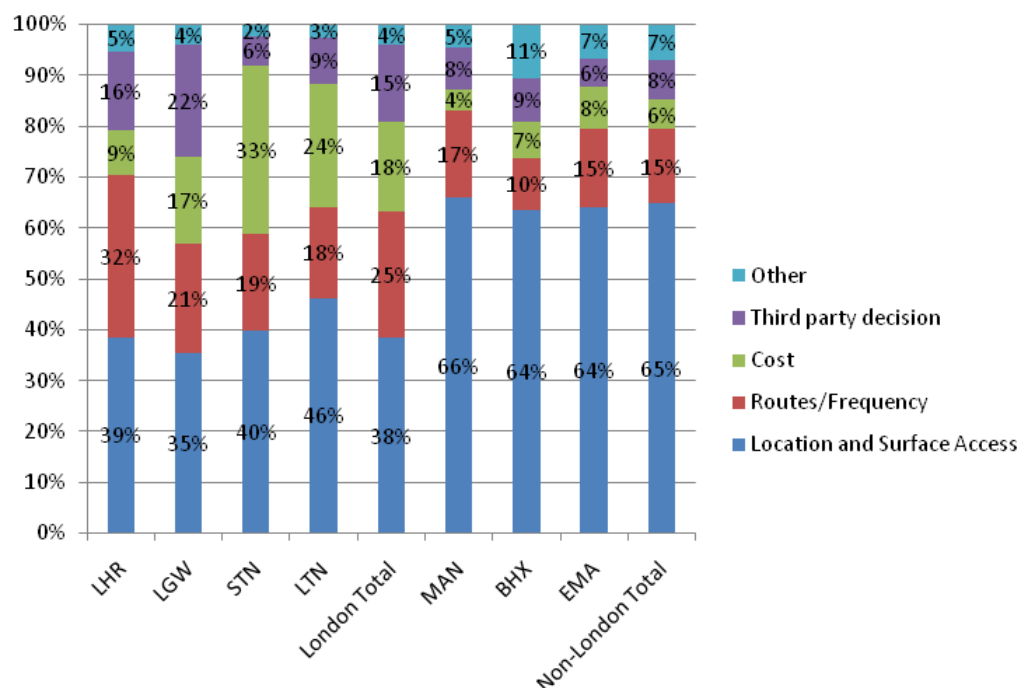
### **Passenger segmentation**

- 5.42 There are a number of segmentations of the passenger base that could be considered as candidates for segmenting the product market for airport operation services, including:
- surface and transfer passengers; and
  - business, leisure and VFR passengers.
- 5.43 Figure 5.2 (below) shows passengers' reasons for their airport choice which could be considered as aspects of the airport product for passengers.

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<sup>228</sup> CAA, Initial Views, paragraphs 2.10-2.14.

<sup>229</sup> This compares to Heathrow and Stansted, through which 1.5 and 0.2 million tonnes passed respectively. Source: CAA Airport Statistics 2012.

**Figure 5.2: Reasons for airport choice**

Source: CAA Passenger Survey Working paper November 2011

- 5.44 Figure 5.2 shows that location and surface access is the primary driver and that a third party decision (such as by an employer or other family member), was the second most cited reason of choice. Routes/frequency was the third most cited reason.
- 5.45 The CAA considers that the factors passengers cite as their reasons for airport choice are, in the main, outside of the influence of the airport over the short to medium term, for example, location and surface access after their construction.
- 5.46 The CAA notes, however, that to some extent, surface access can be altered. However, this can take a considerable time period for any modifications to come on stream, or may be part of wider government initiatives, for example the Crossrail project which will link into Heathrow.<sup>230</sup> The CAA also notes that although the airport does have some influence on cost, through airport charges, these are a small part of the overall fare. Routes/frequency (and to a certain extent

<sup>230</sup> The development of Crossrail began in 2001 receiving full support from Parliament in 2008. When Crossrail opens in 2018 it is expected to bring four trains an hour to Heathrow. See: <http://www.crossrail.co.uk/>, (accessed 2 April 2013).



third-party decision where it is a business account), can only be impacted indirectly by an airport operator's engagement with airlines.

- 5.47 The CAA's current consideration is therefore that it would not be possible for an airport to identify with accuracy differing passenger groups, nor to prevent arbitrage by passengers that would eliminate any possibilities of price discrimination.
- 5.48 However, in aggregate the CAA considers that passengers' demand influences the services offered by airlines, which in turn impacts on the airline's demand for airport operation services. Through the purchase of an airfare passengers also self-select and reveal information about their preferences, on which an airport may be able to discriminate through charges on airlines.
- 5.49 The CAA does not therefore consider it is appropriate to segregate the product market by passenger groups. The CAA notes, however, that it considers passenger switching in more detail in regards to the geographic market, where passengers switching between similar services at differing airports is likely to affect the geographic scope of the market.

### **Supply side substitution**

- 5.50 As well as considering demand-side substitution, the CAA also needs to consider issues relating to the supply of services by airports.
- 5.51 Supply-side substitutability is the ability of an alternative airport operator to enter the market at short notice and provide services in competition with the current provider(s) without incurring substantial sunk costs<sup>231</sup>.
- 5.52 The CAA notes that in addition to (as an alternative to), new entry, an existing airport operator could also expand or develop its current offering to compete with GAL. If alternative operators can effectively provide additional capacity in the short term (i.e. less than one year), that would be reasonably likely to discipline GAL's pricing behaviour.
- 5.53 The CAA considers that there are a number of ways in which supply-side substitution could occur, including:

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<sup>231</sup> CAA, Guidelines, paragraphs 3.56-3.58; see also OFT 403, paragraphs 3.12-3.18 and EC Market Definition Notice, paragraphs 20-23. The CAA refers here to sunk costs specifically as costs incurred in entering the market that are not recoverable on market exit.

- conversion of a military airfield to civilian use;
- investment in infrastructure at a current general aviation airport to allow the use of commercial passenger flights; and
- a commercial airport improving its current infrastructure to accommodate larger aircraft.

5.54 The CAA notes, however, that the amount of investment needed in any of these scenarios (and any other) will depend on a number of factors as there are many constraints on the type and volume of traffic that an airport can handle.

5.55 To illustrate this point, the CAA focuses on one of the main factors that affect the ability of airlines to operate from particular airports, runway length. Long-haul services, for example, tend to be operated with larger aircraft than those used by short-haul operators, and therefore require longer runways for take-off and landing.

5.56 The CAA notes that with one runway at 3,000m in length, GAL is able to offer services to all currently available commercial passenger aircraft at Gatwick. Similar services can also be offered at Heathrow and Stansted as they have runways of a suitable length. However, nearby airports, such as Luton and London City, are restricted in the type of operations they can support due to runway length. For example, London Luton Airport Operations Limited (LLAOL) told the CAA that:

*"The [Luton] runway of approximately 2km in length largely precludes long-haul traffic from operating.<sup>232</sup> The model is based on high frequency; short sector (mostly 2 hours and a couple of 5/6hours)".*

5.57 Virgin, a FSC, has highlighted a number of supply-side issues that it considers have limited substitutability in terms of operating long-haul services from regional airports:

*"Many regional airports do not have runways that can accommodate long-haul aircraft. ...which means that, we could not operate services using our current fleet without altering the passenger payload and/or the cargo carrying capabilities.*

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<sup>232</sup>Source: LLAOL. Luton has since stated that with recent improvements to aircraft technology, new aircraft such as the B787, which have shorter take off distances, could potentially facilitate long-haul aircraft.

*Many regional airports do not have the terminal capacity or suitable facilities to operate regular long-haul services. For example, due to the high passenger density, check-in desks and immigration services need to be designed for the high volume of passengers which need to be processed in a condensed space of time. We operate our aircraft in a high density configuration of up to 451 seats. To compete effectively as a full-service airline, we require airport facilities to accommodate particular service standards including separate designated, differential queue standards and the use of business class lounges, as well as facilities for transfer passengers. Many regional airports have insufficient airside facilities to handle wide-body aircraft used for long haul routes. For example, we prefer to use contact stands with direct airbridge access on to the aircraft."<sup>233</sup>*

- 5.58 The CAA notes that investment in a runway extension (or other airport infrastructure), can be a complex and resource intensive exercise. While the precise costs and practicalities of any such development are likely to depend on the location of an airport and the technical nature of the project, some of the challenges associated with such a project may include:
- significant capital and resource cost for the airport operator;
  - local and possible national planning restrictions;<sup>234</sup> and
  - potentially physical restrictions that are site specific.
- 5.59 The CAA considers it is likely that substantial investment costs involved in supply-side substitution would be of a level that would rule it out as a short-term response to direct airport competition. In addition, due to planning restrictions and other constraints, entry or expansion is not reasonably likely to occur within one year.
- 5.60 The CAA therefore considers on the supply side that the market is likely to be segmented by the provision of infrastructure and as a result by the types of aircraft that can be served from the existing infrastructure.

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<sup>233</sup> Source: Virgin.

<sup>234</sup> For example, there is currently a government moratorium on airport expansion at Heathrow, Gatwick and Stansted.

**Conclusion on product market definition**

- 5.61 The CAA considers that the evidence and discussion presented above shows that LCCs' business models focus on maximising asset utility by employing a high rotation model with minimal use of airport infrastructure. From a supply perspective, it is also apparent that, given sufficient infrastructure in terms of runway length, a number of airports neighbouring Gatwick and indeed across the UK and Europe are able to supply these facilities to LCC and charters. However, heavily congested airports, such as Heathrow, are unlikely to be able to provide services to LCCs especially given the need for a prompt turnaround times at the airport.
- 5.62 For FSCs and associated feeder traffic airlines, the CAA considers that the evidence shows that demands on infrastructure appear much greater driven by a business model requiring a number of differentiated airline services. These include differentiation of facilities for premium passengers, facilities for the processing of bellyhold cargo and facilities for transfer passengers. The CAA notes that Gatwick, Heathrow and Stansted have these facilities. However, the CAA also notes that Stansted does not currently provide airport operation services to these airlines.
- 5.63 The CAA is therefore minded to consider that, based on the demand from airlines and the limited opportunities for supply side substitution by current commercial airports or new entrants in a reasonable timeframe, the product market should be defined broadly on the basis of the following airline business models:
- a) LCC and charters consisting of the aeronautical services including, but not limited to:
    - the use of the runway and taxiways;
    - aerodrome ATC;
    - aircraft parking;
    - ramp handling services;
    - fuel and oil handling;
    - aircraft maintenance facilities;
    - infrastructure for airside and landside groundhandling

- services;
  - check-in, baggage handling and security screening facilities;
  - passenger holding facilities;
  - airline staff processing facilities; and
  - passenger transit facilities.
- b) FSC and associated feeder airlines consisting of the aeronautical services including, but not limited to:
- the use of the runway and taxiways;
  - aerodrome ATC;
  - aircraft parking;
  - ramp handling services;
  - fuel and oil handling;
  - aircraft maintenance facilities;
  - infrastructure for airside and landside groundhandling services;
  - check-in, baggage handling and security screening facilities;
  - passenger holding facilities;
  - airline staff processing facilities;
  - passenger transit facilities;
  - bellyhold cargo processing facilities;
  - premium passenger facilities; and
  - integrated transfer facilities for passengers and baggage between flights.

### Retail and car parks

5.64 This section briefly outlines the CAA's approach to the airport operation services that are not included in the definition above, including the services outlined in section 68(3)(b)-(c) of the Act:

*"(b) facilities for car parking, and*

*(c) facilities for shops and other retail businesses.*"<sup>235</sup>

- 5.65 In relation to the provision of facilities for retail and car park (RCP) activities, the CAA would need to be assured that the services in the airline product market and RCP services are interdependent<sup>236</sup> for them to be in the same market.
- 5.66 The CAA notes that although retail services would not be needed if the airport did not operate, in principle, an airport could operate without the provision of facilities for retail activities.
- 5.67 The CAA also notes that although some passengers may take into account the retail offering and/or prices of products sold at the airport when making a decision on the airline/airport with which they choose to fly, evidence suggests that this varies across different passenger groups, and expectations vary by airport.<sup>237</sup> To phrase it another way, 'all shoppers are fliers, but not all fliers shop'.
- 5.68 The CAA considers that, in practice, the price for retail activities is unlikely to affect passengers' choice of an airline or airport in a significant way. Further, in considering how to respond to an increase in rent and/or change to other terms of their contracts, the CAA considers that concessionaires' decisions are likely to be independent from decisions made by airlines in relation to aeronautical services.
- 5.69 The CAA's current view is therefore that, in examining the existence and extent of GAL's market power; it is likely to be more appropriate to define a separate market for the provision of facilities for retail activities and car parks that is distinct from that of the aeronautical product market. The CAA notes that this approach is consistent with

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<sup>235</sup> Section 68(3).

<sup>236</sup> In this context, the CAA defined interdependent such that an increase (decrease) in the price to one set of customers impacts on the demand from another set of customers and vice versa. The CAA notes that it is not enough for the pricing on just one side of the market to impact on the other, interdependence requires reciprocation.

<sup>237</sup> *Understanding Airport Passenger Experience*, Independent Social Research on behalf of the DfT, March 2009: <http://webarchive.nationalarchives.gov.uk/+http://www.dft.gov.uk/pgr/aviation/airports/reviewregulatioukairports/understandingexperience.pdf>; and Consumer Research, Accent for CAA, May 2011: <http://www.caa.co.uk/docs/2107/2131ConsumerResearch06122011.pdf>.

the approach adopted by the CC with respect to RCP.<sup>238</sup>

- 5.70 Based on the above, the CAA does not therefore consider, for the purpose of this market power assessment, it is necessary to define this distinct market in more detail at this stage.

## Section 2: Geographic market definition

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- 5.71 The CAA considers that the geographic market "*comprises the area in which the undertakings concerned are involved in the supply of products or services and in which the conditions of competition are sufficiently homogeneous.*"<sup>239</sup>

- 5.72 The CAA notes that:

- this area can be distinguished from neighbouring areas because the conditions of competition are appreciably different; and
- it important to recognise that, as airports serve a number of different users, there may be different relevant geographic markets for different groups of users.<sup>240</sup>

- 5.73 As explained in chapter 3, the assessment of competitive constraints for geographic market definition will include an analysis of the ability of airlines to switch away from an airport as well as the potential for passengers to switch between airports, whether independently or by following a particular airline. This section considers:

- airport views;
- airline views;
- instance of switching;
- route overlap; and
- passenger analysis.

### Airport views

- 5.74 This section presents the views on the market(s) in which GAL

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<sup>238</sup> CC (2009) report paragraph 2.41.

<sup>239</sup> CAA, Guidelines, paragraph 3.8 and EC Market Definition Notice, paragraph 8.

<sup>240</sup> CAA, Guidelines, paragraph 3.59.

operates that have been put forward by airports.

- 5.75 GAL has undertaken analysis of possible passenger switching, similar to that which the CAA sets out in the following sections. In its initial submission to the CAA, GAL stated that:

*“The CC, the CAA and the DfT have to date consistently concluded that the relevant geographic market is at least as wide as “the South East”. These conclusions are clearly supported by updated analysis [presented by GAL]. We show that many passengers regard the airports as good substitutes, as demonstrated by the evidence arising from iso-chrone analysis, catchment area overlaps, passenger surveys, and evidence that airlines located at different airports compete. This points to a large number of **marginal** passengers, which is the relevant consideration for a market definition assessment.*

...

*As the links to Heathrow improve – Crossrail – its competitive position will increase. As the transport links between Luton and Gatwick improve – Thameslink – this will again change the competitive dynamic.”<sup>241</sup>*

- 5.76 Further, in response to the CAA’s Initial Views, GAL stated that:

*“We agree that the proposed geographic market definitions reflect the competitive constraints present. In particular we agree that there is at least a broad ‘south east of England’ market in which Gatwick competes with Heathrow, Luton, Stansted and London City airports. We also agree with the CAA that the geographic market could well be broader than this.”<sup>242</sup>*

- 5.77 In summary, GAL considers that it competes with a number of airports within the UK especially those in the South East, namely Heathrow, Luton, Stansted and London City and considers that the market could be broader.<sup>243</sup> GAL argues that this is consistent with geographic market definitions previously used by other authorities, including the

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<sup>241</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick airport to inform the CAA's review of airport competition, Q5-050-LGW05, November 2011.

<sup>242</sup> Source: GAL.

<sup>243</sup> Source: GAL.



CC,<sup>244</sup> previous CAA considerations, the OFT, DfT and the European Commission.<sup>245</sup>

- 5.78 On this basis, GAL submits that Gatwick's passenger market share is no more than 25 per cent of the South East market. GAL notes that dominance is "*very rarely*" found by competition authorities at market shares below 30 per cent and, therefore, considers it is incumbent on the CAA to provide "*exceptional and compelling reasons*" in support of any finding that Gatwick has SMP.<sup>246</sup>
- 5.79 The CAA notes that GAL's commercial statements about competition with other airports are not underpinned by an analysis conducted under the SSNIP test and the extent to which marginal customers will move in response to a small but permanent increase in price.
- 5.80 The CAA also notes that GAL's evidence focuses on the ability of passengers to switch, not on the key relationship between airlines and the airport. The CAA considers passenger switching and its implications for market definition below.
- 5.81 GAL has also submitted evidence with regards to airline switching (discussed in the instances of switching section below). It has also made references to development of airlines<sup>247</sup> and changes in the disposition of the LCC bases across the EU.<sup>248</sup>
- 5.82 The CAA does not dispute the facts of the evidence outlined in paragraph 5.81. Indeed, the CAA notes that both Ryanair and easyJet have both seen significant and continuing growth since commencing their operations, even during the recent period of low economic growth. They have both developed substantial based operations across Europe.
- 5.83 However, the CAA considers that the growth and development achieved by Ryanair and easyJet across Europe is consistent with airline competition. The CAA does not consider that such growth and development is necessarily illustrative of the ability of these airlines to

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<sup>244</sup> Source: GAL, Airport Competition: Competing to Grow and become London's airport of choice, November 2011, Ref: Q5-050-LGW05, pages 21-24.

<sup>245</sup> Source: GAL.

<sup>246</sup> Source: GAL.

<sup>247</sup> Source: GAL.

<sup>248</sup> Source: GAL.

rationally and easily switch out of markets. The CAA notes that this issue is discussed in more detail in the European Market section later in this chapter.

- 5.84 With respect to changes in airline mix, the CAA considers that this is consistent with airlines reacting to competition and the incentives imposed on them by the airports. For example, in the recent complaint (under section 41 of the Airports Act) by Flybe into landing charges at Gatwick, the CAA concluded that GAL's increase in landing fees was justified as their expectation was that it would incentivise airlines to move to larger aircraft, which was rational. The CAA does not expect fleet or carrier mix at an airport to remain a constant.
- 5.85 In 2012, London Luton Airport Operations Limited (LLAOL) has stated that it considers it competes with GAL for airlines rather than for passengers. LLAL considers its size limits the ability for it to compete for passengers. Further LLAL noted that the demographics of the Gatwick catchment area are identical to those of Luton but there was a perception that Gatwick's catchment area was better and delivered higher yields. It is also said that it is possible that the higher yields at Gatwick are (at least in part), a result of the strength of airline brands at the airport and in particular the legacy airlines.<sup>249</sup>
- 5.86 HAL also presented regression analysis which suggests that it faces differing demand conditions to Gatwick and as a result of which suggest that the airports are not substitutes.<sup>250</sup> HAL has also submitted evidence comparing Heathrow to Gatwick which shows that:<sup>251</sup>
- 99 per cent of air transport services from Heathrow are delivered by FSCs compared to 36 per cent at Gatwick;
  - the average fare at Heathrow is three times higher; and
  - the yield at Heathrow is 30 per cent higher.
- 5.87 STAL has also indicated that it considers it competes with GAL.<sup>252</sup> STAL's responses suggest that it is actively seeking to attract airlines

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<sup>249</sup> Source: LLAOL.

<sup>250</sup> HAL, Response to the CAA's consultation on the Initial Competition Assessment, March 2012.

<sup>251</sup> Source: HAL.

<sup>252</sup> Source: STAL.

from Luton and Gatwick as well as other UK and European airports, and that it has lost airlines to Gatwick.

### Airline views

5.88 This section considers the views of airlines. The section is split in to the product markets that have been defined in Section 1. The evidence starts with FSC and associated feeder airlines.

### FSCs and feeder airlines

#### Substitutability between Gatwick and Heathrow

5.89 In the Initial Views, the CAA considered that for FSCs, the likely geographic market included Gatwick and Heathrow. The CAA concluded that the:

*"geographic market [for] FSC... might include only Gatwick and Heathrow, particularly for those airlines based at Gatwick"*<sup>253</sup>

5.90 At the time, the CAA considered it was likely that Heathrow provided an asymmetric restraint i.e. Heathrow constrains Gatwick but not vice versa.

5.91 The limited substitutability between Gatwick and Heathrow is supported by the response from Virgin to the Initial Views, where it indicated that:

*"whilst [the CAA analysis] suggests that Gatwick appears to compete with Heathrow for long-haul leisure destinations, this competition will in reality be limited by available capacity at Heathrow which acts as a barrier for entry"*<sup>254</sup>

5.92 In further submissions, in response to questions on the substitutability of Heathrow for Gatwick, Virgin also noted that:

*"It is Virgin Atlantic's experience that Gatwick fails to act as a suitable substitute for Heathrow, but to a large extent Heathrow may be a competitor to Gatwick. Particularly amongst business passengers, Heathrow acts as an appropriate substitute for Gatwick due to its demographic profile, greater access, convenience, timesaving and route availability. For leisure passengers there is evidence that a*

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<sup>253</sup> CAA, Initial Views, paragraph 2.190.

<sup>254</sup> Source: Virgin.

*degree of competition exists between the airports, however this should not be exaggerated.*

*... it is Virgin Atlantic's belief that if we were able to move all services that we currently operate from Gatwick to Heathrow virtually all current passenger traffic would transfer with these services*

*...If Virgin Atlantic were able to move services from Gatwick to Heathrow, the services would retain current levels of transfer traffic. Indeed, Virgin Atlantic would expect that the number of transfer passengers of any services moved to Heathrow would increase, due to its greater transfer potential. This further exemplifies the ability of Heathrow to act as a commercially appropriate substitute for Gatwick. When Virgin Atlantic has previously switched services from Gatwick to Heathrow, it experienced a positive effect on yields*

*Capacity constraints are a key limitation on substitution. Virgin Atlantic would want to move more of its services to Heathrow, but has been unable to do so because of a lack of runway slots."<sup>255</sup>*

- 5.93 Virgin has also supplied the CAA with quantitative analysis which suggests that [X].<sup>256</sup> This evidence supports the CAA's analysis that Heathrow provides an asymmetric constraint to Gatwick.
- 5.94 In addition, Virgin has noted that it operates effectively separate fleets for its Gatwick services than those from Heathrow.<sup>257</sup> The leisure fleet from Gatwick uses aircraft with around 14 Upper Class seats. However, the Heathrow fleet consists of aircraft with between 33 and 45 Upper Class seats providing a greater premium offering.<sup>258</sup>
- 5.95 BA considers that there are significant switching costs in their operation, which would mean that the movement of marginal traffic between airports may be unfeasible.<sup>259</sup> For example, BA has indicated:

*"It is clearly not viable to move our LHR operation, for a number of*

<sup>255</sup> Source: Virgin.

<sup>256</sup> Source: Virgin .

<sup>257</sup> Virgin uses the same fleet for its flights from Manchester and Glasgow.

<sup>258</sup> Source: Virgin.

<sup>259</sup> The CAA interprets this to mean the switching of marginal routes to airports at which BA does not currently operate.

*reasons, including the lack of sufficient hub capacity in the London market area. Similarly, our Gatwick operation has [redacted] short haul aircraft and [redacted] long haul aircraft. 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>260</sup>

5.96 BA has also noted the different ways in which its operations are organised at Gatwick noting that BA's Gatwick operation is now also run as a separate business unit. BA considers that its Gatwick operation is not scheduled as a hub (i.e. flights are not timed to provide feed to each other), but is operated on a point-to-point basis which focuses on serving Gatwick's surface catchment passenger demand. BA's Heathrow operation is however operated as a hub. As a result connecting traffic (approximately [redacted]) is not as significant as at Heathrow – but it does make an important contribution to the overall profitability.<sup>261</sup>

5.97 Further, BA considers that the market is limited by its client base and has indicated:

*"Although British Airways regards the London area as a single market, our premium customers are not equally distributed across the south east.*

*Our analysis of [redacted].*

*Our analysis also shows that the further away from the three London Airports that BA serves these premium passengers are, then the [redacted] .... We see London area as a single market BUT [...] the areas extending to [redacted] have the greatest number of high value customers, this implies that were we to consider moving traffic away from LGW or LHR then we would have to rebase it one of the airports in the South or East of the South East or risk losing premium traffic. Or alternatively we could only move our non-premium traffic, which again would risk incurring heavy fixed costs for [redacted].*

*In any event, the location of LHR and LGW and our established premium customers with their propensity to travel, severely limits our*

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<sup>260</sup> Source: BA.

<sup>261</sup> Source: BA.

*ability to move traffic from LHR and LGW."*<sup>262</sup>

- 5.98 The CAA considers that this suggests that there is a separate geographic market for FSCs and their premium passengers.
- 5.99 Emirates, which is based in Dubai and operates three daily flights from Gatwick and five daily flights from Heathrow, has indicated that:<sup>263</sup>
- *Heathrow and Gatwick appeal to separate markets but to the extent that they are substitutes, this appears to be one-way.*
  - *There is a geographic and market distinction between Gatwick and Heathrow in that they both serve different catchments and markets.*
  - *Gatwick has built a reputation as a "leisure-based airport" for charter airlines. And that while this perception is deep rooted, it is slowly changing under Gatwick's new ownership.*
  - *There is a huge catchment overlap between the Gatwick and Heathrow (i.e. areas such as Guildford), but Gatwick serves a separate market: serving the south coast is its "winning card" as this is where Emirates consider that the core population resides.*
  - *Heathrow has significant inbound carrier traffic feed and is business-focused. Heathrow has higher yields due to the better concentration of business passengers and better connectivity to the USA, Canada and Europe. On the other hand Gatwick is a UK originating airport for Emirates (with 65-70% of passengers connecting onwards at Dubai) and is leisure-focused.*<sup>264</sup>
- 5.100 Cathay Pacific, which does not currently fly into Gatwick but operates daily services from Heathrow to Hong Kong has indicated that:
- "Although LGW has recently improved, LHR remains the preferred airport for passengers flying out of London. LHR is well-connected into the centre of London. It first started flying to London in the 1980s into LGW, but its passengers made it clear that they prefer LHR and CP*

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<sup>262</sup> Source: BA.

<sup>263</sup> Source: Emirates.

<sup>264</sup> Source: Emirates.

*switched when they got the opportunity".<sup>265</sup>*

- 5.101 Delta, an American carrier operating between Heathrow and a number of cities in the USA, has recently stopped its services from Gatwick and moved them to Heathrow. When questioned about this move it stated that:

*"Many corporate companies are in the central London area and LHR is better placed to serve these pax due to the good transport links (such as the Heathrow Express), hotels and other facilities etc. LHR is the preferred London airport; it is where business passengers are. LGW is a great airport with great facilities and good links with the Gatwick Express, but LHR is closer and perceived to be the London airport".<sup>266</sup>*

- 5.102 Further, Delta noted that:

*"There is a long history of competition evaluation between LHR and LGW in ascertaining whether they are substitutable, and this has found that they are not. The overwhelming conclusion is that business travellers prefer LHR which is why it is prepared to absorb large leasing costs in order to operate from there. Furthermore, as it has a relatively small footprint, it would be quite awkward to operate from two airports".<sup>267</sup>*

- 5.103 Lufthansa, which operates from both Gatwick and Heathrow, has indicated that it considers each airport to be a market within itself for the airport's own core catchment. Its motivation for commencing a service from Gatwick has been to service Gatwick's catchment more directly providing feeder and point to point traffic into Frankfurt.<sup>268</sup> However, it also noted that it would not move away from Heathrow due to the considerable switching costs involved and the presence of the Star Alliance at Heathrow.

- 5.104 Aer Lingus<sup>269</sup>, Emirates<sup>270</sup> and FlyBe<sup>271</sup> share the view that Gatwick is

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<sup>265</sup> Source: Cathay Pacific.

<sup>266</sup> Source: Delta.

<sup>267</sup> Source: Delta.

<sup>268</sup> Source: Lufthansa.

<sup>269</sup> Source: Aer Lingus.

<sup>270</sup> Source: Emirates.

<sup>271</sup> Source: Flybe.

its own market and emphasise Gatwick's good leisure connectivity and easy access to London and the south coast.

- 5.105 The evidence on the substitutability between Gatwick and Heathrow shows that each airport possesses a strong and different brand. This is reflected in the demand for and use by the airlines and impacts on the substitutability of the airports. Gatwick is seen by airlines as being leisure focussed and point to point whereas Heathrow is the business airport and operated as a hub. The evidence from BA suggests that its premium customer base is present mostly in the areas close to Heathrow and Virgin operates different a fleet with different specifications to serve the Gatwick demand compared to those that it uses at Heathrow.
- 5.106 From the evidence outlined above, the CAA considers that airlines will switch from Gatwick to Heathrow and that this may be beneficial for them to do so. However, given the differences in airport brand and usage, the CAA considers that the evidence does not appear to suggest that airlines would consider moving from Heathrow to Gatwick at this time. Further, the CAA considers that the current capacity constraints at Heathrow will limit the ability of airlines to creditably threaten to switch.

### Substitutability with Stansted and other regional airports

- 5.107 As noted in the product market definition section above, Stansted has the requisite infrastructure for the provision of services to FSCs and, in theory at least, could be a potential competitor to Gatwick.
- 5.108 However, BA has indicated that it would not consider Stansted as a substitute for Gatwick as it has no feed, a less convenient location for BA's existing Gatwick passengers and no BA presence. Stansted is also 72 miles from Gatwick and is not a viable alternative as passengers want to travel from their local airport and are only willing to travel further if it is cheaper. BA cannot switch its base at Gatwick because of its sunk investments in infrastructure, crew base, community ties and loyal passenger base.<sup>272</sup>
- 5.109 The CAA has been provided with evidence that indicates that Stansted is not regarded as a viable substitute because of its weaker catchment area and lower connecting passenger feed (especially as

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<sup>272</sup> Source: BA.



LCCs are more interested in serving point-to-point passengers rather than providing interlining services). This is despite significant efforts made by STAL to attract traffic. These efforts appear to have been unsuccessful for the following reasons:

- The Stansted catchment was not considered to support the level of traffic needed given the routes it operates;
- Insufficient opportunities for interlining at Stansted;
- Significant switching costs due to previous investment at Gatwick;
- These factors were sufficient to limit the viability of the offer made by STAL<sup>273</sup>

5.110 Emirates, which operate services from Dubai to the UK out of Gatwick, Birmingham, Glasgow, Heathrow, Manchester and Newcastle,<sup>274</sup> noted that its regional operations are not substitutable with those in London as its operations in London are vital given its magnetic appeal to passengers from around the world who want to travel there. It also does not regard Stansted as a viable alternative at present due to its difficult geographical location, small catchment (some of which overlaps with LHR and LGW) and poor transport links.<sup>275</sup>

5.111 Flybe has made representations to the CAA suggesting that Gatwick constitutes a market in itself.<sup>276</sup> The CAA notes that evidence suggests that Flybe faces substantial barriers to switching arising from the sunk costs of its investments in establishing a network of services at Gatwick. Flybe also mentioned that it faces substantial barriers to entry at Heathrow and that slot constraints at Heathrow would prevent the airline from:

*"being able to construct a weekly timetable for its regional services which would be timed consistently day by day and operate at times which fitted the relevant markets and were operationally achievable."*

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<sup>273</sup> Source: [§<]

<sup>274</sup> Route Map, Emirates.com, (accessed 13 February 2013).

<sup>275</sup> Source: Emirates. Emirates have since noted that it expects the new owners of Stansted to improve transport links to the airport.

<sup>276</sup> Source: Flybe, Complaint to the Civil Aviation Authority under section 41 Airports Act 1986 paragraph 3.9, March 2011.

- 5.112 Flybe has also indicated that it does not consider that Luton, Stansted or London City are effective substitutes, as Flybe needs to cater for:
- a local market which can provide a core of regular passengers;
  - passenger whose origin or destination is central London; and
  - those who are travelling onwards from a regional point.
- 5.113 In addition, Flybe noted that all three airports are situated to the North and East of London. As a result the airports enjoy a much smaller local natural market (subject to greater competition from rail and car) than Gatwick, which attracts strong flows of traffic with origins and destinations to the South of the airport. Furthermore, Flybe considered that interlining opportunities are virtually non-existent at Luton and Stansted as they are both viewed as LCC airports.<sup>277</sup>
- 5.114 Flybe has also indicated that London City is a different type of airport from Gatwick and, as well as being geographically distant from Gatwick, it would not provide the benefits to users which Gatwick historically provided.<sup>278</sup> In later discussions with the CAA, Flybe expanded on this point and stated that operating from London City did not provide access to the South London and the South coast; or opportunities for connecting business and leisure traffic.<sup>279</sup>
- 5.115 The CAA also questioned Flybe over the possible use of Southampton airport<sup>280</sup> as a substitute for Gatwick. In response, Flybe noted that it considers Southampton as a complementary operation to Gatwick; as most of the routes it flies from Gatwick are also flown from Southampton. A recent study conducted by Flybe also suggests that it would be unable to service their Gatwick routes from Southampton.<sup>281</sup>
- 5.116 Air Malta flies from Heathrow, Gatwick and Manchester to Malta with a mainly leisure product and is an unaligned airline. Originally, Air Malta

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<sup>277</sup> Source: Flybe, Complaint to the Civil Aviation Authority under section 41 Airports Act 1986, March 2011.

<sup>278</sup> Source: Flybe, Complaint to the Civil Aviation Authority under section 41 Airports Act 1986, March 2011.

<sup>279</sup> Source: Flybe.

<sup>280</sup> Southampton airport is a similar travel distance from Gatwick as Luton and Stansted airports. It is also a significant base for Flybe.

<sup>281</sup> Source: Flybe.

operated exclusively from Heathrow. However, due to limited availability of slots, which meant that it could not grow, it commenced operations from Gatwick.

5.117 Air Malta indicated that if there was a significant expansion of capacity at Heathrow, it would develop its operations there. However, it also noted that, at this stage it wasn't sure whether this would be at the expense of Gatwick (i.e. removing its frequency from Gatwick altogether).<sup>282</sup>

5.118 Air Malta also indicated that the main difference between Heathrow and Gatwick is the level of connectivity:<sup>283</sup>

- *The level of connectivity at Gatwick is much more limited than at Heathrow ( i.e. much fewer transatlantic flights)*
- *If it uses Heathrow, it not only can connect to the UK, but internationally as well (to important markets in the US, Canada, Australia, Japan etc)*
- *Its passengers prefer Heathrow.*

5.119 When questioned by the CAA on its possible reaction to a 5 to 10 per cent price increase at Gatwick, Air Malta noted:<sup>284</sup>

- *Last year, it operated double daily routes to Gatwick, which has now decreased to once a day because Gatwick economics were not as good as Heathrow. An increase in costs is something it would have to consider very carefully in deciding whether it should continue its presence at Gatwick or call it a day by moving to other routes (such as Munich) that are more economically viable.*
- *Another important consideration would be whether or not it should reduce frequencies when there are carriers like easyJet operating.*

### **Summary of the evidence from FSC and associated feeder airlines**

5.120 The CAA considers that the evidence that has been presented to the CAA by FSCs and associated feeder traffic airlines points towards the geographic market consisting of both Gatwick and Heathrow.

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<sup>282</sup> Source: Air Malta.

<sup>283</sup> Source: Air Malta.

<sup>284</sup> Source: Air Malta.

- 5.121 However, the evidence also suggests that it appears that the constraints imposed by Heathrow on Gatwick are asymmetric in nature. As a result, a number of airlines appear to be using Gatwick as a next best alternative while they await capacity at Heathrow. The CAA notes that the presence of severe capacity constraints at Heathrow will limit the competitive pressures that it could exert on Gatwick. Issues associated with capacity constraints are discussed in more detail in chapter 7.
- 5.122 The CAA also notes that the airlines have consistently reported views on the different brands of Gatwick and Heathrow. Gatwick is generally considered as a leisure airport while Heathrow is viewed as an airport for business passengers. The CAA considers that this suggests that the different airports serve different demand characteristics; airlines appear to use Gatwick as a point to point airport with significant local demand, whereas at Heathrow airlines operate more on a hub basis utilising the many available connections at Heathrow.
- 5.123 The CAA notes that other airports have been considered by airlines, including London City, Luton, Stansted, Southampton and other regional airports. However, airlines have generally discounted these airports as viable substitutes for various reasons, including:
- catchment area;
  - poor connectivity at the airports;
  - inadequate infrastructure; and
  - and passenger preference.

### **LCCs and charter airlines**

- 5.124 In the Initial Views, the CAA considered that for LCCs and charters the likely geographic market could include Gatwick and other large airports in the South East, such as Stansted, Luton and possibly even nationwide.<sup>285</sup>
- 5.125 Thomson Airways, part of TUI travel PLC, considers that Gatwick is a "must have" airport for charter operators and is an important airport for the UK business. Gatwick has a London area catchment, and in spite of the North/South barrier where passengers south of the Thames do

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<sup>285</sup> CAA, Initial Views, paragraph 2.190.

not typically travel north to fly from Luton or Stansted, Gatwick has a pull even in the north of London. Another factor in the attractiveness of Gatwick is that it is situated in an affluent part of the UK, and also proximate to a capital city, which means there is a considerable feed of inbound passengers from other airlines to the area.<sup>286</sup>

- 5.126 Thomas Cook, which has its own airline as part of its overall holiday business, shared similar views to Thompson. Thomas Cook explained that Gatwick is important for charters. It has a large catchment area, its customers are comfortable with the airport, there is a familiarity in their customer base as to the routes it offers, and Gatwick holds a good brand. Thomas Cook noted that it is possible to fly from Stansted but the catchment is small and local. It also does not have a reputation for being a holiday departure point and considered that Stansted is a LCC airport. Further, it does not consider it could sustain a single aircraft at Luton despite the fact it is considered a holiday airport.<sup>287</sup>
- 5.127 Monarch, which operates scheduled and charter services, does not regard Heathrow as an alternative option to Gatwick because of the higher charges and lack of slot availability at Heathrow. It also noted that its leisure business does not "fit with the mix" at Heathrow and that Gatwick has a reputation as a "holiday destination airport". In addition, it noted that Gatwick has a "very big pull" for tour operators with a wider choice of charter operators as it acts as a consolidated charter and package holiday airport.<sup>288</sup>
- 5.128 Monarch also gave evidence that, although it has operated from Stansted in previous years, it does not regard it to be a viable alternative to Gatwick because of its location. Similarly, it does not regard Luton as a substitute because of its short runway<sup>289</sup>.
- 5.129 easyJet, the largest airline operating from Gatwick, has submitted a wide range of evidence to the CAA. Early strategy papers from easyJet suggest that they view London as a series of discrete catchments with limited overlap. Indeed some evidence suggests that they focus on a relatively small catchment area of up to [X] minutes,

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<sup>286</sup> Source: Thomson Airlines.

<sup>287</sup> Source: Thomas Cook.

<sup>288</sup> Source: Monarch.

<sup>289</sup> Source: Monarch.

with airports having unique [X] minute catchments.<sup>290</sup>

- 5.130 The CAA questioned whether Luton and Stansted are perceived as possible alternatives to Gatwick. easyJet noted:<sup>291</sup>
- *It views them as separate markets as each have their own demand and catchment areas.*
  - *There is some overlap in these catchment areas and in choice, but this does not impact upon easyJet's core business.*
  - *There is marginal competition between airlines at other London airports. For example, someone living in Guildford has the choice to go to Gatwick or Heathrow and easyJet will compete with BA for those passengers.*
- 5.131 The CAA has seen documentary evidence from easyJet which shows a clearly differentiated strategy for the North London airports and Gatwick. These support its more recent representations<sup>292</sup> where it has stated that:
- "The market is characterised by a [X] where continued growth in [X]. Growth in [X] due to a wide range of external and internal factors such as competition, market share as well as airport infrastructure issues"*<sup>293</sup>
- 5.132 The evidence that the CAA has seen on the development of easyJet's Southend operation shows that easyJet were not concerned over impacts that the development may have on its operations at Gatwick. The focus was the Stansted and Luton operations.<sup>294</sup>
- 5.133 Ryanair has stated that:
- "Ignoring capacity constraints in any consideration of airport substitutability only leads to incorrect conclusions. In the case of London airports, LHR, LGW, LTN and LCY are substitutable but are fully utilised (or fully utilised in peak periods in the case of LTN), and where planning and policy constraints prevent the addition of new*

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<sup>290</sup> Source: easyJet.

<sup>291</sup> Source: easyJet.

<sup>292</sup> Source: easyJet.

<sup>293</sup> Source: easyJet.

<sup>294</sup> Source: easyJet.

*airport capacity at these airports, airport substitutability cannot be assessed in ignorance of these facts.*

*...The European Commission has ruled that LHR, LGW, LTN and LCY are substitutable but capacity constraints mean that Ryanair cannot move there.*<sup>295</sup>

- 5.134 Ryanair's statements show that it considers there is to some extent a generic London airport product. However, Ryanair highlights that the opportunities for substitutability between London airports are constrained to a high degree by an absence of spare capacity and congestion. Ryanair goes on to consider that:

*"To the extent that there exists a very limited room for growth at the London airports that are suitable for Ryanair's operations, these airports are only partially substitutable for STN. The reason for this limited substitutability is the fact that each of these three airports [Stansted, Luton, and Gatwick] serves a distinct catchment area (with only a limited overlap), with customer bases of different levels of affluence and propensity to travel by air, as well as the fact that each of these three airports has a different appeal for inbound traffic to London."*<sup>296</sup>

- 5.135 Ryanair also doubts whether passengers originating from Stansted's catchment area to the north of London consider Gatwick as a suitable substitute for Stansted.<sup>297</sup>
- 5.136 Wizz, an inbound LCC, had considered other London airports when deciding to open operations at Luton. Of the airports it considered, it considered Heathrow was least accessible due to high costs and the scarcity of suitable slots. By contrast, Gatwick, Luton and Stansted were a much better strategic fit for Wizz's business model.<sup>298</sup>
- 5.137 Wizz illustrated to the CAA the decision-making process it undertakes when considering switching between airports:

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<sup>295</sup> Source: Ryanair.

<sup>296</sup> Source: Ryanair.

<sup>297</sup> Source: Ryanair.

<sup>298</sup> Source: Wizz Air.

- A key consideration was the extent of catchment overlap between the airports, and the impact of growing a route at the new airport on the airline's existing services at its current airport and the impact of growing an existing service at that airport, e.g. how many passengers would follow a service moving from one airport to another, and how much of the passenger base would need to be rebuilt if the service was moved.
- The impact at their current airport of switching some services to a new airport would need to be considered. For example, if Wizz switched a route/part of its network to a new airport, another airline may enter at the current airport on the route(s) previously served by Wizz. Additionally considering their downstream competition with beginning operations at an airport where the same route(s) were already operated by a competitor with significant capacity results in increased competition on these routes at that airport. This could drive down fare levels and profitability of each airline's operations on the relevant routes.
- Wizz considered that:
  - Luton and Stansted catchments overlap and both airports predominantly have low cost carriers and are in competition. Their catchment overlap covers approximately 60-70 per cent of Wizz's passenger base.
  - Heathrow's catchment overlaps with that of Luton but it is highly capacity constrained and serves a different airline segment (namely long-haul).
  - Gatwick has lower degrees of overlap with the rest of the London airports than do Luton and Stansted, due to its location in the south of London. Its catchment overlaps with approximately 30-40 per cent of Wizz's Luton catchment.<sup>299</sup>

### Summary of evidence from LCCs and charter airlines

5.138 The evidence from LCCs and charters suggest that Gatwick may be a market within itself, with limited catchment overlap between Gatwick and other airports. A number of airlines consider that there is a North/South split across London with passengers from the south

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<sup>299</sup> Source: Wizz Air.



unwilling to travel to the North London airports. Although the airlines consider that GAL has a significant pull for passengers to the north as well as in the south. A number of airlines have considered and currently operate some services from other London airports. However these appear to be treated operationally as compliments rather than substitutes.

- 5.139 In general, the LCC do not consider that Heathrow is a substitute for GAL given its airline mix, capacity constraints and congestion. Absent the constraints imposed by capacity and congestion LCC have, however, noted that they would consider operating from any of the major London airports.

### Instances of switching

- 5.140 This section considers the evidence on actual airline switching that has been observed to and from Gatwick. The CAA notes that considering the actual switching that has taken place provides it with a view of the current market dynamics and of substitutability between airports.
- 5.141 In its initial submission to the CAA, GAL made representations to the CAA on airline switching at the airport. As part of this, GAL listed a number of airline moves that have taken place since 1991. The CAA shows below those moves that have taken place since 2009 as these are most likely to be of relevance to the market(s) in which GAL currently operates.<sup>300,301</sup>

### Switches from Gatwick to Heathrow

- October 2009, BA closed a number of services from Gatwick and switched some further services back to Heathrow.
- May 2011, Qatar Airways pulls out of Gatwick for Heathrow.
- April 2012, Delta pulls out of Gatwick for Heathrow.<sup>302</sup>

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<sup>300</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick airport to inform the CAA's review of airport competition, Q5-050-LGW05, November 2011.

<sup>301</sup> The CAA has amended and extended the initial list submitted by GAL to reflect changes it is aware of since GAL's submission.

<sup>302</sup> Source: GAL.

- From March 2013 US Airways switching Charlotte service from Gatwick to Heathrow.
- 5.142 Where possible, the CAA has sought to ascertain the motivations behind the observed switching behaviour – it has, however, only been able to do this with respect to Delta.
- 5.143 Delta recently switched its operations from Gatwick to Heathrow. The CAA notes that the reasons for this move are detailed earlier in this chapter. In summary, the key motivation for Delta's switch appears to have been to secure passenger demand. Importantly, the CAA considers that this move has not been undertaken due to changes in relative price or quality. Indeed, Delta has commented on the good quality of Gatwick's facilities:
- Gatwick is a great airport with great facilities and good links with the Gatwick Express, but Heathrow is closer and perceived to be the London airport.*<sup>303</sup>
- 5.144 The CAA considers that this evidence shows switching from Gatwick to Heathrow but not vice versa, which is consistent with the existence of asymmetric constraints between Gatwick and Heathrow. In other words, although Heathrow may be a substitute for Gatwick, Gatwick appears to impose little constraint on Heathrow.

### Switches between Gatwick and Stansted

#### *Stansted to Gatwick*

- Mid 2009, Norwegian Air Shuttle moved its entire operation from Stansted to Gatwick.
- February 2011, Air Berlin moved two of its five Stansted routes to Gatwick.
- October 2011, AirAsia X switched from Stansted to Gatwick. The service was cancelled in April 2012.

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<sup>303</sup> Source: Delta.

### *Gatwick to Stansted*

- April 2013, Air Moldova switched its limited twice weekly service from London to Moldovan capital Chişinău from Gatwick to Stansted.<sup>304</sup>
- 5.145 Norwegian Air Shuttle indicated that it moved from Stansted to Gatwick due to:
- Gatwick's good connectivity and transport links to London; and
  - its improved ability to attract business passengers from Gatwick, compared to Stansted, which is more leisure orientated and associated with LCCs.
- 5.146 Norwegian Air Shuttle also indicated that it did not consider Luton as it is "*unknown*" in Scandinavia and London City was not compatible with its aircraft. It also considered that the limited ability to grow due to slot constraints and the excessive costs of entry into Heathrow did not make Heathrow suitable for its operations.<sup>305</sup>
- 5.147 Air Berlin switched traffic in recent years from Stansted to Gatwick. Airport charges were given as a secondary concern in its switching decision; its primary consideration was the level of passenger demand available at the airports, noting that Gatwick and Stansted have different catchment areas. It was also influenced by the fact that Gatwick is a base for its One World alliance partners.<sup>306</sup> The CAA note that Air Berlin has since closed some routes offered out of Gatwick.
- 5.148 In October 2011, Air Asia X<sup>307</sup>, which flew limited services between Kuala Lumpur and London, switched its services from Stansted to Gatwick. It noted that it did not initially start operating into Gatwick due to restrictions placed on them by the Malaysian Government. The move was based on the following reasons:
- Gatwick is closer to a greater proportion of the London catchment;

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<sup>304</sup> Reported in the press and on STAL's website, the CAA has not been able to discuss the motivations for this move with the airline, see: <http://www.stanstedairport.com/about-us/media-centre/press-releases/new-airline-for-new-stansted-owners>, (accessed 29 April 2013).

<sup>305</sup> Source: Norwegian Air Shuttle.

<sup>306</sup> Source: Air Berlin.

<sup>307</sup> Source: Air Asia X.

- most of Air Asia X's passengers self connect and Gatwick has more low cost flights to more destinations than Stansted;
- surface access provision to Gatwick is cheaper than to Stansted; and
- Gatwick had a [X].

5.149 Air Asia X also noted that [X].

5.150 The CAA notes that majority of these switches are all moves in the same direction, that is, from Stansted to Gatwick. Only the most recent move by Air Moldova has been from Gatwick to Stansted. The CAA considers that this suggests that Gatwick faces little competition from airports north of the river. It also notes that this finding is supported by input from the airlines concerned, which emphasised that the moves were not price-related.

#### **Switches from Gatwick to regional airports**

- November 2011, SAS ceased operations from Gatwick, for services at Manchester<sup>308</sup>

5.151 The CAA has not been able to discuss this switching with SAS but currently considers that this move constitutes a switch out of the market. Although a move out of a market it is a valid response to price rises, and may discipline the airport's pricing, the CAA does not currently consider that this particular piece of behavioural evidence is sufficient to widen the market.

#### **New services or closures at Gatwick**

- October 2011, Lufthansa opened operations from Gatwick.
- December 2011, Turkish Airlines opened operations from Gatwick.
- December 2011, Vietnam Airlines opened operations from Gatwick.
- March 2012, Hong Kong Airlines opened operations from Gatwick. However the route was cancelled in September 2012.<sup>309</sup>

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<sup>308</sup> SAS ceased its Gatwick-Bergen service from November 2011, in January 2012 SAS launched Manchester-Bergen. It has been reported that this new route is effectively a replacement for the Gatwick service. See <http://www.breakingtravelnews.com/news/article/sas-to-move-bergen-flight-from-london-to-manchester/>, (accessed 6 March 2013).

<sup>309</sup> The CAA has note that Hong Kong Airlines departure from Gatwick was reported within the

- April 2012, Air Nigeria opened operations from Gatwick the service was cancelled in September 2012.
- April 2012, Korean Air opened operations from Gatwick. Korean cancelled its winter 2012 flying programme. It was originally GAL's understanding that this was to resume in summer 2013, however GAL, following the launch of a BA route from Heathrow to Incheon, considered that this was uncertain. GAL does however now understand that the Korean route is likely to return in summer 2013.<sup>310</sup>

- May 2012, Air China opened operations from Gatwick.
- March 2013, Vueling to open operations from Gatwick.<sup>311</sup>

- 5.152 The CAA notes that the examples provided by GAL do not denote switching as such but rather represent new entry by airlines (and in some cases exit without switching to another neighbouring airport).
- 5.153 The CAA also notes that although these new services may indicate that airlines are willing to serve the London area from Gatwick, the CAA has not been able to examine the choices made. The choice of Gatwick may be influenced by capacity constraints at Heathrow. For example, Heathrow has told the CAA that Vietnam Airlines wanted to fly from Heathrow in preference to Gatwick, and Heathrow was interested in developing the South East Asia catchment, but was unable to offer them any slots.<sup>312</sup>
- 5.154 As noted earlier in this chapter, Lufthansa opened a service at Gatwick in 2011. This occurred to serve the Gatwick catchment which it perceives as being a complement to its services at Heathrow. However, for the 2012 winter season, Lufthansa removed its Gatwick service and has stated that this decision was due to a lack of demand and was not influenced by airport charges.
- 5.155 Similarly, the choice of using Gatwick for new routes, over other

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media as being due to weak overall economic outlook in Europe and the company refocusing on its regional business. See: <http://www.travelweekly.co.uk/Articles/Details/41319>.

<sup>310</sup> Source: GAL.

<sup>311</sup> Vueling, press release, October 2012, available at: <http://www.vueling.com/en/we-are-vueling/press-room/press-releases/corporate/vueling-network-to-expand-to-100-destinations-from-barcelona-el-prat-airport-in-2013/>, (accessed 26 February 2013).

<sup>312</sup> Source: HAL.

airports, such as Luton or Stansted, may be due to airlines not regarding these alternative airports as adequate substitutes, regardless of price.

- 5.156 In conclusion, the CAA considers that switching appears to be from the North London airports to Gatwick or from Gatwick to Heathrow, (with only one reported move in the opposite direction). The CAA notes that this is consistent with the airlines' view that GAL faces some constraint from Heathrow but that GAL poses little constraint on Heathrow.
- 5.157 The CAA also considers that there also appears to be a degree of asymmetric constraints posed by Gatwick on the North London airports. Based on the evidence available, the CAA considers that this appears supportive of LCCs being able to switch to Gatwick from Stansted, although the reasons that airlines have given have generally been motivated by non-price related issues. Similarly, moves by feeder airlines into Gatwick from Stansted have been motivated by non-price issues.

### Airline route overlap

- 5.158 In the Initial Views and in the 'minded to' market power determination assessment for Stansted,<sup>313</sup> the CAA considered what route overlap may reveal about the markets in which airports operate.<sup>314</sup>
- 5.159 In particular, the Initial Views indicated:
- *A large share of short-haul and domestic passengers in the London area can use other airports for their particular flights – about three quarters of short-haul/domestic routes from Gatwick are available from at least one other airport and more than one half of routes from Gatwick are also available from Stansted.*<sup>315</sup>

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<sup>313</sup> CAA, Stansted Market Power Assessment - Developing our Minded to position, January 2013 at "STAL MPA".

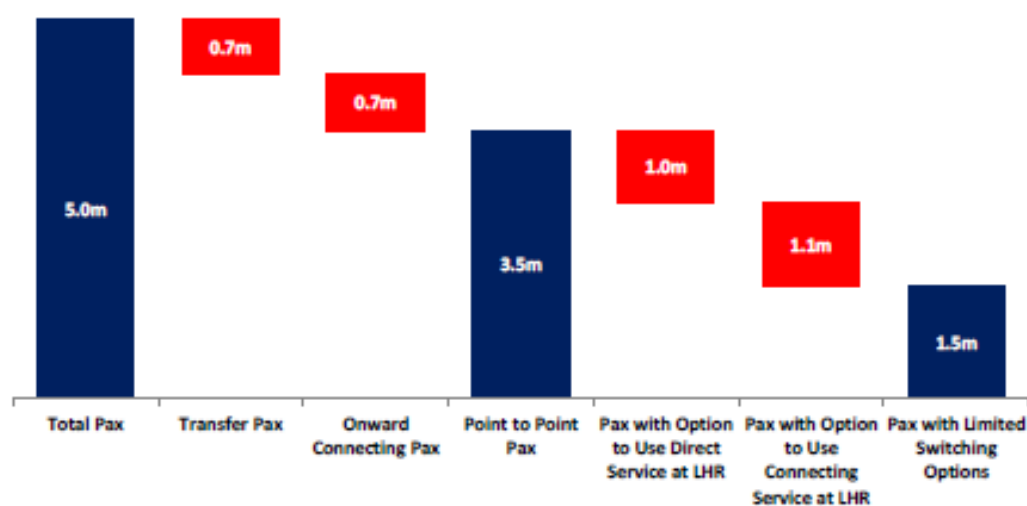
<sup>314</sup> CAA, STAL MPA, paragraph 4.86-4.92.

<sup>315</sup> CAA, Initial Views, paragraphs 3.124.

- For long-haul there is a lower degree of overlap, with 39 per cent of long-haul routes from Gatwick were available from Heathrow. A high share of long-haul routes from Gatwick are to holiday-focused destinations, are served relatively infrequently (less than daily), and are not served from Heathrow.<sup>316</sup>

- 5.160 The CAA continues to consider that the significant level of route overlap between the London airports (at this aggregate level) represents a significant level of choice for passengers and in turn may indicate some degree of airport competition.
- 5.161 GAL has submitted, as part of their evidence, a report by Avia Solutions (Avia) on the ability of long-haul passengers to switch from Gatwick given alternative route options available.<sup>317</sup> Although the CAA considers there are a number of limitations to the Avia analysis, there is merit in reviewing the analysis as part of a discussion on route overlaps.

**Figure 5.3: Estimated passenger demand to long haul destinations switching options**



Source: GAL (AviaSolutions)

- 5.162 Figure 5.3 shows that of the five million passengers on long haul services from Gatwick in 2011, around 70 per cent may have what AviaSolutions describes as a good switching opportunity. The report

<sup>316</sup> CAA, Initial Views, paragraph 3.125.

<sup>317</sup> Source: GAL.

also noted that:

- *At a geographic region level, switching opportunities were greatest for passengers travelling to destinations in North America, Asia and the Middle East.*
  - *North America: It could be argued that almost all passengers had good switching opportunities, with 1.9m (out of 2.0m) either transferring, connecting at their next destination or having access to a competing direct or indirect service at Heathrow.*
  - *Middle East: A significant proportion of passengers were connecting at Dubai and direct competing services existed for all point to point passengers.*
  - *Asia: The majority of passengers were point to point, all of which had the option to either use a competing direct or indirect service from Heathrow.*
- *Switching opportunities appear to have been more limited for passengers travelling to destinations in the Caribbean and Mexico and Africa.*
  - *Caribbean and Mexico: Approximately 1/3 of passengers were either transferring, had onward connections or had the option to use a competing indirect service at Heathrow and therefore had switching opportunities. It could also be argued that a substantial proportion of passengers on these predominantly leisure routes are not destination specific and therefore have a wider range of switching opportunities.*
  - *Africa: Not a material destination region from Gatwick in 2011, with fewer than 200k passengers. Over 40% of passengers were either transferring or were travelling to a destination for which there is evidence of material connecting flows from Heathrow.*

5.163 Similar to its analysis in the Initial Views, the CAA considers that the route overlap indicates the choice that passengers may have. However, such analysis in isolation does not take into account passenger preferences for particular airlines or the price and time sensitivities of passengers. Rather, it highlights the theoretical maximum potential for passenger switching for passengers demanding long-haul services.



- 5.164 The CAA also notes that it considered an alternative view of route overlap within its STAL 'minded to' decision,<sup>318</sup> and stated that route overlap may not be indicative of airport competition if they are offered by the same airline. As noted in chapter 3, airlines operating in a competitive market are more likely to have significant information on their passengers' preferences which in turn influences the development of their services.
- 5.165 The CAA considers that this suggests that airlines may plan less route overlap at airports where there is a higher degree of substitutability between the airports, as passengers would travel to the neighbouring airport to access the unique route from their chosen airline.
- 5.166 In planning their routes, the CAA also considers that airlines are unlikely to operate routes that would be in direct competition with their own routes. In this case, route overlap by an airline with itself could be interpreted to indicate that the airports served differing markets. As a simple metric, the CAA would expect greater overlap in routes from the same airline at airports that are not substitutable.
- 5.167 Based on this hypothesis, the CAA considers it would be expected that where airports are within the same market, an airline would schedule less route overlap. Where airports are not in the same market, more route overlap would be expected.
- 5.168 easyJet is the largest airline at Gatwick and operates out of both Luton and Stansted. In the summer season of 2011 it operated 89 routes out of Gatwick, 31 from Luton and 28 from Stansted. Figure 5.4 (below) shows that of the routes offered at Luton and Stansted, 94 per cent and 79 per cent were also provided out of Gatwick. The CAA considers that this suggests that Gatwick is in a separate market to Luton and Stansted.

**Figure 5.4: easyJet route overlap for summer 2011**

	easyJet Routes	easyJet routes also provided at LGW	Overlap
<b>Luton</b>	31	29	94%
<b>Stansted</b>	28	22	79%

Source: CAA analysis

<sup>318</sup> STAL MPA, paragraphs 4.88-4.92.

- 5.169 Similar data for BA shows that in summer 2011, of the 40 routes operated from Gatwick, 25 per cent were operated from Heathrow. The data for Virgin shows that there was no route duplication between Gatwick and Heathrow.
- 5.170 The CAA recognises that there are limitations to this analysis. However, the CAA considers that it supports a conclusion of a Gatwick-only market for LCC and charters.
- 5.171 For FSCs and associated feeder traffic airlines, a Gatwick market that contains Heathrow is supported given the low route overlap. However, the evidence submitted by both BA and Virgin indicates that they operate their services from these airports as separate leisure and business-focussed operations, which suggests that Gatwick and Heathrow are in separate markets.

### Passenger analysis

- 5.172 This section considers what analysis of the passengers implies about the boundaries of the market. As noted in chapter 3, the CAA considers that airlines (to some degree), internalise the passenger preferences and broad demand. In this section, the CAA reviews the evidence available on passengers' choice of airport to assess whether independent passenger analysis supports airlines' evidence on the geographical market. In particular, this section considers:
- catchment analysis;
  - passenger preference;
  - analysis of price elasticity of demand (PED); and
  - the impact of airline competition.

### Catchment areas

- 5.173 This section considers the analysis of airport catchment areas and draws from the CAA's catchment working paper published in 2011.<sup>319</sup>
- 5.174 The CAA notes that catchment analysis can provide useful evidence regarding an airport's passenger base. In particular, it is a way of estimating the geographic area from which a large proportion of an

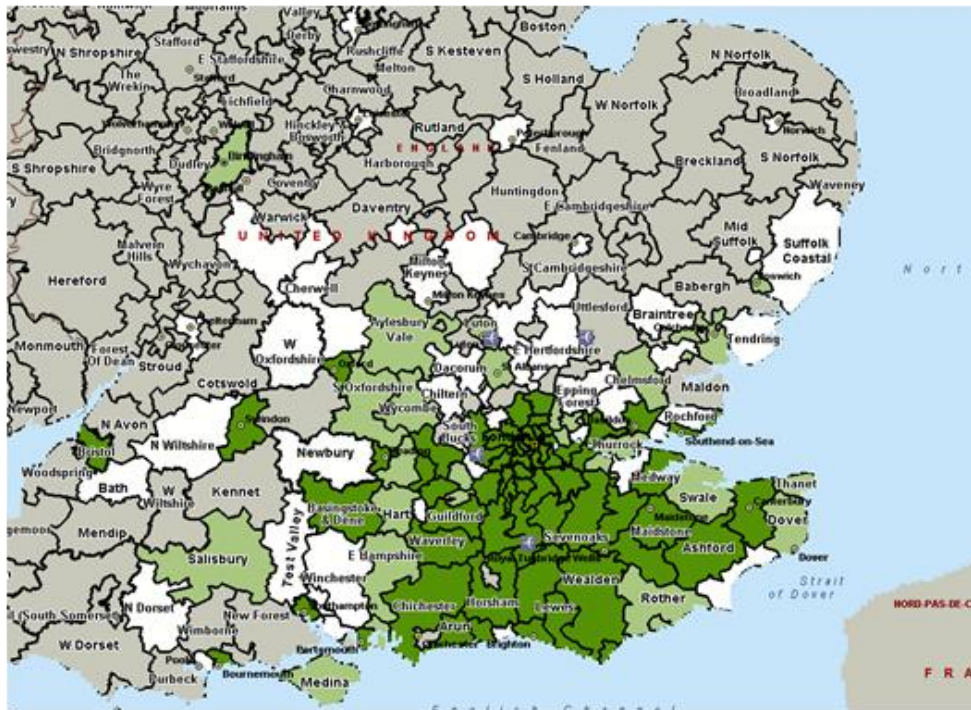
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<sup>319</sup> Source: CAA (2011), Catchment area analysis - working paper, available at: <http://www.caa.co.uk/docs/5/Catchment%20area%20analysis%20working%20paper%20-%20FINAL.pdf>

airport's outbound passengers originate. The size of catchment areas and overlaps between catchment areas of neighbouring airports can also provide useful evidence of the potential competition (if any) between the various airports.

- 5.175 Catchment analysis does not, however, take account of passengers' price sensitivities as it only considers their location and the travel times that they may face. It may therefore overestimate the competitive constraint arising from passengers' ability to switch.
- 5.176 Further, there are also difficulties with assessing the impact of prices on passengers' airport decisions, since different services offered by different airlines at different airports will vary in perceived quality and the fares may vary significantly. The CAA notes, therefore, that it is hard to compare flights from Gatwick with those from Heathrow, Luton or Stansted, as it is impossible to identify whether price differentials are due to a different passenger mix or location premium or perceived quality.

**Figure 5.5: Gatwick historical usage catchment area**



Note: shading shows cumulative proportion of passengers; Dark green – 70 per cent, Light green – 80 per cent, White – 90 per cent of passengers.

Source: CAA Catchment area analysis working paper October 2011.

5.177 Figure 5.5 (above), shows that very few passengers flying from Gatwick originate from East Anglia, or the north east of London. The CAA considers that this indicates that:

- passengers may be reluctant to travel to or from the other side London, or that Stansted or Luton may be poor substitutes for Gatwick in many cases; and
- Gatwick draws passengers from some distant urban centres such as Bristol and Southampton this may reflect the populations of these districts propensity to fly and their relatively fast transport links to the airport.

**Figure 5.6: Gatwick historical catchment area overlap**

Overlaps	Districts	Proportion of passengers at GAL
LGW	23	13%
LGW/LHR	21	18%
LGW/STN	4	2%
LGW/LHR/STN	7	6%
LGW/LHR/LTN	8	6%
LGW/LHR/STN/LTN	28	34%
<b>Total LGW catchment</b>	<b>91</b>	<b>78%</b>
<b>Out of catchment</b>		<b>22%</b>
<b>Total</b>		<b>100%</b>

Source: CAA Catchment area analysis working paper October 2011

Notes: Districts refer to UK planning districts; they are ranked by reference to the amount of passengers that used the airport and originated from or visited the district. An upper limit of 80% of the airports passengers was taken

5.178 Figure 5.6 (above), shows how the historical catchment of Gatwick translates into overlaps. In particular, it shows that Gatwick draws passengers from 23 unique districts representing 13 per cent of Gatwick's traffic. The majority of its passengers (34 per cent) come from 28 catchments that it shares with the other four London airports.

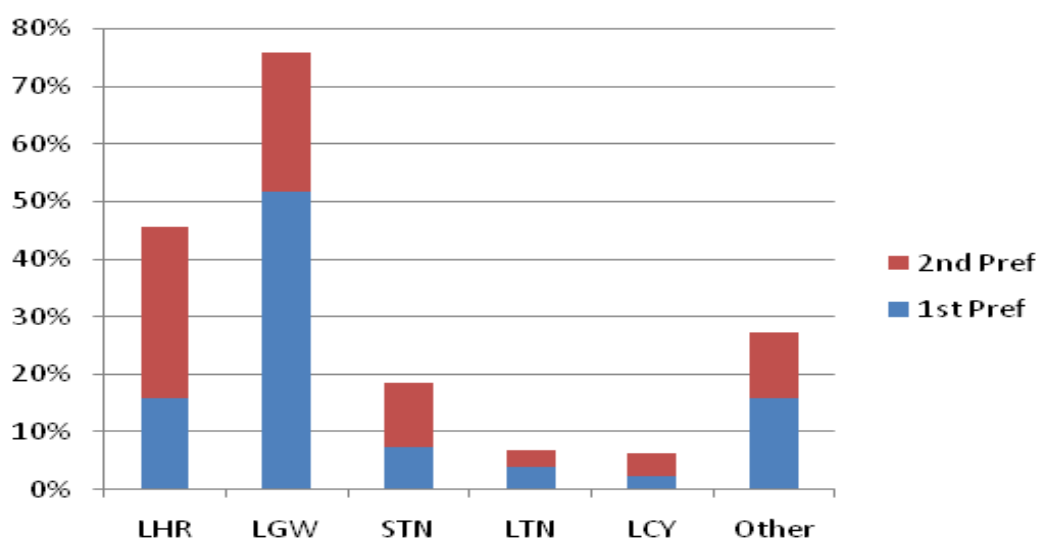
5.179 The catchment area analysis shows the potential for competition amongst airports. In particular, it shows that only 13 per cent of passengers originated from a districted served only by Gatwick, with the majority of passengers at Gatwick (66 per cent) historically coming

from areas that are served by at least one other London airport. The airport draws a number of passengers (22 per cent) from outside of its catchment area. The CAA notes that the airport draws passengers from both Southampton and Bristol where there are airports that are not included within this analysis. The inclusion of these airports would therefore likely increase the overlap observed.

### Passenger Preference

- 5.180 Passenger preferences clearly have an impact on the potential for competition between airports. As noted in chapter 3, passengers' responses to airport pricing are likely to be muted, due to charges levied by airports forming a low proportion of the overall airfare. Further, it must be noted that the CAA is unable to disentangle the degree to which airport choice is driven by airline preference using passenger data. For example, a stated preference to travel from Gatwick may be the result of a preference to fly with easyJet (its largest airline); similarly a preference to travel from Heathrow may be a result of a preference to fly BA.
- 5.181 As noted earlier, in late 2011, the CAA produced a working paper on passenger preferences for airports within the South East. From this paper, certain relevant insights can be drawn about passenger behaviour.

**Figure 5.7: First and second preference airports for short haul passengers flying from Gatwick**



Source: CAA Passenger Survey Working paper November 2011

- 5.182 Figure 5.7 (above), shows Gatwick's passengers' stated preference of airport for short haul flights. The figure shows that over 50 per cent of passengers flying from Gatwick have Gatwick as their first preference. Fifteen per cent of passengers flying from Gatwick cited Heathrow as their first preference airport. The remaining London airports as a first preference are all below 10 per cent. Heathrow is cited as second preference by 30 per cent of Gatwick short haul passengers, while 24 per cent are using Gatwick as their second preference and 11 per cent would choose Stansted as their alternative preference.
- 5.183 The CAA considers that this evidence suggests that passengers may be able to fly from a number of the London airports but that passengers value the location of the airport and route availability, as both these factor highly in the reason for airport choice (see section 1). Likewise passengers seem to present a strong preference for the airport from which they are flying.
- 5.184 The CAA notes that for those passengers flying from Gatwick, Gatwick appears to be their airport of preference. However, passengers clearly have a preference for particular airports as alternatives. It is not clear from this survey the extent to which passenger preferences are influenced by airline routes.

### **Analysis of price elasticity of demand (PED)**

- 5.185 The CAA has reviewed a number of pieces of evidence with regards to PED for GAL's services.<sup>320</sup> PED is a measure of the responsiveness of the amount of demand for a product in relation to a change in price. It provides an indication of whether it would be profitable or not for an undertaking to raise its prices on a particular product.
- 5.186 The CAA notes that typically, a PED of one<sup>321</sup> would suggest the demand changes on a one-for-one basis with price. A PED greater than one suggests that demand changes by a greater proportion to a price change; where a PED is less than one, demand changes by a lesser proportion than the change in price.
- 5.187 The CAA notes that given the interactions of the ancillary revenues

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<sup>320</sup> A fuller discussion of the PED analysis is provided in chapter 4.

<sup>321</sup> For most goods and services elasticities are negative numbers. By convention they are cited to as absolute numbers.

that Gatwick derives from retail and car parking a PED which is at or just above one would likely result in a price increase being unprofitable due to the additional losses of these revenues. The CAA's evidence suggests that for the airport to be able to profitably raise prices it would need to face a PED of less than 0.7.<sup>322</sup>

- 5.188 The CAA's review of the evidence for Gatwick suggests that GAL faces a passenger base<sup>323</sup> with an elasticity of demand of 0.3 to 0.5. This suggests that, given the substitution possibilities available to GAL's passenger base, at GAL a SSNIP would be profitable. The CAA considers that it strengthens the argument for a Gatwick-focused geographical definition.

### Impact of airline competition

- 5.189 A useful way to assess the potential for passenger switching across airports is to consider the extent airlines compete across airports. A 2008 working paper by the CC analysed airline yield data and found some evidence that BAA airports (Heathrow, Gatwick and Stansted) are substitutes for passengers. In particular, the CC considered that:

*“It is not possible to estimate cross-price elasticities [faced by airports] directly: historical joint-ownership has prevented competition between the airports and so we observe only a few instances of switching behaviour by airlines. This means we must look to passenger willingness to substitute between airports in response to relative airfare changes instead to guide our view on incentives for airlines to switch in response to changes in relative airport charges.”*

- 5.190 The CAA has analysed easyJet route revenue and profitability data.<sup>324</sup>

<sup>322</sup> See critical loss analysis in chapter 8.

<sup>323</sup> The CAA notes that the studies focus mostly on passenger demand rather than the strategic actions of airlines (and they have assumed that airlines follow passengers). The analysis also assumes airlines are, in effect, free to switch their service to an equivalent service from one of the other airports, which assumes no capacity constraints, no significant switching costs, and that the airlines route would have a viable catchment to serve at the new airport to replace the business that would not switch. The CAA notes that these are very strong assumptions that are unlikely to hold in many cases and that as a result it can be considered that these are reflective of an unconstrained passenger PED.

<sup>324</sup> For the analysis, the CAA constructed a panel fixed effects model, matching easyJet route revenue to the CAA aviation statistics data. The CAA regressed easyJet revenue against a number of capacity variables for London airports. See chapter 8 for more detail.

The CAA used this data to try to understand the extent to which there is competition between airlines across the London airports and to aid in our understanding of the extent to which passengers substitute between London airports.

5.191 Results for easyJet's Gatwick routes suggest that:

- One extra seat provided at another London airport to the same destination reduces easyJet revenue on a route between Gatwick and the destination by about £ [X]. One extra seat provided at Gatwick by another airline but to the same destination reduces easyJet revenue on that route by about £ [X].
- There is some evidence that Heathrow and Luton seem to be constraining route revenue at Gatwick, [X].

5.192 Whilst the CAA did not compute elasticities of demand from that analysis, it tentatively concluded that:

- There are signs of airline competition for passenger demand at and across London airports.
- Competition between routes at the airport seems to be stronger than competition from other London airports.
- [X].
- Air services from different London airports may place different constraints on easyJet routes but it is difficult to say where from the constraint is bigger.

### Summary of passenger analysis

5.193 The evidence on catchment areas suggests that Gatwick has a large catchment in which a number of other airports operate. However, the CAA contends that despite this showing an apparent wide choice for passengers it shows only the maximum potential of switching, as it fails to take into account passengers' sensitivities to price and service or airline preference.

5.194 The analysis on customer preference also shows that passengers have a strong preference for particular airports. In particular, it shows that the majority of passengers using Gatwick have a strong preference to fly from that airport.



- 5.195 The CAA considers that the PED analysis is a particularly strong indicator that Gatwick is a market within itself. This does not negate the evidence on airline competition, which suggests that there are airline competitive interactions across the system of London airports.
- 5.196 The CAA considers that the passenger preference and PED evidence highlights the limitations of the catchment analysis. Taking these together, the evidence suggests a narrow geographic definition for the market(s) in which GAL operates. In particular, the PED analysis clearly indicates passengers insensitivity to airport pricing changes such that insufficient numbers would switch to render a SSNIP by the airport unprofitable.

### European market

- 5.197 The Guidelines,<sup>325</sup> suggest that airports operate in a European market. Similarly, the Initial Views considered the possibility that GAL operated in a European market.
- 5.198 The CAA notes that this view was based on submissions to the CAA on airlines' ability to move aircraft, with limited focus on passengers' ability to switch. The ability of aircraft to switch was in-turn based on the flexibility of the LCC business model and the number of European bases that they operate out of. The CAA considered that, at that time, this lowered the switching costs faced by these airlines. Additionally the Initial Views considered that inbound carriers could easily switch between arrival airports, given limited sunk costs.
- 5.199 Since the release of the Initial Views, and consistent with its discussion in the STAL 'minded to' decision,<sup>326</sup> the CAA considers that the theory of a pan-European airport market is not supported by the evidence it has seen in relation to GAL. In particular, the CAA considers that the evidence that it has considered to date indicates that the main consideration for airport competition is limited geographically.
- 5.200 The CAA notes that this represents a departure from its Initial Views and reflects the fact that at that stage, the CAA had not yet fully explored the costs and strategic implications involved in switching for LCCs. The CAA also considers that insufficient weight was given, at

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<sup>325</sup> CAA, Guidelines, paragraph 3.67.

<sup>326</sup> CAA, STAL MPA, paragraphs 4,116-4,124.

that time, to the impact on passengers.

- 5.201 The evidence that the CAA has been presented with to date shows airlines flying from airports in the South East operate primarily to serve the demand generated by the local catchment area or those that wish to travel to London and the South East. As shown in the airline evidence above, airlines have explicitly stated that the UK regions are non-substitutable for services at Gatwick, or other London airports more generally. Therefore, by extension, operating from an airport in Europe cannot serve the local catchment area either.
- 5.202 In addition, the CAA considers that it does not appear that airlines are, in general, constrained in their choice of airport by either the number of aircraft or bases that they can operate.<sup>327</sup> This being the case, the CAA considers that the decision to open up new bases or deploy aircraft on particular routes would be driven by individual route or base profitability.
- 5.203 The CAA notes that a base/route has to be profitable (not more profitable than an existing base/route); if a base/route is unprofitable it would close. The CAA also notes that if this assumption does not hold, and airlines are limited in their ability to procure aircraft and open bases, then a base would only be opened, and aircraft diverted, if it were more profitable than the current options. Profitable bases/routes would close so that airlines may service more profitable routes, which may be more indicative of a wider airports market.
- 5.204 Taking these points into consideration, the CAA considers that it would be inappropriate to widen the geographic scope of the market to a European level. The CC reached a similar conclusion with regards to airport markets as part of the BAA airports investigation (and subsequently in its report considering possible changes of circumstances). The CC view is summarised as:

*“...if Ryanair has a customer who wants to fly from the UK to Spain, the customer will not think that an airport in Italy is a close and effective substitute for Stansted from which to fly. It seems to us that airlines care about access to particular locations precisely because*

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<sup>327</sup> Airbus forecasts that from 2012-2031 that it will supply 5,700 aircraft to European airlines. It estimates that 40 per cent of deliveries over this period will be for replacement with the remainder for growth. See: Airbus, Global market forecast; Navigating the future 2012-2031, pp. 40-41, available at: <http://www.airbus.com/company/market/forecast/>, accessed 4 March 20130.

*the passengers who will choose to fly from a UK airport will not be the same as those who are based close to, for example, an Italian one.*<sup>328</sup>

- 5.205 Although the CAA does not consider that the market should be widened to include European airports, it does recognise that the LCC business model, which is significant at Gatwick, does operate a pan-European network.
- 5.206 The CAA also notes that network yield optimisation of LCCs involves a degree of switching assets between differing markets across Europe. The CAA considers that this ability to yield-manage across a range of markets is likely to provide some degree of constraint on airport pricing. However, when moving capacity from Gatwick to a European airport, more so than to a neighbouring UK airport, the airline will be giving up on its competitive position at Gatwick and the customers it serves. That is, the CAA considers that this is not so much switching as market exit.
- 5.207 The CAA also notes that while Gatwick serves FSCs and associated feeder traffic airlines, the majority of services from Gatwick are point-to-point.
- 5.208 The CAA has not at this stage considered in detail the level of constraint that may be posed from non-UK airports that handle significant transfer traffic or that may be considered as hub airports. That is to say that, given an airport SSNIP, whether a sufficient number of transfer passengers would switch to an alternative transfer airport for their connecting flights such as to be able to discipline airport pricing.<sup>329</sup>
- 5.209 The CAA considers that, for transfer passengers, the connecting airport's charges are likely to be an even smaller component of the total airfare than observed in point-to-point operations. Therefore, a SSNIP by that airport is likely to have less of an impact on the overall fare level than it would on a point to point flight. As a consequence,

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<sup>328</sup> CC's 2011 report, paragraph 181.

<sup>329</sup> The CAA is disinclined to consider that airlines would move aircraft or bases as charges for transfer passengers flex. Where an airline provides the majority of point to point traffic from airport feeder traffic, it is unlikely to be of a significant level such that losing the local demand would constitute a rational reaction. For a hub operation, the CAA consider that an airline would be require to move its entire operation to service a hub model from a differing airport and therefore this move would also appear irrational given the likely costs involved.

transfer passenger reactions to a SSNIP in airport charges are likely to be lower than those of point to point passengers.

- 5.210 The CAA's initial consideration is therefore that the argument put forward by the CC is likely to hold for FSC and associated feeder airlines. Substitution opportunities would be limited such that the market for FSC and associated feeder airlines at Gatwick would not be widened to include non-UK airports.

### Conclusion on geographic market

- 5.211 The CAA considers that the evidence from the airlines suggests that for FSCs and associated feeder airlines there is a focus on Gatwick and Heathrow as part of the same market. However, the constraints that Heathrow poses on Gatwick appear to be asymmetric, as Heathrow is generally preferred to Gatwick and not vice versa.
- 5.212 However, the CAA considers that there are limited options available for airlines switching services to Heathrow due to capacity constraints on the airport. The capacity constraints are likely, therefore, to significantly reduce the competitive constraint that Heathrow will pose on GAL's behaviour. The CAA notes that the constraint that Heathrow poses is discussed in more detail in chapters 6 and 7.
- 5.213 The evidence from LCCs and charters suggests that Gatwick is not constrained by other airports. This is especially the case with charter airlines, where there is a strong perception of Gatwick as a "must have" airport. LCCs appear to see the North London airports as complements to their Gatwick operations, running duplicate routes to maximise use of the respective airports catchment areas. However, there is evidence of some airlines having considered the North London airports (Luton and Stansted) as alternatives to operations at Gatwick.
- 5.214 Against the airlines' view, GAL considers that it faces competition from at least the other London airports and possibly wider.
- 5.215 The CAA considers that the evidence it has been able to obtain on switching suggests that moves by airlines to Gatwick have not been motivated by relative prices but by a series of differing demand characteristics that Gatwick offers compared to other London airports. The CAA considers that this supports the airline views on the markets in which Gatwick operates, where they regard Gatwick as serving a

different catchment area, with a better mix of business and leisure passengers and with better transport links to central London and the South East.

- 5.216 The CAA also notes that airline routes overlap suggests that passengers are likely to have significant choice in a point of departure or entry to London. This is especially the case for short-haul destinations. However, in the context of airlines' planning, route overlaps suggest complementarities between Gatwick and the North London airports for LCCs. For FSCs and associated feeder traffic, the more limited route overlap between Gatwick and Heathrow, suggests more substitutability between the two airports.
- 5.217 The catchment area analysis that the CAA has undertaken also suggests that the passengers flying from Gatwick are likely to have a reasonable choice of alternative airports, with the majority of passengers coming from areas where other London airports' passengers originate. The passenger analysis also suggests that passengers have a strong preference for a particular airport, although not all passengers flying will necessarily be using their airport of choice. To some extent, passenger choice is dictated by the airlines' different offers at the different airports.
- 5.218 That said, the analysis that the CAA has available on PED suggests that for both LCCs and charters, and FSCs and associated feeder traffic airlines the market is likely to be no wider than Gatwick. In particular, the PED analysis shows that there is some level of airline competition across the system of London airports. However, the CAA notes that the competitive pressures appear to be strongest where airlines are in competition on the same route from the same airport.
- 5.219 Lastly, the CAA considers that the evidence suggests that there is no basis for widening the geographic market for LCCs and charters and the FSCs and associated feeder airlines to include airports outside of the UK.
- 5.220 On the balance of the evidence, the CAA is therefore minded to consider that there are two distinct geographic markets, one for each of the product markets defined in the relevant section above.
- 5.221 The CAA considers that the likely geographic market for LCCs and charters consists of Gatwick. It is unlikely that the market includes

Luton and/or Stansted on the current evidence, especially that of the airline switching and the passengers' PED analysis. However, to the extent that they impose relevant constraints on Gatwick the CAA will take them into account within its market power analysis.

- 5.222 The CAA considers that the evidence is less clear on the likely geographic market for FSCs and Feeder airlines. The geographic market could be considered to consist of either just Gatwick, or it may include Heathrow. The CAA observes that in either case the constraints that Heathrow poses on GAL are likely to be asymmetric.
- 5.223 Considering a geographic market that is Gatwick-focused is supported by the PED analysis. It is also apparent that airlines appear to be making differentiated demands of the airport services, with airlines operating Gatwick as leisure focussed point to point airport, whereas Heathrow is operated as a business focussed hub. Although there has been switching from Gatwick to Heathrow this does not appear to have been motivated by changes in airport charges and there does not appear to have been any switching in the opposite direction.
- 5.224 However, the CAA considers that the airline evidence suggests, absent capacity constraints at Heathrow, that airlines would prefer to operate from Heathrow over Gatwick. It is also clear that airports have a significant overlap in catchment and facilities required for FSC and associated feeder airlines to operate. At this stage the CAA considers that the exclusion of Heathrow from the geographic market may underplay the potential for Heathrow to constrain Gatwick.
- 5.225 In either event given the significant capacity constraint at Heathrow, it is unlikely that Heathrow will in practice pose a significant constraint on GAL's behaviour. Given that it is likely that no new capacity will be developed until 2025 at the earliest, this situation is likely to persist.

### Section 3: Temporal markets

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- 5.226 In the Initial Views, the CAA considered the possibility that the market definition should recognise differing demand characteristics at different times of the year.<sup>330</sup>

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<sup>330</sup> CAA, Initial Views, paragraphs 2.89-2.99.

- 5.227 The CAA recognises that there are different demand patterns in the winter and summer seasons both in terms of the routes operated and the absolute number of passengers wanting to fly. For example, evidence the CAA has seen suggests that a number of airlines change their routes (for example to serve the ski resorts) and others redeploy their aircraft to serve different markets. Thomson Airways<sup>331</sup> noted that during the winter season, where there is lower demand in the UK for its services, it has leased its aircraft to companies that provide 'winter sun' holidays from Canada. Similarly Thomas Cook<sup>332</sup> stated that during the winter months its aircraft operate on routes from Scandinavia to 'winter sun' destinations. The CAA does not consider that these changes impact on the inherent competitive structure of the market between the airlines, such that the analysis would benefit from segmenting the market in this way. Additionally, the CAA has not seen evidence to suggest that passengers become more price sensitive between seasons.
- 5.228 That said, as GAL currently varies its landing charges both by season and by time of day, it is appropriate to consider this further. Figure 5.8 (below) highlights the landing charges for GAL for 2012/13. The figure shows only that landing charges vary as other charges at Gatwick do not vary. It also illustrates that landing charges show significant variation across the weight of the aircraft and noise certification in all periods.

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<sup>331</sup> Source: Thomson Airways.

<sup>332</sup> Source: Thomas Cook.

**Figure 5.8: GAL's Landing charges effective from 1st April 2012**

Volume	Weight	Noise Cert	Charge 12/13	
Peak 0600-1159 and 1700-1859, 1 April to 31 October	All weights	Chapter 2 and non certified	£5,069.17	
		Chapter 3 high	£2,534.59	
		Chapter 3 base	£1,689.72	
		Chapter 3 minus	£1,520.75	
		Chapter 4	£1,436.26	
Summer Off peak 1 April to 31 October, all times other than those designated as peak	MTOW < 16 metric tonnes	Any noise certification	£491.60	
	16 metric tonnes <= MTOW <= 50 metric tonnes	Chapter 2 and non certified	£1,663.82	
		Chapter 3 high	£737.39	
		Chapter 3 base	£491.60	
		Chapter 3 minus	£442.44	
		Chapter 4	£417.86	
	MTOW > 50 metric tonnes	Chapter 2 and non certified	£1,663.83	
		Chapter 3 high	£831.91	
		Chapter 3 base	£554.61	
		Chapter 3 minus	£499.15	
		Chapter 4	£471.42	
	Winter Off Peak 1 November to 31 March	MTOW < 16 metric tonnes	Any noise certification	£491.60
		16 metric tonnes <= MTOW <= 50 metric tonnes	Chapter 2 and non certified	£1,663.82
			Chapter 3 high	£737.39
			Chapter 3 base	£0.00
Chapter 3 minus			£0.00	
Chapter 4			£0.00	
MTOW > 50 metric tonnes		Chapter 2 and non certified	£1,663.83	
		Chapter 3 high	£831.91	
		Chapter 3 base	£0.00	
		Chapter 3 minus	£0.00	
		Chapter 4	£0.00	

Source GAL's Conditions of Use Issued 29 March 2012



**Figure 5.9: Seasonality at UK airports**

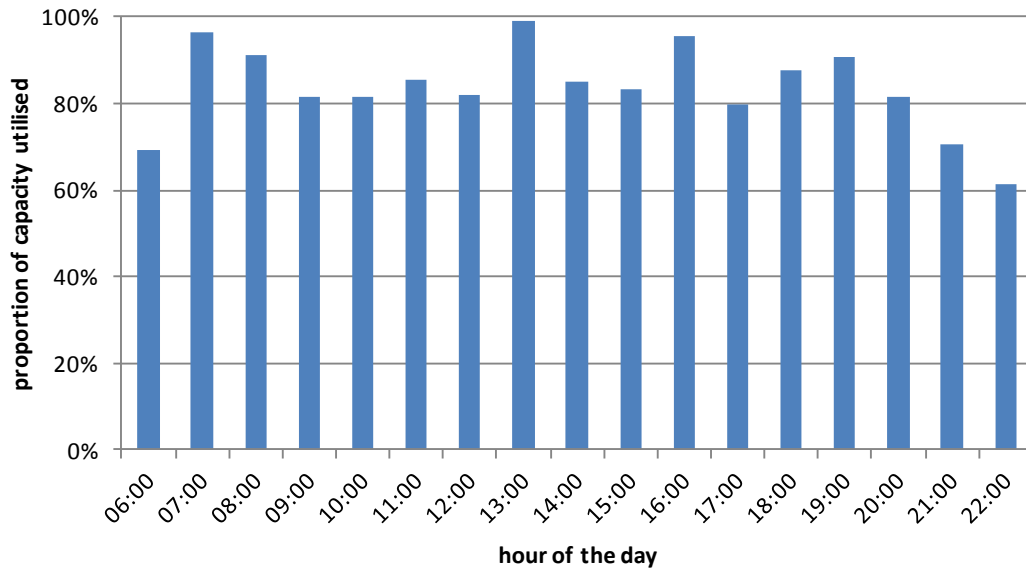
[✂]

*Source: easyJet*

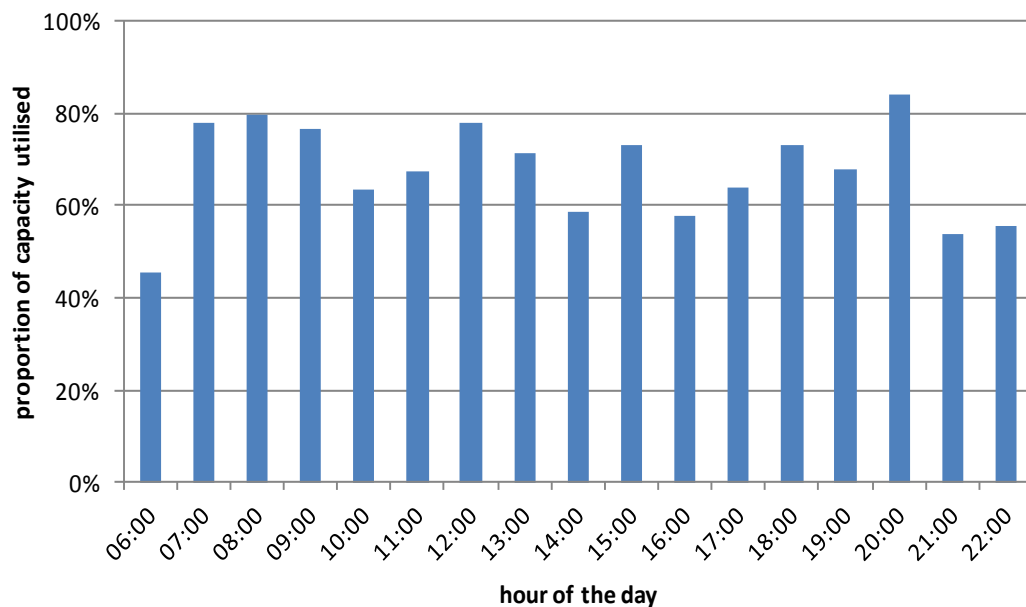
- 5.229 As can be seen in Figure 5.9 (above), a number of airports within the UK face a level of seasonality. Of those airports, only GAL and Manchester Airports Group apply charges that differ with the season.
- 5.230 Figures 5.10 and 5.11 explore the seasonality in capacity utilisation at Gatwick for the summer and winter season from 2008-2012. Overall, slot allocation at Gatwick has fallen from 94 per cent to 87 per cent in summer traffic seasons between 2008 and 2012<sup>333</sup>, while falling from 87 per cent to 75 per cent in the winter traffic seasons, with a notable decline of 10 per cent between winter 2010 and 2011.
- 5.231 The CAA notes that there can also be a considerable difference in slot allocation and utilisation for a given hour of the day. Slot utilisation remains high at Gatwick throughout the day, which reflects the diverse airline customer base and consequently different slot demand patterns.
- 5.232 Figure 5.10 shows that runway slot utilisation at Gatwick has remained above 80 per cent in all but the first and last three hours of the day during the summer traffic season between 2008 and 2012. Figure 5.11 shows a similar slot utilisation pattern for the winter traffic seasons although at lower levels of movements, although the airport is not operating at full capacity, utilisation does appear to be higher in the mornings than the rest of the day.

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<sup>333</sup> Two per cent year-on-year until 2011 and unchanged between 2011 and 2012.

**Figure 5.10: Slot utilisation per week summer 2011/22**

Source: CAA airport statistics and ACL declared capacity data

**Figure 5.11: Slot utilisation per week winter 2011/12**

Source: CAA airport statistics and ACL declared capacity data

5.233 Given the evidence outlined above, the CAA is minded to consider that there is no relevant segregation of the market to reflect differing temporal markets for Gatwick.

5.234 The CAA considers that GAL's charging structure is most likely a form

of price discrimination within the markets in which it operates, which allows it to maximise its returns under the current price cap. As GAL is currently price capped on average revenue, the CAA considers that it is rational for it to seek methods by which it can maximise its return.

- 5.235 The CAA notes that one way in which GAL can look to maximise its return is through seasonal pricing, especially where one season faces consistently stronger demand. The CAA also notes that given the price cap, increasing prices in the high season requires sacrifices of prices within the low season.
- 5.236 However, the CAA considers that winter pricing may have limited impact on the demand for services. In particular, the CAA notes that revenue in absolute terms is already higher in the summer season compared to winter due to higher passenger demand and season length. Having high prices where the demand is consistently stronger is likely to reduce the risk to the overall revenue stream and allow the airport to maximise its revenue.
- 5.237 The CAA also notes that there is a seasonal fall in traffic and that it considers that this is a reflection of the operation of air transport markets and that the impact is, in general, consistent across airports. The CAA has not received evidence to show that the competitive choice set for airlines in purchasing airport operation services changes with the seasons. Further, the CAA does not consider that it would be rational for an airline to operate services from one airport in the summer and switch to another in the same market for the winter season, given the costs associated with switching routes.

## Section 4: Conclusions on market definition

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- 5.238 Based on the analysis that the CAA has undertaken in the product market definition, the CAA has identified a single generic product, which it considers to be a core bundle of airport operation services that airlines are required to purchase.
- 5.239 The CAA considers this bundle is likely to consist of at least:
- the use of the runway and taxiways;
  - aerodrome ATC;

- aircraft parking;
- ramp handling services;
- fuel and oil handling;
- aircraft maintenance facilities;
- infrastructure for airside and landside groundhandling services;
- check-in, baggage handling and security screening facilities;
- passenger holding facilities;
- airline staff processing facilities; and
- passenger transit facilities.

5.240 Through analysis of the potential market segments, the CAA also considers that there are two market segments – one consisting of LCCs and charters and one consisting of FSCs and associated feeder traffic airlines.

5.241 With regards to LCCs and charters, the CAA considers that their demand is for the product described above. With respect to FSC and associated feeder traffic airlines, the CAA considers that they place additional demands on airports. The product bundle for FSC and associated feeder airlines therefore consists of the product bundle described above plus airport infrastructure and airport operation services for:

- bellyhold cargo processing facilities;
- premium passenger facilities; and
- integrated transfer facilities for passengers and baggage between flights.

5.242 The CAA considers that the likely geographic market for LCCs and charters consists of Gatwick. It also notes that based on the current evidence (in particular airline switching and the passengers' PED analysis), that it is unlikely that the market includes Luton and/or Stansted. However, the CAA notes that to the extent that they impose relevant constraints on Gatwick that it will take them into account within its market power analysis.

5.243 With respect to the likely geographic market for FSCs and feeder

airlines, the CAA notes that there is some uncertainty, but that the CAA currently considers that it may comprise of both Gatwick and Heathrow. The CAA recognises that the constraint that Heathrow poses on GAL is likely to be asymmetric. It also recognises that the geographic market could be considered (as with LCCs and charters) Gatwick focused, indeed the PED analysis would suggest that this is the case for FSCs. However, the CAA considers that the airline evidence suggests that, absent capacity constraints at Heathrow, those airlines would prefer to operate from Heathrow over Gatwick. The CAA considers that that evidence is sufficient to conclude that the exclusion of Heathrow from the geographic market would underplay the potential market dynamics between the airports.

5.244 In either event, regarding services to FSCs and associated feeder traffic airlines, given the significant capacity constraint at Heathrow, it is unlikely that Heathrow will in practice pose a significant constraint on GAL's behaviour. Given that it is likely that no new capacity will be developed until 2025 at the earliest, this situation is likely to persist.

5.245 Therefore the CAA is minded to consider that there are two markets in which GAL operates for the provision of airport operation services to airlines and their passengers within the core area of Gatwick:

- c) Aeronautical services supplied to LCC and charters at Gatwick including, but not limited to the following services:
  - the use of the runway and taxiways;
  - aerodrome ATC;
  - aircraft parking;
  - ramp handling services;
  - fuel and oil handling;
  - aircraft maintenance facilities;
  - infrastructure for airside and landside groundhandling services;
  - check-in, baggage handling and security screening facilities;
  - passenger holding facilities;
  - airline staff processing facilities; and

- passenger transit facilities.

5.246 The CAA refers to this market as the Gatwick LCC market.

d) Aeronautical services supplied to FSC and associated feeder airlines at Gatwick and those similar service provided at Heathrow including, but not limited to the following services:

- the use of the runway and taxiways;
- aerodrome ATC;
- aircraft parking;
- ramp handling services;
- fuel and oil handling;
- aircraft maintenance facilities;
- infrastructure for airside and landside groundhandling services;
- check-in, baggage handling and security screening facilities;
- passenger holding facilities;
- airline staff processing facilities;
- passenger transit facilities;
- bellyhold cargo processing facilities;
- premium passenger facilities; and
- integrated transfer facilities for passengers and baggage between flights.

5.247 The CAA refers to this market as the Gatwick FSC market.

**CHAPTER 6****Assessment of potential competitive constraints –  
low cost carriers and charter airlines**

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**Introduction**

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- 6.1 As part of its assessment of market power, the CAA needs to identify the existence and the potential strength of the competitive constraints<sup>334</sup> within the relevant markets it has identified (see chapter 5). The CAA needs to do this to determine whether the relevant markets are subject to effective competition or not.
- 6.2 This chapter looks at the low cost carriers (LCCs) and charter airlines (charters) market at Gatwick (and possibly at Luton and Stansted). This analysis is necessary because, as explained in chapter 3, market shares, viewed in isolation, may not be a reliable indicator of significant market power. The consideration of wider competitive constraints can therefore help inform the CAA's assessment of the degree of market power (if any) held by GAL.
- 6.3 As part of its assessment, the CAA looks to analyse the likely reactions, both within and outside the relevant market, to any attempt by GAL to restrict output, increase prices above the competitive level and/or reduce quality at Gatwick below the levels that would be seen in a competitive market.<sup>335</sup> In particular, the CAA examines:
- Barriers to entry and expansion and the extent of potential competition. If these constraints are sufficient, they can prevent GAL's prices increasing above, and its investment or service quality falling below, the levels expected in a well functioning market.

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<sup>334</sup> The OFT describes competitive constraints as 'market factors that prevent an undertaking from profitably sustaining prices above competitive levels': see OFT 415, paragraph 1.2 and DG COMP's Discussion Paper on the application of Article 82 to Exclusionary Abuses, paragraph 2.4.

<sup>335</sup> A discussion on the competitive price at Gatwick is outlined in chapter 4.

- The mechanisms and ability of LCCs and charters to discipline GAL if it looked to exercise market power. Understanding this can provide insight into the ability of airlines to constrain GAL's behaviour.

6.4 This chapter builds on the analysis that was undertaken in the Initial Views and is structured:

- Section 1 considers GAL's response to the Initial Views;
- Section 2 considers the potential options for LCCs and charters switching;
- Section 3 considers switching costs and the ability of LCCs and charters at Gatwick to switch;
- Section 4 considers countervailing buyer power;
- Section 5 considers barriers to entry & expansion and capacity constraints;
- Section 6 considers demand forecasts and implications for capacity constraints;
- Section 7 considers entry and expansion by other airports; and
- Section 8 draws together the CAA's 'minded to' views on the potential competitive constraints at Gatwick for LCCs and charters.

## Section 1: GAL's response to the Initial Views

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6.5 In the Initial Views<sup>336</sup>, the CAA noted:

- The available evidence supports the view that LCCs have lower switching costs relative to Full Service Carriers (FSC), and are likely to operate some of the most marginal services at Gatwick (i.e. those most likely to switch).

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<sup>336</sup> CAA, Initial Views, paragraphs 3.33-3.105.



- LCCs generally have flexible business models and operate on a pan-European basis and that might be expected to make them more able to switch their operations away from Gatwick, given their independence from any network and their lower capital investment costs.
- LCCs may have more bases to choose from and can switch an aircraft to a different airport without significant losses.
- Some airlines had indicated that the higher yields available at Gatwick meant that they would incur higher switching costs relative to other airports that they may be operating from. The CAA also noted that it was mindful of the difficulties in attributing high yields to the exercise of market power since they could be due to capacity shortages or locational/service advantages.<sup>337</sup>
- Frontier Economics' analysis suggested that the switching of these airlines is not sufficiently strong to discipline the airport.

6.6 The Initial Views also outlined that charters generally rely less on network operations, but due to their higher staffing requirements at airports, pooling large numbers of flights at one airport is likely to create some operational economies of scale that might be lost when moving individual flights to other, smaller, airports. Similarly, long-haul charter flights might have higher airport infrastructure requirements, due to the larger aircraft sizes, that might only be available at a small number of airports across the UK.<sup>338</sup>

6.7 In addition, the Initial Views outlined that Gatwick was more resilient to economic downturns than other London airports, such as Luton and Stansted. The CAA noted, for example, that:

- passenger losses at the airport since 2007 were less pronounced than a number of other airports; and
- the evidence suggests that the impact of aircraft switching might have been mitigated by GAL being able to fulfil previously unmet demand from airlines that had not been able to secure the necessary slots in the past.<sup>339</sup>

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<sup>337</sup> CAA, Initial Views, paragraphs 3.95-3.97.

<sup>338</sup> CAA, Initial Views, paragraph 3.43.

<sup>339</sup> CAA, Initial Views, p. 69.

- 6.8 GAL responded to the Initial Views by noting (among other things), that:
- *[It was] concern[ed] with the high-level nature of the CAA's assessment of airline switching costs based on sunk investments and were of the view that it was insufficient to overturn previous findings of the CAA and the CC.*<sup>340</sup>
  - The CAA had misinterpreted the data on higher airline yields at Gatwick and that this was *'more likely prima facie evidence that the regulated price at Gatwick is below the competitive price level'*.<sup>341</sup>
  - *Switching costs for most of Gatwick's traffic are generally low and the presence of some moderate switching costs does not imply a lack of substitutability between airports for airlines.*<sup>342</sup>
  - *[The] CAA's analysis of airline yields focuses on average yields, rather than marginal yields, understating therefore the potential for switching and making this evidence irrelevant for assessing competitive constraints.*<sup>343</sup>
  - *Best practice suggests that the focus of substitutability should be on marginal customers, those able and willing to move [and that] [t]he existence of some groups of non-marginal passengers that have a strong preference for Gatwick is less relevant to the examination of market definition and market power.*<sup>344</sup>
- 6.9 GAL also noted that the degree of historical airline switching demonstrates that there is a good degree of substitutability between airports in the South East, and elsewhere.<sup>345</sup> To further support its view, GAL provided the CAA with examples of switching decisions that have occurred since May 1991, changes in the fleet mix at Gatwick from the year 2000 onwards and fleet deployment changes

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<sup>340</sup> Source: GAL.

<sup>341</sup> Source: GAL.

<sup>342</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, p. 49.

<sup>343</sup> Source: GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref Code: Q5-050-LGW09, pp. 5-6.

<sup>344</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, p. 4.

<sup>345</sup> Source: GAL.

by easyJet and Ryanair.<sup>346</sup> It also provided examples of switching decision by LCCs, FSCs and Charters.

- 6.10 Since the publication of the Initial Views, the CAA has considered the issues of competitive constraints in more detail. The CAA's views on these issues (and stakeholders' views) are outlined in the sections below.<sup>347</sup>

## Section 2: Potential options for LCCs and charters at Gatwick to switch

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- 6.11 This section considers the ways LCCs and charters may constrain GAL in a competitive market by switching marginal aircraft or services away from Gatwick.

### Scale of LCC and charter switching required to discipline GAL

- 6.12 To impose a competitive constraint on GAL, the level of switching of marginal aircraft or services following a price increase (or a fall in service quality or investment) must be sufficiently large to undermine the profitability of an increase in the prices charged at an airport.
- 6.13 There are several ways in which LCCs and charters (or any other airline) could look to discipline GAL:
- volume growth could be allocated to other airports, by opening new routes or increasing frequencies on routes operated elsewhere;
  - decreasing the frequency of existing services to and from the airport, for based and/or inbound aircraft;
  - grounding aircraft or reducing the use of based aircraft during a particular traffic season; and/or
  - moving based aircraft to other bases, or opening a new base by relocating aircraft currently at the airport.
- 6.14 Each of these issues is explored below.

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<sup>346</sup> Source: GAL.

<sup>347</sup> The CAA notes that issues associated with which airport(s) should be considered in the same market(s) at Gatwick, and the level of airline switching/new entry that has occurred over recent years at various London airports is outlined in more detail in chapter 5.

### **Allocating volume growth to other airports**

- 6.15 Allocating volume growth to other airports is one mechanism that an airline could adopt to look to discipline an airport. This approach does, however, require that an airline have access to sufficient spare capacity at other airports across its network and/or at new airports, as well as sufficient aircraft and other relevant assets.
- 6.16 The CAA notes, however, that this form of switching may not, by itself, lead to a reduction in the short term of an airline's existing services at an airport. In particular, the CAA considers that adopting such a strategy may not result in a significant constraint being imposed on an airport operator if its facilities utilisation is fairly full (and there is excess demand). In other words, an airport that has limited spare capacity and is less able to accommodate new traffic growth is less likely to be constrained by such behaviour than an airport that is not capacity constrained.
- 6.17 Putting Gatwick in the appropriate context, the CAA notes that according to ACL start of season reports, there is considerable excess demand for early morning departure slots at Gatwick.<sup>348</sup> In addition, GAL told the CAA that a number of currently based and inbound airlines have sought to expand operations during the early morning departure peak, but have been unable to do so due to the appropriate slots not being available. GAL also indicated that it is aware of active consideration by airlines not currently at Gatwick to base aircraft at the airport.<sup>349</sup>
- 6.18 The CAA notes that, given the lead times potentially involved in allocating volume growth to different airports and the existence of capacity constraints at other airports (see section 5), an airport operator may consider that increasing its prices will help increase its profitability over the medium term, as any change in traffic volume may take some time to filter through. Furthermore, if the vacated slots are taken up by other airlines, demand will remain relatively constant, notwithstanding that charges may have increased.

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<sup>348</sup> The CAA notes, however, that there is greater capacity available at other times of the day. The slot utilisation per week (declared capacity) at Gatwick, over both the summer and winter seasons, is outlined in more detail in section 5.

<sup>349</sup> CAA, Annex 4 – Capacity constraints and airline switching at Stansted, paragraph 3.39.

### Reducing the frequency on existing services

6.19 The CAA notes that reducing the frequency of existing marginal routes to and from an airport might constrain an airport operator if the reduction is of a sufficient scale (although it could have certain service quality implications for the airline's services). An airline could, for example, reduce frequencies on its existing services by:

- reducing frequencies (and consequently the utilisation of those particular aircraft);
- flying longer sectors which create a downward pressure on volumes; and
- altering the flight patterns of aircraft that serve an airport. For example, turning a back and forth pattern into a 'W pattern' – under this option, an aircraft would fly from its base to a 'non-base' destination and then fly to another (non-base) destination before returning to its base.

6.20 In the Initial Views, the CAA noted there had been relatively few recent examples of airlines decreasing their use of Gatwick.<sup>350</sup> However, it was noted that:

- Ryanair was a notable example, as it had cancelled about one third of its 2011/12 winter flights to Gatwick; and
- this reduction took place against a background of a general volume reduction across Ryanair's entire network and it was unclear whether it was a response to price or to wider economic factors.

6.21 This section looks at the potential of LCCs and charters to decrease the frequency on existing marginal services to try to discipline an airport operator.

### LCCs

6.22 GAL indicated that decreasing the frequency of any service at the airport would have a significant effect on its business and therefore can act as a disciplining effect on it. In particular, GAL indicated that:

*In practice, actual or threatened switching by airlines with services at Gatwick is a real threat that Gatwick faces. Where Gatwick loses a*

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<sup>350</sup> CAA, Initial Views, paragraphs 3.52-3.55.

*service it faces a major loss of income, not just in terms of airport charges but also through loss of commercial revenues. [and that] This was recognised by the CAA in its investigation into the dedesignation of Stansted and Manchester airports.*<sup>351</sup>

6.23 GAL also noted that:

*[The] withdrawal of a limited number of services can have a major impact on Gatwick's economics. This point is also linked to passenger substitutability. We note that a switch in a relatively small number of passengers can make a flight less profitable thereby increasing the propensity of that flight to switch. In this way, the impact of marginal passenger switching is magnified by the nature of airline and airport operations and economics.*<sup>352</sup>

6.24 The CAA also notes that evidence from easyJet suggests that the scope for it to discipline an airport by reducing the frequency of services may be relatively limited. For example, a Frontier Economics report commissioned by easyJet highlighted that the vast majority of easyJet's routes are operated under the standard 'back and forth' pattern as this:

- provides airlines with a greater ability to respond to delays and incidents;
- leads to economies of scale with regard to maintenance, engineering and management at the base airport; and
- allows crews that are located around the base airport to be home overnight.<sup>353</sup>

6.25 easyJet also indicated that it can use W patterns to:

- take advantage of profitable opportunities as a quick, short term, measure to establish a presence on a route; and

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<sup>351</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, pp. 40-41.

<sup>352</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, p. 5.

<sup>353</sup> Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared for easyJet, p. 18.

- establish a presence in new airports without having to establish a base, which is a lengthy and expensive process.<sup>354</sup>

6.26 In addition, easyJet indicated that it deploys aircraft on triangular patterns, though these are a small proportion of total flights (between 5 and 7 per cent of its routes). These patterns are used to ensure that aircraft serve particular markets at appropriate times of day, rather than as a tool to discipline an airport's pricing. There are related cost issues (in particular crew) and added complexities to operating such patterns, which reduce their feasibility when trying to constrain an airport operator.

6.27 Norwegian Air Shuttle has also indicated it does not operate W patterns<sup>355</sup> and evidence provided by Ryanair with respect to its operations suggests that W patterns are rarely operated. Ryanair noted, for example, that it agreed with the European Commission's reasons that the use of W routes would be kept to an absolute minimum.<sup>356, 357</sup> It also noted that it keeps these to a minimum as the commencement of W patterns entails a number of costs and risks.<sup>358</sup> This evidence is also consistent with evidence provided by a number

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<sup>354</sup> Source: easyJet.

<sup>355</sup> Source: Norwegian Air Shuttle.

<sup>356</sup> Source: Ryanair.

<sup>357</sup> The European Commission found that while there were some examples of carriers operating W patterns, their use were rare and that the majority of carriers tended to avoid using them or only used them on a transitional basis as: (1) this model is not regarded as optimal by most carriers as they usually prefer operating from a base; (2) operating between two points that are not connected to a base entails an increased risk, for example in case of technical problems on the route, which in turn can expose airline to costs and liabilities generated by delays in service; (3) crews could not be simply exchanged in the middle of the day on a non base connected destination; and (4) such an approach would only be commercially viable for routes that generate sufficient traffic for 3-4 roundtrips a day since otherwise the dedicated aircraft would not be used sufficiently. Source: European Commission M.4439, paragraphs 572-577.

<sup>358</sup> Ryanair has, for example, indicated that it: (1) currently operates only 30 such routes (mostly through Paris Beauvais and Venice Treviso) out of 1500 routes in its network, and its objective is to eliminate all such routes over time; (2) Since the summer 2008 traffic season, routes operated on a W pattern from Stansted have represented between 0.6 per cent and 1.6 per cent of Ryanair's weekly departures; and (3) W patterns are used in exceptional circumstances to facilitate routes between two non-base airports, and are always intended to be a short-term solution until a base can be established at one end of such a route. Source: CAA, Initial Views, paragraph 5.13.

of long-haul airlines (see chapter 7).<sup>359</sup>

- 6.28 Ryanair also indicated that (with respect to Stansted), modifying daily flight patterns of based aircraft to W patterns would not effectively constrain an airport as this would not constitute a sufficiently large withdrawal of capacity.<sup>360</sup> The CAA considers that this is likely to be true with respect to LCCs operating at Gatwick, not least as there is significant demand for many of the slots, particularly peak slots, which LCCs need, in general, to operate.
- 6.29 Connected with the above point is the fundamental issue that the LCC business model does, in general, require that aircraft are used throughout the day – that is, there is a need for LCC aircraft to have a high number of rotations per day. Reducing route frequency may therefore make a route unviable for a LCC and may necessitate the complete withdrawal of a route.
- 6.30 In addition, a number of airlines have highlighted the need to protect their positions at an airport for strategic reasons. For example, an airline may maintain a route that it would otherwise close to ensure that there is sufficient frequency through-out the day, as this may prevent passengers considering other airlines and/or prevent other airlines operating/expanding that route. In addition, an airline may maintain a route as it knows it may be difficult (due to cost and/or scarcity) to re-acquire that slot at a later date. For example, easyJet has noted that in constrained airports (such as Gatwick), it needs to consider its long-term ambitions. This can mean forgoing short-term profits in order to protect long term interests.<sup>361</sup> Strategic costs are, however, an issue that is examined in more detail later in this chapter.
- 6.31 Based on the evidence outlined above, the CAA considers that, while in theory there would be scope for LCCs to discipline GAL by reducing

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<sup>359</sup> For example, Aer Lingus indicated that (1) reducing frequencies through the use of W patterns would be difficult as they are inefficient and complex; and (2) If it were to move one aircraft away from Gatwick, it would still face sunk costs in the form of staff, costs associated with establishing a base at Gatwick overnight parking, aeronautical charges etc. Source: Aer Lingus. Air Malta has also expressed reservations about the use of W patterns – it noted that it operated a W pattern between Malta, Gatwick and Catania 3 years ago but stopped doing so due to falling demand (and because it did not have enough capacity to justify the additional expense of combining two routes). Source: Air Malta.

<sup>360</sup> Source: Ryanair.

<sup>361</sup> Source: easyJet.



the frequencies of its existing marginal routes to and from Gatwick, in practice this is unlikely to constrain GAL's behaviour significantly. In particular, the CAA considers that the evidence suggests that there are various operational and financial challenges associated with reducing frequency in the form of W patterns over the medium term.

- 6.32 More broadly, the CAA notes that there is, in general, a need for LCCs to maximise the number of rotations per day that an aircraft performs in order for their business model to succeed. This would suggest that the scope for the airlines to discipline GAL by reducing the frequency of their flights may be relatively limited.

### Charters

- 6.33 As per the discussion (above) on LCCs, GAL indicated that decreasing the frequency of any service at the airport would have a significant effect on its business and therefore can act as a disciplining effect on it.<sup>362</sup>

- 6.34 In addition, GAL indicated that:

*Charter operators are generally a source of significant non-aeronautical revenues which disproportionately contribute to overall revenue. Thomas Cook (6%), Monarch (6%) and Thomson (9%) each represent major parts of Gatwick's business. Decisions by these airlines to switch away from Gatwick (as opposed to growing their duration throughout the summer season) will risk reducing our non-aeronautical revenue streams and correspondingly put pressure on our profitability. These airlines may view other airports around the South East as potential alternatives to threaten Gatwick with, and Stansted could be a stronger competitor than in the past.*<sup>363</sup>

- 6.35 While these issues are important, the CAA considers that they are more appropriately examined within the context of the section (in this chapter) on switching. That said, the CAA notes that charters appear to be relatively 'captive' at Gatwick as they have, over a period of

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<sup>362</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, p. 5.

<sup>363</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, pp. 76-77.

decades, helped develop Gatwick's reputation as a 'holiday destination airport'.

- 6.36 The CAA also notes that the business model for charters is quite different to that of LCCs. In particular, due to their higher staffing requirements at airports, pooling large numbers of flights at one airport is likely to create some operational economies of scale that might be lost when moving individual flights to other, smaller, airports.
- 6.37 Another important feature of the charter business model appears to be relatively greater reliance on summer season traffic for the successful operation of their business. The CAA understands that the summer season is a period of time when, in general, charters are particularly busy and where aircraft are often fully utilised. For example, Thomas Cook indicated that '*they have 3 times as much capacity in summer than in winter at Gatwick.*'<sup>364</sup>

And:

*It has a major business challenge due to its focus and reliance on summer activity.' It has also noted that: '[p]rofitability principally comes from school holiday business (roughly 10 weeks a year) and if it did not achieve profit at this time it would lose money 12 months a year.*'<sup>365</sup>

- 6.38 The importance of the summer season has also been identified by Monarch, which provides both scheduled and charter operations, which indicated that:

*Their charter & leisure operations are mainly driven by the tour operators' (TO) choice of airport for the flight they offer in their packages. .... [and that these have been provided at a variety of airports] ... during previous summer seasons due to TO choice.*<sup>366</sup>

- 6.39 Monarch also suggested that there may more scope for charters to discipline the airport in the winter more so than in summer. Specifically, Monarch noted:

*If it were to move aircraft, empty slots would be taken by other airlines. If it moved capacity during the summer, GAL could easily fill*

<sup>364</sup> Source: Thomas Cook.

<sup>365</sup> Source: Thomas Cook.

<sup>366</sup> Source: Monarch.

*these empty slots (it has very little capacity to discipline LGW). This would be more difficult in the winter (it has more capacity to discipline LGW during the winter).*<sup>367</sup>

6.40 However, Monarch also noted that '*It would be difficult for it to move to another airport as a lot of its customers only fly from LGW*'.<sup>368</sup>

6.41 Evidence also suggests that while there is scope for charters to use W patterns, they tend not to be used as a disciplinary action towards an airport. Rather, the use of W patterns provides charters the scope to offer short and mid haul services (and eliminates the need to establish bases in multiple locations, which, as outlined earlier, has costs).<sup>369</sup> For example, Monarch (which provides both scheduled and charter services) indicated that:

*It didn't think the operation of W Patterns would discipline GAL in any way; it would only add additional cost and complexity to its operations. It did note that it had operated W patterns at other airports where it did not have a base.*<sup>370</sup>

6.42 Based on the evidence outlined above, the CAA considers that the scope for charters to discipline an airport by reducing the frequency of its services during the summer may be relatively limited, particularly where:

- the scope for charters to operate successfully at other airports is limited; and
- there is scope for empty summer slots to be easily filled by another airline.

6.43 During the winter season, the CAA considers that it may, in principle, be possible for a charter to try to discipline an airport by withdrawing aircraft from an airport.<sup>371</sup> However, the CAA understands that demand is lower in winter and that one way a charter can look to

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<sup>367</sup> Source: Monarch.

<sup>368</sup> Source: Monarch.

<sup>369</sup> Source: Thomson Airways.

<sup>370</sup> Source: Monarch.

<sup>371</sup> This is supported in principle by Monarch who stated that it would be easier to discipline GAL during the winter months but also pointed to wider logistical, operational and financial difficulties associated with switching. Source: Monarch.

offset this is by using their aircraft in different markets.<sup>372</sup> However, given the strength of the Gatwick catchment these aircraft will need to return to the airport for the summer season – as Thomas Cook noted, Gatwick is: *the default airport for holiday flights in the South of England.*<sup>373</sup>

6.44 And that:

*in the event of a price increase there was no guarantee that it would shift airports (from Gatwick ...), rather it would consider all options including reducing its flights.*<sup>374</sup>

6.45 Similarly, Monarch (which provides both scheduled and charter services) indicated that Gatwick is the leisure hub for the UK, commenting:

*In terms of where the tourism and leisure market is ... [t]oday, that market is now consolidated at LGW.*<sup>375</sup>

6.46 And:

*LGW is left as the only viable choice because of the convenient catchment and the TO [Tour Operator] support which is very important to its business.*<sup>376</sup>

6.47 More broadly, the CAA understands that charters' access to key morning slots is important to their operations and that failing to access such slots, or reducing the use of such slots to try and discipline an airport, could be highly disruptive to their operations.

6.48 The importance of Gatwick to the charters has also been identified by GAL itself, which in one of its internal strategy documents noted that Gatwick was '*[t]he home of the UK Charter carriers*'.<sup>377</sup>

6.49 Based on the evidence outlined above, the CAA considers that the

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<sup>372</sup> For example, Thomson Airways operates in the Winter season approximately 8 aircraft to SunWing, a Canadian charter operator, to serve the "winter sun" routes in Canada. Source: Thomson Airways.

<sup>373</sup> Source: Thomas Cook.

<sup>374</sup> Source: Thomas Cook.

<sup>375</sup> Source: Monarch.

<sup>376</sup> Source: Monarch.

<sup>377</sup> Source: GAL.

scope for charters to discipline GAL by reducing the frequencies of their marginal routes to and from Gatwick is unlikely to significantly constrain GAL's behaviour.

- 6.50 In particular, the CAA considers that the need for charter operators to have a significant presence in the holiday periods, particularly the summer period, suggests that the scope for them to discipline GAL by reducing frequencies is relatively limited.
- 6.51 The evidence (from charters and LCCs) also suggests that there are operational challenges associated with reducing frequency in the form of W patterns over the medium term.

### **Grounding and switching LCC based aircraft and charters**

- 6.52 Using ACL start of season reports, Frontier Economics estimated, on behalf of easyJet, that based aircraft represented approximately 82 per cent of air traffic movements at Gatwick.<sup>378</sup> This suggests that switching marginal based aircraft away from Gatwick could be an effective way to constrain GAL.
- 6.53 Grounding one or more based aircraft, or equivalently reducing their utilisation, is a form of switching that should, in theory, have a similar effect to re-basing aircraft. Both could have a material impact on the number of passengers moving through the airport. For example, for easyJet, the withdrawal of one route on a 'back and forth' pattern would result in the removal of 6 daily movements; equating to 350,000 passengers per annum.<sup>379</sup>
- 6.54 With respect to the switching of LCC aircraft, GAL has (amongst other issues) indicated that LCCs are quite flexible and can easily move aircraft to other airports. Specifically, GAL indicated:
- Airlines which run a low cost operation are arguably most able to take advantage of substitution possibilities. In part, this is due to many of these airlines operating out of multiple bases in the London area ... . This provides a high degree of flexibility to these carriers to switch routes and rebase aircraft between the portfolio of airports from which*

<sup>378</sup> Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared for easyJet, p. 18.

<sup>379</sup> Source: Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared for easyJet, p. 18.

*they operate. Indeed, this is their business model.*<sup>380</sup>

6.55 And:

*As well as having multiple bases in the London area, these airlines also have significant presence at numerous airports across Europe. This increases the ability of these airlines to switch the utilisation of aircraft away from serving London to serving other routes, perhaps on a limited basis for rotations during a day.*<sup>381</sup>

6.56 GAL has also suggested that charters can easily move their aircraft to other airports in the South East. In particular, GAL noted:

*Charter airlines have traditionally had a strong presence at Gatwick, but also operate from Stansted and Luton in the South East. It is also the case that charter operators fly from smaller airports throughout the UK indicating that there is no inherent need for them to operate from large, well connected airports such as Gatwick.*

*In the South East, while there is charter presence at Stansted and Luton, there is the potential for these airports to develop further their offering to charter carriers, providing viable substitution possibilities for these airlines. In addition, smaller, less utilised airports such as Southend and Southampton could also provide potential.*<sup>382</sup>

6.57 GAL also indicated that airline customers can, and do, use the threat of switching or reducing current services at Gatwick or holding back future growth in services. In particular, it noted that:

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<sup>380</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, p. 4.1

<sup>381</sup> Source: GAL Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, p. 42.

<sup>382</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, p. 42.

- *'Low Cost Carrier airline models have become increasingly important at Gatwick in recent years'* but that LCCs have set up bases in multiple airports in multiple countries and frequently change the deployment of their aircraft assets.<sup>383</sup>
- *Charter operators are generally a source of significant non-aeronautical revenues which disproportionately contribute to overall revenue.*<sup>384</sup> Decisions by these airlines to switch away from Gatwick (as opposed to growing their duration throughout the summer season) will risk reducing its non-aeronautical revenue streams and correspondingly put pressure on its profitability.<sup>385</sup>

6.58 GAL also noted that charters may *'view other airports around the South East as potential alternatives to threaten Gatwick with, and Stansted could be a stronger competitor than in the past'*.<sup>386</sup>

6.59 More broadly, GAL noted that the profit impact on Gatwick where it loses a service without obtaining any replacement at all is substantial since Gatwick loses not just the airport charge revenue, but also the commercial revenues associated with serving these customers.<sup>387</sup> The CAA considers, however, that this outcome is unlikely to occur for LCCs and charters. In particular, the CAA notes that GAL has indicated that a number of currently based and inbound airlines have sought to expand operations during the early morning departure peak, but have been unable to do so due to the appropriate slots not being available.

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<sup>383</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, pp. 75-77.

<sup>384</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, pp. 75-77.

<sup>385</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, pp. 75-77.

<sup>386</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, pp. 75-77.

<sup>387</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, pp. 75-77.

- 6.60 GAL also provided the CAA with a list of airlines that had switched airports since May 1991, a period that included switching that occurred before Gatwick was sold (in late 2009) by the then BAA group.<sup>388</sup> The switches that have occurred both to and from Gatwick since 2009, as well as the new airlines that are operating from Gatwick (and the UK) are outlined in chapter 5. In summary, this analysis found that:
- switching appears to be from the North London airports to Gatwick or from Gatwick to Heathrow with no moves in the opposite direction. This is consistent with the airlines' view that GAL faces some constraint from Heathrow but that GAL poses little constraint on Heathrow.
  - LCCs appear to be able to switch to Gatwick from Stansted, although the reasons have generally been motivated by non-price related issues. Similarly, moves by feeder airlines into Gatwick from Stansted have been motivated by non-price issues (see chapter 5 for more information).
- 6.61 In relation to the grounding of aircraft, GAL did not provide any specific information on this issue. The CAA notes, however, that the concerns GAL raised with respect to the loss of any aircraft (see earlier discussion) is equally applicable to this scenario.
- 6.62 Ryanair, however, indicated that it has grounded aircraft but mainly at '*high cost airports such as Stansted and Dublin*', and that these decisions are largely driven by high airport charges.<sup>389</sup> In addition, it indicated that the opportunity cost it faces for suspending routes and grounding aircraft during the summer traffic seasons is very high. As a result, it is only viable for it to consider grounding aircraft during the Winter traffic seasons, where the cost of leaving the aircraft idle on the ground is lower than losses that would be generated on many routes.<sup>390</sup>
- 6.63 easyJet also indicated that, in the past, it had tried to [~~✗~~] by [~~✗~~] and

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<sup>388</sup> The CAA notes that under joint (BAA) ownership the negotiations concerning the movement of an aircraft/airline from one London airport to another may have been influenced by broader BAA airport portfolio considerations.

<sup>389</sup> Source: Ryanair.

<sup>390</sup> Source: Ryanair.



[redacted]. However, it also noted that this strategy [redacted] and that as a result it has taken a more [redacted].<sup>391</sup>

6.64 Monarch (which provides both scheduled and charter services) has also noted that it considers that grounding and switching of its aircraft would have minimal impact on GAL's behaviour. In particular, Monarch noted:

*If GAL's charges became too high, at most [redacted]. It wouldn't be able to react more strongly in disciplining LGW because of the strength of its 'consolidated TO and holiday package' reputation and pull.*<sup>392</sup>

6.65 And:

6.66 *Some of the aircraft types it operates from LGW would struggle to operate with the same pay load out of LTN with its shorter runway. For longer and transatlantic routes, this would be impossible [redacted].*<sup>393</sup>

6.67 Related to the above, Monarch has indicated:

*...in order to serve London it is not in a position to [redacted] or [redacted] as there are [redacted].*<sup>394</sup>

6.68 *If it moved capacity during the summer, GAL could easily fill these empty slots (it has very little capacity to discipline LGW).*<sup>395</sup>

6.69 Having considered the ways in which a LCC or charter might, in principle, be able to ground or switch marginal based aircraft away from Gatwick, the CAA considers that the evidence suggests that a strong disciplinary action that an airline can take is to relocate its based aircraft. In particular, the substitution of a sufficient number of based aircraft away from Gatwick could significantly impact on GAL's profitability and therefore constrain its behaviour.

6.70 The CAA notes, however, that in practice there are a number of reasons why the actual scope for LCCs and charters to discipline GAL by switching marginal aircraft (or threatening to switch) is limited. This issue is highlighted by the critical loss analysis (below) and by the

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<sup>391</sup> Source: easyJet.

<sup>392</sup> Source: Monarch.

<sup>393</sup> Source: Monarch.

<sup>394</sup> Source: Monarch.

<sup>395</sup> Source: Monarch.

other analysis outlined in this chapter.

### Critical loss analysis

- 6.71 Having found that, in principle, LCCs and charters could constrain an airport by switching, the CAA now considers the necessary scale of switching and the likelihood of such switching following a 10 per cent price increase.
- 6.72 Frontier Economics estimated on behalf of easyJet that, to make a 10 per cent price increase unprofitable, Gatwick would have to lose between 1.8 million and 2.3 million passengers per year out of 32 million. It estimated that this was equivalent to 46 daily ATMs<sup>396</sup>, which means that to discipline the airport, easyJet would need to relocate 7 to 8 of the aircraft currently based at Gatwick. However, Frontier Economics also indicated that the presence of excess demand at Gatwick would complicate matters as the airport could expect vacated slots to be filled by other operators who are currently unable to obtain a peak hour slot.<sup>397</sup> Frontier Economics therefore concluded that the estimated number of flights required to switch could therefore be viewed as a lower estimate.<sup>398</sup>
- 6.73 CAA analysis based on the same methodology, with a 10 per cent increase in aeronautical revenue per passenger, estimated that approximately 8 to 9 aircraft, representing between 2.3 and 2.7 million passengers per year, would amount to a “critical loss” of movements for Gatwick, making an increase in airport charges unprofitable (see chapter 8 for more information).
- 6.74 The CAA notes that GAL has expressed some concern with the methodology that Frontier Economics adopted for this study, and which the CAA referenced. GAL’s concerns are examined in more detail in the next section.

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<sup>396</sup> Having estimated the passenger numbers required to respond to a price increase Frontier Economics convert this into the number of planes required to switch away from an airport. To derive the number of planes required to switch, Frontier Economics assumed that there is a uniform percentage reduction in passengers across ATMs.

<sup>397</sup> Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared for easyJet, p. 2.

<sup>398</sup> Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared for easyJet, p. 16.

- 6.75 Using the underlying allocation model of the DfT's Aviation Forecast NAPALM methodology, Frontier Economics estimated how many passengers at Gatwick would switch away from the airport in light of an increase of 10 per cent in the cost of using the airport. The results show that an estimated 1.28 million passengers would switch away from Gatwick in such a scenario, which is equivalent to approximately 4 aircraft. When modelling capacity constraints, by restricting substitution to Heathrow and London City airport, Frontier Economics indicated that the airport would only lose 0.95 million passengers in the face of a 10 per cent increase in airport charges. As the estimated actual loss in passengers is smaller than the critical loss, Frontier Economics suggested that Gatwick might be able to increase its prices profitably by 10 per cent.<sup>399</sup>
- 6.76 The CAA notes, however, that there are a number of factors linked to the NAPALM<sup>400</sup> model that affect the way that these results should be interpreted. While the CAA only alluded to these in the Initial Views, key factors worth noting are<sup>401</sup>:
- The report's analysis of airline switching restricts any switching to the London airports. This does, however, appear to be a reasonable restriction given the importance of operating from London for LCC's and charters.
  - The analysis of passenger switching restricts passengers' choices. In particular, the model does not allow passengers to exit the market following a price rise (i.e. to decide not to travel), and only allows them to switch or fly from their current airport. In addition, the model does not seem to allow for route substitution; for example, a passenger flying to Paris Charles de Gaulle airport can only switch to another flight to the same destination airport.

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<sup>399</sup> Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared for easyJet.

<sup>400</sup> The National Air Passenger Allocation Model is a fully-estimated multinomial choice model that is used to convert unconstrained forecasts of air passenger demand into forecasts of passenger demand by airport.

<sup>401</sup> It should be noted that these factors are examples of the types of limitations that are typically experienced when the complexity of markets are simplified to allow a tractable model to be constructed.

- The NAPALM model treats flights by LCCs, charters and FSCs as not being substitutable from the point of view of passengers, which limits the scope for substitution in the model.
- The modelling is a static analysis of the change in passenger numbers over one year, taking the existing route networks at UK airports as given. This allows estimation of the short-run reaction from the price increase, although omits longer-term implications. However, these dynamic reactions are taken into account by the CAA in the overall assessment of the degree of Gatwick's market power, through the analysis of passenger switching (see chapter 8).

6.77 The limitations of the NAPALM model suggest that the level of passengers actually switching may be higher than the estimated level, which is influenced by the use of an estimated elasticity in the model, as well as other modelling restrictions. Nonetheless, the CAA considers that the available evidence highlights the difficulties of disciplining the airport operator in this way given existing capacity constraints. The impact of capacity constraints are considered in section 5 (below).

6.78 In addition, the CAA notes that the disciplining effect of grounding and / or switching of aircraft on an airport operator will be influenced by a number of factors, including the potential costs associated with switching. The higher the switching costs, the less likely that an airline would ground and/or switch aircraft to try and discipline an airport. For example, if switching costs were low and demand for the airport was high (and there were no constraints), an airport operator might easily replace an airline that had switched with one that was keen to commence/expand its operations at the airport.

### Section 3: Switching costs

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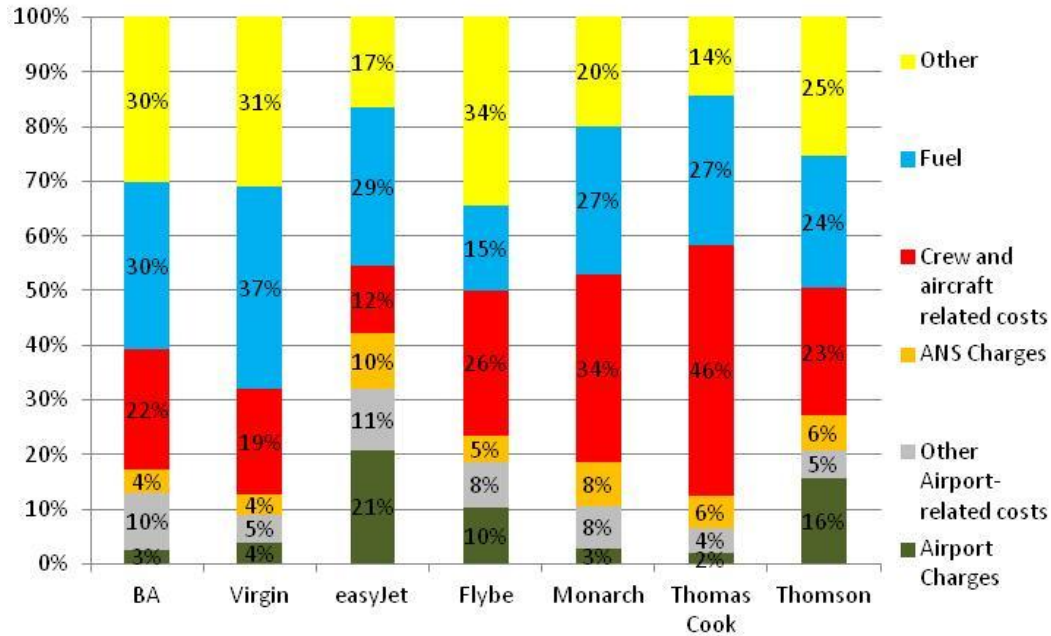
6.79 In this section, the CAA examines switching costs and the ability of Gatwick airlines to switch marginal aircraft as well as the practical considerations involved in any exercise of the ability to switch. In particular, this section:

- highlights the different costs that may be incurred with grounding and/or switching depending on the business model that an airline has adopted;
- summarises the categories of switching costs that an airline may face; and
- explores:
  - how switching costs apply to based and inbound LCCs and charters; and
  - the strategic costs that an airline may incur in switching.

6.80 The CAA notes, however, that switching costs alone will not solely determine the level of switching that may occur – other issues, including capacity constraints, also play an important role and it is for that reason that some of these are issues are discussed in this chapter.

6.81 In addition, as per chapter 2, the CAA notes that there are a variety of airline business models operating at Gatwick. The CAA therefore considers that the costs associated with grounding and/or switching marginal aircraft will vary across the different models. For example, the CAA considers that LCCs are likely to be the most sensitive of business models to any increase in prices by an airport operator as these charges represent a larger proportion of their costs. The proportion of airport charges and other operating costs for some of the airlines operating at Gatwick are outlined in Figure 6.1 below.

**Figure 6.1: Cost breakdown for various airlines**



Source: CAA airline account information, latest available financial years

6.82 Examining the switching costs and the ability of marginal service provided by LCCs, both based and inbound, and charters to switch can therefore be useful in helping to understand the ability of airlines to constrain GAL’s pricing and other competitive behaviour and is the focus of the next section. However, before this issue is examined, the CAA notes that Box 1 (below) outlines a number of switching costs that the CC identified in its 2009 BAA Report.

**Box 1: Summary of the switching costs identified in the CC's 2009 BAA Report**

*Cost of physical relocation:* these are one-off costs incurred when re-basing aircraft, which could include relocating flight crew if the airport to which the aircraft is rebased is a considerable distance from the current airport. There may also be ground staff redundancy or recruitment expenses. If an aircraft is being relocated to an airport where the airline has existing operations, these costs may well be smaller than if it were opening a new base, in which case some additional start-up expenses might be incurred.

*Long-term commitments:* an airline might have a multi-year contract with an airport where the charges it pays are linked to the volume of passengers it carries. An airline could also have long-term arrangements for maintenance facilities at the airport. Full or partial switching of aircraft or services could well break these agreements, and the benefits of these agreements would need to be considered against the offer at an airport to which the airline may switch.

*Loss of economies of scale:* switching away one or more aircraft from a base could result in the loss of economies of scale at that particular airport as the size of the airline's operations is reduced. However, this switching cost might be offset by the creation of economies of scale at the airport to which the aircraft is (are) being relocated, or may not be significant if the aircraft switching occurs between two or more sizeable bases.

*Market effects:* these include transitory costs of switching aircraft to substitute airports. Marketing costs can be incurred for new routes, and the lower yields in the first year(s) of a route's operation as the yields reach maturity. These costs could be offset to an extent by the airport to which the aircraft is (are) relocated offering discounts (or direct marketing support) to new airlines or for the operation of new routes. In addition, these costs may be smaller if the aircraft and routes are moved to airports that are proximate to the original airport, and whose catchment area(s) overlap with it. However, there may be longer-term market effects resulting in lower yields, even on mature routes, which could occur from operating routes from airports whose location is less attractive or where the airline faces more direct competition.

*Network effects:* network effects can occur at an airport where the number of airlines or routes offered increases the number of passengers choosing to fly from the airport, which in turn can make the airport more attractive to other airlines. Switching away from an airport, in particular to a smaller airport, might result in the airline losing the benefits of these network effects. However, the

strength of these effects varies on a case-by-case basis.

*Capacity constraints:* capacity constraints at other airports that are seen as substitutable by an airport's incumbent airlines can reduce the threat and likelihood of airline switching as airlines might be less able to relocate aircraft in a profitable way and on a sufficient scale to constrain the airport. These capacity constraints can occur, for example, from a lack of suitable runway slots, aircraft parking stands capacity, and/or terminal capacity.

*Sunk costs:* these are irrecoverable costs resulting from an airline's investment in infrastructure and facilities at an airport, either through purchase or leasing. Where the assets are owned by the airline, the initial investment costs might be, to an extent, recoverable through the sale of the assets, thereby reducing the size of the sunk costs.

6.83 The CAA notes that the different types of switching costs outlined in Box 1 are likely to affect airlines operating to and from Gatwick differently according to their business model and the nature of their operations, and this issue is examined next.

### Based LCCs

6.84 easyJet is the largest LCC at Gatwick, carrying approximately 40 per cent of Gatwick's traffic in 2012.<sup>402</sup> Other based LCCs at the airport include:

- Norwegian Air Shuttle, with 4 per cent of Gatwick's traffic;<sup>403</sup> and
- Ryanair, with 3 per cent of Gatwick's traffic.<sup>404</sup>

6.85 In the Initial Views, the CAA noted with respect to switching costs of LCCs that:<sup>405</sup>

<sup>402</sup> See chapter 2 for more detail.

<sup>403</sup> The CAA notes that Norwegian Air Shuttle has opened a London base at Gatwick. See: <http://www.anna.aero/2013/04/10/norwegian-opens-london-gatwick-base/>, (accessed 10/04/2013). Norwegian was included in this category, recognising that this is a recent development.

<sup>404</sup> The CAA notes that Ryanair has a number of aircraft based at Gatwick and supplements these aircraft with aircraft from other bases.

<sup>405</sup> CAA, Initial Views, paragraphs 3.36-3.39.



- easyJet commissioned Frontier Economics to assess, amongst other things, the level of its switching costs to determine the level of the increase in airport charge necessary for easyJet to switch routes away from Gatwick.<sup>406</sup>
- The Frontier Economics report considered two types of switching costs – marketing costs and costs arising from a loss of route maturity – and concluded that the average costs of switching would significantly outweigh a 10 per cent increase in aeronautical airport charges at Gatwick. It also noted that this was the reason why it would be, on average, unprofitable for easyJet to switch any traffic away from Gatwick in response to a 10 per cent price rise.
- The Frontier Economics analysis uses a number of average values (rather than marginal values which are conventionally used in market analysis) as input assumptions in its modelling and that consequently the analysis was likely to over-state the magnitude of switching costs arising from the impact on yields. As such, the CAA noted that Frontier Economics' outputs might provide an upper estimate of switching costs for easyJet's operations.

6.86 The CAA also noted that:<sup>407</sup>

- A number of airlines indicated that one of the main reasons why they would incur high switching costs if they moved from Gatwick was that they could achieve higher yields from Gatwick relative to other London airports (except Heathrow) and from UK regional airports. However, it also noted that yield was not in itself a sign that one airport has more or less market power than another.

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<sup>406</sup> This document is available from the CAA's website: [http://www.caa.co.uk/docs/5/rpt-easyJet%20Competition%20Assessment%20Final%20Report\\_Abridged.pdf](http://www.caa.co.uk/docs/5/rpt-easyJet%20Competition%20Assessment%20Final%20Report_Abridged.pdf)

<sup>407</sup> CAA, Initial Views, paragraphs 3.95-3.97.

- It is difficult to identify whether the observation of higher yields is an indication of airport market power. In principle, the higher yields could reflect the combination of capacity scarcity brought about by underinvestment (or capacity hoarding) and a binding price cap that is preventing prices rising above a competitive level. Alternatively, the higher yields might reflect a superior product and/or locational advantages of the airport, such as its catchment and surface access connections.<sup>408</sup>

6.87 Subsequent to the release of the Initial Views, GAL expressed concern with the switching cost analysis that the CAA and airlines had undertaken. In particular, GAL suggested that the CAA's analysis of switching costs is: (1) '*very high level and lacks detail*'; and (2) is not sufficient to overturn previous findings by the CC and the CAA that, '*notwithstanding the presence of switching costs for some airlines, a substantial level of competition could be expected between the London airports*'.<sup>409</sup>

6.88 GAL also expressed concern that using average yields rather than marginal yields would understate the potential for switching and that high yields reflects the effect of regulation, in particular the regulated airport price being set below the competitive price. Specifically, GAL noted:

*The airlines' and CAA's analysis of airline yields focuses on average yields, rather than marginal yields, understating therefore the potential for switching and making this evidence irrelevant for assessing competitive constraints. For yield analysis to be relevant, it should be conducted on the basis of marginal yields i.e. yields on those services that are most vulnerable to price increases, as it is the potential for those services to switch that imposes constraints on an operator's ability to increase prices.*

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<sup>408</sup> In this respect, it would also be relevant if there was evidence of capacity hoarding and/or underinvestment. As discussed elsewhere in this chapter, the CAA has identified no evidence to suggest that GAL is under-investing or hoarding capacity.

<sup>409</sup> Source: GAL, Initial Response to CAA's Initial Views, 4 April 2012, Ref: Q5-050-LGW09, p. 4. See also GAL, Airport Competition: Competing to Grow and become London's airport of choice, November 2011, Ref: Q5-050-LGW05, footnote. 92.

*However, more fundamentally, the possibility that yields at Gatwick are higher than at other London airports (excepting Heathrow) does not create a “switching cost”. Higher relative yields are most likely to be reflective of scarcity and locational rents at Gatwick and the CAA has consistently argued that the presence of such scarcity and locational rents does not equate to market power. The fact that they appear to rest in the hands of the airlines is a product of the constraining effect of regulation. For the CAA to use them in its analysis of switching would be effectively to rely on evidence from an artificially constrained market when that analysis should be directed to the underlying fundamentals of the market absent regulation. This is one of the reasons why the CAA has traditionally, and in its most recent market power guidelines, put such emphasis on the criticality of the competitive price level to competition analysis.*

And:

*[The] likely explanation for the higher yields [at Gatwick] is that they arise from the current regulated airport price being set below the competitive price level.<sup>410</sup>*

- 6.89 The CAA notes that since the release of the Initial Views it has examined the issue of switching costs in more detail.
- 6.90 As part of this, the CAA notes that the issues considered and the analysis undertaken by the CC as part of its investigation into ‘the effects of features of such market or markets for airport services in the United Kingdom as exist in connection with the supply of airport services by BAA’<sup>411</sup>, is a different exercise from a market power assessment of a particular airport. While the CAA accepts that there is information in the CC’s report that can be drawn on to help inform the CAA’s views, including on switching costs – an issue that this section examines – the CC’s findings have to be considered in the appropriate context.
- 6.91 The CAA also accepts that marginal rather than average yield analysis is the more relevant factor when considering switching. As

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<sup>410</sup> GAL, CAA’s Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, pp. 5-6.

<sup>411</sup> CC, [http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/core\\_term\\_s\\_of\\_reference.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/core_term_s_of_reference.pdf), p. 1.

such, the CAA notes (as per the Initial Views), that Frontier Economics' analysis is likely to over-state the magnitude of switching costs arising from the impact on yields and can only be taken into account as an upper limit of the estimated switching costs for easyJet's operations.

6.92 That said, the CAA considers that there are a number of practical difficulties associated with undertaking marginal yield analysis. In particular, putting aside the regulatory burden that may have to be imposed to collect the required data, clear evidence as to which routes would be withdrawn may be difficult to obtain. In particular, the CAA (or its consultants) would need to apply 'judgement' on the merits of business specific routes to:

- reconcile the lower yields that may be achieved on established, mature routes relative to the higher yields that may be achievable on new (and relatively untested) routes; and
- determine which route is important for the strategic direction of an airline. For example, it is possible that a marginal route may be retained at the expense of a more viable route as the marginal route may, for example, be considered pivotal for future development of the airline.

6.93 The CAA also agrees with GAL that locational advantage, and therefore the ability to offer higher airlines yields, does not necessarily mean that an airport has significant market power.

6.94 However, the CAA considers that the potential loss of yields from switching, particularly if they are from an airport of strategic importance to an airline, is a cost that a profit seeking airline would consider if it was considering switching (see discussion later in this section). In addition, irrespective of how these rents are labelled, the CAA considers that it suggests that there is limited competition. If switching to other airports was an effective constraint on GAL, rents would be squeezed out of the system, and this is true regardless of whether the rents are allocated to the airlines or the airports by the regulatory framework.

6.95 Given the above, the CAA considers that while the Frontier Economics analysis has some limitations – in particular, being likely to over-state the magnitude of switching costs arising from the impact on

yields and can therefore only be taken into account as an upper limit of the estimated switching costs for easyJet's operations – it nonetheless provides information that is useful to our decision making process.

6.96 The CAA notes that the Frontier Economics report indicated (amongst other things) that easyJet faces £ [X] per passenger in additional marketing costs in the first year of operating a new route. It also provided additional information on how these costs changed overtime. Specifically, it noted that:

[X];<sup>412</sup> and

[X].<sup>413</sup>

6.97 The Frontier Economics report also provided information on switching costs. In particular, it:

- provided switching cost estimates from Gatwick on a per passenger basis. In particular, it found that an increase of airport prices equated to switching costs that ranged from £ [X] to £ [X] per passenger. In contrast, as a result of a SSNIP by GAL, the airline would face a per passenger price increase of £ [X], which would be a recurring cost over if it were to remain at the airport.<sup>414</sup>
- noted that easyJet would be likely to absorb an increase in charges in the short-run but that in the longer term this would have to be passed through to easyJet's customers.<sup>415</sup> However, Frontier Economics also noted that excess demand at Gatwick may insulate Gatwick from the effect of incumbent airlines switching to other airports. In particular, Frontier Economics indicated that excess demand may exacerbate market power at Gatwick as the airport could expect vacated slots to be filled by other operators who are currently unable to obtain a peak hour slot.<sup>416</sup>

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<sup>412</sup> [X]

<sup>413</sup> [X]

<sup>414</sup> Source: Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared for easyJet, confidential version.

<sup>415</sup> Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report prepared for easyJet.

<sup>416</sup> Frontier Economics, Market power assessment: Gatwick and Stansted Airport, A report

- 6.98 The CAA notes that the difference between these costs appears to be considerable. In addition, while these are only estimates, and might vary on a case-by-case basis, they appear to provide an indication of the potential switching costs faced by easyJet and the airline's likely switching reaction in practice.
- 6.99 easyJet has also indicated that it would need to take into account the likelihood and extent to which other airlines would replace their operations in a scenario where they switch away based aircraft. In addition, it noted that an airline's threat to switch would lose credibility in face of airline backfill for any airport's passenger base.<sup>417</sup> There are two separate aspects to this which may constrain airline switching:
- first, the airport operator may not be constrained by an airline exiting a route, as another airline would be likely to take its place; and
  - second, airline backfill by a competing airline may reduce the profitability to the airline of exiting the route and operating it from another airport.

6.100 While Ryanair's presence at Gatwick is relatively small compared to easyJet's (and relative to its own base at Stansted), the CAA notes that Ryanair engaged consultants to look at switching costs, albeit with respect to its Stansted operations.<sup>418</sup> The CAA considers that this study contains useful information that can help inform its consideration of the position of comparable LCCs at Gatwick. In particular, the CAA notes that while Ryanair indicated it had very little tangible investments at Stansted, it considered that it had large sunk switching costs associated with:

- the expenditure it has incurred through marketing and promotional fares offered on more than 100 routes at Stansted over the past two decades – costs that Ryanair considers are substantial and which prevent it from withdrawing a significant part of traffic on a year-round basis.<sup>419</sup>
- loss of yield (relative to a mature route) from opening a new route<sup>420</sup>, redundancy costs, the loss of efficiency of engineering facilities and economies of scale.<sup>421</sup>

6.101 The CAA recognises that when considering the impact of lower yields, it is quite normal for different services to have different prices. Therefore, the CAA has carefully considered the evidence that it has on yields and notes that the loss of yields is not a 'traditional' switching cost and that the categorisation of this cost as a switching cost such may cause some confusion. However, the CAA also notes that the inclusion of costs of this type is an issue that the CC has considered, including in its recent BAA Airports Market Investigation. In addition, the CC notes that irrespective of how these costs are categorised they represent an opportunity cost of switching and are therefore relevant.

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<sup>418</sup> The CAA notes that CAA airport statics suggest that Ryanair has been growing at Gatwick from 2005 to 2011 but that in 2012 this growth was reversed. The CAA also notes that easyJet indicated that Gatwick '*is a relatively high cost airport but also does not attract [✗]*'. Source: easyJet.

<sup>419</sup> Source : Ryanair.

<sup>420</sup> Source: Ryanair.

<sup>421</sup> Source: Constructive Engagement Working Group, September 2012.

- 6.102 The CAA also notes that GAL considers that the manifestation of high yields at Gatwick reflects the current regulated airport price being set below the competitive price level (see earlier discussion) and that GAL has submitted a significant amount of material to the CAA that explores this issue.
- 6.103 The CAA notes GAL's concerns but considers that GAL's pricing is broadly competitive to other comparator airports and that its current cap is not significantly below the competitive price. The CAA's views on price (as well as the views of stakeholders) are outlined in more detail in chapter 4.
- 6.104 Overall, the evidence that the CAA has received, and the analysis that it has undertaken, suggest that, compared to full service airlines with typically more significant capital investments at an airport (see chapter 7), the based short-haul LCCs at Gatwick would face relatively low traditional switching costs if they were to switch away aircraft from the airport. However, the additional marketing costs per passenger and the risk of airline backfill appear to be sufficiently high to constrain these airlines' ability to switch away in the short-run.

### **Inbound (short-haul and long-haul) LCCs**

- 6.105 With respect to in-bound short-haul LCCs, the CAA considers that the absence of based aircraft (and sunk costs) would result in minimal switching costs, although some relatively minor costs may be incurred. This view is supported by Wizz Air, which indicated that (in relation to Luton):

*As Wizz Air is an inbound carrier into LTN, it said it would not face many switching costs. Though it would face some operational costs, its crew and aircraft are based in Central and Eastern Europe. In order to rebuild part of its passenger base after a move to another airport such as STN, one-off marketing costs support would be needed but this would not be likely to be major.<sup>422</sup>*

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<sup>422</sup> Source: Wizz Air.



- 6.106 With respect to in-bound long-haul LCCs, the CAA notes that there is an absence of this business model at the airport at this time. However, the CAA notes that Air Asia X did fit into this category. Air Asia X commenced operations at Gatwick in October 2011 but ceased operating from a UK base shortly thereafter – prior to its move to Gatwick, Air Asia X operated at Stansted.
- 6.107 With respect to switching airports, Air Asia X provided the CAA with evidence on the level and types of costs that it incurred when switching airports. In particular, it noted:
- it did not encounter any significant costs of switching from Stansted to Gatwick, largely because it did not have any based aircraft in the UK;
  - catering, groundhandling and hotel contracts were terminated, and notice served; and
  - there were some costs of transferring passengers impacted by the move to Gatwick, e.g. because they were connecting to a Ryanair flight at Stansted or live around Stansted and that transportation (bus or taxis) was arranged to remedy this.<sup>423</sup>
- 6.108 Air Asia X also noted that the situation would have been totally different if it had based aircraft in Stansted. Specially, it noted that the move would have been far less simple and that the costs it would have incurred '*would have included moving staff, crew, parts, equipment, etc.*'<sup>424</sup>
- 6.109 The absence of significant investment in infrastructure at Gatwick by inbound short haul LCCs means that they retain greater flexibility in their ability to respond to a price increase by switching away marginal aircraft and services from Gatwick.
- 6.110 The CAA considers that this suggests that, in an unregulated airport, in a well-functioning, competitive market that GAL would be likely to price discriminate towards airlines on a bilateral basis through long-term contracts.<sup>425</sup> Under these conditions, the CAA considers that contracts may be more aligned to an airline's willingness to pay. As

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<sup>423</sup> Source: Air Asia X.

<sup>424</sup> Source: Air Asia X.

<sup>425</sup> Airlines are protected from tariff-based price discrimination by competition law.

such:

- airlines that were more able and willing to switch away from the airport in light of price increases may face lower prices; and
- airlines that were more constrained in their ability to move their operations may face higher prices – that is, this approach may result in relatively less protection for airlines that have a more inelastic demand for the airport’s services.

6.111 The CAA notes that the situation outlined above contrasts with the situation under price regulation, where an airport prices to the cap (and offers no discounts for short-haul services). In this scenario, airlines are more likely to face the same prices for the services they consume and if an airport increases its charges (and maintained its pricing policy of no discounts), then the airport’s short-haul airlines would face the same increase in prices. As such, marginal airlines might switch away to such an extent that the loss of revenue would make the price increase unprofitable, thereby protecting the more captive airlines from the price increase.

## Charters

6.112 As per the discussion on based LCCs, the Initial Views highlighted that one of the switching costs associated with charters was the loss of the relatively high yields that were available at Gatwick. The CAA notes that Thomas Cook, Thomson Airways and Monarch all have based aircraft at Gatwick.<sup>426</sup>

6.113 In general, the charters that the CAA spoke to emphasised the importance of Gatwick’s catchment, its links and reputation as a holiday airport which together mean that switching from Gatwick to other London based airports could be difficult.

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<sup>426</sup> For example, the CAA understands that Thomas Cook, Thomson and Monarch have, respectively, 7, 15 and 10 aircraft based at Gatwick. The CAA notes that some of these aircraft are used for both scheduled and charter operations. Sources: Monarch, Thomson Airways and Thomas Cook.

- 6.114 However, in the event that the charters were to switch airport, a number of switching costs were identified. Specifically:
- Thomas Cook indicated that, other than the cost associated with operating new slots, there would be staff redundancy and recruitment costs involved in moving airports. As a result, some financial and reputational costs would be incurred.<sup>427</sup>
  - Thomson Airways indicated that typical switching costs would include crew relocation, labour/union issues, and selling and buying office space.<sup>428</sup> Thomson Airways also noted that the airline has an engineering facility at the airport.<sup>429</sup>
  - Monarch indicated that if it were to move its operations it would 'have to invest in crew location, crew facilities and air side support'.<sup>430</sup> In addition, it noted that:
    - *It is a unique airline as it doesn't have a standardised fleet. As LGW ground handling operators deal with a variety of different fleets, they can handle this. Elsewhere, other ground handlers wouldn't be able to cope with the complexity of its operation model (this would also be very costly)*<sup>431</sup>
- 6.115 On the whole, the CAA considers that charter airlines are likely to face some switching costs due to the size of their based operations at Gatwick. As some infrastructure investment at the airport is required for based charter airlines, the CAA considers that these switching costs would, in general, be greater than for inbound charter airlines. However, as airport costs represent only a small component of the total costs that are incurred by charters (as they tend to provide a package of services not just the flight) this may translate into a proportionally less significant increase in costs, should costs increase at the airport, when compared to non-charter airlines.

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<sup>427</sup> Source: Thomas Cook.

<sup>428</sup> Source: Thomson Airways.

<sup>429</sup> Source: Thomson Airways.

<sup>430</sup> Source: Monarch.

<sup>431</sup> Source: Monarch.

- 6.116 The CAA therefore considers that the evidence suggests that traditional switching costs may not be sufficient to be prohibitive to a charter switching. This is a general position that GAL has recognised as it has noted that: *'Switching costs for most of Gatwick's traffic are generally low and the presence of some moderate switching costs does not imply a lack of substitutability between airports for airlines'*.<sup>432</sup> However, the CAA considers that there are other switching costs that need to be considered, namely strategic switching costs, for the complete picture to be seen, and these are discussed below.

### Strategic constraints on switching

- 6.117 The CAA considers that some LCCs and charters at Gatwick may face strategic (commercial) switching costs from switching between London airports, or to other non-London airports in the UK or in continental Europe. This is an issue that the CAA did not explore in the Initial Views but is an issue that the CAA's subsequent analysis suggests is an important factor in an airline's decision to switch.

### Based LCCs

- 6.118 In theory, given the breadth of their networks, easyJet should be able to switch marginal aircraft or routes to a range of airports across the UK and the rest of Europe.
- 6.119 While easyJet has moved aircraft between its respective bases, it has indicated that operating from London is central to its business model. For example, easyJet has indicated that: *'London is Europe's largest aviation market and the economic engine of this company. The aim here is to develop and strengthen the robustness and the financial performance of our business in the capital.'*<sup>433</sup> Furthermore, in terms of total European capacity, London is the leading network point, followed by Paris.<sup>434</sup>

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<sup>432</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, p. 5.

<sup>433</sup> Source: easyJet.

<sup>434</sup> Source: easyJet.

- 6.120 Similarly, Ryanair has told the CAA that its '*network could not function without a significant London presence*<sup>435</sup> as London is '*the main centre of commerce in Europe, a major tourism destination, as well as the largest agglomeration in Europe, London is of significant importance to any airline network*'.<sup>436</sup> The airline has also indicated that a London connection is a '*must have*' for most of the 170 airports from which it operates.<sup>437</sup>
- 6.121 In a report commissioned by Ryanair, RBB set out reasons why a strong presence in London is important:
- a strong presence in London affects the brand value of an airline;
  - the thickness of demand in London allows a large number of routes to be operated from the same base, which results in efficient aircraft utilisation;
  - new routes can be launched with lower risk, in regard to profitability, from London airports rather than from non-London airports; and
  - significant sunk costs in marketing its London bases. There is a significant option value to a London presence associated with the ability to operate from London in the future.<sup>438</sup>
- 6.122 Based on this evidence, it appears likely that Gatwick's based LCCs would consider switching marginal aircraft to another London airport before considering relocating aircraft away from the London airports. While competition with more distant airports is important when airlines are starting new services and are able to put these at a number of different airports, rivalry with more distant airports is likely to be less relevant when prices for existing services are being renegotiated. Indeed, the CC has previously stated that, while non-neighbouring airports do exert a degree of competitive constraint on each other, the constraint is considered to be weaker than that from neighbouring

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<sup>435</sup> Source: Ryanair.

<sup>436</sup> Source: Ryanair.

<sup>437</sup> Source: Ryanair.

<sup>438</sup> RBB Economics, Ryanair: Assessment of Airline Bargaining Power at Stansted Airport, a report commissioned by Ryanair, November 2012, available at: <http://www.caa.co.uk/docs/5/rbb%20stansted%20final%20non-confidential%20version%2029%20Nov%2011.pdf>, p. 16.

airports.<sup>439</sup>

6.123 Considering its options to switch to other London airports, easyJet has noted that:

- Gatwick and Stansted are '*separate markets as each have their own demand and catchment areas*';<sup>440</sup> and
- *a key switching cost for it is route maturity and that it takes time for the profitability of a route to reach its full potential, which creates a cost every time we change a route and in effect start again.*<sup>441</sup>

6.124 In addition, easyJet's strategy documents show that it manages its operations at London airports by dividing them according to a [X].<sup>442</sup>

6.125 Ryanair has also told the CAA that the '*three London airports that are suitable for Ryanair's operations*' are Stansted, Luton and Gatwick.<sup>443</sup> However, it has also told the CAA that, generally:

*...other London airports are only partially substitutable for Stansted, because each airport serves a distinct catchment area (with only a limited overlap), with customer bases of different levels of affluence and propensity to travel by air, as well as the fact that each of these three airports has a different appeal for inbound traffic to London.*<sup>444</sup>

6.126 In addition, Ryanair noted, with respect to outbound traffic, that:

*...passengers originating from the south of London are unlikely to regard LTN and STN airports as good substitutes for LGW. Similarly, passengers originating from STN's catchment area to the north of London are unlikely to consider LGW as a suitable substitute for STN.*<sup>445</sup>

6.127 Regarding the possibility of relocating marginal aircraft and services to airports out of the market – see chapter 5 for market definition – and

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<sup>439</sup> CC, BAA airports market investigation, Consideration of possible material changes of circumstances, 19 July 2011.

<sup>440</sup> Source: easyJet.

<sup>441</sup> Source: easyJet.

<sup>442</sup> Source: easyJet.

<sup>443</sup> Source : Ryanair.

<sup>444</sup> Source: Ryanair.

<sup>445</sup> Source: Ryanair.

into continental Europe, easyJet's strategy documents do not appear to discuss switching to continental European airports, which suggests that the airline in general manages them separately.<sup>446</sup>

6.128 However, easyJet indicated that, as airport charges play an important role in its capital allocation decisions, any decision to switch aircraft based at Stansted to a continental European airport is directly related to the potential profitability of such a move. This means that relocating aircraft to continental European airports is in principle likely to be feasible.<sup>447</sup> However, in practice, and as noted earlier in this chapter, London is central to easyJet's business model.

6.129 Other strategic costs that stakeholders have raised include those associated with maintaining a network and preventing entry by competing airlines in routes that it may have served. For example, Wizz Air noted that if it was considering switching:

*...the impact at LTN of switching some services to STN would need to be considered. For example, if Wizz Air switched a route/part of its network to STN, another airline may enter at LTN on the route(s) previously served by Wizz Air.*<sup>448</sup>

6.130 Based on the evidence above, the CAA considers that it appears that based LCCs face considerable strategic switching costs to relocate marginal aircraft away from the London airports to other UK or continental European airports, principally due to the importance of London to their respective networks and often to maintain their current (and potentially) future networks. The CAA notes that this last issue is particular important where there are capacity constraints at the airport during times where LCCs need access.

## Charters

6.131 Charters tend to regard each airport on a case-by-case basis rather than looking at a route as a city-pair. In particular, the CAA considers that the evidence suggests that charters look to serve the core catchment associated with the airport that they operate from and prefer to consolidate their scheduled and chartered holiday flights from one "leisure hub". Thomas Cook, Thomson Airways and

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<sup>446</sup> Source: easyJet.

<sup>447</sup> Source: easyJet.

<sup>448</sup> Source: Wizz Air.

Monarch have emphasised that Gatwick's must have status as the default airport for holiday flights,<sup>449</sup> <sup>450</sup> with its large catchment area<sup>451</sup> and tour operator support networks.<sup>452</sup>

6.132 The CAA notes that charters:

- operating from Gatwick are largely based in the UK and tend to only fly inbound to non-UK airports;<sup>453</sup> and
- are unlikely to relocate aircraft to airports outside of the UK, as this would require the opening of overseas operations but that they do have the scope to switch aircraft to other UK airports.

6.133 However, charters have also indicated that they would consider switching away their marginal operations if there was an alternative local core catchment that it could capture, as their business model is focused on serving the local core catchment of each airport from which they offer flights.<sup>454</sup> That said, given the relative size and importance of the charters' operations at Gatwick, it appears likely that strategic constraints would impose a constraint on charters switching.

## Summary

6.134 The CAA considers that the evidence suggests that strategic constraints play an important factor in a LCC and/or charter's decision to switch away marginal aircraft from one airport to another, whether it is to another London airport or to another airport that is out of the defined market(s) (see chapter 5), such as a continental European airport.

6.135 The CAA also considers that, while traditional switching costs may be relatively low for these operators, consideration of the strategic constraints reduces the scope for these airlines to switch aircraft serving marginal routes to other airports. This is particularly the case for the charters that have based aircraft at Gatwick, as their business

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<sup>449</sup> Source: Thomas Cook.

<sup>450</sup> Source: Thomson Airways.

<sup>451</sup> Source: Thomson Airways.

<sup>452</sup> Source: Monarch.

<sup>453</sup> An exception to this is Air Transat, a Canadian based charter airline that operates at Gatwick.

See: <http://www.airtransat.co.uk/en/gammes.aspx?langid=en&parentid=64&type=voyageur&id=35> (accessed 6 February 2013).

<sup>454</sup> This may differ for inbound charters.



model targets an airport's local core catchment area, which in this case is seen as particularly robust.

- 6.136 The CAA notes that consideration of strategic switching costs increases LCCs' and charters' switching costs relative to that outlined in the Initial Views. The CAA recognises that as a consequence of its further analysis that it considers that the actual scope for these airlines to switch marginal aircraft away from Gatwick is more limited than it suggested in the Initial Views. In addition, the CAA notes that an airline's particular circumstances will ultimately determine the scope of any movement away from an airport and therefore caution needs to be exercised when making board assumptions about the level of marginal switching that may occur.

## Section 4: Countervailing buyer power

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- 6.137 In this section, the CAA considers the ability of LCCs and charters to constrain GAL's pricing power by using the importance of its operations to the airport during negotiations. In particular, this section considers what the CAA said in the Initial Views, and stakeholders' responses, to the level of countervailing buyer power that some stakeholders may have.
- 6.138 Airlines may be able to constrain an airport operator's pricing power by using the importance of their operations to the airport during negotiations. As stated in OFT guidance<sup>455</sup>, this countervailing 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 in negotiations.*'
- 6.139 The OFT guidance further states that '*size is not sufficient for buyer power. Buyer power requires the buyer to have choice.*' This means that, to have a degree of buyer power, an airline would typically need to be a significant proportion of a particular airport operator's business and have a number of substitute airports to which it could credibly switch in response to the airport's behaviour. The buyer needs to be well informed about alternative sources of supply and could readily, and at little cost to itself, switch substantial purchases from one

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<sup>455</sup> OFT, Assessment of market power guideline (OFT415), paragraph 6.2.

supplier to another while continuing to meet its needs or else, sponsor new entry through an alternative supplier relatively quickly and without incurring substantial sunk costs.<sup>456</sup>

- 6.140 As set out in section 3, easyJet (40 per cent), Norwegian Air Shuttle (4 per cent), Ryanair (3 per cent) and the charters (19 per cent) account for around 66 per cent of Gatwick's passengers. While these market shares (individually and together) may, at first glance, suggest that these airlines could have significant countervailing power, there are a number of issues associated with relying on market shares as an indicator of market power (see chapter 3).
- 6.141 The CAA uses this section of this chapter to explore some of the specific characteristics of the LCCs and charters operating at Gatwick. In doing this, the CAA recognises that the level of countervailing power that an airline may have will be influenced by its ability to switch away from the airport.
- 6.142 In the Initial Views the CAA noted (amongst other things) that:
- LCCs generally have flexible business models and operate on a pan-European basis and that this might be expected to make them more able to switch their operations from Gatwick. However, the CAA also noted that Frontier Economics' analysis suggested that the switching of these airlines was not strong enough to discipline the airport.<sup>457</sup>
  - LCCs and short haul carriers may have some countervailing power in the seasonal peak but that it had yet to reach a firm view on this aspect of the competition assessment.<sup>458</sup>
  - Gatwick, on the whole, has been able to replace any lost operations with new routes or carriers and this suggests that any threat of airlines switching away from Gatwick has in the past not translated into a need to reduce prices.<sup>459</sup>
- 6.143 GAL responded to the Initial Views and indicated (amongst other things) that it faces significant buyer power from some of its airlines

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<sup>456</sup> OFT, OFT415, paragraph 6.2.

<sup>457</sup> CAA, Initial Views, p. 66.

<sup>458</sup> CAA, Initial Views, p. 34.

<sup>459</sup> CAA, Initial Views, p. 69.

and that it faces competition from a range of different sources – other London airports, regional airports, non UK airports and in some cases railways:

*Gatwick faces significant buyer power from airlines that account for the majority of Gatwick's traffic. This includes easyJet (which accounts for around 35% of Gatwick traffic), British Airways (with around 15 per cent), and some other airlines that account for smaller shares of Gatwick's traffic. We have needed to offer discounts to attract some of our newer airlines to Gatwick and we have seen our existing airlines move routes to Heathrow and Stansted. This is all evidence of buyer power.*

*Gatwick also faces competition from sources outside the market (where the market is defined as the South East). Most important of these is the ability of some airlines, in particular low cost carriers (LCCs), to switch aircraft capacity to non-UK airports.*

*Competition from regional airports is also important, and competition from other forms of transport for very short haul services also needs to be taken into account.<sup>460</sup>*

6.144 And

*We recognise that for most routes other forms of transport will not be viewed as good substitutes by passengers. However, rail (and in some cases road and ferry) services will be viewed as substitutes by some passengers for domestic UK flights and flights to nearby continental destinations (especially those where access is offered by the Eurostar).<sup>461</sup>*

6.145 GAL also indicated:

*... the CAA in its assessment does not methodically explain its consideration of each of the relevant factors set out in its guidelines. Moreover, in its review of Stansted the CAA implies the existence of buyer power that weakens the airport's market power, whereas at*

<sup>460</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, p. 6.

<sup>461</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, Q5-050-LGW05, November 2011, p. 83.

*Gatwick its findings do not comment on the potential for easyJet (or any other airline or combination of airlines) to exert buyer power. This is despite easyJet and other major airlines clearly having the ability to redeploy their aircraft and associated traffic to alternative bases. The ability of airlines to redeploy their aircraft to alternative bases has been demonstrated on numerous occasions, including by easyJet and Ryanair. Recent examples include easyJet's decision to withdraw capacity from Madrid and Ryanair withdrawing capacity from Edinburgh.*<sup>462</sup>

6.146 With respect to the points made by GAL, the CAA notes:

- That it does not consider that the appropriate markets for Gatwick should be defined as the 'south east' – the relevant markets for Gatwick are discussed in chapter 5.<sup>463</sup>
- While there is scope for an airline to withdraw an aircraft from an airport the actual ability to do this will vary from airport to airport and will depend on a range of factors, including the importance of that airport to their ongoing business operations. As noted earlier, London has been identified as being fundamental to the operations of LCCs and charters, with charters also emphasising the particular importance of Gatwick to their operations.
- That the ability of LCCs and charters to constrain GAL's pricing power by leveraging the importance of their operations at the airport during negotiations is discussed in more detail below.

### easyJet

6.147 The CAA notes that easyJet is the largest airline at Gatwick in terms of passengers and ATMs and its share of passengers has grown quite strongly over the past decade as Figure 6.2 (below) shows.

**Figure 6.2: easyJet's passengers as a proportion of Gatwick's passengers over time (per cent)**

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012

<sup>462</sup> Source: GAL.

<sup>463</sup> GAL's concern on the substitutability of other transport modes, such as trains and ferries, is examined in chapter 3.

%	6	10	11	15	16	17	26	31	35	37	40
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Source: CAA airport statistics

- 6.148 The size of EasyJet's operation at Gatwick fulfils the first requirement for the existence of buyer power in that its business reflects an important part of GAL's revenues and it is therefore more likely to cede better terms to easyJet to retain its custom. However, evidence regarding the airline's ability to credibly threaten to switch away from Gatwick is less clear cut.
- 6.149 easyJet also told the CAA that it [redacted]. It has, for example [redacted] and [redacted]. *The strategy [redacted]. As a result, easyJet have taken a '[redacted]',*<sup>464</sup>
- 6.150 In addition, easyJet informed the CAA of the importance of the London market (see earlier section on the strategic constraints on switching) and that: *'it invests long term and that it costs a lot to move assets around and it is not easy to move aircraft from base to base.'*<sup>465</sup> It has also indicated that (with reference to analysis undertaken by Frontier Economics) that the costs faced by airlines in switching routes from one airport to another prevent it from switching enough routes to impact the airport's passenger volume (or in other words, 'switching costs are too high').<sup>466</sup>
- 6.151 The CAA notes that during a stakeholder meeting with the CAA Board (16 January 2013), easyJet suggested that, notwithstanding it having a relatively strong presence at Gatwick, it was unable to exert sufficient influence (countervailing power) to make the airport change its position on numerous issues. Other (smaller) airlines present at the stakeholder meeting also highlighted that if easyJet did not have countervailing power what chance did they have.
- 6.152 The CAA also notes that airlines' experience in their negotiations with GAL, and the CAA's 'minded to' views on these issues, are explored in the section on negotiations in chapter 9.
- 6.153 On balance, the CAA considers that the evidence suggests that easyJet currently has a limited degree of countervailing buyer power

<sup>464</sup> Source: easyJet.

<sup>465</sup> Source: easyJet.

<sup>466</sup> Source: easyJet.

against Gatwick and that this will continue. The CAA notes that, in effect, easyJet has sponsored new entry at Southend and has switched aircraft to Southend from Stansted<sup>467</sup> There is scope for easyJet to leverage the 3 aircraft that are currently based at Southend airport and potentially move further aircraft there once further development of the airport occurs. However, as the airline considers that Gatwick is a separate market from the other markets that it operates in, the actual scope for this to occur in practice is limited.

### Other LCCs

- 6.154 Norwegian Air Shuttle is the second largest LCC at Gatwick, with it having 4 per cent of the annual passengers carried at Gatwick in 2012. Norwegian Air Shuttle has, however, only been operating at Gatwick for a relatively short time (prior to it operating at Gatwick it operated from Stansted). The CAA also notes that Norwegian Air Shuttle has indicated that it has had a positive experience with GAL since its move to Gatwick.<sup>468</sup> In particular, Norwegian Air has indicated (amongst other things) that:
- 6.155 *Under BAA, NAS [Norwegian Air Shuttle] was a smaller player and didn't get any attention. BAA's whole focus was on base carriers. BAA's approach was "this is what we have, take it or leave it". It has noticed dramatic changes in attitudes and improvements since new ownership at LGW' [and] 'When travelling around Europe, it always use GAL as an example for how other airports should behave and work with partner airlines'.<sup>469</sup>*
- 6.156 However, the CAA notes that this positive relationship may reflect GAL's desire for the airline to base itself at the airport (and grow). In particular, the CAA notes that Norwegian Air has recently announced it has established a base at Gatwick. In addition, the CAA notes that, based on the evidence of other stakeholders, this positive experience may not continue. In particular, the CAA notes that numerous stakeholders have suggested that GAL's approach to incumbent airlines is quite different to that which Norwegian Air (as a new airline

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<sup>467</sup> This issue was discussed in the minded to decision for Stansted, available at: [http://www.caa.co.uk/docs/78/FINAL%20STAL%20Market%20Power%20Assessment%20\(Summary.Tests%20A,B,C\).pdf](http://www.caa.co.uk/docs/78/FINAL%20STAL%20Market%20Power%20Assessment%20(Summary.Tests%20A,B,C).pdf), p. 108.

<sup>468</sup> Source: Norwegian Air Shuttle.

<sup>469</sup> Source: Norwegian Air Shuttle.

at Gatwick) has experienced. In particular, [redacted] has indicated:

*New carriers get more say than incumbent airlines; for example Norwegian Air Shuttle has a big marketing campaign, significant space and discounts. GAL's strategy is to focus on attracting new carriers and then once they start operating, it focuses its attention on another new carrier, without maintaining its incumbents.*<sup>470</sup>

6.157 Ryanair is the third largest LCC at Gatwick in terms of annual passengers carried, and its share of the airport's passengers has changed over the last five years, with growth between 2005 and 2011 and a decline in 2012.

6.158 The CAA notes, however, that:

- Ryanair's presence at Gatwick is relatively small compared to its based operations at Stansted and considers that Ryanair's countervailing buyer is likely to be limited; and
- the ability of Ryanair to move its aircraft to other London airports may be more limited than one would originally expect and that issues associated with this are outlined in more detail in the CAA's 'minded to' position on Stansted.<sup>471</sup>

6.159 Other inbound LCCs have more options as to where they operate from and provided they obtain access to London, access to a specific airport is less important. While access to peak periods can be important, there may be scope for relatively greater flexibility and therefore bargaining power. While the evidence on which airlines would fit into this category is limited, easyJet noted that Wizz Air may be an example of an airline that an airport (in that case Stansted) may not have market power over. Specifically, it noted that this may be the case as Wizz Air:

- operates off peak in bound traffic and as a result have a good negotiating position;
- their passengers are inbound focused – the catchment is less relevant as their passengers just want to get to London; and

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<sup>470</sup> Source: [redacted]

<sup>471</sup> This document is available from the CAA's website:

[http://www.caa.co.uk/docs/78/FINAL%20STAL%20Market%20Power%20Assessment%20\(Summary,Tests%20A,B,C\).pdf](http://www.caa.co.uk/docs/78/FINAL%20STAL%20Market%20Power%20Assessment%20(Summary,Tests%20A,B,C).pdf)

- off peak – there are more slots available in London so there is more ability to switch flights.<sup>472</sup>

6.160 The above view is supported by evidence from Wizz Air, which noted that:

*Overall, the London airport market contains lots of choice for Wizz Air. The airline can play airports against each other during negotiations, and the decision to operate from an airport ultimately comes down to operational considerations.*<sup>473</sup>

6.161 On balance, the CAA considers that the evidence suggests that the level of bargaining power that the LCCs have is, in general, limited. In particular, the evidence suggests that incumbent LCCs at Gatwick (irrespective of size) have a limited degree of countervailing buyer power and that this will continue. The CAA does, however, note that 'new' LCCs and inbound LCCs, particularly those that are expecting to expand their operations, appear to have some scope to negotiate with the airport – this issue is, however, explored in chapter 9.

### Charters

6.162 Charters represent about 19 per cent of the passenger traffic at Gatwick. The three largest charters are Thomson, Monarch and Thomas Cook, with 8 per cent, 6 per cent and 4 per cent of the passenger traffic respectively.

6.163 Given the individual size of these charters at Gatwick, the CAA considers that their individual countervailing buyer power is likely to be limited.

6.164 However, and more importantly, the CAA notes that the ability of charters to move to other airports appears quite limited, due to, amongst other issues, their dependence on the importance of Gatwick's catchment and Gatwick's "must have" reputation/brand for holiday operations.

6.165 [X] has, for example, indicated that:

*Negotiations are driven by GAL as opposed to being run*

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<sup>472</sup> Source: easyJet.

<sup>473</sup> Source: Wizz Air.



*collaboratively with airlines.*<sup>474</sup>

6.166 And:

*[GAL] knows they will always have a presence at the airport because there is nowhere else for them to go. For that reason they do not need to 'play court' and don't bother.*<sup>475</sup>

6.167 [S<] has also noted that 'new carriers get more say than incumbent airlines'<sup>476</sup> (see paragraph 6.156 above).

6.168 Based on the evidence outlined above (and in previous sections), the CAA considers that the charters have limited ability to constrain GAL's pricing power by leveraging the importance of its operations to the airport during negotiations.

6.169 Overall, considering both LCCs and charters, the CAA considers that, on balance, they have limited ability to constrain GAL's pricing power by leveraging the importance of their operations to the airport during negotiations.

## Section 5: Capacity constraints and barriers to airline entry and expansion

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6.170 As explained in chapter 3, market shares alone cannot indicate the competitive pressure from existing competitors expanding their services or the entry of potential competitors. Barriers to expansion or entry are an important part of any market power analysis.<sup>477</sup> In the UK, there are legal barriers to airport expansion in the form of government planning and policy regarding airport development, economic barriers in the form of sunk costs and economies of scale and scarcity of capacity in the form of limited runway slots and terminal facilities.

6.171 This section considers how the availability of spare capacity can affect the actual and/or potential competition between Gatwick and other

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<sup>474</sup> Source: [S<]

<sup>475</sup> Source: [S<]

<sup>476</sup> Source: [S<]

<sup>477</sup> Guidelines, paragraphs 5.1-5.12 and DG COMP Discussion Paper on the application of Article 82 to exclusionary abuses.

airports, in the form of new entry or expansion. Specifically, this section examines:

- Gatwick's own capacity;
- the capacity constraints at other airports; and
- demand forecasts and the implications this has for capacity constraints.

6.172 In the Initial Views, the CAA indicated that:

- Gatwick has been operating with consistently high utilisation rates of its single runway for the last 10 years, with utilisation rates around 80 per cent, although this can go higher in individual time frames, e.g in the 5-7am time window for departures in the summer season.<sup>478</sup>
- Capacity constraints in the South East of England are contributing to reduce competitive constraints faced by Gatwick.<sup>479</sup>

6.173 In response to the Initial Views, GAL indicated that there is adequate capacity available in airports in the South East to accommodate sufficient airline and passenger switching.<sup>480</sup> It maintained that recent findings of the CC, as well as DfT passenger forecasts that go to 2030, indicated that airports in the South East have substantial capacity to handle additional ATMs and passengers.

6.174 In addition, GAL considered that capacity is available and can be expanded at Stansted and Luton. It noted that Frontier Economics' evidence "provides some corroboration" for its views regarding the availability of peak capacity in Stansted and Luton.<sup>481</sup> It also considered that Heathrow, notwithstanding it being '*one of the most intensively used airports in the world*' could increase capacity, including in peak periods, by using larger bodied aircraft and increased load factors.<sup>482</sup> GAL also considered that the economic

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<sup>478</sup> CAA, Initial View, p. 89.

<sup>479</sup> CAA, Initial View, p. 90.

<sup>480</sup> Source: GAL, Airport Competition: Competing to Grow and become London's airport of choice, November 2011, Ref: Q5-050-LGW05, pp. 50-56.

<sup>481</sup> Source: GAL.

<sup>482</sup> Source: GAL, Airport Competition: Competing to Grow and become London's airport of choice, November 2011, Ref: Q5-050-LGW05, pp. 50-52.

downturn had increased the level of capacity in the South East.<sup>483</sup>

6.175 GAL also noted that:

- *The CAA's assessment and treatment of capacity constraints in the south east is inappropriate and such capacity constraints are in themselves not a source of market power.*<sup>484</sup> The CAA's assessment should also take into account other factors which are likely to enhance available capacity, even during peak periods. These include enhanced incentives for efficient use of runway capacity, the ability to acquire peak slots through secondary trading and other mechanisms and the ability to switch to larger aircraft.<sup>485</sup>
- The presence of capacity constraints is not inconsistent with a finding that effective competition is present.<sup>486</sup>
- The discussion of capacity does not appear consistent with the CAA's geographic market definitions.<sup>487</sup>

6.176 The CAA notes that, since the publication of the Initial Views, it has:

- undertaken further analysis on capacity constraints; and
- sought to ensure greater consistency in both its approach and in the phrasing that it uses in its documents.

6.177 The CAA also notes that capacity constraints experienced by actual and potential substitute airports can affect the ability of airlines, including LCCs and charters, to switch marginal services between them. Analysing the extent of capacity constraints across London airports can therefore inform the scope for LCC and charter substitution to and from Gatwick, and consequently the extent to which these airlines might be able to constrain GAL's behaviour.

6.178 In addition, the CAA notes that to allow efficient aircraft utilisation, LCCs and charters with based aircraft require early morning departure slots as this allows a sufficiently early departure to serve passenger

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<sup>483</sup> Source: GAL, Airport Competition: Competing to Grow and become London's airport of choice, November 2011, Ref: Q5-050-LGW05, pp. 50-55.

<sup>484</sup> Source: GAL.

<sup>485</sup> Source: GAL.

<sup>486</sup> Source: GAL.

<sup>487</sup> Source: GAL.

demand and allow the aircraft to perform the minimum number of rotations that are necessary. Indeed, the CAA's discussions with LCCs and charters suggest that access to these slots is fundamental to the successful implementation of their business models. Similarly, long-haul charters and LCC would need appropriately timed (usually early morning slots), to ensure they arrive/depart at appropriate times in such places as Canada, the Caribbean and the United States of America.

- 6.179 Given the importance of access to these slots, for based LCCs and charters flying short-haul routes to consider switching to another London airport, there needs to be sufficient capacity<sup>488</sup> at an alternative airport to meet both morning and evening peak requirements.<sup>489</sup> In addition, due to the typical "back and forth" pattern of some of these aircraft, there also needs to be sufficient capacity available outside of this period for further rotations.
- 6.180 Similarly, access to appropriate slots for long-haul LCCs and charters will be important if they are to consider switching to another London airport.
- 6.181 Slot utilisation, aircraft parking and terminal facilities are not, however, the only factors that needs to be considered when examining capacity constraints. Other factors that also need to be considered include capacity utilisation (see below) and aircraft size.

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<sup>488</sup> In terms of terminal, aircraft parking stand and runway slot capacity.

<sup>489</sup> In particular, an alternative airport would need to be able to accommodate the first rotation of all necessary aircraft during the early morning departure peak period (which is approximately between 0600 and 0759 BST), and during the evening peak arrival period as the aircraft return to base.

6.182 With respect to aircraft size, the CAA notes that the use of larger aircraft at Gatwick and across the London system could help alleviate capacity constraints going forward. However, there are a number of issues that need to be considered within the LCC and charter context, including:

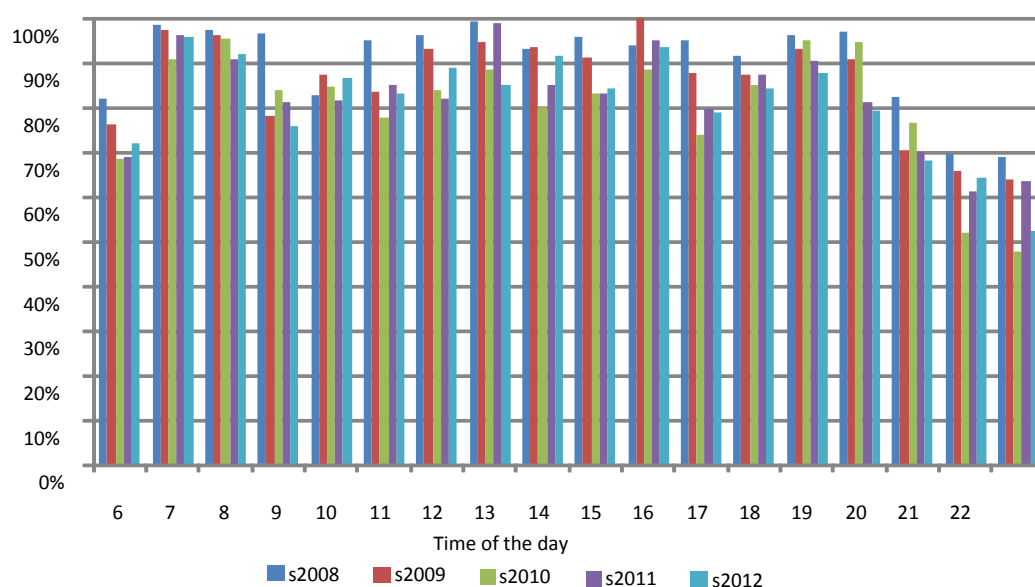
- The LCC (short and long-haul) business model tends to, amongst other factors, minimise costs by having fleet uniformity and having high seat capacity (given the undifferentiated passenger class). Thus, changing only a limited number of aircraft or flying larger aircraft with fewer occupied seats (assuming that demand does not increase uniformly across its network) may lead to additional costs and lower margins.
- Higher frequency of smaller aircraft may more appropriately meet passengers' preferences as to when they fly (and may be important if a LCC was looking to capture more of a different market segment, such as passengers travelling for business. For example, having one flight (on a larger aircraft) at one time of the day may (rather than two flights on smaller aircraft), result in a passenger selecting a non LCC rather than an LCC airline due to reduced scheduling.
- There may be capacity constraints at airports that limit the scope for larger aircraft to be used. For example, the scope for LCCs to use larger aircraft at Luton and Southend would not be possible in the short term as these airports' runway are not of sufficient length. Given that LCCs often fly to secondary airports this problem may be particularly acute.
- The ordering and purchasing of new aircraft can take some time, and assumes that that an airline is able and willing to finance those aircraft.

6.183 The CAA therefore considers that, while increasing aircraft size for LCCs and charters can look to address some capacity constraints, the scale of change required over the next few years is unlikely to play a significant role in expanding capacity in the London system.

## Capacity utilisation at Gatwick

6.184 As outlined in chapter 2, LCCs and charters represent around 47 per cent and 19 per cent of Gatwick's customer base when measured by passengers.<sup>490</sup> Slot utilisation is high throughout the day in the summer traffic season, and there appears to be very little available departure slot capacity during the early morning period to accommodate additional based aircraft for either scheduled or charter services from LCCs. This is illustrated in Figure 6.3 below.

**Figure 6.3: Slot utilisation per week, Summer 2008-2012 (ATM/ACL declared capacity)**

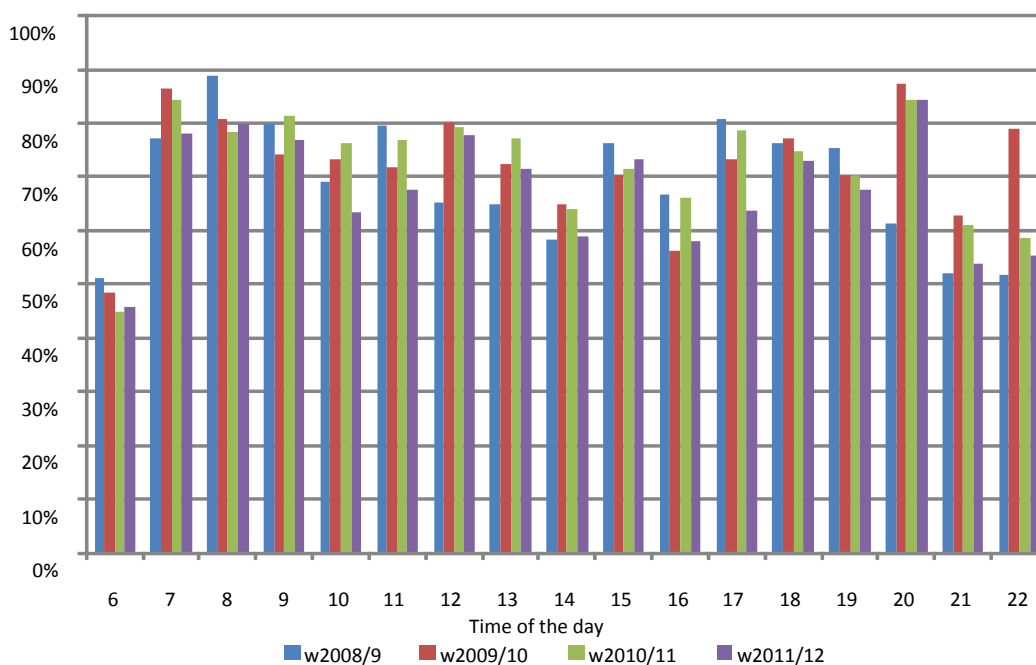


Source: CAA airport statistics and ACL declared capacity data

6.185 Gatwick does, however, have more capacity available during the mid-morning and mid-afternoon periods, and there is a greater level of capacity available during winter (see Figure 6.4).

<sup>490</sup> The CAA has included all of Thomson and Monarch's flights as charter operations for the purposes of this estimate, although many of their operations are scheduled.

**Figure 6.4: Slot utilisation per week, Winter 2008/09-2011/12 (ATM/ACL declared capacity)**



Source: CAA airport statistics and ACL declared capacity data

- 6.186 The CAA's analysis also suggests that there is currently sufficient aircraft parking stand capacity as well as sufficient terminal capacity to accommodate additional based aircraft.
- 6.187 The CAA notes that the airport's capacity expansion plans are also likely to only increase available capacity at the margins, as Gatwick is not currently permitted to build a second runway. Better utilisation is likely to be the only increase until 2025, and this could increase scope for switching from other airports. However, the CAA considers that this would principally depend on the scope for increasing declared departure capacity during the early morning peak for the summer traffic seasons, and the extent to which this capacity expansion allows underlying demand growth to be accommodated.

- 6.188 The availability of some departure slot capacity is also likely to provide GAL with an incentive to attract additional traffic from incumbent or new airlines, through offering discounts for new routes and/or increased passenger numbers. However, the CAA notes that in examining the availability of early morning departure slot capacity<sup>491</sup>, a key operating window for a based LCC or charters, there does not appear to be sufficient capacity available to make a substantial switch to Gatwick.
- 6.189 The CAA notes that while some slots may be available at Gatwick, this capacity is unlikely to affect the ability of LCCs and charters to discipline GAL to any significant degree.
- 6.190 The CAA considers that the ability of these airlines to constrain GAL will be determined by the ability of airlines to switch away aircraft from Gatwick and, importantly, the availability of spare capacity at substitute airports. The CAA notes, however, that this needs to be considered in light of the relevant markets, and as per the discussion on market definition (chapter 5), the CAA considers that for LCCs and charters, the market is limited to Gatwick but could include Luton and Stansted. Issues associated with capacity at other London airports are briefly outlined below.

### Capacity utilisation at Stansted

- 6.191 STAL has indicated that, in annual terms, Stansted is operating at 50 per cent of capacity, with the extent of spare capacity varying according to different traffic seasons, weeks, day and times of day. It has also indicated that during the early morning departure peak, Stansted's busiest time, there were typically 20 departure slots unused in the summer 2012 traffic season.
- 6.192 The CAA's analysis of capacity constraints at Stansted confirms that, on average, there were approximately 20 early morning departure slots unused in the summer 2012 traffic season.<sup>492</sup> In addition, the CAA's analysis identified that:

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<sup>491</sup> See charts above.

<sup>492</sup> Stansted also submitted movement data showing the number of departures during the early morning peak has fallen over time since 2007. As CAA Airport Statistics use the same data, our findings are consistent.



- there is a considerable amount of departure and arrival slot capacity across the rest of the day;
- slot utilisation is higher during the summer season than during the winter traffic season, though the utilisation pattern remains similar; and
- there are currently no binding aircraft parking stand capacity constraints.

6.193 The CAA notes that in addition to the existing spare capacity at Stansted, STAL has a number of capacity expansion plans – linked to taxiway, terminal and stand capacity – which would need to be implemented when passenger traffic reaches (depending on the project) 25, 30 or 35mppa.<sup>493</sup>

6.194 The CAA considers that this suggests (putting aside switching costs), that LCCs and charters, including long-haul LCCs and charters, could switch away aircraft from Gatwick to Stansted. The CAA notes, however, that the actual ability to successfully operate such services from this airport may be quite limited. Charters, in particular, may find the ability to successfully operate from other London airports quite difficult due to smaller catchments and Gatwick’s status as the “default airport for holiday flights” – see section 3. For example, Thomas Cook (who provide short and long-haul charter services) indicated:

*It is possible to fly from Stansted but the catchment is small and local. It also does not have a reputation for being a package holiday departure point.*<sup>494</sup>

6.195 Monarch (who provides scheduled and charter services) also indicated:

*It has operated from Stansted in the past, but these would have been sporadic charter flights. It hasn’t had a based aircraft at STN for the last 15 years. [And] Stansted’s location isn’t very convenient for Gatwick customers.*<sup>495</sup>

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<sup>493</sup> Source: STAL.

<sup>494</sup> Source: Thomas Cook.

<sup>495</sup> Source: Monarch.

- 6.196 Similarly, Air Asia X, which started operating at Stansted before switching to Gatwick (and then ceasing to operate out of London) noted the importance of Gatwick's [X]:

*[X] played an important role. There were repeated demands by passengers to move to either LGW or LHR, and the move was a response to these demands. LGW is easier to get to and cheaper for both the UK and Asia markets. [X]<sup>496</sup>*

And:

*The airline did not consider switching from STN to any airport other than LGW.<sup>497</sup>*

### Capacity utilisation at Luton

- 6.197 The type of airline business at Luton is similar to Stansted's, with LCCs constituting most of Luton's airline business.<sup>498</sup> However, Luton also has a number of airlines operating long-haul services.

- 6.198 The availability of departure slots during the early morning peak and the off-peak periods at Luton suggests that based low cost and charters might, in theory, have scope to move aircraft or services from Gatwick to Luton. However, limited aircraft parking stand capacity at the Luton means that few additional aircraft could be based at the airport. In addition, there will be some limitations as to the size of the aircraft that can operate from the airport.

- 6.199 Furthermore, Luton is restricted in terms of the type of operations they can support due to runway length. For example, London Luton Airport Operations Limited (LLAOL) told the CAA that:

*The [Luton] runway of approximately 2km in length largely precludes long-haul traffic from operating. The model is based on high frequency; short sector (mostly 2 hours and a couple of 5/6hours).<sup>499</sup>*

- 6.200 Similarly, Monarch has indicated:

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<sup>496</sup> Source: Air Asia X.

<sup>497</sup> Source: Air Asia X.

<sup>498</sup> See Annex 4 of the Stansted minded to document for more details.

<sup>499</sup> Source: LLAOL. Luton has since stated that with recent improvements to aircraft technology, new aircraft such as the B787 which have shorted take off distances, could potentially facilitate long haul aircraft.

*Some of the aircraft types it operates from LGW would struggle to operate with the same payload out of LTN with its shorter runway. For longer and transatlantic routes, this would be impossible (for example [✕]).<sup>500</sup>*

- 6.201 Luton's current Masterplan does however outline plans to expand the number of aircraft stands and increase peak movement rate from 34 to 40 movements per hour by 2031, with a forecast increase from 9.5mppa in 2011/12 to 12.1mppa by 2019. These plans could, in the long term, increase the number of based LCC and charter aircraft that could switch from Gatwick. Projects to expand terminal capacity have also been put forward.<sup>501</sup>
- 6.202 The CAA considers that this suggests (putting aside switching costs), that the scope for LCCs and charters to switch away aircraft from Gatwick to Luton in the short or medium term is relatively limited (although in the longer term this may be possible).

### Capacity utilisation at Southend

- 6.203 In April 2012, easyJet commenced operations at Southend following the relocation of three aircraft previously based at Stansted.<sup>502</sup> Southend expects traffic to reach between 600,000 and 700,000 passengers in 2012 and 2 million passengers by 2020.
- 6.204 The CAA notes that while the airport could technically handle more passengers, there is currently an air traffic movement cap in place which restricts the total number of flights. Perhaps more importantly, although the airport capacity is not currently impacted by the air traffic movement limits, Southend is an airport of limited size and overall capacity.<sup>503</sup>
- 6.205 The runway at Southend is 1739m TORA, which means that some aircraft, for example Ryanair's current aircraft, are unable to operate

<sup>500</sup> Source: Monarch.

<sup>501</sup> LLAO Masterplan, September 2012, available at: <http://www.london-luton.co.uk/en/content/8/1171/Masterplan.html>, (accessed January 2013).

<sup>502</sup> easyJet's passengers constitute around 90 per cent of Southend's traffic, followed by approximately 9 per cent of passengers being transported by Aer Arann. These shares were constructed using passenger data at the airport between April and September 2012.

<sup>503</sup> Source: Southend Airport.

from this airport.<sup>504</sup> This physical characteristic of the airport suggests (putting aside switching costs), that the scope for other Gatwick LCCs and charters to relocate aircraft to Southend may be relatively limited, as they may face similar operational difficulties.

### Capacity utilisation at Heathrow

- 6.206 Discussions with LCCs and charters have, in general, suggested that Heathrow is not a realistic alternative airport due to its high charges and/or capacity constraints, although they could in theory operate out of the airport. This is a view that the CAA considers that GAL shares, as GAL's stakeholder discussion documents state: '*London Heathrow is full with no mixed mode possible*'.<sup>505</sup>
- 6.207 This chapter does not examine Heathrow's capacity constraints as they are not relevant to LCCs and charters. This issue is discussed in the chapter dealing with capacity constraints and FSCs (chapter 7).

## Section 6: Demand forecasts and implications for capacity constraints

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- 6.208 The way in which capacity constraints at London airports are expected to evolve in the short to medium term has implications for the dynamic assessment of market power of GAL in both the LCC and charter market and the FSC and associated feeder market. To this end, the CAA examined a range of forecasts and estimates that have been produced to inform its view on capacity constraints going forward. The CAA notes that this issue was not explored in much detail in the Initial Views.

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<sup>504</sup> Source: Ryanair, <http://www.caa.co.uk/docs/5/MOLearytoIO25112011.pdf>, paragraph 5 and Southend Airport.

<sup>505</sup> Source: GAL.

- 6.209 The CAA notes that it has seen evidence from GAL that indicates that it considers that 'LGW will benefit from LHR overflow traffic once slots there become full and there is no room for extra capacity / new entrants'.<sup>506</sup> GAL marketing material also supports this view. In particular, evidence submitted to the CAA by GAL suggests while it has limited capacity it will benefit from airport growth in the London market as Heathrow is full. Specifically, GAL indicated:
- *London market growth 31% to 2017*
  - *London Heathrow is full with no mixed mode possible*
  - *Gatwick has limited capacity*
  - *Significant differential in airport charges vs. Heathrow.*<sup>507</sup>
- 6.210 The view that there are constraints in the London system is further supported by more recent (2012) work undertaken by GAL's consultants, assessing the risks presented by a commercial transaction, which noted (amongst other things):
- Heathrow is operating very close to its maximum ATM capacity limit, which is not expected to rise further;
  - Grandfathered rights for existing users make it very difficult (and/or expensive) for new entrants to grow at Heathrow. This, coupled with the airport's operational resilience challenges, [redacted];<sup>508</sup> and
  - [redacted].<sup>509</sup>
- 6.211 GAL's consultants have, however, identified that while Heathrow's runways are full, the airlines that have slots could increase capacity through using larger aircraft in line with terminal capacity. There is considerable evidence that airlines are already doing this, particularly with the introduction of the 'double decker' airbus A380 aircraft on key long-haul markets. In addition, certain secondary slot trading mechanisms can facilitate market entry to Heathrow, particularly for

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<sup>506</sup> Source: GAL.

<sup>507</sup> Source GAL.

<sup>508</sup> Source: GAL.

<sup>509</sup> Source: GAL.

long-haul airlines buying slots from short haul carriers.<sup>510</sup>

6.212 GAL's 2012 Master Plan also highlights that '[a]s local markets grow beyond the capacity of individual airports, the unfulfilled demand will either spill to another airport or will be lost to the wider market. With a single runway Gatwick has sufficient runway capacity until around 2024/25 when some traffic is expected to be forced elsewhere'.<sup>511</sup>

6.213 Importantly, over the forecast period, GAL's 2012 Master Plan notes that:

- the mix of routes it caters to is expected to change as it attracts new long-haul services to Gatwick;<sup>512</sup>
- in 2011/12 6.2 per cent of all passenger ATMs at Gatwick were destined for long-haul markets. By 2021/22 long-haul destinations are expected to account for 8.2 per cent of passenger ATMs although it should be noted that a higher proportion of charter traffic will also be flying on long-haul routes (about 15 per cent of charter total);
- there is potential for long-haul leisure markets to shift from Heathrow to Gatwick and potential for more long-haul services from Gatwick to some of the world's fastest growing economies,<sup>513</sup> and
- there is an expectation that the average load, which was 140 passengers in 2011/12, will rise to 148 in 2021/22 and that this increase is expected to be achieved through a combination of higher load factors and increasing seats per aircraft movement, as airlines up-size their fleets over time.<sup>514</sup>

6.214 GAL also outlined passenger forecasts within a number of other consultation documents, including its revised business plans to 2024. Within that document, GAL indicated that:

*In January 2012, at the request of Gatwick, SH&E updated the long term passenger forecast. This forecast underpinned the Initial Business Plan. The updated forecasts were somewhat lower than*

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<sup>510</sup> Source: GAL.

<sup>511</sup> Source: GAL, Gatwick Master Plan, July 2012, p. 34.

<sup>512</sup> Source: GAL, Gatwick Master Plan, July 2012, p. 36.

<sup>513</sup> Source: GAL, Gatwick Master Plan, July 2012, p. 36.

<sup>514</sup> Source: GAL, Gatwick Master Plan, July 2012, p. 36.

*those presented in May 2011, reflecting the slightly softer demand outlook.*

*In September 2012, at the request of Gatwick, SH&E further updated the forecasts in order to inform the Revised Business Plan. Gatwick was able to share these forecasts with its airline customers through Constructive Engagement.<sup>515</sup>*

6.215 The CAA notes that the reasonableness of GAL's passenger forecast is being assessed as part of the Q6 process. It does, however, note that as part of the Q6 constructive engagement process, a Constructive Engagement Working Group (CEWG) comprising representatives from GAL and airlines was formed to constructively engage on GAL's initial business plan, including its passenger forecasts. The CAA notes while there appears to be no major disagreement on the approaches to forecasting passenger numbers, there is currently no agreement on the traffic forecasts that should be used for forward planning.<sup>516</sup>

6.216 Looking to further consider the relevant information available, the CAA has considered the DfT's 2012 Aviation Demand Forecasts. These forecasts state that:

*In the central forecast, the five largest South East airports are forecast to be full by 2030. However, the high and low demand scenarios underline the uncertainty around this conclusion. With the range of demand used they could be full as soon as 2025 (the high case) or take until 2040 (the low case). Heathrow had effectively reached capacity in 2011 and it is forecast to remain at capacity in all scenarios. In the high and central demand cases, a number of other airports are expected to reach capacity over the forecast period including Birmingham, Bristol, East Midlands and Manchester.<sup>517</sup>*

6.217 The CAA also notes that DfT's constrained forecasts make a number of assumptions, including:

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<sup>515</sup> Source: GAL.

<sup>516</sup> This is taken from the CAA's understanding of the process to date.

<sup>517</sup> Source: DfT, Aviation Forecasts 2012, p. 8 – available at:

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/70259/aviation-forecasts.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/70259/aviation-forecasts.pdf)

- no new runways are built in the UK. The CAA considers this to be reasonable for forecasts, at least up to 2020, as the Davies Commission is scheduled to report in 2015 and there would a lag in capacity becoming available following this decision;
- schemes that are already in the planning system and airport masterplans are implemented by 2020;
- incremental growth to full potential long-term capacity by 2030 taking into account the airports' own longer term plans, physical site constraints and up to 13 per cent capacity gain (where possible) through operational and technological improvements;
- terminal capacity increased incrementally to service additional runway capacity; and
- no changes after 2030.

6.218 Based on those assumptions, DfT's Aviation Forecasts find that capacity utilisation will reach 100 per cent for Heathrow and Gatwick by 2020, and London airports overall will have 86 per cent utilisation.<sup>518</sup> This is illustrated in Figure 6.5 below:

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<sup>518</sup> The CAA notes that DfT's 2012 constrained forecasts are lower than the forecasts that it produced in 2011. However, the CAA considers that the evidence clearly suggests that capacity constraints will tighten in the short to medium term up to at least 2020, as no new runway capacity is currently expected before that date.



**Figure 6.5: DfT's runway capacity forecasts – UK airports runway capacity used, 2010-2050, 'max use' capacity scenario (central forecast)**

Airport	2010	2020	2030	2040	2050
Heathrow	99%	100%	100%	100%	100%
Gatwick	90%	100%	100%	100%	100%
Stansted	58%	69%	100%	100%	100%
Luton	59%	60%	100%	100%	100%
London City	56%	87%	100%	100%	100%
Southend		42%	100%	100%	100%
London	81%	86%	100%	100%	100%
Manchester	49%	57%	55%	58%	100%
Birmingham	45%	56%	79%	100%	100%
Bristol	35%	38%	37%	100%	100%
East Midlands	22%	17%	20%	43%	100%
Southampton	27%	36%	52%	100%	100%
Other modelled	22%	24%	28%	33%	43%
National	39%	43%	50%	54%	63%

100 per cent = runway or terminal capacity exceeded, other per cent refer to runway usage.

Mainland UK airports only

Source: DfT Aviation Forecasts 2012

6.219 In addition, the analysis suggests that Gatwick (and Stansted) may benefit from “spill” of international destinations from Heathrow up to 2030 – see Figure 6.6 (below). The CAA notes that while this figure suggests that Heathrow can grow, this growth is limited, with the number of international destinations that Heathrow is able to service between 2011 and 2030 only increasing by 1 destination.

**Figure 6.6: DfT's projected aircraft spill to Gatwick (and Stansted) – Modelled international destinations served at selected UK airports, 2011, 2030 & 2050, central demand**

	All types of carriers 2011*	All types of carriers 2030	All types of carriers 2050
Heathrow	135	136	121
Gatwick	79	86	83
Stansted	56	74	68
Luton	26	42	31
London City	17	22	14
Southend	0	5	4
London **	178	212	230
Manchester	40	65	105
Birmingham	21	40	67
Glasgow	6	6	12
Edinburgh	11	20	31
Newcastle	6	8	17
Belfast International	1	9	16
Bristol	13	28	41
Liverpool	15	23	35
East Midlands	7	9	54
Other modelled airports	22	49	79
Total **	178	215	242

\* 2011 is modelled. Modelled numbers will vary slightly from observed patterns because they represent a full year of operation: observation data will include seasonal services and new start-ups or routes withdrawn during the course of the year.

\*\* Total different destinations available, not sum of individual airport destinations.

Source: DfT Aviation Forecasts 2012

- 6.220 Based on the evidence outlined above, the CAA considers that, notwithstanding the scope for better utilisation of runways and the potential use of larger aircraft, Gatwick is likely to benefit from the expected tightening of capacity constraints across the South East. In particular, this outcome may increase the relative power of GAL in its negotiations with airlines.
- 6.221 The CAA notes that while larger aircraft and better utilisation of slots may, to a certain extent, help to address expected capacity constraints, based on DfT's and GAL's passenger forecasts, the CAA is minded to conclude that, in the next five years, the tightening of capacity constraints at Heathrow are likely to result in an increase in the degree of market power at the London airports that have spare capacity.

## Section 7: Entry and expansion by other airports

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- 6.222 In this section, the CAA briefly outlines:
- what it said in the Initial Views on barriers to entry and expansion by other airports; and
  - the actual evidence of entry or expansion.
- 6.223 The CAA considers that this discussion is relevant to the discussion on both the LCC and charters market and the FSC and associated feeder market (see next chapter).
- 6.224 In the Initial Views, the CAA noted that:
- competitive constraints can arise from entry and/or expansion of airports in the relevant market(s);
  - the impact of this form of competitive constraint will be limited by the magnitude of barriers to airport entry and expansion; and
  - in the context of the airports in London and the South East of England, and in the UK more generally, the likelihood of new entry the short to medium term is very low.<sup>519</sup>

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<sup>519</sup> CAA, Initial Views, p. 90.

- 6.225 GAL, in response to the Initial Views, noted (among other issues) that the CAA underestimates the scope for supply side substitution. In particular, GAL stated that:

*the CAA's analysis significantly understates the potential for supply-side substitution in response to a price rise. ... A particular example where this could impact the outcome of the CAA's analysis is the CAA's view that other airports such as Stansted could not provide services to long-haul airlines on the basis that it currently (i.e. whilst under BAA's ownership) does not provide any such services.*<sup>520</sup>

And:

*Competition to deliver new runways and/or other forms of capacity expansion (or market re-orientation) remains a real possibility. By focussing solely on the state of competition at a "snapshot" in time, the CAA fails to take into account the likelihood that continuing to regulate will result in major distortions to incentives in respect of capacity and service provision.*<sup>521</sup>

- 6.226 Since the publication of the Initial Views, the CAA has considered the scope for entry and expansion of other airports in more detail, as additional alternative airports could have a significant effect on decisions made by stakeholders. The CAA's thoughts on this issue, which address GAL's concerns, are outlined below.

## Barriers to entry and expansion

- 6.227 The Guidelines note that barriers to entry in airport markets are particularly high and that expansion of existing airports is more likely to represent a competitive constraint on existing airports than the threat of entry by an entirely new airport.<sup>522</sup> New airports can

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<sup>520</sup> Source: GAL.

<sup>521</sup> Source: GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref Code: Q5-050-LGW09, pp. 10-11. The CAA notes that GAL also raised the scope for competition with other modes of transport (GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, Q5-050-LGW05, November 2011, p. 83), and as a result, the entry and expansion of these alternative modes of transport may affect the demand for current and future aircraft. The CAA does not, however, explore this issue in this chapter – see chapter 3.

<sup>522</sup> The Guidelines are available on the CAA's website:

<http://www.caa.co.uk/docs/5/Final%20Competition%20Assessment%20Guidelines%20-%20FINAL.pdf>

sometimes enter the market, but the investment and lead times involved in new entry are likely to significantly limit the impact of this form of competitive constraint.<sup>523</sup>

- 6.228 Expansion and/or entry by existing aerodromes, and/or the threat thereof, may represent a source of competitive constraint. However, as in the case of a new airport, the cost and timescales involved in expanding to accommodate sufficient switching may still be too great to constrain GAL's prices in the short to medium term.

### Evidence of actual entry or expansion

- 6.229 One way to understand the nature of barriers to entry and expansion is to consider the history of entry and expansion in the market. As outlined in the Initial Views, there is very limited evidence of significant entry or expansion in the relevant markets. However, there are two recent examples of expansion in the form of Southend and the recent announcement of Luton's intention to increase capacity:

- In April 2012, easyJet opened based operations at Southend airport. Although Southend airport constitutes entry on a relatively small scale and does not compete with Gatwick, the airport currently has plans to expand to handle 2 million passengers by 2020.<sup>524</sup>
- Luton airport's Masterplan sets out a plan to increase capacity at the airport from 10.3mppa in 2013 to 18mppa by 2030, including a forecast increase in traffic up to 12.1mppa by 2019.<sup>525</sup>

- 6.230 The CAA notes that the Government has currently put a hold on the expansion of the 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 also considers that any change in government policy following the release of the Davies Commission final report is likely to take some time to be implemented and that any significant capacity expansion is not expected until 2025, outside the timeframe for considered as part of this market power assessment.

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<sup>523</sup> For example, Robin Hood Doncaster Sheffield airport opened in April 2005, and London City Airport opened in 1988.

<sup>524</sup> Source: Southend Airport.

<sup>525</sup> For more information see: <http://www.london-luton.co.uk/en/content/8/1171/Masterplan.html>

- 6.231 In summary, while the use of larger aircraft and relatively small scale expansion is possible, the CAA considers that the timescale required achieving adequate airport expansion/new entry to accommodate sufficient switching is too long to constrain prices in the short term. The CAA also notes that (as per the previous section) that DFT's and GAL's passenger forecasts suggest that over the next five years, the tightening of capacity constraints at Heathrow are likely to result in an increase in the degree of market power at the London airports that have spare capacity.
- 6.232 The CAA also considers that there is, however, some potential for larger aircraft and expansion projects to constrain pricing through the loosening of capacity constraints in the LCC and charter market in the medium term.

## Section 8: 'Minded to' conclusions on potential competitive constraints for LCC and charters

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- 6.233 In this chapter, the CAA considered the extent to which LCCs and charters are actually able to switch marginal services out of Gatwick. In principle, GAL's ability to exploit market power could be constrained by the switching behaviour of airlines within Gatwick's LCC and charter market.
- 6.234 Based on the above evidence, the CAA considers that the ability of LCCs and charters to switch marginal aircraft out of Gatwick is more limited than it outlined in the Initial Views. In particular, the CAA considers that there are sunk and strategic switching costs that may make it relatively difficult for these airlines to move. For example:
- easyJet, notwithstanding having a relatively large presence at Gatwick, has a relatively limited degree of countervailing buyer power and the CAA considers that this will continue going forward. In particular, the CAA considers that easyJet's large presence (and associated sunk costs) at the airport and its relatively limited scope to transfer aircraft to other London bases has contributed to this.<sup>526</sup>

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<sup>526</sup> While the CAA notes that in its minded to decision on Stansted that it found that easyJet was well positioned to leverage Stansted, this threat is not as relevant for Gatwick.

- Based charters countervailing buyer power towards GAL is limited, and GAL is likely to hold the stronger negotiating position for the foreseeable future, in part exacerbated by the charters' inability to switch to other airports.<sup>527</sup>

6.235 The CAA also considers that, in the next five years, there will be a tightening of capacity constraints at Heathrow which is likely to result in an increase in the degree of market power at the London airports, including those that currently have spare capacity, such as Gatwick. Given its range of facilities and some degree of spare capacity at key periods, the CAA anticipates that GAL is likely to be a significant beneficiary of this spill over effect.<sup>528</sup>

6.236 In addition, the CAA notes that while expansion of capacity in the market is possible, the timescale required to achieve adequate expansion to accommodate sufficient switching is too long to constrain GAL's prices in the short term. However, in the medium term, the CAA considers that there is some potential for future development to constrain GAL's pricing. The CAA also notes that the Davies Commission is due to report in 2015 its findings on airport expansion, but significant capacity expansion is not expected until 2025.

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<sup>527</sup> The CAA notes that inbound LCCs and charters are also present at the airport and that relative to their size they may have relatively greater counter veiling buyer power. The CAA also notes that while there are a number of issues that may limit the willingness of these airlines to select an alternative London airport, including the quality of Gatwick's catchment and its reputation as the holiday airport, there is often relatively more scope for these airlines to move if the price and/or quality that is being offered is insufficient to meet their needs. This issue is addressed in chapter 9, in the discussion on negotiations.

<sup>528</sup> The CAA also notes that even if Gatwick was not regulated, GAL may benefit through the overflow from Heathrow, as this is likely to put upward pressure on prices.

## CHAPTER 7

# Competitive constraints – FSCs and associated feeder traffic airlines

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## Background

### Section 1: Introduction

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- 7.1 This chapter considers the existence and the potential strength of the competitive constraints faced by GAL in the full service carriers (FSCs) and associated feeder airline market identified in chapter 4. This involves a consideration of:
- the ability and likelihood of airlines to switch marginal services away from Gatwick in light of a ten per cent price increase; and
  - whether the extent of such substitution would be sufficient to constrain GAL's pricing and behaviour.
- 7.2 This chapter also analyses the ability of FSCs and associated feeder traffic airlines to constrain the airport operator by credibly threatening to switch away services during negotiations. The implications of capacity constraints in the relevant market are also considered. Barriers to entry and expansion of airports and the implications of future demand forecasts were examined in chapter 5. They are considered specifically with regard to the Gatwick FSCs and feeder airline market in this chapter.
- 7.3 This chapter builds on the analysis that was undertaken in the Initial Views and is structured as follows:
- Section 2 considers the types of switching available to FSCs and feeder airlines to constrain the airport, in light of a SSNIP, and whether these could be a realistic response;
  - Section 3 analyses the switching costs and practical considerations that airlines may face;
  - Section 4 considers whether FSCs and feeder airlines at Gatwick might be in a position to constrain GAL's pricing through countervailing buyer power;



- Section 5 examines the capacity constraints at Gatwick and Heathrow and the potential implications for FSCs and feeder airlines seeking to switch away from Gatwick; and
  - Section 6 concludes as to the potential competitive constraints that FSCs and associated feeder traffic airlines might impose on GAL.
- 7.4 The analysis in this chapter takes into account two general types of airline business models, both of which may be either based or inbound at Gatwick:
- FSCs<sup>529</sup>, which may operate long-haul and/or short-haul routes; and
  - carriers for which business models are, in part, aimed at providing feeder traffic for FSCs and which typically operate domestic or short-haul routes.
- 7.5 The CAA notes that in response to the Initial Vies where that GAL contends that the CAA has failed to assess competitive constraints at the margin, instead its analysis of switching opportunities is improperly based on averages.<sup>530</sup>
- 7.6 The CAA agrees with GAL that the analysis of competitive constraints should be considered at the margin. In this chapter, the CAA considers the scope for FSCs and associated feeder traffic airlines to constrain GAL by switching away marginal units and the implications of any interrelationships between their business models.

## Section 2: Potential options for FSCs and associated feeder traffic airline switching

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- 7.7 As outlined in chapter 4, to impose a competitive constraint on GAL, the scale of switching of marginal services, following a price increase (or a fall in service quality or investment), must be sufficiently large to make a price increase unprofitable for the airport.

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<sup>529</sup> These typically include the national flag “legacy” carriers of different countries, and provide differentiated cabin classes. In addition, they tend to operate hub-and-spoke services from one of their respective country’s largest airports.

<sup>530</sup> Source: GAL.

- 7.8 In this section, the CAA looks at (as per section 2, chapter 6), four possible types of switching to determine how FSCs and feeder airlines are most likely to try to constrain GAL by switching away marginal services.<sup>531</sup>

### Allocating growth to other airports

- 7.9 Allocating volume growth to other airports, by opening new routes or increasing frequencies on routes operated elsewhere, is one way an airline could discipline an airport. The CAA notes that the general considerations regarding the requirements and limitation of this form of switching are discussed in chapter 6 (and are not repeated here).

### Based FSCs and associated feeder traffic airlines

- 7.10 The largest FSCs based at Gatwick, British Airways (BA) and Virgin Atlantic (Virgin), also have the largest based operations at Heathrow<sup>532</sup>, with Virgin also basing a smaller number of aircraft at Manchester.
- 7.11 In theory, both these airlines could allocate new growth to other airports from which they operate. However, the limited spare slot capacity available at Heathrow, and the cost of slot acquisition, is likely to restrict that in practice.<sup>533</sup> In addition, the comparatively limited demand for long-haul departures at regional airports is likely to restrict the scope for allocating new growth to those airports.
- 7.12 The CAA notes that there are also a number of other FSCs based at Gatwick, such as Aer Lingus and Flybe (up until 2012), which operate a larger number of bases at other, less capacity-constrained, airports. A broader distribution of their capacity across airports might enable airlines to allocate new growth to another airport more easily.
- 7.13 Another option that FSCs could use to try and constrain GAL could be

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<sup>531</sup> The four possible types of switching are: (1) volume growth could be allocated to other airports, by opening new routes or increasing frequencies on routes operated elsewhere; (2) decreasing the frequency of existing services to and from the airport, for based and/or inbound aircraft; (3) grounding aircraft or reducing the use of based aircraft during a particular traffic season; and/or moving based aircraft to other bases, or opening a new base by relocating aircraft currently at the airport.

<sup>532</sup> BA bases its operations at Heathrow and Gatwick, while Virgin has based aircraft at Heathrow, Gatwick, and Manchester.

<sup>533</sup> Capacity constraints and slot acquisition are discussed in more detail below.

to allocate new growth to another airport by opening a new base. However, due to the considerable costs involved in opening a new base, (see discussion below), this is unlikely to occur in response to a ten per cent price increase.<sup>534</sup>

### **Inbound FSCs and associated feeder traffic airlines**

- 7.14 In contrast to based carriers, inbound FSCs and associated feeder traffic airlines at Gatwick are typically flying 'spoke' services between the airport and their respective domestic hub(s) (or base airports for feeder airlines). For example, Emirates flies spoke services from Gatwick to its hub in Dubai.
- 7.15 Since Gatwick is not at the centre of the networks of these carriers, the CAA considers that they would be able to allocate growth from their home hub(s) to another airport with comparatively more ease than their based counterparts at Gatwick. However, the CAA notes that in 2012, connecting passengers accounted for only approximately eight per cent of Gatwick's total passengers, which suggests that the constraint from inbound airline switching might be limited.

### **Conclusion**

- 7.16 The CAA considers that allocating new growth to other airports may not, by itself, directly lead to a reduction of an airline's existing services at an airport and is likely to take place too slowly to be an effective constraint.
- 7.17 Furthermore, as Gatwick has a relatively stable passenger traffic level, high historical and current slot utilisation throughout the day and different traffic seasons (see chapter 6, section 5), the CAA considers that Gatwick is unlikely to be affected materially by airlines allocating new growth to other airports. As a result, allocating new growth to other airports is unlikely to be an effective response to a ten per cent increase in airport charges.

### **Reducing frequency on existing routes**

- 7.18 A more direct form of switching could be for FSCs or associated feeder traffic airlines to reduce their frequency of service on existing routes at Gatwick. The general considerations regarding the

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<sup>534</sup> However, this could be a feasible longer-term strategy for an airline in response to a series of price increases.

requirements and limitations of this form of switching are discussed in chapter 6.

### Reducing the number of frequencies

- 7.19 FSCs and associated feeder traffic airlines typically consider the impact of modifying their short and long-haul services, including reducing their frequency, on a network-wide basis due to the potential impacts on the profitability of other services. For example, in a 2013 presentation, BA indicated, regarding the commencement of a Gatwick-Las Vegas service, that:

*Our decisions had to be evaluated at the overall Network level.*<sup>535</sup>

And:

*BA plans its network around 2 years ahead.*<sup>536</sup>

- 7.20 Evidence from Cathay Pacific, an inbound full-service carrier operating a spoke service to Hong Kong from Heathrow, supports this view. For example, when asked whether it had taken aircraft from existing routes to fund its expansion, or whether it had used new aircraft, it indicated:

*Moving aircraft around is not an easy task and in terms of route planning, it is important to fit in as much flying time as possible (and minimise down-time).*<sup>537</sup>

- 7.21 Lufthansa similarly told the CAA that:

*When asked whether there is a minimum number of frequencies that it had to operate to LHR, it added that it does look at this in terms of the contribution to the network result.*<sup>538</sup>

- 7.22 For some carriers, in spite of the need to consider overall network profitability, it appears that reducing the number of frequencies can still be a viable means of trying to constrain a price increase by GAL. For example, Air Malta told the CAA that:

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<sup>535</sup> Source: BA.

<sup>536</sup> Source: BA.

<sup>537</sup> Source: Cathay Pacific.

<sup>538</sup> Source: Lufthansa.

- *Last year, it operated double daily routes to LGW, which has now decreased to once a day.*
- *An increase in costs is something it would have to consider very carefully in deciding whether it should continue its presences at LGW or call it a day.*
- *Another important consideration would be whether or not it should reduce frequencies when there are carriers like easyJet operating; (reducing frequencies would not make sense.<sup>539</sup>*

7.23 Flybe has indicated that it:

*“...typically aims to operate a four times daily frequency on a particular route with the first aircraft delivering passengers to LGW in time for a business day and the last one taking them home again in time for dinner...”<sup>540</sup>*

7.24 Flybe has, however, also told the CAA that there is some scope for it to reduce frequencies. In particular, it noted:

*On reducing frequencies at LGW, possible options included:*

- *grounding aircraft*
- *reduce frequencies by cutting mid-day flights (easiest option)*
- *using aircraft on different routes to increase cross-over<sup>541</sup>*

7.25 Indeed, in response to an effective price increase of 18 per cent, Flybe said in its 2011 section 41 complaint that it had reduced frequencies. In particular, it stated:

*“Flybe has already announced the termination of its routes to LBA and DUS, and it has planned a reduced frequency on JER, GCI and NCL.*

*Apart from the actions which it has already taken, there are no other realistic means open to Flybe to mitigate the additional expense which it will incur.”<sup>542</sup>*

7.26 However, evidence also indicates that, by itself, a ten per cent

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<sup>539</sup> Source: Air Malta.

<sup>540</sup> Source: Flybe.

<sup>541</sup> Source: Flybe.

<sup>542</sup> Source: Flybe.

increase in airport charges might not be sufficient to prompt a significant switching response overall by FSCs and associated feeder traffic airlines. For example, BA told the CAA that:

*It currently has an annual bill for Gatwick airport charges of £ [X]. A 10 per cent price increase would mean a rise in costs of £ [X]. This translates approximately as an additional cost of £ [X] per passenger. This also means that [X].*

*It is a vicious cycle:*

- *Its first reaction would be [X], although [X];*
- *If BA were to [X], it would lead to [X], which could lead to a [X] which would lead to [X]. This cycle would over time perpetuate itself. This in turn would result in [X]. To avoid this, BA tries to [X].<sup>543</sup>*
- *Over the last 10 years, it should have increased its prices by [X] to cover price increases, but managed to have an increase of only [X], as the market would have not supported higher fare increases.<sup>544</sup>*

7.27 Another stakeholder also indicated that a short-run switching response would not necessarily be realistic. In particular, it indicated:

7.28 In light of a 10 per cent price increase at LGW, its first reaction would be [X] and [X], as well as find ways to [X].<sup>545</sup>

7.29 This view does not appear to be limited to based carriers. For example, Emirates, an inbound carrier, has indicated that it would be unlikely to undertake any switching. In particular:

*It noted that it had never considered leaving Gatwick*

And:

*It noted that it had only discussed a possible reduction of capacity owing to the economic climate in general during the 2009/10 Winter*

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<sup>543</sup> Source: BA.

<sup>544</sup> Source: BA.

<sup>545</sup> Source: [X]

*traffic season, and not due to pricing.*<sup>546</sup>

- 7.30 Overall, the CAA considers that, while reducing frequencies might be a viable way of responding to a price increase, network-level considerations - as well as the implied costs in reducing aircraft utilisation - may make a reduction of frequency more costly for an airline relative to absorbing a ten per cent price increase in charges.

### **Modifying flight patterns**

- 7.31 Another option to reduce frequencies on its services, and thereby discipline an airport operator, could be for an airline to modify an aircraft's flight pattern. For example, moving from a back and forth to a W or triangular pattern would reduce the number of sectors flown from Gatwick.

### **Short-haul routes**

- 7.32 A number of FSCs and feeder airlines operating in short-haul sectors commented on the potential use of W and triangular patterns. The majority of these suggested that there are operational and cost issues associated with their use. For example, BA told the CAA that:

*It does not operate any W patterns.*

*The introduction of W patterns would require additional assets, if BA was to maintain the total amount of Gatwick flying (it would have to buy or lease more aircraft), it would also need to consider market presence, operational costs and infrastructure.*

*Starting W patterns would also involve additional point-to-point flights between non-base airports, as well as expensive night stops at these airports, e.g. for any one night stop additional crews and hotel costs are incurred.*<sup>547</sup>

- 7.33 Air Malta, when asked whether could make use of W patterns, told the CAA that:

*The possibility is there but it is not something it needs to do from a commercial perspective as it can sustain point-to-point/direct routes.*

*A few years ago, it did operate a W pattern (linking LGW to Malta via*

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<sup>546</sup> Source: Emirates.

<sup>547</sup> Source: BA.

*Catania) but it stopped doing this 3 years ago.*

*Today, demand is such (having one daily flight only) that it doesn't need to combine destinations to operate LGW routes.*

*The W patterns currently operated across its network are less than 5% [of total services]<sup>548</sup>*

7.34 Aer Lingus, similarly, told the CAA that:

*The feasibility of reducing frequencies through the use of W patterns would be difficult as they could increase costs, and are inefficient and complex.<sup>549</sup>*

7.35 In addition, Flybe told the CAA that:

*It does operate W patterns into the Channel Islands, although it doesn't like to use them as passengers are not too keen...*

*Another reason for avoiding the use of W patterns is the knock on impact unforeseen obstacles could have on scheduling integrity (such as fog, or problems with line maintenance).<sup>550</sup>*

### Long-haul routes

7.36 In contrast to short-haul services which tend to be operated a number of times per day, an aircraft on long-haul routes typically performs a back and forth pattern across the week between its base airport and various destinations, also taking in scheduled engineering. This is illustrated in Figure 7.1 (below), which shows BA's utilisation of various B777s. The CAA notes that the difference in utilisation pattern is primarily influenced by the longer sector length of long-haul flights.

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<sup>548</sup> Source: Air Malta.

<sup>549</sup> Source: Aer Lingus.

<sup>550</sup> Source: Flybe.



**Figure 7.1: Examples of flight patterns for B777s - BA**

	Tue 17 Jun 09	Wed 18 Jun 09	Thu 19 Jun 09	Fri 20 Jun 09
BA 77Y -1	BA194 L H R	BA193 D F W	BA192 L H R	BA197 I A H
BA 77Y -2	BA52 S E A	BA103 L H R	BA102 L H R	BA103 Y Y C
BA 77Y -3	ENGINEERING			
BA 77Y -4	ENGINEERING L H R	BA173 J F K	BA172 L H R	BA193 D F W

Source: BA

7.37 BA also told the CAA that:

*Its long-haul fleet is fully utilised all year round as aircraft are expensive assets which need to be used in order to make a profit.*<sup>551</sup>

7.38 As a result, the CAA considers that reducing long-haul aircraft utilisation might be a more complex operational decision than for short-haul services. This means that modifying a long-haul flight pattern is unlikely to be a viable switching response in light of a ten per cent price increase.

7.39 Similar to the discussion on LCCs in chapter 6, the CAA considers that the use of alternative flight patterns on both short and long-haul services is unlikely to be a viable means of constraining the airport in light of an increase in airport charges.

## Grounding aircraft

7.40 For based carriers, a more extreme form of reducing frequencies would be for them to ground some (or all) marginal aircraft (i.e. fully reducing their utilisation) without relocating them.

7.41 The CAA notes that there is some precedent for based FSCs grounding aircraft. For example, in winter 2009, BA grounded a number of aircraft in response to falling profitability.<sup>552</sup>

7.42 BA has also told the CAA that the grounding of aircraft followed an increase in airport charges considerably greater than ten per cent:

<sup>551</sup> Source: BA.

<sup>552</sup> See for example: <http://www.guardian.co.uk/business/2009/jul/31/ba-loss-airline-industry-gloom>, (accessed February 2013) and <http://www.flightglobal.com/news/articles/british-airways-to-ground-16-747s-and-757s-for-winter-326904/>, (accessed February 2013).

*There were also significant changes to short-haul and long-haul operations due to the economic crisis and recession, the increase in fuel and the high passenger charges (Q5) where Gatwick airlines faced a 56% increase in prices:*

2. *Its short-haul fleet of 34 based aircraft was reduced to [X].*

3. *It also had to ground its 757 fleet<sup>553</sup>*

7.43 Virgin has also told the CAA that it responded similarly during the same period:

*VAA says that it has not tended to ground aircraft, except in 2008/09 during the recession and at Heathrow (3 grounded aircraft),*

*but that generally*

*grounding aircraft would not be a realistic response to 10 per cent price increase.<sup>554</sup>*

7.44 Overall, based on the evidence outlined above, the CAA considers that grounding aircraft does not appear to be a realistic means of switching away in light of a ten per cent price increase.

### Switching marginal based aircraft

7.45 Switching marginal based aircraft is another means by which an airline could fully reduce aircraft utilisation to constrain an airport such as Gatwick. In theory, this may be easier where FSCs have multiple bases (as discussed above).

7.46 However, in practice, the ability for FSCs or associated feeder traffic airlines to switch aircraft may be more limited.

### Switching marginal aircraft to existing bases

7.47 The CAA notes that the largest FSCs at Gatwick – BA and Virgin – have their main base at Heathrow. The CAA considers that, in theory, the proximity of these two bases suggest that switching marginal aircraft between these two bases (airports) might involve relatively low switching costs.

7.48 However, stakeholder evidence suggests that the ability of these

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<sup>553</sup> Source: BA.

<sup>554</sup> Source: Virgin.

airlines to actually switch in the short run is limited. For example, BA indicated that:

- *LGW is slot constrained at peak, LHR is constantly slot constrained, LTN is constrained at certain points as well as elsewhere in Europe*
- *Any network planning requires available slots and aircraft.*
- *BA plans its network around 2 years ahead.*<sup>555</sup>

7.49 Virgin has similarly indicated that while the cost of physically relocating an aircraft would be small, other costs would be incurred. Specifically, it noted that:

*In order to move aircraft from LGW to LHR, it would not incur significant costs of physically relocating the aircraft.*

*However, there would be costs in acquiring slots and reconfiguring the aircraft from leisure configuration (circa 14 Upper Class seats) to a business configuration (circa 33-45 Upper Class seats) to meet the demand profile of the routes at LHR.*<sup>556</sup>

7.50 The CAA notes that these other costs would constitute an additional barrier in switching to Heathrow. However, the CAA considers that the economic benefits derived over the same time period from operating from Heathrow could outweigh the initial costs of reconfiguring the aircraft.

7.51 [X] has also told the CAA, with respect to potentially switching aircraft to Heathrow, that any move would have to be sustainable for its operations. In particular it noted:

*In terms of a minimum scale of operations, it could not imagine operating with fewer than [X] aircraft at LGW.*<sup>557</sup>

*Hypothetically, if it had sufficient slots at LHR, it would consider [X] and [X]. However, this is [X].*

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<sup>555</sup> Source: BA.

<sup>556</sup> Source: Virgin.

<sup>557</sup> Source: [X]

*However, if it was [redacted]...this would not be sustainable.<sup>558</sup>*

7.52 In regards to potentially switching to other bases outside of London, the CAA has also received evidence that indicates that *GLA and MAN are not commercially viable commercial alternatives to LGW<sup>559</sup>*

7.53 In light of a 10 per cent price increase at Gatwick, [redacted] has also told the CAA that its:

*first reaction would be [redacted]and [redacted], as well as find ways to [redacted].<sup>560</sup>*

7.54 Flybe has also indicated regarding the costs of switching based aircraft from LGW to another airport that:

- *Any aircraft needs to be placed on profitable routes.*
- *As many of these profitable routes are already flown by Flybe or by other airlines, it would be very difficult to find any.*
- *There are also start-up costs for new routes as well as the fact that it usually takes 3 years for a route to mature and become profitable.*
- *Operationally, costs include crew relocation, but it would depend on the airport.<sup>561</sup>*

7.55 As indicated above, Flybe previously reduced frequencies in light of an increase in airport charges. In February 2013, Flybe also informed the CAA that, following continual increases in charges:

*Until 2012, it had one based aircraft at LGW but had to close its base as it was no longer financially viable.<sup>562</sup>*

7.56 The CAA considers that this evidence shows that the removal of based aircraft (sometimes involving the closure of a base) is likely only to be a viable response in the longer term. Further, for some airlines such as Aer Lingus (and until 2012 Flybe) switching away the only aircraft based at an airport may not be a viable option in response to ten per cent increase in airport charges, as this would precipitate the closure of their base. More generally, capacity

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<sup>558</sup> Source: [redacted]

<sup>559</sup> Source: [redacted]

<sup>560</sup> Source: [redacted]

<sup>561</sup> Source: Flybe.

<sup>562</sup> Source: Flybe.

constraints at Heathrow are likely to severely restrict an airline's scope to switch marginal aircraft away from Gatwick.

### Switching marginal aircraft to a new base

7.57 While switching between existing bases appears to be a viable means of switching away from Gatwick, the CAA considers that relocating aircraft to a new base is less likely to be a possible response to a price increase. For example, BA indicated that it would face significant costs if it were to move an aircraft to a new base. Specifically, BA indicated:

*“When an aircraft is based at an airport, it incurs a range of significant costs. For example, there are engineering requirements which would require the establishment of an engineering base. The aircraft would need crew: flight, cabin and ground, which would require the establishment of a crew base. And then there would also be the costs of disruption involving the changing of schedules and the marketing costs of establishing a brand presence at a new airfield. These costs are all large and relatively fixed, and even if they were borne, would be borne for a single aircraft which would be a sub-scale and inefficient operation. Given the scale of these costs, we do not believe that it would be viable to move a single aircraft.”<sup>563</sup>*

7.58 The CAA considers that this argument is also likely to apply to moving a small number of aircraft to a new base, as this scale of switching might be insufficient for the new base to achieve its minimum efficient scale and would be likely to involve unrealistic costs to constrain a ten per cent price increase.

7.59 Similarly, Flybe told the CAA that:

*Considering its strong national presence, it is very unlikely that it would move to an airport which it doesn't operate at. It would also be cheaper to move to the airports currently in its network.”<sup>564</sup>*

7.60 Based on the evidence above, the CAA considers that switching away aircraft by opening a new base is unlikely to be a viable option in light of a ten per cent price increase.

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<sup>563</sup> Source: BA.

<sup>564</sup> Source: Flybe.

## Conclusion

- 7.61 This section has considered the likely viability of four different strategies that FSCs and associated feeder traffic airlines might employ to switch away from Gatwick in light of a ten per cent increase in airport charges. The first option was for an airline to allocate new business growth to other airports. However, the indirect nature of this switching response means that it may not lead to a reduction in services already operated at the airport and, therefore, would be unlikely to constrain GAL's pricing.
- 7.62 The second potential switching response involves reducing frequencies on the current operations at Gatwick. While the scope for modifying flight patterns is likely to be limited by cost and operational considerations, the reduction of the number of frequencies appears to be a viable means of switching away. However, the cost of reducing aircraft utilisation might, in some cases, outweigh the benefits of constraining GAL's pricing.
- 7.63 The third and fourth options involve grounding or switching away marginal aircraft from the airport. The evidence suggests that grounding is not a realistic response to a 10 per cent increase in airport charges, while switching marginal aircraft to Heathrow is likely to be severely limited by capacity constraints and the associated costs of slot acquisition. The scope for switching by opening a new base is also restricted for cost reasons.
- 7.64 Overall, the CAA considers that reducing frequencies would be the most likely way airlines would try to switch away from Gatwick. However, network-level considerations - as well as the implied costs involved in reducing aircraft utilisation - may make a reduction of frequency more costly than absorbing the price increase. This means that the scale of frequency reductions might not be sufficient to constrain GAL's behaviour in light of a ten per cent increase in airport charges.

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## Section 3: Switching costs

- 7.65 The above analysis established that frequency reductions would be the most likely way in which airlines would try to switch away from Gatwick in light of a ten per cent price increase. This section

examines the switching costs that FSCs and associated feeder traffic airlines at Gatwick might incur in practice and explore whether airline substitution of marginal units would be sufficient to constrain the airport.

7.66 In undertaking this analysis, the CAA refers to the categories of switching costs outlined in the CC's 2009 BAA Report, which are summarised in chapter 6, Box 1.

### CAA Initial Views

7.67 In the Initial Views, the CAA:

- set out a table of factors affecting airline switching costs and indicated that it would welcome further evidence from airlines regarding the absolute levels of the different types of switching costs,<sup>565</sup>
- noted evidence which suggested that long-haul FSCs providing a premium product would incur higher costs from a loss of economies of scale, partly because of the loss of network effects and partly because of higher capital investment in infrastructure, at their airports;
- considered that long-haul FSCs would face higher switching costs than those airlines operating point-to-point short-haul services<sup>566</sup>; and
- stated additional evidence on the switching costs faced by airlines at Gatwick was one of the issues which needed to be assessed further.<sup>567</sup>

### GAL's submissions

7.68 GAL objects to the conclusion that airline switching costs are significant for airlines operating long-haul services as well as airlines reliant on premium services and feeder traffic.

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<sup>565</sup> CAA, Initial Views, paragraph 3.33.

<sup>566</sup> CAA, Initial Views, paragraph 3.41.

<sup>567</sup> CAA, Initial Views, paragraph 3.224.

- It argues that the CAA’s analysis of switching costs based on such investments is (1) “*very high level and lacks detail*” and (2) is not sufficient to overturn previous findings by the CC and the CAA that, notwithstanding the presence of switching costs, a substantial level of competition could be expected between London airports.<sup>568</sup>
- It contends that write-offs of sunk costs by FSCs will only occur in “*extreme scenarios*” where an airline ceases a large part of its operations at Gatwick. The “*more probable, less extreme, scenario*” involves the substitution of a proportion of aircraft or the withdrawal of certain routes. In this scenario the presence of sunk costs does not present a material barrier to switching, especially when the switch is to an airport where the FSC already has operations.<sup>569</sup>
- It argues that BA and Virgin, Gatwick’s main long haul scheduled carriers, have existing operations at Heathrow. Moreover, because Gatwick’s long haul services are focussed on point-to-point travellers, these and other long haul carriers do not rely on network or hub externalities for their Gatwick operations. For these reasons, it is unlikely that they would face high switching costs.<sup>570</sup>

7.69 In this section, the CAA addresses these arguments and assesses switching costs for airlines trying to relocate units at the margin.

- It notes that switching by long haul airlines is a major element of observed switching and that the evidence presented by the CAA does not show that long haul carriers at Gatwick have high switching costs.<sup>571</sup>

7.70 The scale and impact of switching by long-haul airlines is considered in the context of capacity constraints, which is discussed below.

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<sup>568</sup> Source: GAL, Initial Response to CAA’s Initial Views, 4 April 2012, Ref: Q5-050-LGW09, page 4. See also GAL, Airport Competition: Competing to Grow and become London’s airport of choice, November 2011, Ref: Q5-050-LGW05, footnote 92.

<sup>569</sup> Source: GAL, Initial Response to CAA’s Initial Views, 4 April 2012, Ref: Q5-050-LGW09, pages 4-5.

<sup>570</sup> Source: GAL, Airport Competition: Competing to Grow and become London’s airport of choice, November 2011, Ref: Q5-050-LGW05, pages 47-48.

<sup>571</sup> Source: GAL, Airport Competition: Competing to Grow and become London’s airport of choice, November 2011, Ref: Q5-050-LGW05, page 47.



## Infrastructure costs

7.71 This section sets out the evidence received by the CAA regarding the infrastructure costs of airlines at Gatwick. While these costs can be significant in relocating a large part of their operation away from Gatwick, the CAA notes that it is the switching costs for marginal aircraft and services which are important to determine the ability of airlines to switch away aircraft in light of a price increase.

7.72 BA and Virgin, the FSCs with their largest base at Heathrow and a secondary base at Gatwick, have provided evidence to the CAA regarding the scale of their infrastructure costs at the airport.

7.73 BA has indicated that its infrastructure costs are quite significant. In particular, it has indicated that:

*“Given the scale of these costs, we do not believe that it would be viable to move a single aircraft [to a new airport].”*

7.74 And

*“It would be more appropriate therefore, to think about the costs of moving an operation. It is clearly not viable to move our LHR operation, for a number of reasons, including the lack of sufficient hub capacity in the London market area. Similarly, our Gatwick operation has [x] short-haul aircraft and [x] long-haul aircraft. We do not believe that there is an airfield suitable and with the capacity to absorb this size of operation in the London market area.”<sup>572</sup>*

7.75 In addition, on the basis of evidence from BA, the CAA has estimated that an airline incurs, approximately, £[x] annual charges in leases at Gatwick, with a similar amount in terms of service contracts with third parties for maintenance, on-board catering and groundhandling services at Gatwick.<sup>573</sup>

7.76 Virgin, in its response to the CC’s questionnaire for its BAA Airports Market Investigation, also stated that there were a number of infrastructure costs that it incurs at Gatwick. In particular, it noted that:

*“At Gatwick, Virgin Atlantic’s operating base includes maintenance facilities, hangar, crew and staff facilities, office accommodation and a*

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<sup>572</sup> Source: BA.

<sup>573</sup> Source: BA.

*CIP lounge.*<sup>574</sup>

7.77 There also appears to be an element of cost scaling related to number of aircraft based at an airport. For example, Virgin told the CAA that:

7.78 *In addition, the operating costs at [Gatwick and Heathrow] would increase (decrease) with the addition (withdrawal) of aircraft*<sup>575</sup>

7.79 Aer Lingus, which currently has one based aircraft at Gatwick, also told the CAA that:

- *The costs associated with having a base and based aircraft are; staff members and their needs, crew facility, pilot briefing facility, engineering presence.*
- *Basing aircraft also drives issues surrounding the whole integration and scheduling of aircraft. This can provide opportunities and challenges.*
- *But there is an element of scaling in costs associated with increasing the number of aircraft at an airport, though no step-change in costs*<sup>576</sup>

7.80 In 2011, as part of its section 41 complaint to the CAA, Flybe (which had one based aircraft at LGW), indicated that it has incurred some significant costs. Specifically, it indicated that it:

*“has committed huge sums in establishing a network of services at LGW. Much of these costs will qualify to be regarded as sunk costs because they would not be recovered in the event of a switch from to [another] London airport.”*

And:

*“Even if Flybe were to begin operations at another London airport, there are substantial sunk costs of entry in setting up a base equivalent in scale and scope to the existing base at LGW”*<sup>577</sup>

7.81 However, in 2013, Flybe, which now only operates inbound into Gatwick, told the CAA that:

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<sup>574</sup> Source: Virgin.

<sup>575</sup> Source: Virgin.

<sup>576</sup> Source: Aer Lingus.

<sup>577</sup> Source: Flybe.

*It does not have a hangar or engineering base at LGW. Instead it either uses a line engineer or third-party subcontractor for engineering and maintenance*

And

*The aeronautical services bought from LGW directly include:*

*Landing, passenger, parking, specified charges (PRMs, check-in desks), accommodation costs, back of house ticket desk (rental) staff car parking, security passes<sup>578</sup>*

7.82 Flybe has also told the CAA:

*It has invested significantly at LGW, even though it no longer has a base. If it were to move, costs that it would face include:*

- a. advertising/marketing costs*
- b. interlining costs*
- c. code share costs (which cost £50,000 to set up)*
- d. slots (which were very expensive in 2008)*
- e. route development costs<sup>579</sup>*

7.83 By contrast, evidence from FSCs and associated feeder traffic airlines operating inbound services into Gatwick suggests that these airlines have fewer infrastructure costs. For example, Emirates told the CAA that it used:

- "a. It is North Terminal operator.*
- b. It offers limousine drop off services outside the terminal.*
- c. It uses the 'check in' in the north terminal's new wing.*
- d. It uses the fast track security service (especially for business passengers.*
- e. It leases a personal business lounge.*
- f. It uses pier b, and gates 50-60.*

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<sup>578</sup> Source: Flybe.

<sup>579</sup> Source: Flybe.

*g. It can use the facilities for connecting passengers.*<sup>580</sup>

7.84 Other inbound airlines have also indicated their relatively low infrastructure costs. For example:

- Delta told the CAA that:

*Historically, it had a Delta lounge at LGW, but it then started to use a third-party*<sup>581</sup>

- Air Malta told the CAA that:

*It wouldn't face costs in terms of breaking leases etc, and doesn't have any other liabilities apart from 1 employee (who is based at LGW)*<sup>582</sup>

- Lufthansa told the CAA that:

*"LH infrastructure (fixed) costs at LGW and LHR are [X] compared to the [X] but [X] in comparison with [X]; they including office space and check-in desk rental."*<sup>583</sup>

- Air Berlin told the CAA that<sup>584</sup>:

*Air Berlin note that, apart from slots, it would probably need to undertake some new investment at a new airport and that there would be costs associated with that and ticketing (plus other costs) and this would take both time and resources. However, it noted that as it uses a handling agent and a ticketing agent these costs are relatively small.*<sup>585</sup>

7.85 Based on the evidence outlined above, the CAA considers that airlines with operations based at Gatwick tend to have greater infrastructure costs than those providing inbound services.

7.86 The CAA, however, considers that in relocating marginal services (or

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<sup>580</sup> Source: Emirates.

<sup>581</sup> Source: Delta.

<sup>582</sup> Source: Air Malta.

<sup>583</sup> Source: Lufthansa.

<sup>584</sup> The CAA understands Air Berlin has now withdrawn from Gatwick, see:

<http://www.businesstraveller.com/news/air-berlin-to-drop-gatwick-nuremberg-route> accessed April 2013

<sup>585</sup> Source: Air Berlin.

reducing frequencies to the airport in the case of inbound carriers), it does not appear that either based or inbound airlines are likely to face significant costs of physical relocation to existing bases. As discussed in more detail earlier in this chapter, switching based aircraft to a new base would not be a realistic response to a 10 per cent price increase due to the investment required in replicating base infrastructure.

- 7.87 Infrastructure switching costs are only one type of cost that airlines might face in relocating marginal services and also need to be considered together with importance of other switching costs and the implications of capacity constraints at Heathrow. These are discussed in section 5.

### Network effects

- 7.88 FSCs and associated feeder traffic airlines may benefit from increased connectivity – also known as network effects – from the availability of connecting passenger traffic feed and/or the presence of strategic partner airlines at the airport. The importance of network effects as a switching cost is considered in this section.

### Connecting passenger traffic

- 7.89 Evidence suggests that FSCs rely, to varying degrees, on connecting passenger traffic to supplement their load factors at Gatwick.

- 7.90 For example, Virgin, which operates long-haul routes from Gatwick, has indicated that:

“[§]. We achieve high load factors by attracting the largest possible combination of:

- *domestic point-to-point passengers (mixture of business, leisure and VFR);*
- ***domestic connecting passengers;***
- ***international transfer traffic; and***
- *cargo.*<sup>586</sup>

- 7.91 Virgin also indicated that:

- *Most of its sales for LGW flights are UK point-to-point sales.*

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<sup>586</sup> Source: Virgin.

- *Connecting passengers are a small but incrementally important part of VAA's load factor at LGW, and affect VAA's margins on these routes.*<sup>587</sup>

7.92 BA, which operates both short and long-haul flights from Gatwick, has also identified that connecting passengers are an important part of its business. For example, it has described its operations at Gatwick as:

*"leisure-orientated longhaul, point-point shorthaul + longhaul feed."*<sup>588</sup>

7.93 However, BA has also noted that:

*"BA operates at Gatwick those services which would generate the smallest contribution to BA's hub network if they were at Heathrow (these tend to be services that generate most of the revenues from point to point passengers)".*<sup>589</sup>

And:

*Today, LGW operates in a point-to-point market and is not run as a hub. BA's LGW operation is now also run as a separate business unit. As a result, connecting traffic (approximately [X]) is not as significant as at LHR - it does help to contribute to the overall profitability.*<sup>590</sup>

7.94 The CAA notes that a number of other airlines provide domestic and short-haul feeder traffic into Gatwick and that these services can often play an important role in helping to fill long-haul FSCs flights. This point has, for example, been made by Flybe, which indicated that:

*"for a short-haul service from London to be viable, it needs to cater for: (a) a local market which can provide a core of regular passengers; (b) passengers whose origin or destination is Central London; and (c) those who are travelling onwards "to the world" from a regional point."*<sup>591</sup>

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<sup>587</sup> Source: Virgin.

<sup>588</sup> Source: BA.

<sup>589</sup> Source: BA Response to CC's Statement of Issues response, 29 October 2007, paragraph 2.4, please see: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/issues\\_statement\\_response\\_ba.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/issues_statement_response_ba.pdf)

<sup>590</sup> Source: BA.

<sup>591</sup> Source: Flybe.

7.95 Figure 7.2 (below) shows that connecting passengers are a significant overall proportion of full service and full service-orientated carriers at Gatwick for the top 20 airlines, in terms of proportion of connecting passengers carried, and account for 32 per cent of passengers at Gatwick.

**Figure 7.2: Percentage of connecting passengers by airline 2011**

Airline	Proportion of connecting passengers	Total passengers at Gatwick
Flybe	32%	1,260,461
BA/AA	25%	4,839,213
Aurigny	21%	201,453
Meridiana	21%	121,164
Qatar*	20%	46,415
Ukraine Intl Alns	18%	81,788
Turkish	15%	2,953
Aer Lingus	15%	777,690
Cubana	13%	9,833
Virgin Atlantic	13%	1,421,793
TAP	12%	235,056
Astraeus	11%	104,351
Emirates	10%	617,100
Pulkovo	10%	28,992
Air Asia X*	10%	23,537
Aerosvit	9%	45,130
MyTravels	9%	231,945
Croatia	8%	45,618
Delta*	8%	127,843
US Airways*	8%	162,229
Royal Air Maroc	7%	36,165
Thomas Cook	7%	213,938
Estonian	6%	26,959

Source: CAA Passenger Survey 2011

Note: CAA airport statistics include both self-connecting and connecting passengers. These figures may

slightly over-estimate the actual proportions of inter- or intra-lining passengers.

Note: asterisk denotes airline no longer operating to/from Gatwick.

7.96 The CAA considers that, although it is less important than at Heathrow, certain airlines at Gatwick benefit from the feed of connecting passengers, as outlined in the Figure 7.2. As a result, the CAA considers that when moving to an airport with less connecting passenger feed (or when considering doing so), such as Stansted, this can constitute a significant switching cost for FSCs or feeder airlines.

7.97 [✂] has previously told the CAA that there is:

*Insufficient opportunities for interlining at Stansted*<sup>592</sup>

7.98 Regarding the lower level of connectivity at other London airports, Flybe has also indicated that:

*“...interlining opportunities at LTN and STN are virtually non-existent.”*<sup>593</sup>

7.99 The CAA notes, however, that the connecting passenger feed at Heathrow, as it is a hub airport, is likely to be superior to that at Gatwick. Indeed, Air Malta has indicated that:

*The level of connectivity at LGW is much more limited than at LHR (i.e. much fewer transatlantic flights)*<sup>594</sup>

7.100 Similarly, Aer Lingus has told the CAA that:

*Connecting traffic at LGW is quite limited*<sup>595</sup>

7.101 The CAA notes that Heathrow's superior connectivity may, in part, be a reflection of the relatively recent loss of a number of US carriers to Heathrow. For example, Emirates has told the CAA that:

*Regarding the declining connecting traffic at LGW it cited that the move of US carriers to Heathrow has had a negative effect on*

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<sup>592</sup> Source: [✂]

<sup>593</sup> Source: Flybe.

<sup>594</sup> Source: Air Malta.

<sup>595</sup> Source: Aer Lingus.



*connecting traffic*<sup>596</sup>

7.102 In its internal documents, GAL also notes that:

*"The loss of transfer traffic at LGW is affecting [X] business (particularly [Y])."*<sup>597</sup>

7.103 Based on the above, the CAA considers that the loss of connecting passenger feed could, in theory, constitute a switching cost for marginal services switching away from Gatwick, particularly when switching to an airport with less connectivity. However, when switching marginal services to Heathrow, the CAA considers that airlines are likely to gain, rather than lose, in terms of network effects.

### **The presence of strategic partner airlines**

7.104 Another factor that can create beneficial network effects for an airline is the presence of its strategic partners at particular airports. For example, airlines can become members of an airline alliance, or sign code-sharing, interlining and other similar agreements with other airlines, to allow passengers to connect or fly on their partner airline's services.

7.105 Consequently, if an airline reliant on inter-connectivity with other airlines were to relocate marginal aircraft or services to an airport from which its partner airlines (or other airlines with similar services) do not operate, it might not have sufficient feeder traffic to make its services viable.

7.106 The CAA, therefore, considers that losing the benefits associated with a strategic partnership can constitute a considerable switching cost that an airline needs to consider when assessing whether to switch away from Gatwick.

### **Alliances**

7.107 Figure 7.3 below shows that approximately 55 per cent of FSCs and feeder airlines at Gatwick are members of an airline alliance, which promotes a degree of operational alignment between services. It also shows that Virgin represents approximately 12 per cent, with the remainder (approximately 33 per cent) comprised of a number of

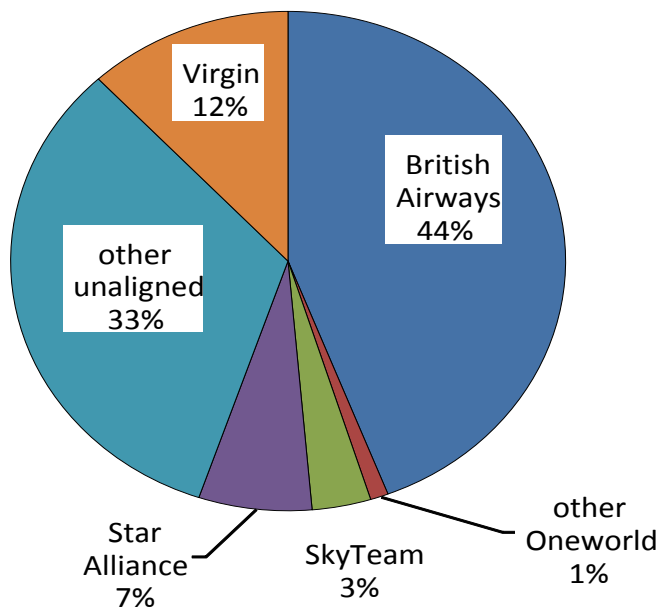
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<sup>596</sup> Source: Emirates.

<sup>597</sup> Source: GAL.

unaligned airlines.

**Figure 7.3: Share of passengers by airline alliance for FSCs and associated feeder traffic airlines at Gatwick, 2012**



Source: CAA Airport Statistics

Note: This figure include the airlines classified as falling within the relevant FSC and associated feeder traffic market.

### Other agreements

7.108 In addition to, or aside from, alliance membership, an airline might also have a number of agreements with other airlines. These can include:

- code-sharing agreements, where an airline reciprocally allows the other airline's passengers to travel on its aircraft;
- interlining agreements, where an airline reciprocally allows another airline's passengers to connect onto its services; or
- joint ventures.

7.109 BA told the CAA that the benefits from interlining agreements can include:

*"Interlining agreements have many uses:*

*a. feeder traffic;*

- b. back up when there are disruptions and unforeseen circumstances;*
- c. it helps ensure connectivity at non-hub airports;*
- d. it allows for increased frequencies on certain routes and increased passengers demand for the services of both interlining partners; and*
- e. can increase bellyhold cargo feed.<sup>598</sup>*

And additionally:

*Although LGW is not a hub, its interlining agreements provide pax with some connectivity which improves viability, produces higher frequency and demand and a greater choice in pax destinations. The same applies for its cargo operations.<sup>599</sup>*

7.110 Examples of airline partnerships at Gatwick include:

- BA signing an interlining agreement with Vueling in July 2012, allowing its passengers to transfer at Barcelona onto Vueling's flights.<sup>600</sup>
- Air Berlin, having joined the Oneworld airline alliance in 2012, relocated a number of its routes to Gatwick<sup>601</sup>, stated that:
- *An additional consideration in its move to Gatwick is that it is part of the 'One World' alliance and Gatwick offers greater connectivity than Stansted<sup>602</sup>*

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<sup>598</sup> Source: BA.

<sup>599</sup> Source: BA.

<sup>600</sup> See: <http://www.vueling.com/en/we-are-vueling/press-room/press-releases/corporate/vueling-network-to-expand-to-100-destinations-from-barcelona-el-prat-airport-in-2013/>, (accessed February 2013), <http://www.vueling.com/en/we-are-vueling/press-room/press-releases/corporate/vueling-flights-from-el-prat-barcelona-to-connect-with-british-airways-broad-network/>, (accessed February 2013) and <http://www.businesstraveller.com/news/ba-and-vueling-launch-interline-agreement>, (accessed February 2013).

<sup>601</sup> The CAA understands Air Berlin has now withdrawn from Gatwick, see: <http://www.businesstraveller.com/news/air-berlin-to-drop-gatwick-nuremberg-route>, (accessed April 2013).

<sup>602</sup> Source: Air Berlin.

- Flybe has told the CAA that it has Special Prorate Agreements with 8 airlines: American Airlines, British Airways, Delta, Emirates, Qatar, TAP Air Portugal, US Airways and Virgin Atlantic.<sup>603</sup>
- Aer Lingus has interlining agreements with a large number of partner airlines including British Airways, Emirates and Virgin Atlantic,<sup>604</sup> and
- Virgin has interlining agreements with at least [X] airlines at LGW.<sup>605</sup>

7.111 The CAA considers that when an airline is contemplating whether to switch to another airport with lower connectivity, such as Stansted, the loss of the benefits related to network effects and transfer passenger feed from the absence of partner airlines is likely to be a considerable switching cost for FSCs and associated feeder traffic airlines.

7.112 The CAA also notes that evidence suggests that interlining agreements require the objectives and business models of the airlines to be compatible. This implies that LCCs might not be suitable as interlining partners for FSCs and feeder airlines. For example, BA has told the CAA that:

*Interlining agreements are commercial arrangements that need both parties to agree to, but LCCs are not set up to provide this service and may be reluctant to do so because of the associated costs of setting up and operating interlining systems. Furthermore, the transfer and LCC models are not compatible as the LCC model needs to keep costs down and transferring pax would be an additional expense and complication to its operations.*<sup>606</sup>

7.113 In addition, Virgin has told the CAA that:

*VAA says that the feed provided by LCCs is not markedly different from that provided by traditional airlines. However, it also notes that LCCs would be more focused on providing services to its own point-to-point passengers, which could conflict with providing feeder*

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<sup>603</sup> Source: Flybe.

<sup>604</sup> <http://www.aerlingus.com/i18n/en/htmlPopups/baggageinformation.html>, (accessed February 2013).

<sup>605</sup> Source: Virgin.

<sup>606</sup> Source: BA.

*traffic.*<sup>607</sup>

- 7.114 Based on the above, the CAA considers that, when switching to an airport where an airline has fewer partner airlines, the loss of network effects can be a significant switching cost. By contrast, the CAA considers that airlines would, in fact, gain additional network benefits from switching a marginal service to Heathrow, which is almost exclusively served by FSCs and feeder airlines. However, the CAA notes that capacity constraints might restrict their ability to switch in a sufficient scale to make a service viable (see section 5).

### The strategic importance of operating from London

- 7.115 In addition to the traditional switching costs discussed so far in this section, some of Gatwick's airlines may face strategic switching costs if they were to switch to another London airport or another airport in the UK or in continental Europe. This is an issue that the CAA did not explore in its Initial Views, but is an issue that the CAA's subsequent analysis suggests is an important factor in an airline's decision to switch.
- 7.116 The strategic importance of London in an airline's network varies depending to their business model and potentially historical and socio-demographic reasons affecting passenger demand for travel to and from London.
- 7.117 The aircraft of the largest based FSCs at Gatwick, BA and Virgin, are in large part based at London airports: the three bases of British Airways are Heathrow, Gatwick and London City<sup>608</sup>, while Virgin's aircraft in London are based at Heathrow and Gatwick. Highlighting the importance of London to its operations, Virgin has indicated:
- “Operating from Heathrow and Gatwick is vital to our operation and business strategy.”*<sup>609</sup>
- 7.118 Other based carriers at Gatwick have also highlighted that London is important to their operations for similar reasons. For example, Flybe has told the CAA that London:
- “plays a vital role in providing air links to London from UK and*

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<sup>607</sup> Source: Virgin.

<sup>608</sup> Source: BA.

<sup>609</sup> Source: Virgin.

*European points, as well as serving LGW's substantial natural catchment and feeding passengers into other services operating over LGW*<sup>610</sup>

7.119 Aer Lingus has similarly told the CAA that:

*It needs to fly pax to make a profit, and to do that it needs to fly where demand supports its services. London is a very important part of its demand profile and London has many airports.*<sup>611</sup>

7.120 Inbound carriers also appear to see a strategic benefit from operating to London. For example, Delta told the CAA that:

*It also serves all the other major European business markets but, in terms of volume, London remains the most important market from a transatlantic perspective.*<sup>612</sup>

7.121 Emirates, though with an apparent focus on Heathrow, added:

*Its operations to London are vital and are built around the connectivity of the "universally recognised" LHR hub:*

- *These start in London and connect to points throughout the Emirates network including Australia, Asia and India sub-continent.*

*It noted London is so appealing because it is where the world wants to travel to and London is a huge magnet for the whole world in terms of retail, culture etc*<sup>613</sup>

7.122 In addition, Air Malta has told the CAA that London is important to its network, stating:

*The UK is its main market and its London routes are its prime routes in its network*<sup>614</sup>

7.123 In light of the above, the CAA considers that the strategic importance of operating to and from London, for both based and inbound FSCs and feeder airlines, is a considerable switching constraint against relocating to other non-London airports in the UK and in Europe.

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<sup>610</sup> Source: Flybe.

<sup>611</sup> Source: Aer Lingus.

<sup>612</sup> Source: Delta.

<sup>613</sup> Source: Emirates.

<sup>614</sup> Source: Air Malta.

### Airline views on the substitutability of Gatwick and Heathrow

- 7.124 When asked specifically about their view on the substitutability of Gatwick with other London airports, FSCs appeared to indicate that Heathrow was their airport of choice. For example, Delta, which recently ceased its operations from Gatwick, has told the CAA that it preferred Heathrow in spite of the quality of Gatwick's infrastructure:
- *LHR is the preferred London airport; it is where business passengers are.*
  - *LGW is a great airport with great facilities and good links with the Gatwick Express, but LHR is closer and perceived to be the London airport.*<sup>615</sup>
- 7.125 In 2007<sup>616</sup>, Delta also told the CC that:
- “LHR is the preferred choice for most Delta customers and LGW the second choice...LHR would be a reasonable substitute for substantially all passengers [Delta] currently services with its LGW services, and would be a preferred alternative by most of those passengers. (The reverse is not true. LGW is not necessarily an adequate substitute for some passengers, particularly time-sensitive business passengers, who evidence a strong preference for LHR service).”*<sup>617</sup>
- 7.126 Cathay Pacific, an airline operating from Heathrow, has also told the CAA that:
- 1. [Heathrow] is the hub airport of the UK. CP works with its ‘hub partner’ BA in the One World Alliance, to allow passengers flying to LHR not only to reach London but also to reach other destinations in the UK and in Europe using its hub partner British Airways. In the UK, LHR is very much the obvious and only place to which to fly due to the proper hub-and-spoke operation at the airport.*

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<sup>615</sup> Source: Delta.

<sup>616</sup> The CAA acknowledges that some time has passed since the evidence that was submitted to the Competition Commission in 2007. However, the CAA considers that, in spite of the change of ownership at Gatwick (and Stansted), the market conditions for FSCs and associated feeder traffic airlines have not significantly changed regarding the substitutability of Gatwick and Heathrow to invalidate the points made to the CC in the context of the BAA airports market investigation.

<sup>617</sup> Source: CC BAA Investigation, Annex 3.5, Airline responses on substitutes for BAA London airports and price reductions at these airports (Annex 3).

*2. Although LGW has recently improved, LHR remains the preferred airport for passengers flying out of London. LHR is well-connected into the centre of London. It first started flying to London in the 1980s into LGW, but its pax made it clear that they prefer LHR and CP switched when they got the opportunity.*

*For the two reasons above, LHR and London are synonymous for Cathay Pacific.*<sup>618</sup>

7.127 In 2007, American Airlines told the CC that:

*“Heathrow connecting passengers would find Gatwick to be a moderately effective substitute, and Stansted a largely ineffective substitute. Gatwick connecting passengers would find Heathrow to be a largely effective substitute, and Stansted a largely ineffective substitute.”*<sup>619</sup>

7.128 Evidence from FSCs and associated feeder traffic airlines operating from both Gatwick and Heathrow suggests that Gatwick might not be fully substitutable with Heathrow, although Heathrow would be considered an alternative to Gatwick, if it were not capacity constrained.

7.129 For example, while describing Heathrow as a unique hub, BA describes its operations at Gatwick as:

*“leisure-orientated longhaul, point-point shorthaul + longhaul feed.”*<sup>620</sup>

7.130 Virgin told the CC in 2007 that:

*“It is Virgin’s experience that Gatwick fails to act as a suitable substitute for Heathrow, but to a large extent Heathrow may be a competitor to Gatwick.”*<sup>621</sup>

7.131 Aer Lingus told the CAA that:

*“LGW and LHR are part of two-airport strategy, operating at both*

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<sup>618</sup> Source: Cathay Pacific.

<sup>619</sup> Source : CC BAA Investigation, Annex 3.5, Airline responses on substitutes for BAA London airports and price reductions at these airports (Annex 3).

<sup>620</sup> Source: BA.

<sup>621</sup> Source: CC BAA Investigation, Annex 3.5, Airline responses on substitutes for BAA London airports and price reductions at these airports (Annex 3) page 65.



*airports involved a trade-off of connectivity vs p-t-p*.<sup>622</sup>

- 7.132 In 2011 Lufthansa began operating in 2011 a service from Gatwick to Frankfurt, in addition to its operations from Heathrow. Regarding the attractiveness of Heathrow, it told the CAA that:
- *LHR is one of the most important airports to LH outside of Germany.*
  - *Lufthansa operates 31 flights per day from LHR: 12 to FRA and also serving DUS, HAM, MUC and TXL.*
  - *This is primarily due to the historically strong economic relationship between London and Germany.*
  - *London is also seen as "the place to be" for Lufthansa's customers.*
  - *For a great part of Lufthansa's customers, London and LHR are synonymous.*<sup>623</sup>
- 7.133 The evidence from Lufthansa also suggests that it considers its operation from Gatwick to be complementary to its Heathrow operation, rather than a substitute:
- *When asked why it commenced LGW-FRA services in the Winter 2011 traffic season, Lufthansa said that sometimes an airline "has to try things.*
  - *Lufthansa also said that each airport is a market in itself, given each airport's core catchment.*
  - *Its expansion into LGW was part of an attempt to serve the airport's catchment more directly, as well as to provide feeder and point-to-point traffic into FRA.*<sup>624</sup>
- 7.134 In addition, some airlines considering beginning operations into London, decided to operate from Heathrow instead of Gatwick. For example, GAL has told the CAA that:
- "In December 2012 AeroMexico launched a 3 times per week service from Heathrow using a 767. Gatwick was in competition with*

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<sup>622</sup> Source: Aer Lingus.

<sup>623</sup> Source: Lufthansa.

<sup>624</sup> Source: Lufthansa.

*Heathrow over this service and had advanced discussion with AeroMexico, however ultimately lost out to Heathrow.*"<sup>625</sup>

- 7.135 Emirates suggested that Gatwick's reputation is an important factor why it is sometimes not seen as substitutable for Heathrow. For example, it told the CAA:

*One of Gatwick's main competitive disadvantages is its image due to its reputation for leisure*<sup>626</sup>

- 7.136 The above airlines' views are consistent with comments from GAL's internal documents regarding its branding in certain long-haul markets.

- 7.137 In its internal documents regarding route development strategy GAL has noted:

- In regard to the "MECA" region (which includes the Middle East) *"GAL will need to work hard to increase frequency on these routes with competition from LHR."*<sup>627</sup>
- *"Attracting new business will need to overcome the perception that wealthy middle eastern airlines need to be at LHR"*
- In regard to South Asia, that *"As with North America GAL will face a challenge developing traffic and its reputation in this region."*<sup>628</sup>
- In regard to East Asia, *"London Gatwick has no profile in these overseas markets and will need to raise this significantly to stand a chance of capturing sufficient market share."*<sup>629</sup>

### **Switching services from Gatwick to Heathrow**

- 7.138 The pattern of FSCs switching between Gatwick and Heathrow has consistently tended to be for airlines to relocate operations into Heathrow when it has become feasible. For example, in 2008, following the "Open Skies" agreement, a number of US carriers operating at Gatwick transferred their services to Heathrow.

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<sup>625</sup> Source: GAL.

<sup>626</sup> Source: Emirates.

<sup>627</sup> Source: GAL.

<sup>628</sup> Source: GAL.

<sup>629</sup> Source: GAL.

- 7.139 Another airline that recently moved its operations from Gatwick to Heathrow is Delta Airlines. In April 2012, Delta airlines operated its last Gatwick route, moving it to Heathrow. Delta told the CAA that:
- *It developed a strategy centred on corporate business. Placing its aircraft at LHR (when it merged with Northwest) provided access to multiple hubs to bring in pax from Detroit, Atlanta as well as the key JFK market.*
  - *Over the last few years, it has increased the number of flights and frequencies into the LHR market.*
  - *The LGW corporate market is not of the same scale and volume as LHR; for this reason it couldn't justify serving it.*
  - *LHR is the preferred London airport; it is where business passengers are.*
  - *LGW is a great airport with great facilities and good links with the Gatwick Express, but LHR is closer and perceived to be the London airport.*<sup>630</sup>
- 7.140 Similarly, US Airways recently announced that it would be ceasing operations at Gatwick, moving its Charlotte route to Heathrow from April 2013.<sup>631</sup>
- 7.141 Regarding the movement of airlines from Gatwick to Heathrow, Flybe has told the CAA:
- *Airlines are waiting for slots at LHR, and then [when they acquire them] they're gone.*
  - *LGW has tried to attract long haul, but at the end of the day, these airlines want to go to LHR.*
  - *LGW is not seen as a business connecting hub.*
  - *It does have some leisure and West Indian connectivity but this has reduced recently.*<sup>632</sup>
- 7.142 The CAA notes, however, that interest in and willingness to switch

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<sup>630</sup> Source: Delta.

<sup>631</sup> See: <http://routes-news.com/news/item/803-us-airways-to-switch-charlotte-london-service-from-gatwick-to-heathrow>, (accessed February 2013).

<sup>632</sup> Source: Flybe.

aircraft to Heathrow is not just limited to US carriers. A number of other airlines, which have operations at both Gatwick and Heathrow, have expressed interest in potentially switching. For example, Virgin has said that:

*“Capacity constraints are a key limitation on substitution. Virgin Atlantic would want to move more of its services to Heathrow, but has been unable to do so because of a lack of runway slots. In addition, Virgin Atlantic has [redacted]”*<sup>633</sup>

*“As a general point, Virgin Atlantic’s growth and expansion has been limited by the lack of available and suitably timed slots, particularly at Heathrow. Hypothetically, if there were no slot constraints (and airport capacity constraints), to date Virgin Atlantic would have sought (as a minimum) to move its current 6 services from Gatwick to Heathrow and therefore operate a significantly larger service (a total of 30 daily slot pairs).”*<sup>634</sup>

7.143 [redacted] also told the CAA that:

*Hypothetically, if it had sufficient slots at LHR, it would consider [redacted] and [redacted]. However, this is [redacted].*

*However, if it was [redacted]...this would not be sustainable.*<sup>635</sup>

7.144 Emirates also told the CAA that:

- *LHR is key; if LHR had four runways we would have never needed to look at Gatwick*<sup>636</sup>
- *LHR has higher yields (due in part to the concentration of business passengers) than LGW and also better connectivity, including to the USA, Canada, UK and Europe.*<sup>637</sup>

7.145 In addition, Air Malta told the CAA that:

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<sup>633</sup> Source: Virgin.

<sup>634</sup> Source: Virgin.

<sup>635</sup> Source: [redacted]

<sup>636</sup> Source: Emirates.

<sup>637</sup> Source: Emirates

- *It used to only operate from LHR, but because of the limited availability of slots - which meant it could not grow further at LHR - the only place for them to go in London was LGW.*
- *If there was a significant expansion of capacity at LHR, it would add capacity, however, at this stage, it wasn't sure whether this would be at the expense of LGW (i.e. removing its frequency from LGW altogether).<sup>638</sup>*

7.146 Air Malta also told the CAA that:

- *Its passengers also prefer LHR<sup>639</sup>*

7.147 The evidence also suggests that airlines at Gatwick might consider it necessary to operate all their services to London from Gatwick, instead of Heathrow, if it is not viable for them to operate from Heathrow or another London airport. For example, in 2011, as part of its section 41 complaint, Flybe stated that:

*"all three of LTN/STN/LCY...enjoy a much smaller local natural market [than Gatwick]."<sup>640</sup>*

*"...interlining opportunities at LTN and STN are virtually non-existent."<sup>641</sup>*

7.148 Flybe also stated that capacity constraints were a major factor why it could not operate from Heathrow:

*"It is impracticable for Flybe to contemplate moving its LGW services to LHR. Slot constraints there are such that there is no prospect of Flybe being able to construct a weekly timetable for its regional services which would be timed consistently, day by day, and operate at times which fitted the relevant markets and were operationally achievable."<sup>642</sup>*

7.149 Similarly, Air Berlin, a partner of BA in oneworld and a recent entrant at Gatwick, told the CAA that:

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<sup>638</sup> Source: Air Malta.

<sup>639</sup> Source: Air Malta.

<sup>640</sup> Source: Flybe.

<sup>641</sup> Source: Flybe.

<sup>642</sup> Source: Flybe.

*It would like to operate out of Heathrow, due to the high catchment attractiveness and the oneworld network available there, but it is a closed shop for it at the present time due to slot limitations.*<sup>643</sup>

## Conclusion

7.150 The CAA considers that the evidence clearly points to:

- FSCs and associated feeder traffic airlines having a strategic requirement to operate to, and from, London for reasons related to the strength of passenger demand.
- Heathrow, being the preferred London airport from which FSCs and associated feeder traffic carriers operate, reflects the greater presence of network benefits, the higher yields from higher premium cabin demand and Gatwick's historical reputation as a leisure airport.

7.151 However, the CAA considers that the scarce slot capacity and cost of slot acquisition at Heathrow are likely to constitute (the main and most considerable) barriers to switching for FSCs and associated feeder traffic airlines considering or attempting to switch away from Gatwick. The capacity constraints at Heathrow are considered further in section 5.

## Section 4: Countervailing buyer power

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7.152 In this section, the CAA considers the ability of FSCs and associated feeder traffic to constrain an airport operator's pricing power by leveraging the importance of its operations during negotiations. In particular, this section considers:

- what the CAA said in the Initial Views;
- GAL's views;
- airlines' responses; and
- the level of countervailing buyer power that some airlines may have.

7.153 GAL's behaviour with regard to attracting new traffic and negotiating

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<sup>643</sup> Source: Air Berlin.

with airlines is considered in chapter 9.

### CAA Initial Views

- 7.154 In the Initial Views, the CAA indicated that GAL had, on the whole, been able to replace lost operations with new routes or carrier; and has achieved this without a significant reduction in average airport charges below the maximum allowed level.<sup>644</sup>
- 7.155 The CAA noted that this might suggest that any threat of airlines switching away from Gatwick had not translated into a need to reduce prices due to the potential for any vacated capacity to be taken up by other, previously unmet, demand that had not been able to secure the necessary slots. It also noted that the potential for backfill of capacity appeared to be a factor that might significantly reduce the strength of competitive pressure faced by the airport operator.<sup>645</sup>

### GAL's submissions

- 7.156 Regarding the degree of countervailing buyer power held by its airlines, GAL has said that:
- *“British Airways (14%) and Virgin (5%) are also important customers for Gatwick. However, as these airlines have their main operations located at Heathrow and Gatwick services could potentially be switched to Heathrow through purchase of the necessary slots, mergers or changing the use of existing slots. This increases the risk of certain routes ceasing at Gatwick and being focussed instead at Heathrow. For example, changes at bmi, if it is sold, could result in more efficient use of slots at Heathrow.*
  - *Other long-haul carriers may be smaller than British Airways and Virgin, but they are difficult to replace (at least with similarly valuable services) and these carriers are well able to play-off different airports, even beyond the South East and the UK, against each other. This is particularly true when the airport acts as a spoke in an airline’s hub network, which is often the case for Gatwick.”*

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<sup>644</sup> CAA, Initial Views, paragraph 3.56.

<sup>645</sup> CAA, Initial Views, paragraph 3.57.

- *“It is the case that several airlines at Gatwick have significant levels of buyer power when negotiating with Gatwick. If Gatwick were to attempt to raise prices above competitive levels, it would be constrained in its ability to do so by the credible threat and ability of airlines to switch their demand away, or to cease to fly certain routes, or to cut back their growth plans for the future”*<sup>646</sup>

7.157 As a starting point, the CAA has considered the relative importance of Gatwick, and its airlines, to their respective operations. Figure 7.4 shows the five airlines in this relevant market that have at least a two per cent share of the airport’s passengers.

**Figure 7.4: Relative importance of Gatwick and its airlines to their respective operations**

Airline	Airline's passengers as share of airport's passengers (2011)	Share of airline's passengers that are served from Gatwick (2011)	Total income (aero + retail) per passenger <sup>647</sup>
BA	14.5%	14%	£ [§<]
VAA	4%	27%	£ [§<]
Flybe	4%	17%	£ [§<]
Aer Lingus	2%	8%	£ [§<]
Emirates	2%	2%	£ [§<]

Source: CAA airport statistics and research based on airline annual reports

7.158 Figure 7.4 shows that FSCs and associated feeder traffic have low individual shares of the airport’s total passengers, with BA having largest share (14.5 per cent). The CAA considers that this suggests that FSCs and associated feeder airlines are unlikely to be sufficiently important to Gatwick’s operations to hold any significant degree of countervailing buyer power.

7.159 However, while the FSCs and associated feeder traffic share of Gatwick’s passenger traffic may not be particularly high, passengers on these carriers are in some cases the most valuable in terms of total

<sup>646</sup> GAL, Airport competition: Competing to grow and become London’s airport of choice, An initial submission from Gatwick Airport to inform the CAA’s review of airport competition, November 2011, Q5-050-LGW05, page 76 and 80.

<sup>647</sup> Source: GAL.



income (including commercial retail expenditure) per passenger. For example, total income per passenger for the FSC and associated feeder traffic tend to be slightly higher than LCCs, [redacted], and among the highest for the airlines constituting 90 per cent of GAL's revenue.<sup>648</sup> This suggests that FSCs and associated feeder traffic airlines can be important contributors to GAL's revenue.

- 7.160 A number of airlines operating from Gatwick have also provided evidence of their perceived ability to threaten, credibly, as part of their negotiations with GAL, to switch away from the airport. For example, BA told the CAA:

*It pays the published tariffs and GAL always charge to the cap.*

[redacted].

[redacted].

*In ACC meetings, GAL has a 'take it or leave it' approach and present their proposals rather than using it as a forum to consult<sup>649</sup>*

- 7.161 Another airline also indicated that it has a challenging relationship with GAL and has at times found it difficult to engage effectively with the airport. In particular it noted:

*It does not receive discounts on aeronautical charges or marketing support for its routes at LGW, and that previous negotiations have not come to anything.<sup>650</sup>*

- 7.162 In addition, Air Malta told the CAA that:

*It does not receive any support from LGW (it hasn't tried to negotiate any discounts, and nothing has been offered). It added that it would be futile to do so.<sup>651</sup>*

- 7.163 Evidence from Flybe also suggests that attempts at negotiating discounts on the tariff aeronautical charges have not been successful.<sup>652</sup>

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<sup>648</sup> Source: GAL.

<sup>649</sup> Source: BA.

<sup>650</sup> Source: [redacted] However, the airline has subsequently told the CAA that [redacted].

<sup>651</sup> Source: Air Malta.

<sup>652</sup> Source: Flybe.

7.164 GAL has provided evidence to the CAA that a number of FSCs and feeder airlines have ceased or reduced operations at Gatwick. If these airlines' decisions were related to price or service quality, this could indicate that they exercised a degree of countervailing buyer power. For example, GAL has told the CAA that [X], having commenced its route to [Y] in the [Z], has:

*"...recently announced their intention to cease the Gatwick operation [X]."*<sup>653</sup>

7.165 The CAA has examined this claim and notes that the motive behind the closure does not appear to be related to the level of airport charges or service quality at Gatwick. In particular, the CAA notes that the airline informed it that:

- *It withdrew the service for the Winter 2012 traffic season due to lack of demand. This decision was not related to pricing at Gatwick.*
- *It is recommencing the service (one daily frequency) for the Summer 2013 traffic season. Demand for this service is sufficient in Summer but not in Winter traffic seasons.*
- *It added that GAL is generally active in seeking to retain services.*<sup>654</sup>

7.166 In addition, GAL told the CAA that Air Berlin, having switched two services from Stansted in February 2011, had become:

*"[X]."*<sup>655</sup>

7.167 Regarding its route to Hannover, Air Berlin<sup>656</sup> also told the CAA that:

*From February 2011, it flew from Gatwick to Hannover but closed this route for commercial reasons.*<sup>657</sup>

7.168 GAL has also provided evidence to the CAA that Hong Kong Airlines, having commenced operations to Gatwick in March 2012, terminated

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<sup>653</sup> Source: GAL.

<sup>654</sup> Source: [X].

<sup>655</sup> Source: GAL.

<sup>656</sup> The CAA understands Air Berlin has now withdrawn from Gatwick.

<sup>657</sup> Source: Air Berlin.

its services in September 2012 "*citing the poor European climate.*"<sup>658</sup>

- 7.169 The CAA also understands that Korean Air, having begun operating from Gatwick in April 2012, and previously suspended their operations during the Winter 2012/13 traffic season, has announced an end to its Gatwick services from April 2013.<sup>659</sup>
- 7.170 The above examples show that a number of airlines at Gatwick have ceased their operations, but they appear to have done so for reasons that were not directly related to the balance of power in negotiations with GAL. In some of these cases, while GAL had made offers to an airline to remain at the airport, the airline did not change its decision. Further, as these airlines each accounted for less than two per cent of the airport's passengers, the CAA considers that it is unlikely that they would have been in a position to leverage any degree of buyer power.
- 7.171 With the exception of BA, FSCs and associated feeder traffic airlines have shares of less than 5 per cent of Gatwick's passenger traffic. However, they can yield a slightly higher total income per passenger than LCCs and charter airlines, which suggests that they can be an important contributor to GAL's revenue. Nevertheless, due to the capacity constraints at Heathrow – the only other airport in the relevant market – and the current unsuitability of Stansted, the CAA considers that these airlines have very limited scope to switch away from Gatwick. As a result, the CAA also considers that they are unlikely to be able to, credibly, threaten to switch away in negotiations.
- 7.172 In addition, evidence of airline switching suggests that the switching that has occurred has been due to the nature of passenger demand, rather than GAL's pricing. The CAA considers that this does not support the contention that the airlines have buyer power.
- 7.173 Overall, the CAA therefore considers that the evidence it has received strongly points to there being little possibility for FSCs and associated feeder traffic airlines to credibly threaten to switch away as part of their negotiations with GAL.

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<sup>658</sup> Source: GAL.

<sup>659</sup> See: <http://www.routesonline.com/news/38/airlineroute/175401/korean-air-closes-reservations-for-london-gatwick-service-in-s13/>, (accessed April 2013).

## Section 5: Capacity constraints and barriers to airline entry and expansion

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7.174 In the preceding sections, the CAA has considered that a reduction in frequency of flights is likely to be the way in which FSCs and associated feeder airlines would be most able to switch away from Gatwick in light of a 10 per cent price increase. By contrast, switching marginal aircraft to Heathrow was considered not to be viable in practice due to the severity of capacity constraints and the costs of slot acquisition. This section analyses, in detail, the extent of the capacity constraints and slot availability at Heathrow to evaluate the scope available to airlines at Gatwick to switch or expand their operations at Heathrow.

### CAA's Initial Views

7.175 In the Initial Views, the CAA indicated that:

- There remains limited capacity at most of the other London airports and that capacity scarcity is likely to develop further, given current government policy.
- There remains a considerable amount of capacity at Stansted and, on the basis of capacity alone, there is scope for airlines to switch certain services away from Gatwick, in particular point-to-point short-haul services being able to use Stansted or Luton.
- Other services, in particular those involving long-haul routes and a degree of network services, are likely to have fewer options given Heathrow's severe capacity constraints.
- While Stansted might be able to provide the necessary infrastructure that can accommodate large long-haul aircraft, it does not, at present, provide any long-haul services and cannot offer new long-haul airlines access to significant volumes of connecting passengers.

7.176 In summary, it would appear that the capacity constraints in the South East of England are contributing to reducing competitive constraints faced by Gatwick, in particular for FSCs relying on a degree of long-haul and network services.<sup>660</sup>

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<sup>660</sup> Source: CAA, Initial Views, paragraphs 3.156-8.

**GAL's submissions**

- 7.177 In its submissions to the CAA, GAL noted several points regarding capacity constraints and their implications for airline switching, including:
- *The demand-capacity balance in the South East has changed markedly in the recent years.*
  - *There is extensive capacity available in the South East market, potentially amounting to 30% extra ATMs and over 40% passengers;*
  - *There is unused peak period capacity at Stansted and Luton;*
  - *This position can be further improved through better use of infrastructure at all airports, including by increasing the number of ATMs, raising aircraft sizes, changing the service mix, or by raising load factors;*
  - *Even when capacity is fully utilised, churn remains high and there is scope to compete for higher value traffic; and*
  - *The recent downgrading of UK and Europe growth prospects suggests that demand will remain subdued for some time and there is some risk of renewed traffic decline, with a further impact on spare capacity.*<sup>661</sup>
- 7.178 As discussed in chapter 5, certain London airports are not considered substitutable for Gatwick by FSCs. This results in the relevant market definition being limited to Gatwick and, possibly, Heathrow. This implies that consideration of capacity at Stansted and Luton is not relevant for the present analysis. The potential impact of UK and European growth prospects are considered in chapter 6, section 6, on future demand growth.
- 7.179 GAL has made several statements regarding the capacity availability at Heathrow. GAL has noted, for example, that:

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<sup>661</sup> Source: GAL, Airport competition: An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Ref: Q5-050-LGW05, page 50.

- *“[DfT’s forecasts indicate] that there is capacity at Heathrow to serve significant numbers of additional passengers, through a shift to the use of larger-bodied aircraft and increased load factors rather than an increase in ATMs. Heathrow can accommodate increased passenger numbers, even in peak periods, notwithstanding runway capacity limitations”;*
- *“Moreover, we note that even at Heathrow, where there is no peak capacity that is currently unused, airlines can still access slots by buying slots or airlines that have holdings of slots... The potential purchase of bmi by British Airways will involve a transfer of peak slots at Heathrow and we see other examples of slot transfer and slot leasing at both Gatwick and Heathrow. In practice, therefore, peak slots are often available at a price. The price reflects the fact that some airport charges are regulated but also the revenue opportunities that airlines derive from selling peak slot services to passengers”<sup>662</sup> and;*
- *“The fact that Heathrow faces capacity constraints overall does not prevent it from acquiring more long haul services (e.g. from Gatwick or through growth) facilitated, for example, by secondary trading of Heathrow slots, airline mergers, or simply normal traffic churn. In addition, it is also the case that there is significant spare capacity for passengers at Heathrow as flights are not operated to capacity and there is scope for increasing the average size of aircraft. Moreover, even though the CAA considers that Heathrow may not be an active competitor for charter or LCC airlines, FSCs operating from Heathrow still carry many point-to-point passengers (and could carry many more), often in competition with LCC or charter operators.”<sup>663</sup>*

7.180 The capacity constraints at Heathrow and implications for airline switching are considered below.

7.181 Regarding Stansted, GAL said:

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<sup>662</sup> Source: GAL, Airport competition: Competing to grow and become London’s airport of choice, An initial submission from Gatwick Airport to inform the CAA’s review of airport competition, November 2011, Q5-050-LGW05, page 51 and 54.

<sup>663</sup> Source: GAL, Letter to CAA, CAA’s assessment of market power at Gatwick, Ref: Q5-050-LGW09, page 5.

- *“...there is currently significant spare capacity at Stansted both in terms of ATMs and passengers.” [ we note that since this examination was made based on 2010 data the spare capacity at Stansted has increase significantly].*
- *In addition to the available capacity at Stansted implied by the above, there is further scope available to it to increase its capacity. This could be for example by increasing its annual ATMs further (as is the case at Gatwick) to around 280,000 and by incentivising a change in the fleet mix using the airport so that larger planes are used. We see no reason why Stansted could not reach the same level of movements and passengers as is being forecast by Gatwick.<sup>664</sup>*

- 7.182 Following the analysis in chapter 5 on market definition, and given the above analysis in this chapter, the CAA continues to take the view that Stansted is highly unlikely to be a viable substitute in current market conditions, despite having considerable capacity. This is due to the airport having a weaker natural catchment, as well as currently lacking scheduled long-haul operations and feeder traffic.
- 7.183 The CAA considers that the network effects between long-haul flights and feeder traffic is such that it creates a “chicken and egg” problem for airlines seeking to relocate marginal services: a lack of onward long-haul connections at an airport is likely to reduce the willingness of feeders airlines to switch to that airport, while a lack of feeder traffic is likely to reduce the willingness of FSCs to switch to that airport.
- 7.184 Overall, the CAA considers that Stansted is not likely to be seen as a viable substitute airport in the short to medium term based on the current low cost carrier and charter mix of traffic operating at the airport. However, the CAA also notes that recent change of ownership of Stansted (from BAA to MAG in March 2013) means that the airport could potentially become a substitute in the longer-term.
- 7.185 Therefore, this section focuses on the capacity constraints at Heathrow and the potential for airlines to switch away from Gatwick.

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<sup>664</sup> Source: GAL, Airport competition: Competing to grow and become London’s airport of choice, An initial submission from Gatwick Airport to inform the CAA’s review of airport competition, November 2011, Q5-050-LGW05, page 51.

## Heathrow

- 7.186 In 2011, 69.4 million passengers travelled through Heathrow, amounting to 476,295 ATMs,<sup>665</sup> which is close to its movement cap of 480,000. This movement cap is unlikely to be lifted in the short to medium-term, in particular because mixed mode operations are prohibited.<sup>666</sup>
- 7.187 Based on the ACL Start of Season report for summer 2012, which is representative of historical patterns, there is on average four and 5 per cent excess demand (i.e. 104 and 105 per cent) for departure and arrival slots at Heathrow for a particular hour of the day.<sup>667</sup> A similar pattern of excess demand can be seen in the Winter traffic seasons.
- 7.188 GAL argues that capacity constraints can be overcome to an extent through;
- *"...better use of infrastructure at all airports, including by increasing the number of ATMs, raising aircraft sizes, changing the service mix, or by raising load factors"; and*
  - *"Even when capacity is fully utilised, churn remains high and there is scope to compete for higher value traffic."<sup>668</sup> The issue of airline churn at Heathrow is considered below when discussing means of slot acquisition".*
- 7.189 As discussed above, Heathrow is within one per cent of the ATM cap to which it is subject. In addition, as Heathrow operates as a hub airport, HAL's incentives are to obtain the optimal mix of traffic for connectivity between services. In light of this, the CAA considers that HAL would need to balance an incentive for efficient use of limited capacity (e.g. structuring airport charges to increase aircraft size)

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<sup>665</sup> Air transport movements.

<sup>666</sup> Mixed mode operation of the runways allows both runways to be used simultaneously for a mix of arrivals and departures, increasing the capacity of the runways.

<sup>667</sup> In general, these figures are lower for the previous two Summer traffic seasons. For departure and arrival slots, the highest excess demand is 28 and 20 per cent respectively. There are a small number of instances where demand is below capacity, though the minimum is 80 per cent slot demand.

<sup>668</sup> Source: GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, page 50.



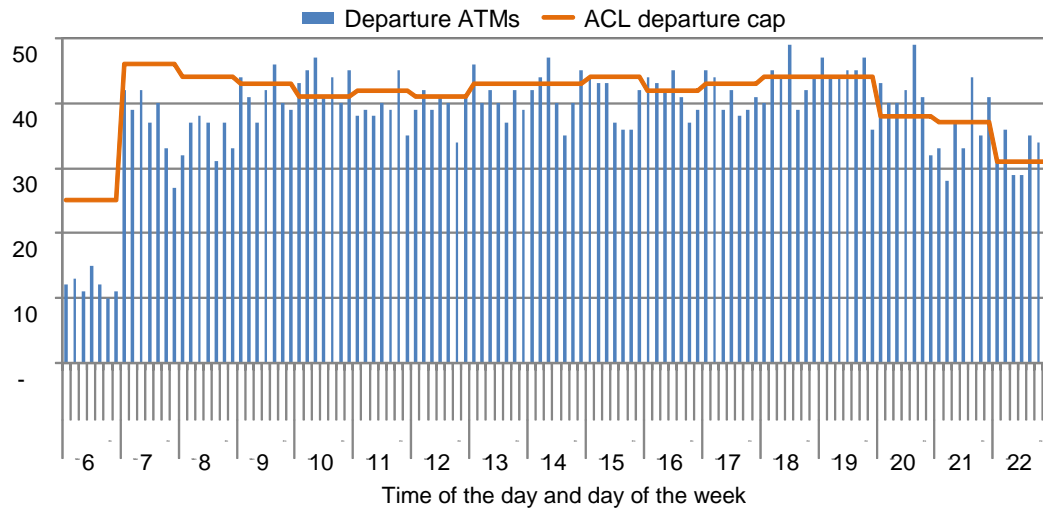
against the need for a suitable mix of services to maintain the airport as a hub for airlines. Related to this, decisions by airlines to increase aircraft sizes or raise load factors can also be affected by their network considerations and passenger demand on services to and from Heathrow.

### **Demand drivers for slot capacity**

- 7.190 Demand for long-haul route slots are driven by the continent (i.e. westward or eastward direction) of the destination airport, as well as carrier-specific consideration with regards to onward connections. Demand for short-haul route slots are determined, in part, by the frequency of the service that an airline seeks to operate.
- 7.191 Icfi highlights, in a report for GAL, that demand for departure slots at Heathrow, though more evenly spread, is weakest during:
- 1700 to 1900 BST
  - After 2100 BST<sup>669</sup>
- 7.192 However, the CAA's analysis suggests another period of weaker demand for departure slots between 0600 and 0900 BST. This might reflect the fact that short-haul feeder flight departures need to be timed so that they coordinate with long-haul arrivals between 0600 and 0800 BST and that there are few, if any, long-haul departures before 0930 BST.

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<sup>669</sup> Source: Icfi.

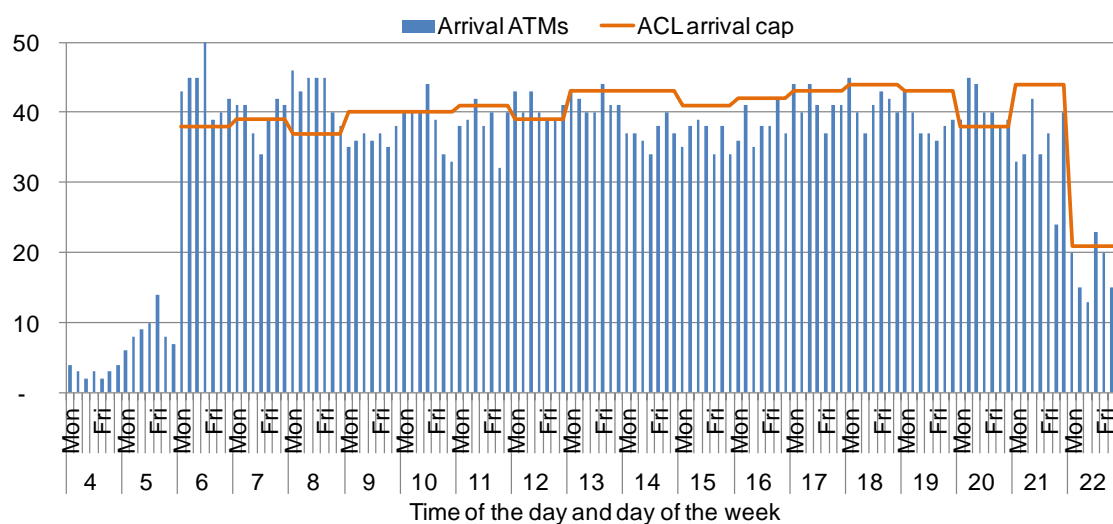
**Figure 7.5: Departure slots vs ACL cap S12 LHR**

Source: CAA airports statistics and ACL declared capacity

7.193 Demand for early morning arrival slots is, in part, artificially concentrated by night turbojet curfews and also affected by the departure time at the other end of the route needing to be reasonable. Icfi also notes that there are three distinct demand peaks for arrivals:

- 0700 to 0900 BST
- 1200 to 1400 BST
- 1900 to 2100 BST<sup>670</sup>

<sup>670</sup> Source: Icfi.

**Figure 7.6: Arrival slots vs ACL cap S12 LHR**

Source: CAA airports statistics and ACL declared capacity

7.194 Overall, the CAA considers that there is limited availability of both departure and arrival slot capacity at Heathrow. The following section considers whether the limited availability could still, in theory, enable carriers to switch their marginal services from Gatwick to Heathrow.

### Availability of suitable slots

7.195 In order to switch away marginal services from Gatwick to Heathrow, FSCs would need to find suitably timed slots with which to operate their routes, probably at a similar time to when their service is currently operated from Gatwick.

### Long-haul routes

7.196 Demand for slots at Heathrow to operate long-haul services varies according to the continent where the destination is located as time differences mean that a reasonable departure and arrival times needs to be obtained. Flights on long-haul routes from Gatwick are mostly concentrated between 0900 and 1430, which broadly reflects the fact that most long-haul flights from Gatwick are to North America, the Caribbean and the Americas.<sup>671</sup> Most long-haul arrivals at Gatwick occur between 0600 and 1035.

7.197 BA told the CAA that:

<sup>671</sup> The small number of exceptions includes two services by Emirates to Dubai, and a morning service to Banjul, Gambia by Monarch.

- *For long-haul route, one slot pair per day is required (assuming a daily service)<sup>672</sup>*

7.198 The CAA considers that this suggests that FSCs operating long-haul services would require one slot pair per day (including one departure and one arrival slot) to relocate a long-haul service from Gatwick to Heathrow, with the number varying between one and seven slot pairs depending on the required weekly frequency of the service. The “marginal unit” for long-haul flights would then be at least one slot pair per week.

### Short-haul routes

7.199 The CAA notes that there are two types of short-haul services; those operated by based FSCs into their hub at Heathrow, for example by BA, and those operated as a “spoke” service into inbound carriers’ respective hub airports.

7.200 The CAA considers that short-haul routes that might be switched to Heathrow would be likely to be positioned to provide connecting feeder traffic to a carrier’s own, or its partner airlines’, long-haul flights.

7.201 To do so, these flights would need to be timed in such a way as to be able to arrive in time to supplement departing long-haul flights and depart with a sufficient lag to allow arriving long-haul passengers to transfer through the airport. In light of this, demand from short-haul route slots is unlikely to be strong during the period of greatest spare capacity, between 0600 and 0900. This point was highlighted by BA, which told the CAA that:

*For a short-haul service to operate a full day, generally 3 slot pairs are required in a given day, one of which will be timed during “peak hours”<sup>673</sup>*

7.202 The CAA considers that this suggests that airlines looking to switch a short-haul service to Heathrow would require at least one slot pair in a day, with weekly slot demand varying according the frequency of service, and for short-haul “hub” flights a minimum of three slot pairs in any given day. In addition, it suggests that airlines operating shorter routes might require more than one daily frequency into Heathrow to

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<sup>672</sup> Source: BA.

<sup>673</sup> Source: BA.

make the service sustainable. As a minimum, the “marginal unit” for short-haul flights would appear to be one slot pair per week, but possibly rising to three daily slot pairs if a full day is operated.

### Slot availability

7.203 Figure 7.7 sets out of the average number of available daily slots at Heathrow during the ACL peak week during summer 2012, with the period of most Gatwick long-haul departures and arrivals highlighted in red and blue respectively.

**Figure 7.7: Average number of available daily slots at Heathrow during ACL peak week – summer 2012**

Hour	Departures	Arrivals
6	13	-5
7	9	0
8	9	-6
9	2	4
10	-3	1
11	3	3
12	2	-2
13	2	1
14	1	6
15	4	4
16	0	4
17	2	2
18	1	3
19	0	4
20	-3	-3
21	1	9
22	-2	2

Source: CAA airport statistics and ACL declared capacity

Gatwick long-haul departure times shown in red, arrival times in blue.

7.204 Figure 7.7 shows the number of flights (ATMs) actually operated against the ACL declared capacity cap. As airlines can reserve 20 per cent of a slot series for resilience, this might mean that fewer flights are operated than slots allocated. As a result, Figure 7.7 might slightly over-estimate the number of available slots for Summer 2012.

7.205 In presentations to airlines, HAL set out the availability in the slot pool for Heathrow, as shown in Figure 7.8 (below). This shows an even

more limited availability than that suggested by the CAA's analysis.

**Figure 7.8: Heathrow slot pool**<sup>674</sup>

S13	Arrivals							Departures						
	Mon	Tue	Wed	Thu	Fri	Sat	Sun	Mon	Tue	Wed	Thu	Fri	Sat	Sun
500	0	0	0	0	0	1	0	0	0	0	0	0	2	8
600	0	0	0	0	0	0	0	0	0	0	0	0	2	7
700	0	0	0	0	0	0	0	0	0	0	0	0	1	3
800	0	0	0	0	0	0	0	0	0	0	0	0	0	1
900	0	0	0	0	0	0	0	0	0	0	0	1	0	0
1000	0	0	0	0	0	1	1	0	0	0	0	0	0	0
1100	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1200	0	0	0	1	1	1	1	0	0	0	0	0	0	0
1300	0	0	1	0	1	1	0	0	0	2	0	0	3	0
1400	0	0	0	0	0	0	0	0	0	1	1	0	2	3
1500	0	1	0	1	0	1	1	0	0	0	0	0	1	0
1600	0	1	0	2	1	5	2	0	0	0	0	0	2	1
1700	0	0	0	0	0	2	0	0	0	0	0	0	1	0
1800	0	0	1	0	0	7	2	0	0	0	0	0	6	2
1900	1	0	2	1	0	4	1	0	0	2	1	0	4	0
2000	2	0	0	1	3	14	4	2	1	1	0	0	4	0
2100	0	0	0	0	1	5	0	1	0	3	1	3	1	4

Source: HAL representation of ACL data

- 7.206 The CAA notes that the evidence is clear that there is very limited spare slot capacity in the periods during which Gatwick's current long-haul flights arrive and depart. This also suggests that these would be the periods during which the slot values are highest and entry through slot acquisition is most costly. More generally, outside of the trough period in departure slot demand, the CAA notes that there is, on average, at most four departure and nine arrival slots available per day (with the median availability being two and four departure and arrival slots respectively across the day).
- 7.207 Despite the marginal unit being only one slot pair in a day for a Gatwick airline to move a long-haul service to Heathrow, the CAA considers that the scope for a significant and constraining level of switching is very limited in light of the scarcity of available suitably-timed slot capacity. With respect to short-haul services, which would require between one and three slot pairs on a given day, it is clear that there is very limited scope for such services to be switched from Gatwick to Heathrow. For example, in the context of whether it was possible for Flybe to move from Gatwick to Heathrow, Flybe said:

<sup>674</sup>Source: HAL.

*“Slot constraints there are such that there is no prospect of Flybe being able to construct a weekly timetable for its regional services which would be timed consistently day by day and operate at times which fitted the relevant markets and were operationally achievable.”<sup>675</sup>*

- 7.208 It can be argued that airlines currently holding slots at both Gatwick and Heathrow might find it comparatively easier to switch marginal services between the two airports without acquiring additional slots at Heathrow. However, relocating a service by allocating it to an aircraft at Heathrow would require the displacement of a route that is currently operated from the airport. For an airline to be willing to displace a service currently operated at Heathrow, the expected future yield of the switched route would need to be equal to, or greater than, the yield of the route it would displace. This means that it would have a neutral or positive effect on the airline’s network profitability.
- 7.209 However, given the leisure-oriented nature of Gatwick operations, typically with lower airline yields due to the lower demand on the route for premium cabins, the CAA would expect this requirement to be a barrier to switching services to Heathrow. In addition, as airlines seek to maximise aircraft utilisation, attempting to constrain GAL by moving a marginal service to Heathrow would result in reduced utilisation for one (or more) of the airline's aircraft at Gatwick. Consequently, in order for this to a viable means of constraining the airport, the cost of reducing aircraft utilisation would need to be less than, or at most equal to, a ten per cent price increase. The CAA considers that this is unlikely to be the case.
- 7.210 Similarly, switching a marginal aircraft from Gatwick to Heathrow to constrain GAL without acquiring additional slot(s), would result in the need to re-allocate - or ground - an aircraft currently at Heathrow. This action would only be viable if an equally (or more) profitable use were found for the displaced aircraft. The lack of such an opportunity would, again, lead to the under-utilisation of aircraft, which is likely to be a substantial cost to the airline, and would be likely to render switching marginal aircraft to Heathrow in order to constrain GAL unrealistic. Overall, the CAA considers that acquiring additional slots appears to an important, and often necessary, means of switching to Heathrow.

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<sup>675</sup> Source: Flybe.

7.211 In relation to this, BA told the CAA that:

*...aircraft are expensive assets which need to be used in order to make a profit.*<sup>676</sup>

7.212 Adding that,

*A decision would also have to address the potential use of empty slots at LGW (and LHR), which would be vacated if an aircraft switched away from the airport.*<sup>677</sup>

7.213 Overall, the CAA considers that the very limited spare slot capacity at Heathrow would restrict the ability of carriers at Gatwick to move marginal services to Heathrow. However, there are several means of acquiring slots which might be open to different airlines. The following section considers these means of slot acquisition.

#### **Means of slot acquisition**

7.214 Airlines holding slots acquire grandfather rights allowing them first refusal of the same slot in the corresponding season the following year. Once allocated by ACL, the independent slot coordinator, slots are operated under a “use-it-or-lose-it” rule whereby a carrier is required to have a utilisation level of 80 per cent for each of its allocated slot pairs over its slot series. Where an airline cannot justify its utilisation below 80 per cent, it must release the slots back to the slot pool, or trade or sell it to another carrier.<sup>678</sup>

7.215 In describing slot trading, HAL explains that a slot transfer involves both the runway slot pair(s) and the associated historical terminal and stand capacity rights:

*"Traded components:*

▪ *Runway slots:*

- *These can be retimed if the runway slots are available.*
- *Any retime must also fit the terminal and stand capacity.*

*Terminal and Stand Capacity:*

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<sup>676</sup> Source: BA.

<sup>677</sup> Source: BA.

<sup>678</sup> The EU slot regulations are currently undergoing review.



- *The Buyer purchases the Historic Terminal and Stand Capacity and can operate from the Historical Terminal.*
  - *e.g. code D aircraft with 150 seats in T3.*
- *A change of terminal/aircraft stand size can be requested and would be assessed against declared capacity.*
- *A new entrant would be assessed against all terminals and allocated to the terminal with the most suitable capacity.*<sup>679</sup>

7.216 HAL also states that, for all the benefits of slot trading, "requests to [sic] change to historic terminal capacity [are] not guaranteed".<sup>680</sup>

7.217 This means that the ability of an airline to find one or more suitable slot pair(s) with which to enter Heathrow depends on the timing of the slot pair but, also, whether the airline is able to operate from a reasonable terminal location at the airport, relative to its strategic partners.

**In its presentations to potential new entrants, HAL set out the advantages and advantages and disadvantages of the various ways of acquiring slots to operate from to operate from Heathrow. This is reproduced in**

7.218 Figure 7.9 below.

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<sup>679</sup> Source: HAL.

<sup>680</sup> Source: HAL.

**Figure 7.9: "Accessing Heathrow"**

Option	Pros	Cons
From slot pool via ACL	Free of charge	Very limited slots available Times likely to need flexible approach
Slot trade - buy slot from another airline	Permanent access to airport Schedule can target ideal times	Higher initial cost
Slot lease - lead slot from another airline	Spread cost over time Schedule can target ideal times	Not permanent
Alliance partner - trade, lease or JV with alliance partner	Deal can be more flexible Schedule can target ideal times	

Source: HAL

7.219 In presentations to airlines, HAL provides an indicative summary of how new entrants since 2008 have acquired slots. The shares of the

different means of slot acquisition are<sup>681</sup>:

- *Pool: 8%*
- *Joint Venture: 20%*
- *Purchased: 34%*
- *Leased: 38%*

7.220 The following sections consider the three most common means of slot acquisition at Heathrow and the implications for the likelihood of airlines switching marginal services from Gatwick to Heathrow.

### Secondary slot trading

7.221 The historical and current scarcity of available slots at Heathrow has resulted in slot pairs gaining considerable commercial value, which is an important barrier to entry for airlines seeking to enter or expand at Heathrow. For example, in 2012, BAA was quoted as saying that the average slot value at Heathrow was €8.7 million per year.<sup>682</sup>

7.222 Icfi, in a report commissioned by GAL, states that the range of slot values vary according to time of day, based on the values of previous trades between 2002 and 2010. Morning slot pairs are valued at between £5 million and £25 million; afternoon slot pairs at between £5 million and £12 million; and evening slot pairs at between £1 million and £3 million per year.<sup>683</sup>

7.223 Given the departure and arrival times of current long-haul services at Gatwick, this implies that, to switch a long-haul aircraft to serve a route at Heathrow, an airline would be most likely to face a cost of between £5 million and £25 million to acquire a suitable pair of slots for a year, if such a slot were available either through sale or lease. This compares to more modest slot values at Gatwick. For example, ACL told the CAA that:

*It is widely understood that there are modest amounts of trading at LGW, and these are traded for modest sums. For example, the value of a slot pair at LHR is reportedly around £10-20m+, and less than*

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<sup>681</sup> Source: HAL.

<sup>682</sup> See, for example, <http://www.routes-news.com/airlines/item/887-heathrow-airport-slot-trading>, (accessed February 2013).

<sup>683</sup> Source: Icfi.

*£1m at LGW. Many Gatwick slots are also not traded for a monetary value.*

*Adria Airways tried to sell LGW slots it obtained after selling those at LHR. The airline reportedly tried to link the value of the slots at LGW to those it sold at LHR previously. This did not work, as the price was reportedly excessive for LGW, the slots were not traded and were returned to the slot pool where they were allocated to airlines on the waitlist.<sup>684</sup>*

- 7.224 Short-haul routes operated daily as “spoke” services into inbound carriers’ respective hubs could face similar entry costs, depending on the time of their operation. However, relocating an aircraft to operate short-haul routes several times a day as hub flights into Heathrow – requiring typically three slot pairs – could entail a possible average expenditure of £33.5 million for suitable slot pairs<sup>685</sup>. The CAA considers that the costs involved strongly suggest that purchasing slots is not going to be a realistic reaction to a ten per cent price increase. Rather, it would be more likely to be a longer term consideration in response to cumulative price increases.
- 7.225 Slots can be traded on the secondary slot market, with all transactions being recorded by ACL on its slottrade.aero platform. In practice, the number of slots traded as a proportion of slots at Heathrow has been on average two per cent of the total slots (approximately 190 of 9500 weekly slots) in a particular traffic season between summer 2001 and Summer 2012. This is shown in Figure 7.10 below.

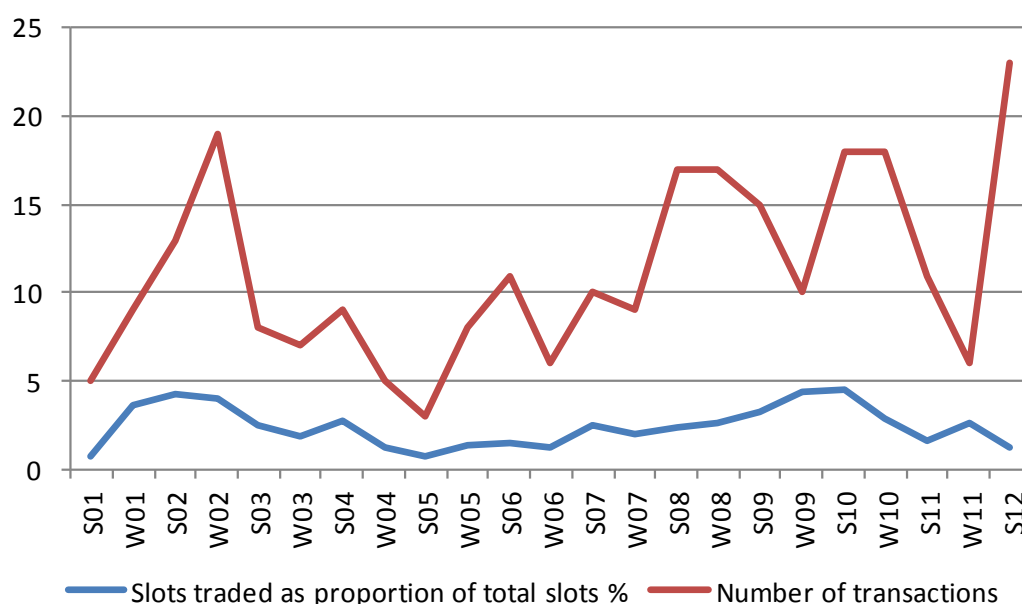
**Figure 7.10: Slot trading at Heathrow<sup>686</sup>**

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<sup>684</sup> Source: ACL.

<sup>685</sup> This figure is only indicative and was calculated on the basis of the average estimated slot value for 1 morning (£15m), 1 afternoon (£8.5m) and 1 evening slot pair (£2m).

<sup>686</sup> The peak in transactions in S12 is attributable in large part to the return of slots by lessees of bmi slots following the acquisition of bmi by IAG.



Source: CAA analysis of slottrade.aero data

7.226 The CAA considers that the above suggests that the secondary slot market at Heathrow is relatively illiquid, which implies that airlines at Gatwick are restricted in their ability to acquire new slots at Heathrow to move marginal aircraft and services. It also implies that the level of airline churn is low at Heathrow. Further, it is not necessarily possible to ascertain the nature of a particular slot transaction. ACL has told the CAA that:

*Trading/leasing/"babysitting" of slots are all regarded as a slot "Exchange" between two airlines, covered by an underlying contract to which ACL is not party.<sup>687</sup>*

7.227 The CAA considers that the apparent illiquidity of the secondary slot market at Heathrow suggests that the purchase of slots is unlikely to often be a viable means of switching services from Gatwick to Heathrow.

### Slot leasing and joint ventures

7.228 The strategic trading of slots is likely to constitute a further barrier to entry at Heathrow for certain airlines, such as those not party to an alliance or with few strategic partners. Indeed, ACL has told the CAA that:

<sup>687</sup> Source: ACL.

*It would appear the slot trades often stay within airline strategic groups, which results in fewer slots returning to the slot pool for reallocation to other carriers, including competitor airlines.*<sup>688</sup>

7.229 For example, ACL also says that:

- *BA has leased slots to Aer Lingus, Air Berlin and Flybe” which are all strategic partners of BA through either interlining agreements or alliance membership in the case of Air Berlin; and*
- *Easyjet has leased slots from Delta, Continental and Virgin.”; and that*
- *At Gatwick, BA has approximately 100 fewer slots a week than 5 years ago in the morning peak, while Easyjet has increased its slot holdings by approximately 100. However, these slots were not traded between these two airlines.*<sup>689</sup>

7.230 BA has told the CAA that it leases slots at Heathrow. Specifically:

*“[At Heathrow], BA currently leases in [X] daily slot pairs [X].*

*[At Heathrow], BA currently leases out [X] daily [slot pairs] [X], including 13 required by competition authorities and [X].”*<sup>690</sup>

7.231 Conversely, for Gatwick, airlines which have strategic partners at Heathrow, it may be possible to acquire slots at suitable times to facilitate the switching away of services from Gatwick to Heathrow.

7.232 For example, GAL stated in internal documents that Delta:

*“[X]*

*[X]”*<sup>691</sup>

7.233 Indeed, Delta has told the CAA that:

*It had to negotiate and lease slots from its partners Air France-KLM, which was a separate process independent from the airport*

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<sup>688</sup> Source: ACL.

<sup>689</sup> Source: ACL.

<sup>690</sup> Source: BA.

<sup>691</sup> Source: GAL.

*development.*<sup>692</sup>

7.234 However, the CAA also notes that Delta has entered into a joint venture with Virgin, which is currently pending regulatory approval. Delta told the CAA that:

*"Its need to expand at LHR was of critical importance. This is why it chose to take a 49% equity share in Virgin Atlantic, which in turn provides a much bigger LHR footprint as well as the ability to offer many more gateways (Atlanta, Los Angeles, Miami, San Francisco, Boston and New York)."*<sup>693</sup>

7.235 The possibility of leasing or purchasing slots from strategic partner airlines may allow certain carriers to switch services from Gatwick, provided they are suitably-timed and that the service being moved will be comparatively advantageous, or equivalent, to the slots' current use. Further, the use of joint ventures by airlines to increase their respective presence at Heathrow further demonstrates the high barriers to entry at the airport that would be faced by an airline seeking to move a marginal service.

### Mergers and acquisitions

7.236 As suggested by GAL, another means of slot acquisition is through airline mergers and through any related slot-based remedies stipulated by competition authorities. The most recent example is the IAG/bmi merger, which resulted in increased slot holdings for IAG and for Virgin through slot remedies.<sup>694</sup>

7.237 In its internal documents, GAL commented on the IAG/bmi merger:

- [X]
- [X] ;
- [X];

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<sup>692</sup> Source: Delta.

<sup>693</sup> Source: Delta.

<sup>694</sup> Indeed, Virgin is commencing short-haul services from LHR. See, for example, <http://www.virgin-atlantic.com/en/gb/frequentflyer/offersandnews/latestnews/newrouteaug12.jsp>, (accessed February 2013).

- [redacted].<sup>695</sup>

7.238 In addition, icfi noted in a report for GAL, as a result of the IAG/BMI merger, that:

[redacted] and

[redacted].<sup>696</sup>

7.239 Regarding the IAG/bmi merger, it appears that BA has acquired the bmi mainline aircraft. The aviation press quotes BA as saying:

*"BA says that there will be a "gradual transition of flights during the summer [2012] period" as it integrates Bmi into its Heathrow operations, and during this period "the exterior and interior design of bmi's aircraft, as well as the onboard experience will gradually transform into British Airways' style."<sup>697</sup>*

7.240 The CAA considers that this evidence strongly suggests that mergers, or the acquisition of an airline which is likely to also involve the acquisition of its fleet, is unlikely to result in significant scope to switch aircraft between airports, as the resulting network planning is likely to involve all existing (and at least a proportion of merger-acquired) aircraft.

7.241 On the whole, the CAA considers that airline mergers are relatively infrequent and are unlikely to be a source of significant slot release at Heathrow, which would facilitate switching from Gatwick. In addition, it is often the case that such transactions also involve the acquisition or retention of current airline fleets. The CAA considers that GAL has been made aware of this and of the possibility that the IAG/bmi merger will not lead to significantly increased competitive pressure for attracting Asian carriers. Overall, the CAA considers that merging with or acquiring another airline is unlikely to be a reasonable response to a ten per cent price increase.

### The role of Open Skies

7.242 The 2008 "Open Skies" air services agreement between the EU and US government relaxed the slot access rights for US and UK carriers.

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<sup>695</sup> Source: GAL.

<sup>696</sup> Source: Icfi.

<sup>697</sup> See: <http://www.businesstraveller.com/news/ba-starts-bmi-integration>, (accessed April 2013).



This agreement led to a number of US carriers at Gatwick relocating their services to Heathrow where possible.

7.243 With regard to the Open Skies agreement, GAL has indicated that:

*“Long haul network airlines have traditionally operated out of Heathrow, which has developed as a hub airport, with the associated infrastructure. However, prior to the “open skies” agreement, Gatwick served a large number of long-haul carriers and routes. With Open Skies, these long haul carriers chose to exercise their ability to switch away from Gatwick to Heathrow. That event demonstrates vividly the ability of long haul airlines to switch their operations between airports when more profitable options become available. It is notable that this switch took place while Heathrow was notionally ‘full’ and illustrates that opportunities for such airlines either to switch or grow at Heathrow or to enter at Heathrow can be expected.”*<sup>698</sup>

7.244 The CAA notes that the airlines moving from Gatwick to Heathrow, following the "Open Skies" agreement, did so in the face of higher airport charges at Heathrow. This strongly suggests that their switching was not motivated by airport pricing but, rather, higher expected profits. The resulting changes following Open Skies are set out in Figure 7.11.

**Figure 7.11 Increases in airline services at Heathrow following the implementation of the EU-US air services agreement**<sup>699</sup>

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<sup>698</sup> Source: GAL, GAL, Airport competition: Competing to grow and become London’s airport of choice, An initial submission from Gatwick Airport to inform the CAA’s review of airport competition, November 2011, Q5-050-LGW05, page 42.

<sup>699</sup> Extract from Airport Coordination Limited – *Heathrow Summer 2008 Initial Coordination Report*, available at:

[http://80.168.119.219/UserFiles/File/LHR%20S08%20Start%20of%20Season%20report\\_1.pdf](http://80.168.119.219/UserFiles/File/LHR%20S08%20Start%20of%20Season%20report_1.pdf)

The table below summarises the changes in transatlantic services at Heathrow. Overall, there are an extra 18 daily services between Heathrow and the US (+22%) and about 10,000 seats per day additional capacity (+19%).

Airline	Route frequency	Terminal
Air France	1 x Los Angeles	2
American Airlines	2 x Dallas, 6 pw Raleigh-Durham; Reduced New York (JFK) by 1 daily service	3
British Airways	2 x Houston, 1 x Dallas; Frequency increases on New York (JFK), Seattle and Washington; Terminated a daily Detroit service	5
BMI	No transatlantic services	1
Continental	2 x Newark, 2 x Houston	4
Delta	2 x New York (JFK), 1 x Atlanta (joint operations with Air France)	4
Northwest	1 x Detroit, 1 x Minneapolis, 1 x Seattle (joint operations with KLM)	4
United Airlines	1 x Denver	3/1 (*)
US Airways	1 x Philadelphia	1
Virgin Atlantic	No change	3

(\*) United move from T3 to T1 on 10 June 2007

- 7.245 The CAA notes that the change in legislative barriers brought about by Open Skies led to significant slot trading between airlines at Heathrow, with airlines paying significant slot prices. For example, Deloitte reported that Continental purchased four slot pairs for approximately £105million.<sup>700</sup>
- 7.246 The CAA considers that while this shows what airlines may be prepared to pay to access Heathrow, the CAA considers that the magnitude of switching from Gatwick to Heathrow following the “Open Skies” agreement reflects, in effect, a market-level adjustment in airline competition following the relaxation of a legislative barrier. Indeed, the CAA considers that the substantial sums paid for slot pairs are likely to indicate the significant expected value of future additional profits, estimated by these carriers to be forthcoming from switching to Heathrow. This is consistent with evidence provided by airlines with regards to the yield differential between Heathrow and Gatwick, as discussed in 7.138 onwards. The transfer of services is also likely to

<sup>700</sup> See: [http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/UK\\_THL\\_OpenforSkiesOpenForBusiness\\_May08\(2\)!!1!!1!.pdf](http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/UK_THL_OpenforSkiesOpenForBusiness_May08(2)!!1!!1!.pdf), (accessed February 2013).

have been facilitated, to some degree, by the presence of the US carriers' strategic partners at Heathrow coordinating slot releases between alliance members, as discussed earlier in this chapter.

- 7.247 The CAA considers that the switching resulting from the "Open Skies" agreement shows that airlines are willing to pay the significant costs of slot acquisition at Heathrow and switch to Heathrow when it is possible to do so. However, the CAA considers that the switching resulting from "Open Skies" was unique as it resulted from a legislative change rather than a change in relative prices or airport attractiveness to airlines.
- 7.248 Evidence also strongly suggests that the historical and current lack of suitably-timed slot capacity at Heathrow acts in combination with the high financial entry costs of purchasing slots at the airport, and/or the coordination and potential financial costs of acquiring slots through trading or leasing with strategic partners.

### Icfi's risk assessment of Gatwick's carriers with respect to Heathrow capacity

- 7.249 In a January 2012 report commissioned for Gatwick, Icfi performed an assessment of the perceived likelihood that the airport's airlines might switch away to Heathrow. Of Gatwick's largest carriers, [redacted]<sup>701</sup>, [redacted] seen as having:

"[redacted]"<sup>702</sup>

"[redacted]"<sup>703</sup>

- 7.250 Table 7.12 summarises Icfi's assessment of the smaller full service or associated feeder carriers remaining at Gatwick in February 2013.

**Table 7.12 Summary of Icfi risk assessment for relevant Gatwick airlines**

Airline	Icfi risk assessment
Short-haul	

<sup>701</sup> Source: Icfi.

<sup>702</sup> Source: Icfi.

<sup>703</sup> Source: Icfi.

[X]	[X]
[X]	[X]
[X]	[X]
[X]	[X]
[X]	[X]
<b>Long-haul</b>	
[X]	[X]
[X]	[X]
[X]	[X]
[X]	[X]

Source: CAA presentation of icfi research

7.251 The CAA considers that Icfi's assessment of potential airline switching shows that there is limited scope for airline switching from Gatwick to Heathrow. This is consistent with evidence provided by airlines and the assessment of capacity constraints at Heathrow.

### **Barriers to entry and expansion**

7.252 Potential competition and the implications of barriers to entry are analysed in chapter 6 (section 7).

7.253 The CAA notes that the Government has currently put a hold on the expansion of the 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 also considers that any change in government policy following the release of the Davies Commission final report is likely to take some time to be implemented and that any significant capacity expansion is not expected until 2025, outside the timeframe for the CAA is considering as part of this market power assessment.

7.254 In summary, while the use of larger aircraft and relatively small scale expansion is possible, the CAA considers that the timescale required for adequate airport expansion/new entry to accommodate sufficient switching is likely to be too long to impose a constraint in the short-term. The CAA also notes that that DfT's and GAL's passenger forecasts suggest that over the next five years the tightening of capacity constraints at Heathrow are likely to result in an increase in the degree of market power at the London airports that have spare

capacity.

- 7.255 Overall, while airlines might be able to increase aircraft capacity at the margins, the CAA considers there is limited scope for capacity expansion to constrain GAL's pricing in the FSCs and feeder market in the medium term.

### Summary

- 7.256 Overall, the CAA considers that the capacity constraints at Heathrow, and the unsuitability of Stansted, mean that FSCs and associated feeder traffic are severely limited in their scope to constrain GAL from imposing a SSNIP by switching away marginal aircraft or services from Gatwick to Heathrow.
- 7.257 Heathrow is, in effect, operating at full capacity. While the marginal "units" are relatively small - one slot pair for long-haul and between one and three for short-haul routes - the availability of suitably-timed slot pairs at Heathrow for services currently operated Gatwick appears to be very limited. There is typically only one or two, if any, slot pair(s) available in the Heathrow slot pool, from which slots are obtained at no cost. This means that the more likely means of slot acquisition would be through:
- buying from the relatively illiquid secondary slot market;
  - leasing slot pair(s) from partner airlines;
  - entering into joint ventures with other airlines; or
  - merging with or acquiring another airline.
- 7.258 However, there are significant costs - for example financial and/or coordination costs - associated with these methods of obtaining the rights to operate from Heathrow. An additional barrier is the need to find an airline willing to transfer (at least temporarily) some of its slot rights at a congested and capacity constrained hub airport. Overall, the CAA considers that the costs of slot acquisition at Heathrow are likely to significantly exceed a 10 per cent increase in airport charges. Further, the CAA considers that airlines are only likely to consider it reasonable to incur these costs in the longer-term and following a number of continual increases in airport charges. As a result, it appears highly unlikely that FSCs and feeder airlines would be able, and willing, to switch marginal services to Heathrow of a sufficient

scale to constrain GAL from increasing airport charges.

- 7.259 With regard to airport entry and expansion, the CAA also considers that the scope for capacity expansion is limited and insufficient to constrain GAL's pricing in both the short and medium-term in the FSCs and feeder market.

## **Section 6: Conclusion on the potential competitive constraints in the FSCs and associated feeder traffic airline market**

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- 7.260 This chapter has analysed the potential competitive constraints that GAL might face from FSCs and associated feeder traffic airlines in the relevant FSCs and feeder airline market that includes Gatwick and possibly Heathrow.
- 7.261 The CAA considers that reducing marginal frequencies appears to be the most likely type of switching that airlines might undertake in an attempt to constrain GAL's pricing. However, the costs of this type of switching might still outweigh any benefits that might arise from constraining a 10 per cent price increase. With regards to switching marginal aircraft, the severity of capacity constraints and the cost of slot acquisition at Heathrow are likely to constitute major switching barriers.
- 7.262 While some based carriers have significant infrastructure costs at Gatwick, the CAA considers that the switching costs associated with physically relocating marginal aircraft, for both based and inbound carriers in this market, appear to be relatively low. The potential loss of benefits derived from network effects - through the availability of connecting passenger feed and strategic partner airlines - can result in considerable switching costs if they were to switch to an airport with less connectivity. However, when switching to Heathrow, FSCs and feeder airlines are likely to gain from the increased connectivity at the hub airport.
- 7.263 Though "traditional" switching costs appear to be relatively low, the CAA considers that the strategic importance of operating from London is a severe constraint on switching to non-London airports for FSCs and feeder airlines. In addition, the evidence shows that these carriers

express a general preference to operate from Heathrow, rather than Gatwick or another London airport. However, they are restricted from doing so due to the severity of capacity constraints and the cost of slot acquisition at Heathrow.

- 7.264 With regards to countervailing buyer power, the CAA has found no evidence of FSCs and feeder airlines being able, credibly, to threaten to switch away from Gatwick to discipline GAL's pricing behaviour. This is largely due to the carriers' individually being a small proportion of the GAL's traffic and a lack of alternative airports to which they can threaten to switch.
- 7.265 Indeed, Heathrow is effectively operating at full capacity. While arbitrage through strategic partners and slot purchases might in certain cases facilitate a degree of switching, the CAA considers that the costs involved are likely to significantly exceed a 10 per cent increase in airport charges and might only be considered in the longer-term in light of continual price increases. In addition, as discussed in chapter 5, Stansted is not a suitable alternative despite having available capacity, due, principally, to its weaker natural catchment and the lack of connecting traffic. The CAA also considers that the scope for capacity expansion is limited and insufficient to constrain GAL's pricing in both the short and medium-term in the FSCs and feeder market.
- 7.266 The future traffic demand forecasts, analysed in Chapter 6, suggest that, notwithstanding the relatively limited scope for certain London airports to encourage better utilisation of their runways and the use of larger aircraft, Gatwick is likely to benefit from the expected tightening of capacity constraints across the South East. In particular, this outcome may increase the relative power of GAL in its negotiations with airlines.
- 7.267 The CAA considers that, in the next five years, the further tightening of capacity constraints at Heathrow is likely, at least, to maintain, if not strengthen, GAL's market position in relation to FSCs and feeder airlines. The CAA also considers that any change in government policy following the release of the Davies Commission final report is likely to take some time to be implemented. As a result, any significant capacity expansion is not expected until 2025, outside the timeframe for the CAA's assessment and beyond the Q6 regulatory period.





**CHAPTER 8****Competitive constraints - passenger switching**

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**Section1: Introduction**

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8.1 This chapter evaluates the strength of the competitive constraint that GAL might face from marginal passengers switching away from the airport in light of a price increase. The CAA notes that this form of constraint could supplement the potential competitive constraints that could be imposed by airlines switching marginal services away from an airport.

**Passenger switching in derived demand**

8.2 The ability and willingness of passengers to switch depends, in part, on the extent to which they regard services at different airports as reasonably close substitutes and the costs they face in switching demand to the next best alternative.<sup>704</sup> The availability of suitable alternative flights to the same destination as well as the willingness of passengers to "follow" an airline to an alternative airport is likely to be important to their willingness to switch.

8.3 As discussed in chapter 3, passengers' demand for airport services is derived from their demand for air travel. The derived nature of passenger demand means that the exposure of passengers to increases in airport charges are likely to be muted, as these are levied directly on airlines but only faced indirectly by passengers in airfares. Two factors are likely to reduce passenger exposure to increases in airport charges:

- First, as illustrated in chapter 6, Figure 6.1, airport charges only constitute at most 30 per cent of an airline's variable cost base (in the case of low cost carriers). This implies that a 10 per cent price increase may be passed through completely into fares as a 3 per cent increase faced by the passenger on a LCC flight, or as a 1 per cent increase for FSC and feeder flights.

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<sup>704</sup> Guidelines, paragraphs 3.34.

- Second, airline airfares may not always reflect airport charges or be priced according to an airline's costs. For example, BA has told the CAA:

*Over the last 10 years, it should have increased its prices by [X] to cover price increases, but managed to have an increase of only [X], as the market would have not supported higher fare increases.<sup>705</sup>*

- 8.4 Connected to the (second) point outlined above, Lufthansa told the CAA that:

*LH fare pricing is not directly based on the costs it faces. Rather, it is based on the prices the market will bear<sup>706</sup>*

- 8.5 Another stakeholder told the CAA that:

*In light of a 10 per cent price increase at LGW, its first reaction would be to [X] and [X], as well as find ways to [X]<sup>707</sup>*

- 8.6 Overall, the CAA considers that the evidence suggests that:

- airport charge increases are unlikely to have a significant impact on airfares; and
- marginal passengers at Gatwick might not switch away in significant numbers in light of a 10 per cent increase in airport charges.

- 8.7 The CAA notes, however, that it is important to consider the number of marginal passengers, and what factors would drive this "marginality". Estimates of the likely actual scale of passenger switching can then be compared to estimates of the required scale of passenger switching (the critical loss), to establish whether a price increase might be profitable.

- 8.8 In this chapter, the CAA's analysis categorises passengers according to whether they travel on domestic and short-haul, or long-haul services. This categorisation was adopted because of data availability and does not reflect the relevant markets for GAL's provision of airport operation services to airlines as defined in chapter 5, which are

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<sup>705</sup> Source: BA.

<sup>706</sup> Source: Lufthansa.

<sup>707</sup> Source: [X].

defined according to the requirements of different airline business models. However, the CAA considers that analysis according to sector length is nonetheless helpful in understanding passenger choices.

### Structure

- 8.9 To consider the scale of passengers required to switch to impose a constraint on GAL, the CAA has examined a number of issues. This chapter is structured as follows:
- The remainder of this section summarises the CAA's Initial Views and GAL's response with their views on passenger switching;
  - Section 2 considers the characteristics of Gatwick's passengers, to identify which passengers have a choice of airport and general trends in their preferences;
  - Section 3 focuses on the preferences of passengers on domestic and short-haul flights to and from Gatwick, seeking to identify potential characteristics of marginal passengers;
  - Section 4 analyses the preferences of passengers on long-haul services to and from Gatwick, seeking to identify potential characteristics of marginal passengers;
  - Section 5 presents the estimates of the critical loss of passengers required to make a increase in airport charges unprofitable;
  - Section 6 sets out a range of modelled passenger elasticities to estimate the likely scale of switching; and
  - Section 7 compares the estimates of critical loss and actual loss of marginal passengers to reach a judgement as to the impact of marginal passenger switching as a constraint on GAL.

### CAA Initial Views

- 8.10 In the Initial Views, the CAA considered that:
- The cost of switching airports for many passengers was unlikely to be large, given the number of alternative large airports in the London area and the large degree of short-haul route overlap between Gatwick and other London airports.

- Long-haul passengers were less likely to have many alternatives to Gatwick.<sup>708</sup>

8.11 The CAA also acknowledged that the results of passenger modelling suggested a high degree of responsiveness to changes in airport charges. However, when the estimated potential passenger switching were compared with critical loss calculations, the modelling supported the view that GAL would be able to increase airport charges from the current level.<sup>709</sup>

### **GAL's submissions**

8.12 In response to the Initial Views, GAL has indicated that when assessing constraints from passengers, the relevant constraint is the presence of significant numbers of marginal passengers. In particular, it noted:

*"the manner in which the CAA considers passenger switching is not appropriate to assessing competitive constraints. It is well established in competition economics, and, indeed, in previous work conducted by the CAA, that when assessing constraints emanating from customers, the relevant constraint is the presence of significant numbers of marginal customers i.e. those that are most likely to switch in response to price changes. The existence of some captive customers does not point to market power if there are sufficient marginal customers to discipline"*<sup>710</sup>

8.13 The CAA agrees that the focus of passenger switching should be the assessment of substitution by marginal passengers. This chapter considers that characteristics that might describe GAL's marginal passengers and estimates whether the likely scale of switching would be sufficient to constrain the airport.

8.14 In addition, GAL made a number of comments regarding evidence of passenger substitutability:

*"Standard competition policy guidelines, best practice, and CAA*

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<sup>708</sup> Source: Gatwick, Market Power Assessments, The CAA's Initial Views, February 2012, page 86.

<sup>709</sup> Source: Gatwick, Market Power Assessments, The CAA's Initial Views, February 2012, page 86.

<sup>710</sup> Source: GAL, the CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Q5-050-LGW09, page 7.

*precedent suggest that the focus of substitutability analysis must be on marginal customers. The presence of some groups of non-marginal passengers that have a strong preference for Gatwick is irrelevant to the examination of market definition and market power"*

*"Examination of isochrones, catchment areas and passenger survey responses all demonstrate that a substantial proportion of passengers view two or more of the South East airports as good substitutes, and therefore that the number of marginal passengers is large;"*

*"Evidence on competition between airlines operating at different airports corroborates the conclusion that passengers view different airports as good substitutes"*

*"The observations made by the CAA at its recent workshop on market power do not suggest that there is a lack of passenger substitutability between Gatwick and other London airports"<sup>711</sup>*

8.15 The CAA agrees that isochrones, catchment areas and passenger survey responses suggest that a substantial proportion of passengers can in theory substitute between two or more airports. However, as discussed further in this chapter, there are also other factors that can drive passengers' choice of airport. Further, it is not necessarily the case that all passengers with a choice of more than one airport would constitute a marginal passenger in light of a 10 per cent increase in airport charges.

8.16 GAL also argued that different types of passengers view the substitutability of airports differently:

*"Leisure passengers have a particularly high propensity to view different airports as good substitutes. Business passengers **place a higher value on airport location, but Gatwick's largest overlaps are with Heathrow which is the market leader in serving business traffic**"<sup>712</sup>*

8.17 The implications of different journey purposes for marginal passenger switching are considered in turn for short-haul and long-haul

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<sup>711</sup> Source: GAL, an initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Ref: Q5-050-LGW05, page 25.

<sup>712</sup> Source: GAL, an initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Ref: Q5-050-LGW05, page 25.

passengers in sections 2 and 3.

- 8.18 Lastly, GAL argued that it faces strong competition from all airports in the South East of England (and potentially further afield):

*"This evidence corroborates the CC and CAA's views that South East airports (when separately owned) are strong competitors for one another and that the relevant economic market is at least as wide as the South East."*<sup>713</sup>

- 8.19 As discussed in chapter 5, the CAA defines the market(s) in which GAL operates with regard to airport operation services to airlines, taking into account passenger switching.
- 8.20 The CAA also notes that GAL makes a number of points regarding long-haul passenger switching. Long haul switching is discussed in section 4 (below).

## Section 2: Passengers at Gatwick

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- 8.21 This section considers the characteristics of Gatwick's passengers, to identify which passengers have a choice of airport and general trends in their preferences
- 8.22 The CAA notes that different groups of passengers have different reasons for choosing a particular airport from which to fly. The variation in passengers' preferences can influence how likely they would be to switch away from Gatwick, to the extent that a 5 to 10 per cent increase in airport charges is passed through in airfares.
- 8.23 The CAA also notes that passengers' preferences at Gatwick, as well as at airports more generally, can vary according to a number of factors, including:
- whether they begin or finish their journey in the airport's catchment area (surface outbound and terminating passengers) or connect onwards at the airport;
  - where they originate in the airport's catchment area;

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<sup>713</sup> Source: GAL, an initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Ref: Q5-050-LGW05, page 25.

- their journey purpose;
- why they choose to travel to/from Gatwick airport; and
- the duration of their flight.

8.24 Each of these factors is considered, in turn, below for passengers at Gatwick as a whole. At the centre of the analysis of marginal passengers is their sensitivity to an increase in airport charges that airlines pass through in the form of higher airfares. This chapter therefore focuses on establishing the potential characteristics of cost-sensitive, marginal, passengers.

### **Surface and connecting passengers**

8.25 Passengers who travel to the airport by surface access transport (such as rail or road) are likely to have a different choice of alternative airports to Gatwick, compared to passengers who are connecting from one flight to another.

8.26 According to the CAA Passenger Survey, in 2011, at least 90 per cent of Gatwick's 33 million passengers travelled to the airport by surface access transport, leaving 10 per cent of passengers either self-connecting or inter/intra-lining<sup>714</sup> between flights.<sup>715</sup>

8.27 In 2011, approximately 3 million passengers connected between services at Gatwick. On domestic routes, connecting passengers accounted for 28 per cent of total passengers, 15 per cent on long-haul services and only 6 per cent only short-haul routes<sup>716</sup>. Typically, connecting passengers were much more likely to use full-service carriers, which generally offer the possibility to connect (with their own and/or their partner airlines' services at Gatwick), in contrast to LCCs or charter carriers.<sup>717</sup>

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<sup>714</sup> Passengers interline when connecting between two flights operated by different carriers, for example from BA to American Airlines. Passengers intraline when connecting between two flights operated the same carrier, for example between two BA flights.

<sup>715</sup> A proportion of passengers (amounting 500,000 passengers at Gatwick in 2011) classed as "connecting" transfer between airports to reach their next flight, which means that they are in fact a "surface" passenger for the airport from which they next fly. As a result, the proportion of connecting passengers estimated by the CAA Passenger Survey is likely to be an over-estimate.

<sup>716</sup> CAA Passenger Survey data, 2011.

<sup>717</sup> CAA Passenger Survey data, 2011.

- 8.28 However, as previously noted, the CAA considers that the increase in airport charges that is passed through to passengers in the form of higher airfares is expected to be small, compared to the airfare that a (connecting) passenger would already be paying. Further, airlines tend to price to the market (i.e. the strength of passenger demand), rather than to fully reflect their cost base. This means that an increase in airport charges may not be passed through to passengers in the short-run, if at all. As a result, the CAA considers that it is unlikely that a 10 per cent increase in airport charges would lead to significant switching by marginal connecting passengers.
- 8.29 Overall, the CAA does not consider that competitive constraints resulting from marginal connecting passenger switching to connect at an alternative airport is likely in itself to be material, due to the relatively small proportion of these passengers at Gatwick. However, it is the aggregate constraint from marginal passenger switching that needs to be considered. This is analysed in sections 6 and 7, where the critical loss of passengers is compared against the estimated actual passenger response.
- 8.30 The remainder of this section (and sections 3 to 5) consider surface passengers.

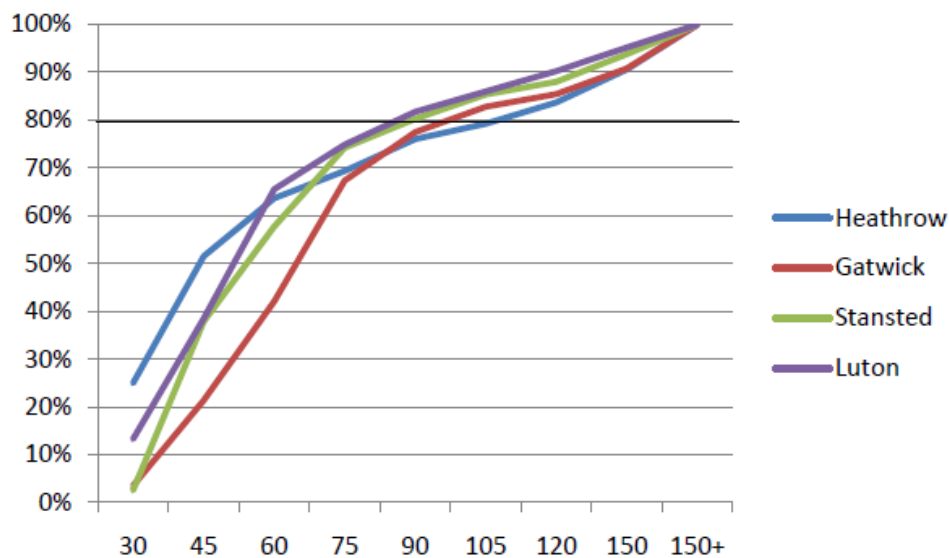
### Travel time and catchment analysis

- 8.31 The point of origin for a surface passenger can influence the amount of time they spend travelling to an airport, and whether they are likely to originate from a location covered by more than one airport's catchment area. This section considers what impact these considerations could have on the degree of airport choice faced by passengers.

### Surface travel times

- 8.32 Figure 8.1 shows the travel time distribution for all passengers accessing the four biggest London airports by surface access transport. Overall, approximately 80 per cent of passengers at each of Gatwick, Luton and Stansted have an estimated travel time of travel of at most approximately 90 minutes. Eighty per cent of Heathrow passengers are within 105 minutes of the airport.



**Figure 8.1: Surface travel time by airport**

Source: CAA Passenger Survey and DfT's Surface Access times

8.33 However different passenger types have a different preferences for travel-time to the airport<sup>718</sup>;

- Passengers travelling for business typically prefer shorter surface travel times, compared to VFR and holiday passengers who are willing to travel for longer periods of time to reach their departure airport<sup>719</sup>;
- Long-haul passengers are typically willing to travel to the airport for longer than those on short-haul and domestic services, reflecting the fact that the surface journey represents a smaller proportion of long-haul passengers' total journey time; and

<sup>718</sup> Full supporting details can be found in the CAA's working paper on Catchment Area Analysis, October 2011.

<http://www.caa.co.uk/docs/5/Catchment%20area%20analysis%20working%20paper%20-%20FINAL.pdf>

<sup>719</sup> This reflects DfT estimates that business passengers are likely to have a higher value of time than other passengers. For example, the DfT assumes a value of time of around £50/hour for business passengers and of around £11/hour for leisure passengers in their modelling.

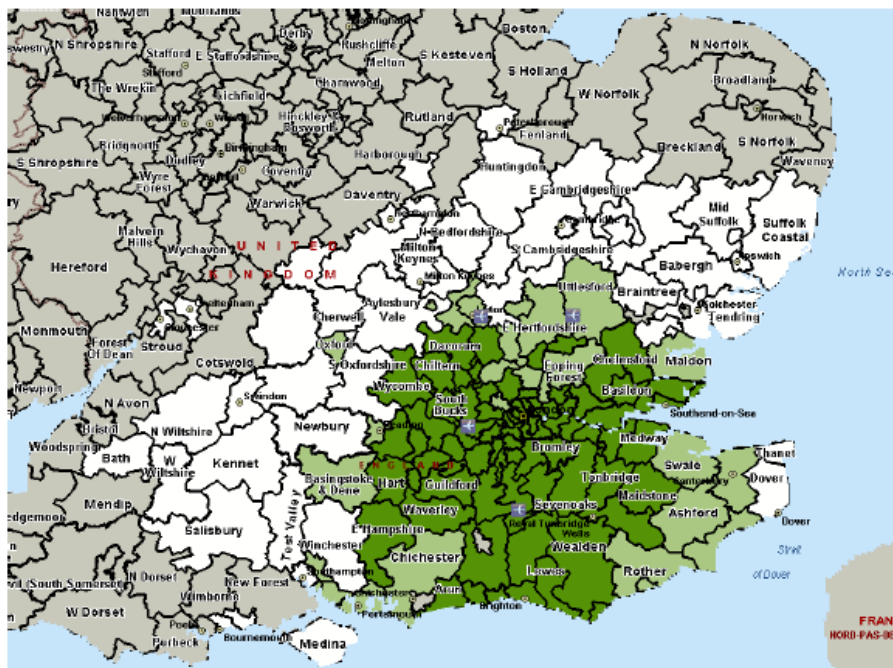
- Passengers residing in the UK tend to have longer surface travel times than foreign residents.

### Catchment area analysis

8.34 An airport's catchment area is an estimate of the geographic area from which a large proportion of an airport's outbound passengers originate, inbound passengers travel to. It can also represent the geographic distribution of passengers within this area. The extent to which catchments overlap is useful in assessing the extent to which passengers might consider airports to be substitutes, on the basis of their location alone.<sup>720</sup>

8.35 Figure 8.2 below shows the districts from which Gatwick would draw passengers, based on surface travel time, with the dark and light green areas together accounting for 80 per cent of Gatwick's total passengers.

**Figure 8.2: Gatwick overall surface travel time catchment area**



Source: CAA analysis of the CAA Passenger Survey 2010 and DfT surface access data.

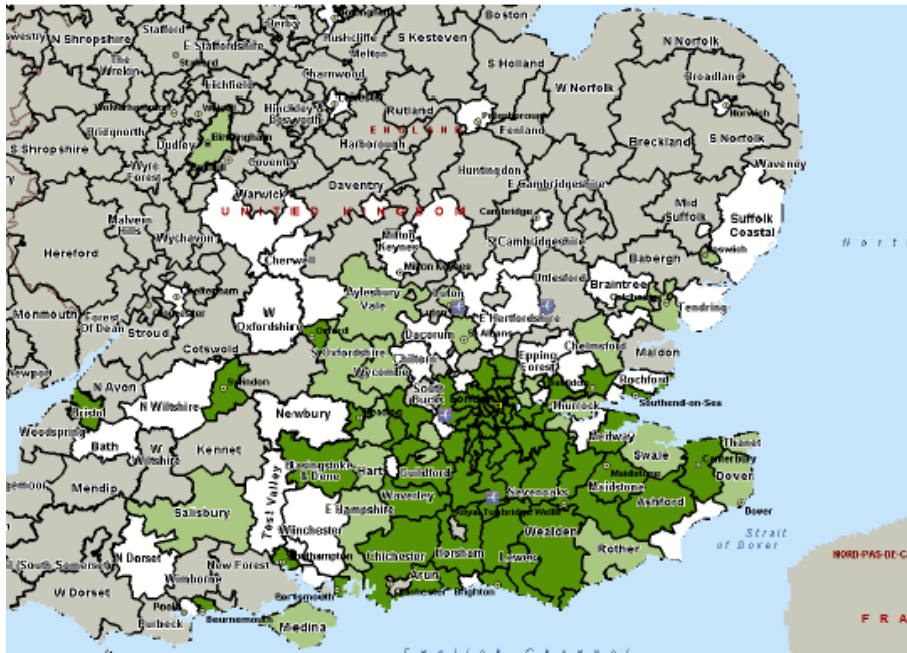
Note: Dark green – 70%; Light green – 80%; White – 90% of passengers

8.36 However, using CAA Passenger Survey data on the historical use of

<sup>720</sup> For full details of this analysis, please see the CAA working paper on Catchment Area Analysis, October 2011.

Gatwick, the airport's catchment area has a different distribution.<sup>721</sup> Notably, some of the dark and light green districts are more distant from London (for example Bristol), which potentially reflects surface access links.

**Figure 8.3: Gatwick historical usage catchment area**



Source: CAA analysis of the CAA Passenger Survey (2010)

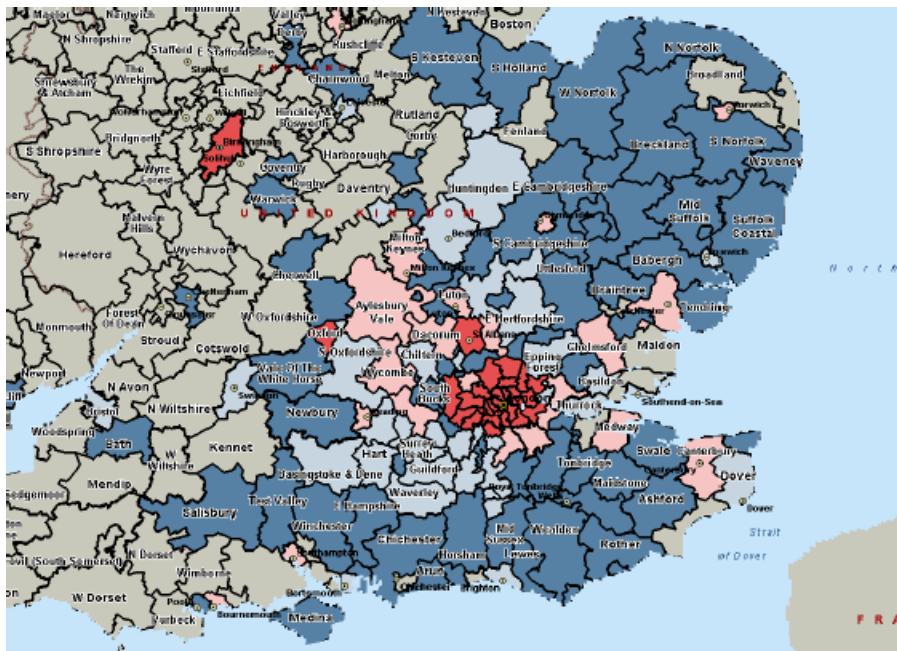
**The degree of passengers' choice regarding which airport from which to fly can be influenced by whether their point of origin lies within an area of catchment overlap of two or more airports.**

**Figure 8.4 illustrates the catchment area overlaps based on historical usage between the four largest London airports (Heathrow, Gatwick, Stansted and Luton) for 80 per cent of passengers within each airport's airport's catchment area, while**

<sup>721</sup> This approach used CAA Passenger Survey data to rank districts according to number of Gatwick passengers, from which a cumulative distribution is obtained.

8.37 Figure 8.5 sets out the underlying proportions.

**Figure 8.4: Overlaps of actual using catchment areas using 80 per cent passengers**



Source: CAA analysis of the CAA Passenger Survey (2010)

**Figure 8.5: Gatwick historical catchment area overlaps quantification**

Overlaps	#Districts	4 Airport Pax	LGW Pax	Proportion (4 APTS)	Proportion (LGW)	LGW Share
LGW/	23	5,487,159	3,639,880	6%	13%	66%
LHR/LGW/	21	9,900,148	4,897,288	10%	18%	49%
LGW/STN/	4	1,301,449	528,347	1%	2%	41%
LHR/LGW/STN/	7	3,528,403	1,606,456	4%	6%	46%
LHR/LGW/LTN/	8	5,539,693	1,683,276	6%	6%	30%
LHR/LGW/STN/LTN/	28	40,577,229	9,428,237	43%	34%	23%
Total LGW Catchment	91	66,334,081	21,783,485	70%	78%	33%
Out of Catchment		28,694,774	6,073,342	30%	22%	21%
Total		95,028,855	27,856,827	100%	100%	29%

Source: CAA analysis of the CAA Passenger Survey (2010)

**Figure 8.5 shows that, cumulatively, 66 per cent of Gatwick's passengers originate from a district where the airport's catchment area overlaps with that of at least one other airport. In particular, 34 per cent of Gatwick's passengers – and 43 per cent of passengers using one of the four airports, begin, or end, their journey in a district lying in a four-way overlap of the catchment areas of Gatwick, Heathrow, Luton and Stansted. From**

- 8.38 Figure 8.4, it can be seen that this overlap is mainly made up of the districts in and around central London. By contrast, only 13 per cent of Gatwick's passengers originate from a district which is only covered by the airport's catchment area.
- 8.39 Based on catchment area analysis alone, it appears that a significant proportion of Gatwick's passengers might be able to consider flying from another of the four largest London airports. However, this analysis does not consider the following factors that can affect passengers' choice of airport:
- the importance of journey purpose;
  - the importance of passenger preferences; and
  - the airline offer available at each airport (business models, destinations and frequencies and passengers preference for them).
- 8.40 These additional considerations can significantly alter a passenger's scope for choosing to fly from another airport in response to an increase in the price of using Gatwick. As a result, the CAA considers it important to analyse them, in order to identify the sources of marginal passengers. Each of these is considered in turn below.

### **Journey purpose**

- 8.41 A passenger's journey purpose can influence their choice of airport, as it is likely to imply particular preferences. For example, preferences

regarding the quality and speed of an airport's surface access links and the particularities of the services provided by airlines including price, destinations and frequencies might all be expected to vary according to the purpose of a passenger's journey.

### **Different types of passengers**

8.42 Based on the CAA Passenger Survey, as well as previous discussions with stakeholders<sup>722</sup>, passengers can be categorised into three different types of journey purpose:

- Holiday passengers – these passengers tend to be the most cost-sensitive, but less time-sensitive and a potentially broader choice of potential destinations;
- Passengers visiting friends and relatives (VFR) – these passengers tend to have more destination-specific preferences; and
- Business passengers – these passengers are likely to be most time-sensitive and have destination-specific preferences.

8.43 The CAA considers that, cost-sensitive passengers would be more likely to consider switching away from Gatwick in light of an increase in the cost of using the airport than those for whom cost is less important. From this, the CAA considers that GAL's holiday passengers would be more likely to switch than VFR or business passengers.

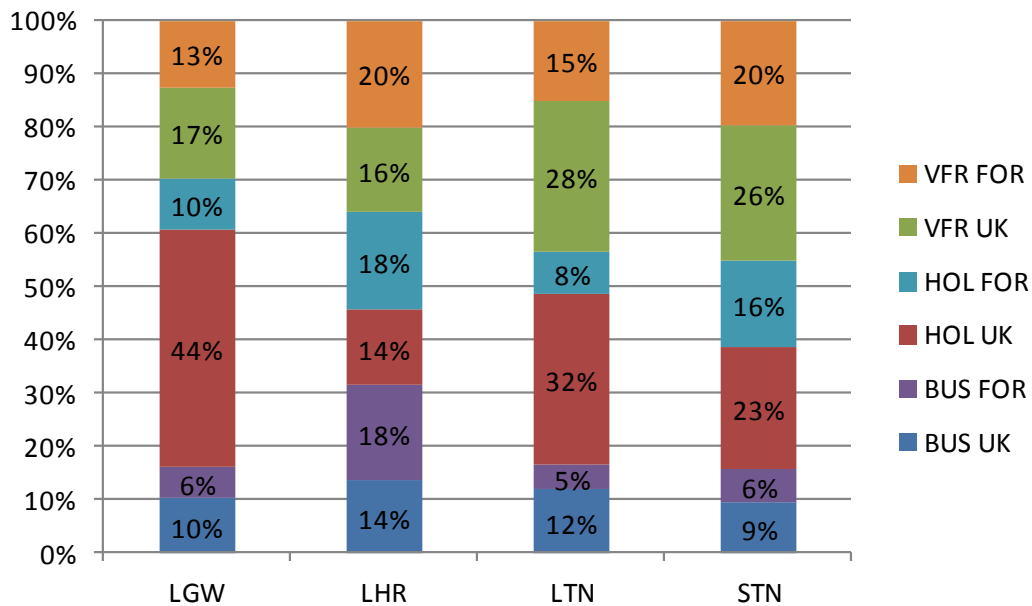
### **Journey purpose at London airports**

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<sup>722</sup> These categories reflect stakeholder views in the context of the CAA's work on preparing for a more competitive airport sector. See for example, the August 2010 Competition Guidelines Issues paper: <http://www.caa.co.uk/docs/5/ergdocs/CompetitionGuidelinesIssuesPaper.pdf> paragraph 3.149.

- 8.44 Figure 8.6 sets out CAA Passenger Survey data on the journey purpose for Gatwick's surface passengers, also taking into account whether or not they are domiciled in the UK. Passengers travelling on holiday (54 per cent) are the largest group, with the majority being UK residents. Visiting friends and relatives (VFR) is the second most common journey purpose (30 per cent), followed by business (16 per cent).
- 8.45 Compared to the three other largest London airports, Gatwick has a considerably larger proportion of holiday passengers as a share of its total passengers than Heathrow (32 per cent), Luton (44 per cent) and Stansted (39 per cent). By contrast, business passengers constitute the lowest proportion of Gatwick's passengers (16 per cent), which is comparable to that of Luton and Stansted but considerably smaller than that of Heathrow. Gatwick also has the lowest proportion of VFR passengers.

**Figure 8.6: Proportion of Surface Passengers by residence by purpose**



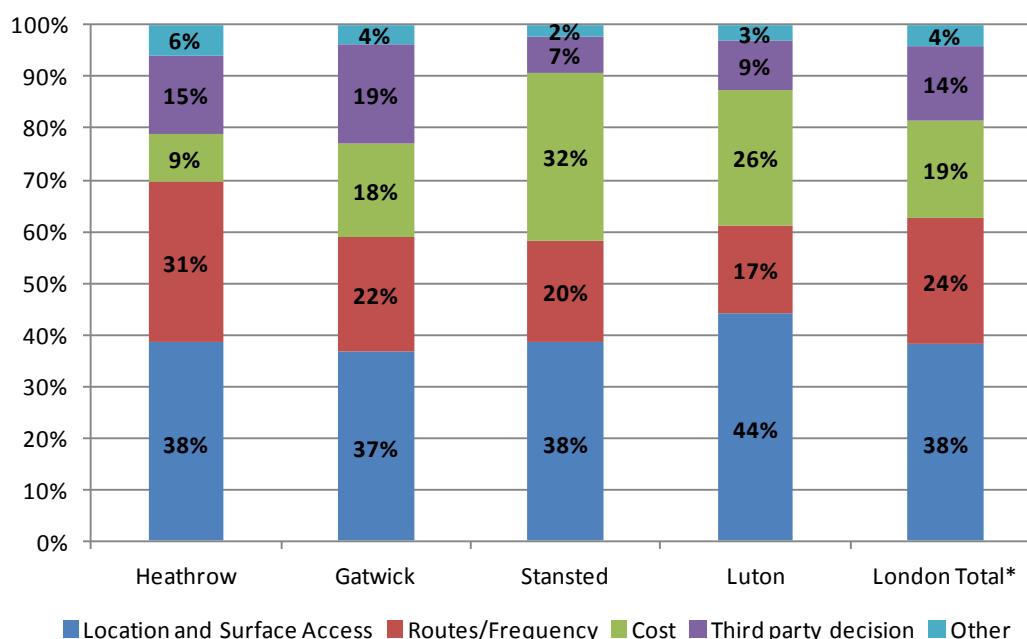
Source: CAA Passenger Survey 2011

### Reason for airport choice

8.46 As well as their journey purpose, passengers might have a specific reason why they chose to travel to and from a particular airport. Figure 8.7 sets out the responses to the CAA Passenger Survey for the four largest London airports.

**Figure 8.7 Reason for airport choice**





Source: CAA Passenger Survey 2011

8.47 For each airport, its location and surface access (37 per cent) are the most common reasons why passengers chose to fly from a particular airport. This reflects the airline evidence that each airport has a "core catchment" area, as discussed in chapter 5. This suggests that location is the most important single reason behind a passenger's choice. Three other reasons are approximately equal (with 20 per cent each) as the joint second most common reason for airport choice: the specific routes and/or frequency available at the airport; the cost of using the airport (including airfare and surface access); and third party decisions.<sup>723</sup> These three reasons are directly related to the airline services available at the airport, and this shows the importance of factors other than location in understanding the likely propensity of passengers to switch airports.

### Third party decisions

8.48 Approximately 20 per cent of passengers at Gatwick chose to fly from the airport because of a third party decision. This might be when holiday passengers have booked a package holiday, or when business passengers travelling according to the terms of a corporate contract that their company has with the airline. At Gatwick, holiday

<sup>723</sup> Due to the sample size, the proportions of these passenger groups are unlikely to be statistically different from each other.

passengers originating in the UK are the group for which a third party decision was most often the reason for choosing to fly from the airport (69 per cent), while, for other passenger groups less than 10 per cent cited this reason.

- 8.49 Figure 8.8 shows that Gatwick served much more UK resident holiday passengers than any other London airport. For many of those passengers (53 per cent) their flights were booked as part of a package. This is likely to reflect the larger presence of charter airlines at Gatwick, compared to other London airports, although full service carriers and increasingly low cost carriers also carry passengers whose tickets were part of a package. For instance, 37 per cent of UK resident holiday passengers that used Heathrow were "Inclusive Tour" passengers. However, the CAA considers that passengers whose use of airport is determined by a third party decision are less likely to have a choice of airport.

**Figure 8.8: Inclusive Tour proportion of UK resident holiday passengers at London Airports**

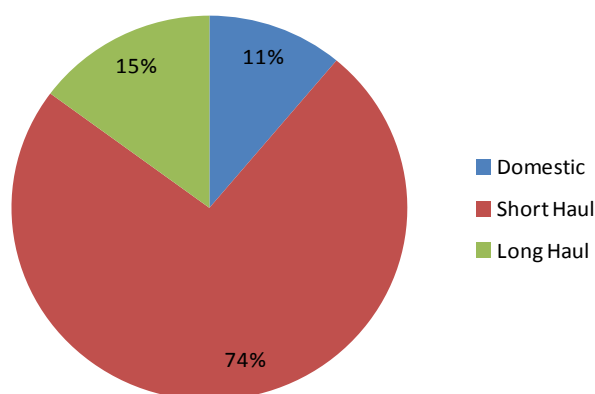
	Passengers in Inclusive tours (m)	Total UK Resident Holiday Passengers (m)	% Inclusive Tour
Gatwick	7.3	13.7	53%
Heathrow	3.1	8.3	37%
Stansted	0.9	4.0	22%
Luton	0.7	3.0	23%

Source: CAA Passenger Survey 2011

### Type of destinations available

#### Passengers at Gatwick, as shown in

8.50 Figure 8.9 fly predominantly to short-haul destinations (74 per cent), with long-haul (15 per cent) and domestic routes (11 per cent).

**Figure 8.9: Proportion of Gatwick passengers by destination type**

Source: CAA Airport Stats, 2011

## Summary

- 8.51 This section has considered broad trends in passenger characteristics at Gatwick compared to other London airports. While catchment area analysis suggests that a significant proportion of the airport's passengers is likely to be able to travel at least two London airports, this does not take into account the other factors that influence passenger preferences in choosing an airport.
- 8.52 The majority of Gatwick's passengers are holiday passengers, who are typically more likely to be cost-sensitive than business and VFR passengers and also less likely to prefer a specific destination. However, only half of the 18 per cent of passengers (approximately 3 million) giving cost as the reason for airport choice were travelling for holiday purposes. Indeed, route and frequency availability and third party decisions also appear to be common reasons why holiday passengers choose to fly from Gatwick.
- 8.53 Almost three quarters of passengers at Gatwick travel on short-haul flights, followed by long-haul and domestic services, which reflects the airline services available at the airport. The extent of route overlaps for these different flight durations could affect passengers' choice of airport.
- 8.54 The following two sections expand on the above analysis according to passengers on domestic and short-haul routes and those on long-haul routes, in order more clearly identify the drivers of passenger marginality.

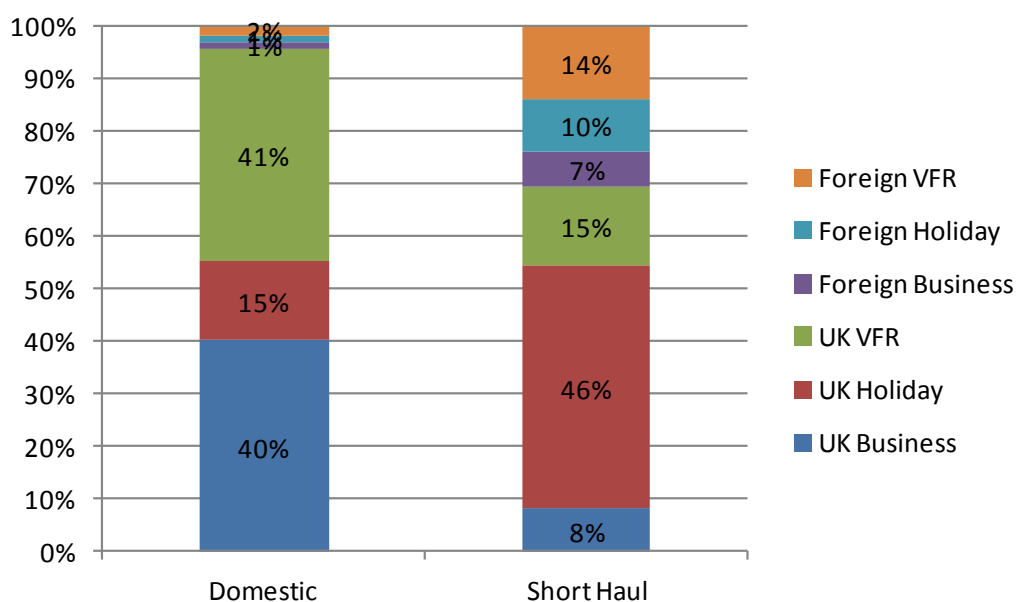
## Section 3: Passengers on domestic and short-haul flights

8.55 Passengers on domestic and short-haul flights together account for approximately 85 per cent of Gatwick's passengers. This section considers in more detail the characteristics of these passengers to determine whether, or to what extent, these passengers are likely to constitute Gatwick's marginal passengers.

### Journey Purpose

8.56 Figure 8.10 shows that approximately 85 per cent of Gatwick passengers on domestic services travel for business or VFR purposes, which are journey purposes that are typically destination-specific and time sensitive in the case of business passengers. By contrast, over half (56 per cent) of short-haul passengers at Gatwick travel on holiday, a journey purpose which is associated with cost sensitivity. This suggests that cost-sensitive passengers are more likely to be flying on short-haul than on domestic routes.

**Figure 8.10: Proportion of Surface Passengers by residence by purpose**



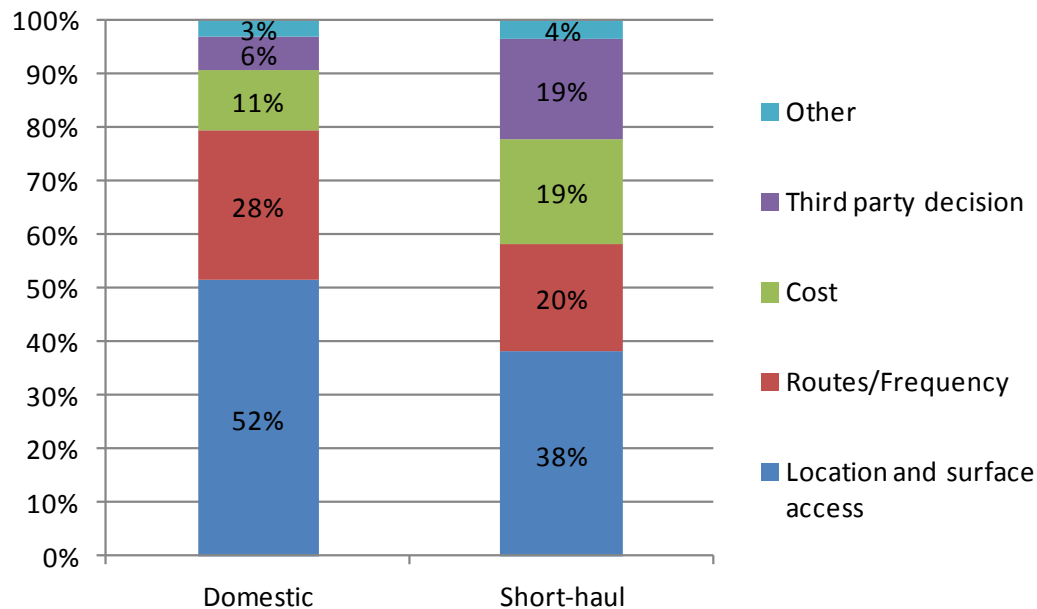
Source: CAA Passenger Survey 2011

### Reason for airport choice

8.57 After location and surface access (52 per cent), the availability of particular routes and/or frequencies (28 per cent) is the second most

common reason why domestic passengers choose to fly from Gatwick. Only 11 per cent domestic passengers chose to fly to from Gatwick for cost reasons. For short-haul passengers, 38 per cent of passengers choose Gatwick for its location and/or surface access. Route/frequency availability, the cost of using the airport and third party decisions (approximately 20 per cent each) were the joint second most common reason to use the airport.

**Figure 8.11: Reason for airport choice for domestic and short-haul passengers at Gatwick**



Source: CAA Passenger Survey 2011

## Route overlaps

8.58 Route overlaps illustrate the extent to which passengers might be able to fly to the same destination from another London airport. Figure 8.12 shows that there is considerable route overlap for domestic (92 per cent) with at least five routes overlapping with Stansted, Luton and London City.

**Figure 8.12: Number of domestic route overlaps between LON airports, 2012**

DOM	Routes	Overlaps	% Overlap	1.LHR	2.LGW	3.STN	4.LTN	5.LCY	6.SEN
1.LHR	7	7	100%		7	4	4	3	1
2.LGW	12	11	92%			5	7	5	2
3.STN	6	5	83%				3	2	1
4.LTN	7	7	100%					5	2
5.LCY	6	5	83%						1
6.SEN	2	2	100%						

Source: CAA Airport Statistics

Notes: UK Cities served with more than 10,000 passengers in 2012.

8.59 Figure 8.13 shows that there is 80 per cent overlap of short-haul routes at Gatwick with other London airports, with Stansted and Luton airports having the most overlap.

**Figure 8.13: Number of short-haul route overlaps between LON airports, 2012**

SH	Routes	Overlaps	% Overlap	1.LHR	2.LGW	3.STN	4.LTN	5.LCY	6.SEN
1.LHR	77	65	84%		54	29	28	15	3
2.LGW	138	111	80%			77	53	19	8
3.STN	147	97	66%				56	14	8
4.LTN	86	73	85%					11	9
5.LCY	28	23	82%						7
6.SEN	9	9	100%						

Source: CAA Airport Statistics

Notes: Geographical Europe Cities with more than 10,000 passengers in 2012.

8.60 Similarly to catchment area analysis, route overlap analysis has a number of limitations. As it is only a measure of whether a route is available at another airport, route overlaps analysis omits related passenger considerations such as the daily and weekly schedule differentiation for a given route across the airports at which it is available. The analysis assumes that a suitable flight on the same destination is available, for example, a charter route would not be a substitute for a scheduled one. Differences in scheduling can affect substitutability. As route overlap takes no account of service differences, it is likely to over-state the extent of passenger switching that could occur in reality. It also ignores the possibility that passengers could decide to use a different airport to fly to a different destination.

- 8.61 The CAA considers that, for an airport to act potentially as a viable substitute for a marginal passenger seeking to travel on a particular route, it would be at least necessary for:
- a passenger to be located in an area of catchment area overlap of at least two airports, and
  - for the route to be available from each of these airports.<sup>724</sup>
- 8.62 Figure 8.14 shows that, with respect to both Luton and Stansted, approximately 4.5 million passengers on domestic flights and 6.5 million passengers on short-haul flights could have a choice of more than one airport for the fly they would be about to take. However, this analysis does not identify the proportion of passengers who would switch away in light of a 10 per cent increase in airport charges.

**Figure 8.14 Passengers with potential choice of alternative airport for current flight**

Airport	Passengers in catchment overlap	Proportion of route overlap	Passengers with potential choice in catchment overlap
Luton – domestic	11,111,513	41.6%	4,622,389
Luton – short-haul	11,111,513	55.8%	6,200,224
Stansted – domestic	11,563,040	58.3%	6,741,252
Stansted – short-haul	11,563,040	38.4%	4,440,207

Source: CAA analysis

Note: Though they considered separately, the passengers in the overlap are not unique to the overlaps for Luton and Stansted respectively. Approximately 9 million passengers are in a four-way area of overlap between Heathrow, Gatwick, Luton and Stansted.

### Short haul airline competition across London airports

- 8.63 Another way to assess the potential for passenger switching across airports is to consider the extent to which airlines compete across airports. A 2008 working paper by the Competition Commission analysed airline yield data and found some evidence that BAA airports (Heathrow, Gatwick and Stansted) are substitutes for passengers. In that analysis, the CC considered that:

<sup>724</sup> The CAA also notes that some (for example leisure) passengers might also have a choice of alternative destinations.



*“It is not possible to estimate cross-price elasticities [faced by airports] directly: historical joint-ownership has prevented competition between the airports and so we observe only a few instances of switching behaviour by airlines. This means we must look to passenger willingness to substitute between airports in response to relative airfare changes instead to guide our view on incentives for airlines to switch in response to changes in relative airport charges.”*

- 8.64 The CAA has analysed easyJet route revenue and profitability data. The CAA constructed a panel dataset of easyJet’s annual revenue and annual profitability on its London routes. The CAA supplemented this data with information for each route from the CAA Airport Statistics about alternative seat capacity at the same airport and at other London airports over a five year period between 2007 and 2011.
- 8.65 The CAA used this data to try to understand the extent to which there is competition between airlines across the London airports and to aid in our understanding of the extent to which passengers substitute between London airports.
- 8.66 To do so, the CAA then fitted a panel fixed effects model where easyJet revenue was regressed against easyJet seat capacity and seat capacity provided at alternative airports to assess the extent to which airport seat capacity at other London airports constrains easyJet route revenue and profitability at Stansted (as well as at Gatwick and Luton).
- 8.67 The results for easyJet’s Gatwick routes suggest that:
- One extra seat provided at another London airport to the same destination on average reduces easyJet’s revenue on the route as operated from Gatwick by approximately £ [X]. One extra seat provided at Gatwick by another airline but to the same destination on average reduces easyJet revenue on that route by approximately £ [X].
  - There is some evidence that Heathrow and Luton seem to be constraining route revenue at Gatwick, [X].
- 8.68 Whilst elasticities of demand were not derived from this analysis, it can be concluded that:

- There are signs of airline competition for passenger demand at and across London airports.
- Competition between airlines at the same airports appears to be stronger than competition between airlines at different airports in London.
- [X].
- Air services from different London airports may place different constraints on easyJet routes, but it is difficult to say from which airport the constraint is largest.

## Conclusion

- 8.69 Analysing catchment area overlaps, reasons for airport choice and route overlaps suggests that a significant number of domestic and short-haul passengers seem to face a degree of choice with regards to flying to the same destination from a different London airport. Econometric analysis of fares also suggests some potential for competition across London airports.
- 8.70 In addition, approximately 10 and 20 per cent respectively of domestic and short-haul passengers appear to be cost-sensitive with regards to travelling through Gatwick. However, this does not necessarily mean that they would all constitute the GAL's marginal passengers in light of a 10 per cent increase in airport charges. As discussed in section 1:
- Airport charges account for a relatively small proportion of an airline's operating costs (at most 30 per cent). A 10 per cent increase in these costs would be then likely to lead to an increase of 3 per cent in airfares. This is a relatively small increase in the price faced by passengers.
  - Airlines might not always in the short run pass through to passengers the increase in airport charges, as airfares are not always priced to fully reflect costs.
- 8.71 The last two factors are likely to reduce the scale of switching by marginal passengers. The likely "actual" loss of passengers following such an increase is estimated in section 7.

## Section 4: Passengers on long-haul flights

8.72 Passengers on long-haul flights account for 15 per cent of Gatwick's total passenger traffic. Typically, their surface travel time to the airport tends to be longer than for domestic and short-haul passengers. However, as it is a smaller proportion of their overall journey time.<sup>725</sup> This section considers the extent to which long-haul passengers might have a choice of alternative airport to which they could switch in light of an increase in airport charges. As with domestic and short-haul passengers, the degree of switching by marginal passengers is likely to depend on the extent to which the airport charges increase is passed through.

### GAL's paper on long-haul switching<sup>726</sup>

8.73 GAL has submitted a paper in September 2012, commissioned from aviasolutions, regarding passenger switching on long-haul routes. Its main argument is that in 2011, 5 million passengers travelling to/from Gatwick on long haul services. In this context, aviasolutions that it could be argued that 3.5 million passengers (70 per cent of long haul passengers) had good switching opportunities:

- 0.7m passengers (15 per cent) transferred at Gatwick;
- 0.7m passengers (15 per cent) connected at their next destination;
- 1m passengers (19 per cent) were point-to-point passengers flying on a route which had a directing competing service from Heathrow; and,
- 1.1m passengers (22 per cent) were point-to-point passengers flying on a route which did not have a direct service from Heathrow but where there is evidence from the CAA survey of a material volume of passengers taking an indirect routing from Heathrow.
- The analysis has been undertaken at a geographic region level as well as at an aggregate level.

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<sup>725</sup> For more details, please see the CAA's working paper on Catchment Area Analysis, October 2011.

<sup>726</sup> Source: GAL.

- It could be argued that the vast majority of passengers travelling on services to North America (strong competition from Heathrow), Asia (strong competition from Heathrow) and Middle East (strong transfer and onward connecting flows) had good switching opportunities.
- While switching opportunities appear to have been more limited for passengers travelling to destinations in the Caribbean and Mexico, approximately 1/3 of passengers were either transferring, had onward connections or had the option to use a competing indirect service at Heathrow and therefore had switching opportunities.

8.74 The paper does not explicitly consider whether, and to what extent, these passengers can be considered to be marginal passengers who would be likely to switch away in light of a 10 per cent price increase to airlines. The remainder of this section attempts to identify drivers of marginality amongst long-haul passengers.

8.75 GAL also notes that long-haul is not defined as a separate relevant economic market for the purposes of the CAA's analysis and that the CAA must examine in greater detail whether Gatwick would have the ability and incentives to exploit the set of passengers that are materially affected by any absence of overlapping services.<sup>727</sup>

8.76 The CAA has outlined its approach to market definition in chapter 4 on the Analytical Framework.

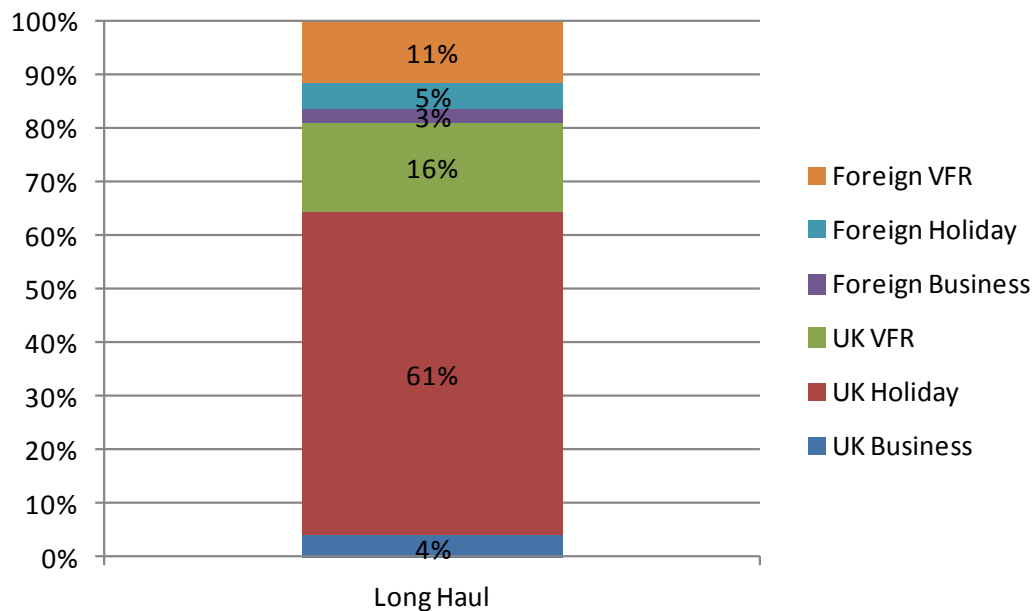
## Journey purpose

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<sup>727</sup> Source: GAL.

8.77 Figure 8.15 shows that 66 per cent of Gatwick's long-haul passengers are flying on holiday, with 27 per cent visiting friends and relatives and 9 per cent flying for business.

**Figure 8.15: Proportion of long-haul surface passengers by residence by purpose**



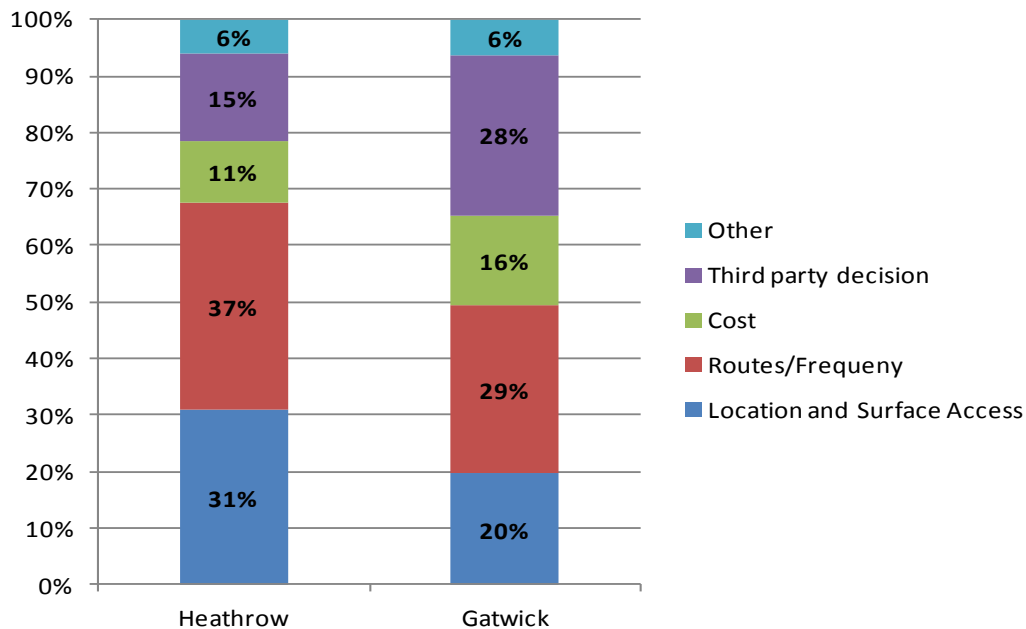
Source: CAA Passenger Survey 2011

### Reason for airport choice

8.78 As discussed in section 3, the CAA considers cost-sensitive

passengers are most likely to respond to an increase in the cost of using the airport by switching away. Figure 8.16 shows that the most common reasons why passengers choose to fly from Gatwick are because of the availability of a particular route and/or frequency (29 per cent), and due to third party decision (28 per cent), which probably reflects the activity of charter and tour operators at Gatwick. In contrast to domestic and short-haul passengers, only 20 per cent of long-haul passengers cite Gatwick's location and surface access as the reason for the choosing to fly from the airport. Cost was cited by the smallest proportion of passengers (16 per cent).

**Figure 8.16: Main reason for airport choice – Long Haul**



Source: CAA Passenger Survey

## Route overlaps

8.79 Route overlaps between Gatwick and the other London airports can

indicate whether a passenger could find a flight to the same destination from another airport in London that might be a substitute for their flight from Gatwick.

### GAL's submissions

8.80 With regards to long-haul passenger switching, GAL argues that:

*"...Therefore, a more appropriate interpretation of the evidence cited above is that for **40 per cent of long haul routes there is a very close substitute available to passengers**. Similarly, the fact that some passengers do not view two airports as close substitutes is significantly less relevant to a competition analysis than the proportion of passengers that do consider that they are close substitutes. From the data presented by the CAA, it is clear that the majority of Gatwick's customers are not "captive". This is not consistent with any claim that Gatwick derives market power due to any preference by South East passengers to use Gatwick, whether in respect of point-to-point services or otherwise"*<sup>728</sup>

8.81 Route overlaps with other London airports for long-haul routes are considerably fewer than for short-haul routes, and only arise between Gatwick and Heathrow. Figure 8.17 suggests that 14 of the 36 scheduled routes at Gatwick (32 per cent) overlap with services from Heathrow. In addition, another 14 routes are operated by long-haul charter airlines at Gatwick and are not operated elsewhere at London airports by another charter airline.

**Figure 8.17 Long-haul route overlaps for LON airports, 2012**

LH	Routes	Overlaps	% Overlap	1.LHR	2.LGW	3.STN	4.LTN	5.LCY	6.SEN
1.LHR	89	15	17%		14	0	0	1	0
2.LGW	44	14	32%			0	0	0	0
3.STN	0	0	0%				0	0	0
4.LTN	0	0	0%					0	0
5.LCY	1	1	100%						0
6.SEN	0	0	0%						

Source: CAA Airport Statistics

Notes: Non-European cities served with more than 10,000 passengers in 2012

8.82 However, since 2012 the airlines and the services they operate at Gatwick have changed. Of the 14 routes overlapping with Heathrow, only 9 routes are still currently operated. The routes that have been

<sup>728</sup> Source: GAL.

dropped are to:

- Atlanta, operated by Delta
- Hong Kong, operated by HK Airlines
- Seoul (Incheon), operated by Korean Air
- Kuala Lumpur, operated by Air Asia X
- Lagos, operated by Air Nigeria

8.83 In 2012, these routes accounted for 125,000 passengers. This reduces the number of passengers cited by aviasolutions as having a direct route alternative at Heathrow from 1 million to 875,000 passengers.

8.84 In addition, five of the overlap routes (to Canada) are overlaps between Air Transat at LGW – a low cost and charter long-haul airline - and Air Canada and other FSCs at LHR. FSC airfares can be up to twice the price of those of charter services.<sup>729</sup> These routes represent 444,174 passengers. The CAA considers that it is extremely unlikely that a 10 per cent increase in airport charges, which is likely to translate to approximately a £1 increase in airfares if passed through, would lead GAL's marginal passengers on these routes to switch to an alternative supplier of the same route whose airfares are approximately double. As a result, this route overlap cannot be considered realistic for the purposes of substitution by marginal passengers, and this reduces the direct route overlap to accounting for 430,826 passengers.

8.85 Further, at least one route overlap is due the same airline operating at both LGW and LHR: Emirates serves Dubai from both Gatwick and Heathrow. The CAA considers that the airline's pricing is unlikely to incentivise competition between its own services. As Emirates told the CAA:

8.86 *It noted there is a geographic and market distinction between LHR and LGW in that they both serve different catchments and markets:*

- *LGW has built a reputation as a “leisure based airport” for charter airlines*

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<sup>729</sup> This is based on a comparison of prices on the airlines' websites.



- *Although this perception is deep rooted, it noted that it is slowly changing under LGW's new ownership*
  - *There is a huge catchment overlap between the two airports (i.e. Guildford), but LGW serves a separate market.*<sup>730</sup>
- 8.87 The CAA considers that an airline's pricing is unlikely to incentivise competition between its own services. Similar considerations apply to BA's services to Las Vegas, which is served from both Heathrow and Gatwick.
- 8.88 Regarding its pricing, Air Malta, which operates to Malta from both Gatwick and Heathrow, has told the CAA that:
- *The fare structure at both LHR and LGW are identical, but the ways in which they are managed are different:*
  - *Although the same fares are listed for each fare "bucket", the sales in the lower yield buckets are closed more quickly at LHR, to maximise sales in the higher yield buckets.*<sup>731</sup>
- 8.89 Taking account of these situations where an overlap route is unlikely to act as an adequate substitute leaves only two current overlap routes where passengers have are likely to face realistic direct alternatives. However, the number of long-haul destinations can vary relatively quickly, for example with the entry of a new carrier, which that this figure could conceivably increase slightly in the short to medium term.
- 8.90 While the scope for marginal passengers to switch to alternative direct services at other London airports appears very limited, the CAA acknowledges that passengers may also consider indirect routes from other airports as alternatives for direct services from Gatwick. This could increase the choices available to passengers flying on long-haul routes who are not time sensitive. The CAA also considers that there remains scope for long-haul passengers to switch to other long-haul destinations at Gatwick or Heathrow, and potentially to short-haul or domestic routes.

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<sup>730</sup> Source: Emirates.

<sup>731</sup> Source: Air Malta.

## Conclusion

- 8.91 The scope for passengers on long-haul services at Gatwick to switch to alternative long-haul routes is restricted to switching between routes at Gatwick and at Heathrow. While the majority of long-haul passengers at Gatwick travel on holiday, only 16 per cent of passengers cite cost as the reason why they chose to fly from Gatwick. This represents approximately 800,000 passengers at the airport. Further, although the catchment area analysis discussed in section 2 suggests considerable overlap, the route overlap analysis indicates that the scope to switch airport and fly to the same destination appears very limited.
- 8.92 Overall, and in contrast to domestic and short-haul passengers, the scope for surface long-haul passenger switching appears to be limited. In addition, as discussed with regards to domestic and short-haul passengers, the effect on airfares of a 10 per cent increase in airport charges – which itself could be limited by airlines not passing through the cost increase – is unlikely to increase prices for passengers to the extent that marginal long-haul passengers would switch in significant numbers.

## Section 5: Critical loss analysis

- 8.93 This chapter has so far considered the likely characteristics that might describe GAL's marginal passengers. This section presents estimates the required "critical" loss of passengers that GAL would have to lose to make a SSNIP unprofitable<sup>732</sup>, and derived the associated price elasticities of demand.

### Critical Loss

#### Approach and assumptions

- 8.94 Critical loss analysis examines the level of passenger demand reduction and flight/aircraft withdrawal by airlines that would be required for an airport charge increase to be unprofitable for the airport operator. The analysis considers a small but significant non-

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<sup>732</sup> A loss of passengers equal to the critical loss means that the price rise would not give incremental profits. When the loss exceeds the critical loss level, the airport would lose existing profits in addition to the price increase not being profitable.

transitory increase in prices of 5 per cent and 10 per cent.

- 8.95 The analysis examines the impact of an increase in revenue from airport charges on top of GAL's current total revenue per passengers, which includes commercial revenue. Due to the vertical nature of the relationships between the airport, airline and passengers, and as the CAA is developing its 'minded to' position with regards to GAL for the provision of airport operation services to airlines, the following critical loss analysis focuses on increases in charges to airlines. However, the analysis takes into account the potential loss to GAL of both the aeronautical and non-aeronautical revenue for each passenger switching away.
- 8.96 The analysis uses regulatory accounts information for 2011/12 and takes into account the impact of a change in charges on operating costs and commercial revenues. The analysis makes the following assumptions:
- Operating cost elasticity with respect to output of 0.5 based on analysis undertaken by Steer Davies Gleave (SDG) as part of the Stansted airport (Stansted) mid-Quinquennium review, using a sample of airports.<sup>733</sup> An alternative elasticity of 0.3 has been used based on work undertaken by the Competition Commission (CC) as part of the STAL Q5 review.<sup>734</sup>
  - Non-aeronautical revenue variability assumptions are shown in Figure 8.18. For the purposes of this analysis aeronautical revenue from non passenger aircraft is included with non aeronautical revenue as non passenger traffic is assumed not to vary with passenger traffic.

### Figure 8.18: Non-aeronautical revenue variability assumptions

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<sup>733</sup> SDG, Stansted airport: Review of operating expenditure and investment consultation (Annex D): Mid term Q5, May 2012, page 57. This document can be accessed at:

<http://www.caa.co.uk/docs/5/SDGStanstedReport.pdf>. The elasticity is quoted as 0.44 but increases to 0.5 in periods with declining traffic. As an increase in charges is likely to lead to a decline in traffic the elasticity of 0.5 has been used.

<sup>734</sup> CC, Annex 5 of Appendix H, Stansted Airport Ltd: Q5 price control review. This document can be accessed at [http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep\\_pub/reports/2008/fulltext/539ah.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2008/fulltext/539ah.pdf)

Non-aeronautical revenue category	2011/12 revenue (£m)	Proportion variable	Variable revenues (£m)
Other traffic related	2.9	0%	0
Retail	160.2	100%	160.2
Property	34.3	0%	0
Other	34	50%	17
Non passenger traffic	2.3	0%	0
Total	233.7	76%	177.2

Source: GAL Regulatory Accounts for the year ended 31 March 2012 and CAA analysis

### Impact on passengers

8.97 Figure 8.19 shows the critical loss analysis. The analysis shows that a 5 to 10 per cent increase in aeronautical charges will increase aeronautical revenue from an average of £7.95 per passenger (representing the price cap for 2011/12) to £8.35 and £8.75 per passenger respectively for a 5 and 10 per cent increase. For the same number of passengers, this results in total aeronautical revenue increasing by £13 and £27 million.

8.98 Based on this, and taking into account the potential reduction in operating costs and loss of non-aeronautical revenue from lower passenger numbers, gives a critical loss of passengers of 1.21 to 1.43 million for a 5 per cent increase in aeronautical charges, and 2.34 to 2.75 million for a 10 per cent increase. This is the reduction in passengers required for the aeronautical charge increase to be unprofitable for the airport operator.

**Figure 8.19: Critical loss in terms of passengers**

SSNIP increment	Increase in aeronautical revenue	
	5%	10%
<i>Background data</i>		
Passengers (mppa)	33.819	33.819
Aeronautical Revenue	269.0	269.0
Non Aeronautical Revenue	233.7	233.7
Total Revenue	502.7	502.7
Operating Costs	280.9	280.9

Aeronautical Revenue per Passenger (£ per pax)	7.95	7.95
Non Aeronautical Revenue per Passenger (£ per pax)	6.91	6.91
Variability of non aero revenue	76%	76%
Total Revenue per Passenger (£ per pax)	14.86	14.86
Operating Costs per Passenger (£ per pax)	8.31	8.31
<i>After price increase</i>		
Aeronautical Revenue per Passenger (£ per pax)	8.35	8.75
Non Aeronautical Revenue per Passenger (£ per pax)	6.91	6.91
Total Revenue per Passenger (£ per pax)	15.26	15.66
Increase in Revenue (£m)	13.45	26.9
<b>Critical loss (mppa) (SDG opex elasticity)</b>	<b>1.425</b>	<b>2.735</b>
<b>Critical loss (mppa) (CC opex elasticity)</b>	<b>1.212</b>	<b>2.340</b>

Source: GAL regulatory accounts 2011/12 and CAA calculations

### Critical elasticity

8.99 Based on the above critical loss figures, the implied "critical" elasticity can be derived. Figure 8.20 shows the implied elasticity from the change in passenger numbers. The reduction in passengers implies that if the airport charge elasticity is between 0.72 and 0.84 then the airport operator cannot profitably increase charges.

**Figure 8.20: Passenger demand elasticity required to render SSNIP unprofitable**

SSNIP increment	Increase in aeronautical revenue	
	5%	10%
Critical loss (mppa) (SDG opex elasticity)	1.425	2.735
Critical loss (mppa) (CC opex elasticity)	1.212	2.340
Change in passengers SDG	4.2%	8.1%
Change in passengers CC	3.6%	6.9%
Implied elasticity SDG opex elasticity	0.84	0.81
Implied elasticity CC opex elasticity	0.72	0.69

Source: GAL regulatory accounts 2011/12 and CAA calculations

**Figure 8.21**

8.100 Figure 8. below converts the critical loss in passenger numbers calculated above and converts it into estimates of the number of flights and aircraft that would need to be withdrawn to make a price increase unprofitable. This conversion takes the average number of passengers per flights at Gatwick in 2012 (142) and assumes aircraft that each Gatwick aircraft makes on average 6 Gatwick flights a day<sup>735</sup>. Overall this implies that based operators at Gatwick would need to withdraw the equivalent of 9 000 to 19,000 flights per annum or between 4 and 9 "Gatwick aircraft", year round, to make a small but significant price increase unprofitable for the airport operator.

**Figure 8.21: Implied passenger, flight and aircraft loss required to render SSNIP unprofitable**

Critical Loss	5% - CC Opex Elasticity	5% - SDG Opex Elasticity	10% - CC Opex Elasticity	10% - SDG Opex Elasticity
Passengers (mppa)	1.212	1.425	2.340	2.735
Flights per annum	8,533	10,035	16,476	19,259
Flights per day	23	27	45	53
"Gatwick aircraft"	4	5	8	9

Source: CAA Calculations

## Section 6: Estimating Gatwick's airport charge elasticity of demand

8.101 In this section, estimates of the charge elasticity of demand (CED) for

<sup>735</sup> The assumption of 6 daily flights is representative of both LCC separately, and the weighted

GAL's airport charge for passengers<sup>736</sup> are calculated. That is the degree to which airport demand varies with respect to changes in airport charges (aeronautical revenue per passenger)<sup>737</sup>. Those elasticities estimates are then compared with the critical CED, i.e. the elasticity threshold above which a SSNIP would be unprofitable.

8.102 By way of context, the CAA first consider general estimates of aviation elasticities and airport specific elasticities of demand. It then considers a number of methodologies that have been used to calculate Gatwick's CED:

- Methodologies based on DfT's aviation forecasting model including:
  - analysis carried out by Frontier Economics on behalf of easyJet; and,
  - analysis carried out by the CAA;
- A methodology developed by Frontier Economics using easyJet booking data.
- The results of the CAA's stated intentions passenger survey.

8.103 For each of the above three approaches outlined above, the CAA describes the methodology, their merits and limitations, as well as its relevance to the estimation of Gatwick's CED. The CAA also derives estimates of Gatwick's CED. A tabular summary of the range of elasticity estimates is provided in Figure 26.

### Context: market-level elasticities of demand

8.104 Passengers do not generally pay for airport use directly. One method of estimating their demand for airport services is to derive it from their demand for air travel. A number of studies have estimated the elasticity of demand for air travel. If airlines pass onto passengers all of the airport charge increase, then the Airport charge elasticity of demand = (Airport charge / Fare) \* (Fare elasticity of demand).

<sup>736</sup> The ability of airlines to switch is considered in chapters 6 and 7.

<sup>737</sup> The relevant price elasticity varies depending on what is considered as the relevant initial price (ideally the competitive price level). However, this annex focuses on the extent to which passengers respond to a price increase rather than on what is the competitive price level at Gatwick (which is discussed elsewhere in this report). Sometimes the modelling will use explicit or implicit assumptions on price, which cannot be changed. However, any assumptions with regards initial airport charges for the calculation of CEDs are shown.

- 8.105 An informative starting point for the analysis of Gatwick's own airport charge elasticity of demand is the large existing body of evidence on aviation market-level price elasticities of demand (that is, the amount demand falls in response to a 1 per cent increase in airfares). Under certain assumptions<sup>738</sup>, there is a relationship between the two.
- 8.106 For instance, in its latest aviation forecasts<sup>739</sup>, the DfT published its own set of national-level air fare elasticity assumptions by market segments<sup>740</sup>. Some market segments are thought to be more price elastic than others: Western Europe UK and foreign leisure segments are more price elastic (around 0.7) than business segments (around 0.2). The DfT also carried out a literature review of demand elasticities<sup>741</sup> and found, where elasticities were equivalent, "price elasticities broadly comparable to those presented" in their latest aviation forecasts.
- 8.107 Another relatively recent and comprehensive study of Aviation elasticities (with a focus on price elasticities) is the 2007 InterVISTAS report prepared for IATA<sup>742</sup>. Drawing upon an extensive literature review, as well as new econometric analysis, this report proposes a fare elasticity calculator for worldwide use in policy analysis. The calculator has a "base" elasticity for "Route/Market" (1.4), National (0.8) and Pan-national (0.6) aggregation levels that can then be adjusted to account for differences between geographic markets and types of service. The report stresses that the higher the level of aggregation, the lower the relevant price elasticity will be. In particular, fare elasticities facing a particular carrier can be expected to be high because if a carrier increases its fare unilaterally, it is likely to lose

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<sup>738</sup> Mainly, that the response of passengers to a fare increase equal to the airport charge increase will be equivalent to the reduction in airline supply should the airline choose not to pass on the charge increase in its prices and that the airport under consideration is the only relevant airport service provider in that market.

<sup>739</sup> See table A4 of <http://assets.dft.gov.uk/publications/uk-aviation-forecasts-2011/uk-aviation-forecasts.pdf>

<sup>740</sup> The market segments are combinations of UK/Foreign residents, Business/Leisure purpose and Western Europe/ rest of OECD / New industrialised countries / Less Developed countries destination group, as well as separate Domestic business and leisure segments and a separate International interliner segment.

<sup>741</sup> DfT, Aviation Elasticities Literature Review, 2010, summarised in

<http://assets.dft.gov.uk/publications/uk-aviation-forecasts-2011/uk-aviation-forecasts.pdf>

<sup>742</sup> [http://www.iata.org/whatwedo/Documents/economics/Intervistas\\_Elasticity\\_Study\\_2007.pdf](http://www.iata.org/whatwedo/Documents/economics/Intervistas_Elasticity_Study_2007.pdf)



passengers to other carriers operating the same route. However, a pan-national price change (such an oil-price increase) can be expected to have a smaller effect on demand because passengers have more limited possibilities of substitution.

8.108 Based on the two reviews mentioned above, and assuming that:

4. Gatwick air services face a fare elasticity of demand somewhere between route/market level and national level;
5. Gatwick airlines pass onto passengers 100 per cent of the airport charges; and
6. Gatwick airport charges are in the region of six per cent<sup>743</sup> of Gatwick fares;

8.109 then Gatwick's CED would be below 0.1.

8.110 However, the CAA considers that using market-level elasticities to estimate Gatwick's CED (i.e. at airport level) would understate the true figure for Gatwick. The market-level analysis looks at a rise in the price of all air travel so it does not capture passengers' response to a rise in the price of travel from one airport relative to others. In other words it assumes no substitution from Gatwick to the wider market. Consequently, demand for air travel at the airport-level can be expected to be more elastic, i.e. show a greater response to a price rise.

8.111 Therefore, the CAA has reviewed the research submitted to or carried out by the CAA to infer a more reasonable CED for Gatwick. This research differs from the above because it allows for, and in some case estimates some degree of airport substitution in a multi-airport city.

### Analysis using the DfT aviation forecasting model

8.112 A number of approaches to estimating the elasticity of demand are based on the DfT's aviation forecasting model, NAPALM. In the initial

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<sup>743</sup> Six per cent is a rough estimate achieved by dividing an approximate airport charge of £8 by an approximate average one-way fare (based on International Passenger Survey data for 2011) of £138. The share of airlines' costs accounted for by airport costs is shown in chapter 6. The results will be different, given the inevitable differences in coverage (e.g. non-aeronautical costs, air navigation, etc.). Even with airport costs up to 25 per cent of the airfare, the CED would be less than 0.5.

views, the CAA stated that, while NAPALM model is primarily designed to estimate long-run passenger demand forecasts, using the model to estimate short run elasticities was a useful contribution to assessing passenger impacts at Gatwick<sup>744</sup>. An advantage of NAPALM is that the model is based on research of past passenger behaviour. As such it may be a more reliable means of assessing passengers' reactions to a price increase than survey responses or inferences drawn from catchment overlaps.

### Frontier Economics' 2011 estimates

8.113 In section 5.2 of its report<sup>745</sup>, Frontier estimates how much of the demand at Stansted and Gatwick would switch to other UK airports as a result of a cost equivalent to 10 per cent of airport charges being added to the cost of accessing those airports. It does this by using the underlying allocation model of the DfT's forecasting methodology.

### GAL's submissions regarding Frontier Economics' analysis

8.114 GAL objects to the critical loss study conducted by Frontier on the following grounds:

- *Critical loss analysis of competition in a market needs to take the competitive price level as the starting point. Frontier erroneously assumes that current airport charges are the best proxy for the competitive price level – in GAL's view, the competitive price level is likely to be higher than the level of the current charge.*<sup>746</sup>

8.115 GAL's arguments regarding the competitive price level are considered in chapter 4. The CAA considers that GAL prices are close to what could be considered as the competitive price benchmark for Gatwick.

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<sup>744</sup> Initial Views paragraph 3.132.

<sup>745</sup> Source: [http://www.caa.co.uk/docs/5/rpt-easyJet%20Competition%20Assessment%20Final%20Report\\_Abridged.pdf](http://www.caa.co.uk/docs/5/rpt-easyJet%20Competition%20Assessment%20Final%20Report_Abridged.pdf) (accessed March 2013).

<sup>746</sup> Source: GAL, CAA review of airport competition: Comments on Frontier Economics report for easyJet and RBB Economics report for Ryanair, page 3.

- *Frontier errs in focussing exclusively on passenger sensitivity to price changes. This ignores the fact that “airline reactions to price increases may be substantially larger than implied by passenger price sensitivity alone”.<sup>747</sup> Reasons for this include:*
- *Some airline services may switch in their entirety to a rival London airport. The airport charge increase at Gatwick, and the response of marginal passengers to it, may be enough to “tip the balance” of profitability of operating at Gatwick compared to a rival;*
- *Some airline services at Gatwick will simply become unprofitable and be withdrawn in their entirety;*
- *Some airlines will relocate aircraft capacity currently allocated to Gatwick to routes at other airports in Europe; and*
- *Some airlines will exert buyer power, acting strategically to discipline Gatwick’s pricing.*
- *Indeed, the interaction of passenger and airline switching amplifies the impact of passengers’ switching as their switching undermines the economics of services, bringing forward switching or termination of airline services.*

8.116 Airline evidence as to their likely to response to a 10 per cent price increase was discussed above. Overall, it suggests that airlines are most likely to absorb the cost increase in the short-run (the period over which Frontier estimates passenger responses), potentially passing them through in airfares at a later stage. The CAA set out its views of the limitations of Frontier's model estimates earlier in this chapter.

- *“Frontier’s conclusions are difficult to reconcile with prior findings by the CAA and the CC”.<sup>748</sup>*

8.117 The CAA notes that the issues considered and the analysis undertaken by the CC as part of its investigation *into* ‘the effects of features of such market or markets for airport services in the United Kingdom as exist in connection with the supply of airport services by

<sup>747</sup> Source: GAL, CAA review of airport competition: Comments on Frontier Economics report for easyJet and RBB Economics report for Ryanair, page 2.

<sup>748</sup> Source: GAL, Airport Competition: Competing to Grow and become London’s airport of choice, November 2011, Ref: Q5-050-LGW05, p.2.

BAA<sup>749</sup> is a different exercise from a market power assessment of a particular airport. With regards to passenger switching, the CAA notes that the CC found that:

*"...the evidence we have seen suggests significant substitutability of passenger demand between the BAA London airports, with significant overlaps between their catchment areas, although to an extent that varies between different categories of passenger: evidence that, in the absence of common ownership, there would be competition between them."*<sup>750</sup>

8.118 The CAA notes that the CC's finding with regard to catchment areas is consistent with its own analysis in section 2 of this chapter. However, as argued in section 2, the CAA considers that limitations of catchment area analysis are such that other factors and indicators of passenger marginality and substitution need to be considered.

8.119 The CC also found that:

*"The results of surveys carried out for the CAA and BAA also suggest that passengers regard BAA's three London airports as better alternatives for each other than non-BAA airports. As with our own survey for Scotland, the CAA's survey also indicated that relatively passenger sensitivity to fare increases (83 to 91 per cent of passengers not switching in response to a £5 increase in air fares, equivalent to an increase of approximately 50 to 100 per cent in airport charges."*<sup>751</sup>

8.120 In 2011, the CAA working paper of Passengers' airport preferences suggested that 20 per cent of short-haul and 31 per cent of long-haul passengers might switch away in light of an increase in their cost of using the airport. However, for short-haul passengers the price increases in question were of £5 for a one-way and £10 for a return

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<sup>749</sup> Source: CC, [http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/core\\_terms\\_of\\_reference.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/core_terms_of_reference.pdf), page 1.

<sup>750</sup> CC BAA airports market investigation page 10:[http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep\\_pub/reports/2009/fulltext/545.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/545.pdf)

<sup>751</sup> CC BAA airports market investigation para 3.134 c: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep\\_pub/reports/2009/fulltext/545.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/545.pdf)

airfare. These respectively represent an increase of approximately 63 and 126 per cent on 2011/12 airport charges<sup>752</sup>. For long-haul passengers, the price increase in question of £50 represented 630 per cent on 2011/12 airport charges.<sup>753</sup>

- 8.121 The CAA considers that both sets of passenger survey results do not ask a comparable question to the one posed when undertaking a market power assessment; that is, the level of marginal passenger switching in light of a 10 per cent increase in airport charges.
- 8.122 GAL argues that historic evidence on the impact of increases in airport charges does not provide reliable guidance because this evidence is affected by a number of factors which are specific to particular airports and increases.<sup>754</sup>
- 8.123 The CAA acknowledges that historic evidence of responses to increases in airport charges may be influenced by other contemporaneous factors. The CAA does not rely on any particular piece of such evidence in this 'Minded To' assessment.

#### Frontier Economics' estimates

- 8.124 According to the report, a 10 per cent increase in airport charges (76 pence at Gatwick) would lead to a reduction of 1.28 million passengers at Gatwick in 2010. This figure falls to 0.95 million when the model assumes Heathrow and London City to be capacity constrained.
- 8.125 This implies an Airport CED in the region of 0.3 to 0.4 for Gatwick for the unconstrained and constrained cases respectively, given the initial price used by Frontier of £7.60<sup>755</sup> and the initial passenger number<sup>756</sup> of 31.6m.
- 8.126 Figure 8.22Figure 8. shows where passengers who switch away from Gatwick would switch to under the two scenarios considered by the report.

<sup>752</sup> This uses the price cap of £7.946.

<sup>753</sup> Using £7.946 as price cap.

<sup>754</sup> Source: GAL, CAA review of airport competition: Comments on Frontier Economics report by easyJet and RBB Economics report for Ryanair, Ref: Q5-050-LGW06, page 3.

<sup>755</sup> The price cap in 2010/11.

<sup>756</sup> From Table 8 of Frontier's report.

**Figure 8.22: Impact of a 10 per cent change in Gatwick's airport charge on passenger numbers (million passengers in 2010)**

	Base Case	No Capacity available at Heathrow and London City
Gatwick	-1.28m	-0.95m
Stansted	0.51m	0.55m
Luton	0.14m	0.16m
Heathrow	0.40m	0.00m
London City	0.03m	0.00m
Out of London	0.19m	0.24m

Source: Frontier Economics

8.127 In the Initial views, the CAA stated that the modelled responsiveness of passengers appeared high, considering that a 10 per cent rise in the airport's revenues would only constitute a small proportion of passengers' total travel costs.<sup>757</sup> Nevertheless, the CAA did point out a number of concerns with the modelling, which might suggest that the responsiveness is at the lower end of the spectrum. For example, this analysis uses the passenger allocation methodology of DfT's forecasting model and not the overall model, thus a price increase at an airport only generates passenger switching to other alternatives, rather than passengers choosing not to fly. Also, it is a one-year static analysis taking the existing route network at UK airports as given. It does not take into account capacity constraints except for the option of not allowing any switching to Heathrow and London City. Finally, it treats passenger demand using Low Cost, Charter and Full Service airlines as separate categories, which limits the substitution possibilities<sup>758</sup>.

### CAA analysis

8.128 To take account of some of the drawbacks highlighted above<sup>759</sup>, the CAA asked DfT to run its aviation forecasting model in a number of

<sup>757</sup> Paragraph 3.134 of the CAA's Initial Views (Feb 2012), available at:

<http://www.caa.co.uk/docs/5/GatwickMarketPowerAssessment.pdf> (accessed in March 2013).

<sup>758</sup> A full list of the concerns is given in paragraph 3.133 of the Initial views (Feb 2012) available at: <http://www.caa.co.uk/docs/5/GatwickMarketPowerAssessment.pdf> (accessed in March 2013).

<sup>759</sup> Namely, to use the overall forecasting model and to gauge the size of dynamic effects of switching effects.

scenarios to simulate the effect of an airport charge increase at Gatwick airport. DfT provided the CAA with the outputs of the Central Case of its latest forecasts (August 2011<sup>760</sup>) as well as the results of a run that tried to replicate an airport charge increase at Gatwick that was passed onto the customer in its entirety. Given the setup of the model, DfT advised that the best way to model a Gatwick price increase was to increase the surface access cost of using Gatwick. In fact, this approach is consistent with those adopted by Frontier Economics in their 2011 report and by HMRC in a 2012 report.<sup>761</sup>

8.129 Figure 8.23 shows that over a period of one year it is estimated that GAL would lose 6.4 per cent of its passengers if it were £1 more expensive to use Gatwick from 2014 from a base of £7. Over the five years between 2014 and 2018, it is estimated that Gatwick would lose 10 per cent of its total passengers over that period. This translates to a 14 per cent increase in airport charges that is fully passed through by airlines. The majority of those passengers would travel from Luton or Stansted instead. Over a period of just one year the amount of switching would be smaller: if it was £1 more expensive to use Gatwick from 2014, it would lose 6.4 per cent (2.1m) of its passengers in 2014.

**Figure 8.23: Forecast passengers (million) using DfT's forecasting model**

Period	2014				2014-2018			
	Base Case	Gatwick increases £1	Absolute Change	% Change	Base Case	Gatwick increases £1	Absolute Change	% Change
Heathrow	73	73	0.6	0.8%	375	377	2.0	0.5%
Gatwick	33	31	-2.1	-6.4%	170	153	-17.0	-10.0%
Stansted	19	20	0.7	3.7%	100	105	5.3	5.3%
Luton	9	10	0.4	3.8%	49	55	5.2	10.5%
London City	3	3	0.1	1.8%	21	23	1.5	7.1%
Southend	0	0	0.0	-0.1%	1	1	0.0	0.9%
Other Airport	93	93	0.3	0.4%	495	497	1.5	0.3%
Total	231	231	-0.1	-0.1%	1,212	1,210	-1.6	-0.1%

Source: CAA analysis of outputs of the DfT's Aviation Forecasting Model

<sup>760</sup> <http://assets.dft.gov.uk/publications/uk-aviation-forecasts-2011/uk-aviation-forecasts.pdf>

<sup>761</sup> The report aimed to understand the impacts of potential price changes resulting of the devolution of Air Passenger Duty to Scotland and Wales, as well as hypothetical APD increases at Heathrow and Gatwick. The report states that "the model is designed to capture the key inter-relationships between demand at different airports" but also acknowledges that "as with all models, it is a simplification of reality and can never capture the full complexity of the aviation sector." This report is available at: <http://www.hmrc.gov.uk/research/report188.pdf> (accessed March 2013).

- 8.130 Using the results in Figure 8.23 and assuming:
- an initial airport charge of £7 (the approximate 2010 average aeronautical revenue per passenger for GAL in 2008 prices since the £1 increase is on that basis);
  - DfT's model is a reasonably reliable representation of reality, the CAA calculates that the implied price elasticities of demand is 0.45 for a response over one year.
  - The implied price elasticity of demand for a longer-run response (over 5 years) is 0.7.
- 8.131 The estimates in Figure 8.23 are on the basis of a 14 per cent increase in airport charges. By assuming a constant elasticity of demand (CES), it is possible to derive an indicative actual loss estimate for a 10 per cent price increase, which would be more comparable to the critical loss estimate.<sup>762</sup> For the short-run response over one year, a 10 per cent price increase with a price elasticity of demand of 0.45 would lead to approximately 1.485 million passengers switching away from Gatwick. For a 5 per cent price increase, the figure would be 742,500 passengers.
- 8.132 Estimating passenger switching over 5 years, a 10 per cent price increase with a price elasticity of demand of 0.7 would lead to approximately 11.9 million passengers switching away from Gatwick. For a 5 per cent price increase, the figure would be 5.95 million passengers.
- 8.133 The CAA considers that using this model to estimate the extent of passenger substitutability across airports is informative as the model attempts to reflect actual passenger behaviour based on survey data.
- 8.134 However, inevitably, this model also has its limitations. In particular, although the model allows routes to be dropped and started at different airports, it does not explicitly model airline behaviour and how this might affect passenger switching. The model works with the underlying assumption that (route) supply will follow (passenger)

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<sup>762</sup> This figure is sensitive to the assumption of demand elasticity. While it is possible that the elasticity of demand is linear and airport charges are a normal good, this would suggest that using the elasticities derived from a 14 per cent increase would be over-estimating the response to a 10 per cent price increase.



demand. As a result, the model would be able to effectively capture the dynamics of passenger-led switching, which is an important determinant of the economic viability of a particular route. However, as airline-led switching is not directly modelled, the dynamics of this kind of switching are not captured. Nevertheless, the CAA considers the effects of airline-led switching by analysing the likely type and scale of airline switching in chapters 6 and 7 for the two relevant markets.

- 8.135 In addition, the modelling approach outlined above assumes a full pass-through of increased airport charges to passengers and no supply-side response from the airlines (i.e. airline route switching above that is induced by passenger-led switching).<sup>763</sup> Increases in airport charges are, however, not always passed through to passengers in the short-run in the form of rises in airfares. While this might occur in the longer term, there might also be some switching of marginal services by airlines. A lower degree of the airport charge increase by the airline would be expected to result in a lower elasticity, while a larger scale response of airlines would increase the elasticity estimates.<sup>764</sup> The CAA considers that, at an airport where there are periods of excess demand for airport operation services, the assumption of full pass-through of airport price charge increases by airlines to passengers is unlikely to be reliable and this can result in a significant overestimate of the CED.

### **Frontier Economics (2007<sup>765</sup>): passengers' airport switching using easyJet booking data**

- 8.136 Frontier used easyJet booking data for a sample of routes, where the routes were served by easyJet from more than one London airport, to construct an airport choice model for easyJet's passengers. Among other controls, the probability of passengers choosing an airport (where easyJet had a service) was modelled against the travel distance and the price of easyJet flights at each alternative airport.

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<sup>763</sup> This is a common assumption to modelling passenger switching.

<sup>764</sup> This assumes a linear demand curve, where point elasticities of demand can vary with the size of the price increase.

<sup>765</sup> Frontier Economics, The De-designation of Stansted Airport, October 2007 <http://www.frontier-economics.com/library/publications/Frontier%20paper%20-%20de-designation%20of%20Stansted%20airport%20Oct%202007.pdf> (accessed March 2013).

- 8.137 The report stresses that the high travel-time elasticities that were found suggest that passengers are unlikely to switch airports if they have to travel much longer than the alternative.
- 8.138 However the report also finds equally high fare elasticities of demand, which suggests that passengers are quite willing to substitute airports if the air-fares at an airport increase.
- 8.139 Although not explicitly mentioned in the main part of the report, the confidential annex contains airfare elasticities of demand for 12 routes served out of Stansted, Luton and Gatwick by easyJet. Figure 8.24 below summarises the fare elasticities found for each route.

#### Figure 8.24: implied route own price elasticities of demand reported

[✕]

Source: CAA analysis of Annex 1 of Frontier's 2007 paper

8.140 [✕].<sup>766</sup>

- 8.141 The main limitation of these estimates is that it only uses easyJet booking data. This restricts the switching options available to passengers. The elasticities are also computed on a route-by-route basis, which does not allow for route substitution.

#### CAA stated intentions passenger survey

- 8.142 In November 2011 the CAA reported in one working paper<sup>767</sup> the results of a passenger survey conducted at some London airports. Short haul passengers were asked whether they would switch to another airport or not travel if the cost of using the airport went up by £5 (one-way). Of those, 17 per cent of passengers at Stansted, 20 per cent of passengers at Gatwick and 10 per cent of passengers at Heathrow responded that they would no longer use that airport. In the case of Gatwick, assuming an airport charge in the region of £8, it translates into an implied CED of around 0.3.
- 8.143 However, given the relatively small sample size and potential biases, the CAA considers that only an approximate CED can be derived from this analysis.

<sup>766</sup> This implied elasticity would increase if it was assumed that the airport charge represented a higher proportion of the ticket price.

<sup>767</sup> <http://www.caa.co.uk/docs/5/Passenger%20survey%20results%20-%20FINAL.pdf> (Figure 12).

## Section 7: Overall analysis of constraints from marginal passengers

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- 8.144 This chapter has considered the likely characteristics of GAL's marginal passengers and analysed how likely they would be to switch away. On the whole, passengers on domestic and short-haul routes appear to have more scope for switching away from Gatwick than passengers on long-haul services.
- 8.145 The CAA considers that the scale of passenger switching is likely to be highly dependent on the pricing response of airlines to an increase in airport charges. Two factors are likely to considerably limit the scope of passenger switching:
- First, airport charges are at most approximately 30 per cent of an airline's operating costs. As such, a 10 per cent increase in airport charges might be passed through, at most, as a 3 and 1 per cent increase in LCC and FSC and feeder airfares respectively.
  - Second, evidence suggests that airlines price to what the passenger market will bear and compete on price with other airlines, rather to fully reflect their cost base. As a result, airlines are unlikely to pass through cost increases in the short run. This is likely to reduce the likelihood and scale of marginal passenger switching.
- 8.146 Sections 6 and 7 have considered, respectively, the critical loss of passengers required to make a SSNIP unprofitable for GAL, and estimated the likely scale of actual marginal passenger switching. These figures are compared below both in terms of the level of switching and their implied elasticities to determine whether switching by marginal passengers is likely to constraint GAL's pricing.

### Conclusion on critical loss analysis

- 8.147 Comparing the critical loss level of marginal passengers with the estimated levels of switching that would be likely to occur can indicate whether a 5 or 10 per cent price increase GAL is likely to be profitable. Figure 8.25 shows critical and actual losses in terms of passenger and translates them into aircraft numbers. This shows that GAL is likely to be able to profitably increase its airport charges.

**Figure 8.25 Comparison of critical loss and actual loss estimates**

Ranges	5 per cent SSNIP	10 per cent SSNIP
Critical loss (mppa)	1.212-1.425	2.340-2.735
Estimated "actual loss" (mppa)	0.742	0.950-1.485
Critical number of "Gatwick" aircraft	4-5	8-9
Estimated "actual loss" of aircraft	2	3-5

Source: CAA summary of CAA and Frontier Economics estimates

### Conclusion on Airport Charge Elasticity

8.148 Based on the above methods, Gatwick CED is likely to be subject to a degree of uncertainty, with some research suggesting that it can be above 0.5 whilst other research points to as low as 0.2. Figure 8.26 summarises the results described above and provides a brief description of each piece of analysis. Airlines' ability to switch services in the face of airport charge increases is considered elsewhere in the report.

**Figure 8.26: Summary Table**

	Gatwick Airport Elasticity	Brief Description
Frontier 2011 (using NAPALM)	~ 0.3 to 0.4	Passenger-led switching of passengers no dynamic effects
Full DfT forecasting runs (£1 increase in 2014)	~ 0.45 over 1 year and 0.7 over 5 years	Passenger-led switching of passengers and routes. The estimate of response over 1 year has no dynamic effects.
[∞]	[∞]	[∞]
Stated intentions passenger surveys	~ 0.3	20% of short-haul passengers at Gatwick say they would switch airport if it was £5 more expensive to fly from Gatwick (representing a 62 per cent increase in airport charges)

8.149 All of the models used inevitably provide an imperfect representation

of reality and each makes different assumptions that affect the results in one direction or the other. In reality many factors will affect the relevant/true Gatwick CED. On the available evidence, the CAA considers that a 0.3 to 0.5 range for a short-run response is reasonable for Gatwick passenger-led CED. These estimates are below the critical elasticity ranges of between 0.72 and 0.85. For the modelled passenger response over a period of five years, an estimated elasticity was 0.7. This suggests that even the level of passenger switching over a longer term period might not be enough to make a price increase unprofitable.

- 8.150 Overall, the CAA considers that switching by marginal passengers as a short-run response to an increase in airport charges to airlines, as well as in the longer term, is unlikely to be sufficient to constrain GAL to the point of making a 10 per cent increase in airport charges unprofitable.

## CHAPTER 9

# Indicators of market power

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### Introduction

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- 9.1 The examination of indicators of market power can provide insight into the performance and behaviour of an airport operator. The CAA recognises that while individual indicators of market power may each suggest slightly different outcomes, when considered as a whole, they can be useful in helping determine whether an airport operator has SMP.
- 9.2 There are a number of indicators of market power and this chapter considers:
- market shares;
  - pricing (an issue also examined in chapter 4);
  - engagement with airlines and commercial negotiation;
  - quality of service;
  - efficiency; and
  - profitability measures.
- 9.3 In interpreting evidence relating to the behaviour or performance of GAL, the CAA recognises that Gatwick is subject to economic regulation and that GAL's behaviour is, therefore, likely to be influenced by this.
- 9.4 This chapter draws upon, where appropriate:
- GAL's perception of Gatwick's current and future market position, as reflected in its internal papers; and
  - a CAA working paper on empirical methods for assessing the behaviour, performance and profitability of airports.<sup>768</sup>

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<sup>768</sup> This working paper is available at:

[http://www.caa.co.uk/docs/78/ERG\\_Working\\_paper\\_Performance\\_and\\_Behaviour-26-11-10\\_FINAL.pdf](http://www.caa.co.uk/docs/78/ERG_Working_paper_Performance_and_Behaviour-26-11-10_FINAL.pdf)

## Market shares

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- 9.5 The Guidelines indicate that evidence on market structure and market shares is commonly used in competition assessments.<sup>769</sup>
- 9.6 In the Initial Views, the CAA explored the issue of market shares in some depth and highlighted (among other issues) that:
- The relevant geographic market for passengers seems to include the Greater London Area and South East of England, possibly extending to include some districts in the South West and East of England.
  - On most measures, Gatwick does not have market shares that would justify a rebuttable presumption of SMP.<sup>770</sup>
  - For those markets where Heathrow is not a reasonable substitute for Gatwick – such as for point-to-point services operated by no frills and charter carriers – Gatwick’s market share rises considerably.<sup>771</sup>
  - When specific segments of the market (such as the South East of England, or outbound holiday travellers) are assessed then Gatwick has market shares of over 40 per cent.<sup>772</sup>
  - There are aspects of airport markets that might reduce the reliability of market shares as an indicator of market power.<sup>773</sup>
- 9.7 In response to the Initial Views, GAL noted (among other issues) that:

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<sup>769</sup> The Guidelines are available at:

<http://www.caa.co.uk/docs/5/Final%20Competition%20Assessment%20Guidelines%20-%20FINAL.pdf>

<sup>770</sup> CAA, Initial Views, p. 63.

<sup>771</sup> CAA, Initial Views, p. 63.

<sup>772</sup> CAA, Initial Views, p. 63.

<sup>773</sup> CAA, Initial Views, p. 63.

- Gatwick's passenger market share is no more than 25 per cent of the South East market. That dominance is 'very rarely' found by competition authorities at market shares below 30 per cent and, therefore, it is incumbent on the CAA to provide 'exceptional and compelling reasons' in support of any finding that Gatwick has SMP.<sup>774</sup>
- The CAA had:
  - downplayed the importance of market shares in its market power analysis and to the extent the CAA does take market shares into account, it does so in terms of market segments, not a defined relevant market.<sup>775</sup> According to GAL this constitutes a 'major departure from the normal approaches to market analysis'<sup>776</sup>; and
  - inappropriately relied on Gatwick's shares of 'market segments' to support its initial view that there is a 'reasonable prospect' that Gatwick has or will have SMP. However, when market shares are calculated with reference to the relevant economic market as defined by the CAA, which would be normal practice, these market shares are well below the levels at which dominance (and by extension, SMP) can be presumed and, indeed, below the levels at which dominance is commonly found.<sup>777</sup>

9.8 Since the release of the Initial Views, the CAA has given further consideration to the markets that Gatwick operates in. The CAA's minded to view on market definition is outlined in chapter 4. The CAA notes, however, that it is the markets that are outlined in this chapter (and not segments of those markets), that it has considered when looking at market shares.

9.9 The CAA also notes that there are a number of difficulties associated with using market share analysis to inform market power assessments (see chapter 3).

9.10 Notwithstanding these concerns, the CAA has calculated market

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<sup>774</sup> Source: GAL.

<sup>775</sup> Source: GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 2.

<sup>776</sup> Source: GAL.

<sup>777</sup> Source: GAL.



shares for Gatwick by reference to the market definition that it adopted in chapter 5.

- 9.11 In the first instance, the CAA has looked at market shares for two different markets: Market 1: LCCs and charters; and Market 2: Full Service Carriers (FSCs) and associated feeder traffic.<sup>778</sup> Importantly, the evidence, including evidence derived from discussions with stakeholders, suggests that:
- Gatwick is the LCC and charter market but the relevant market may include Luton and Stansted. Market shares have been calculated including both these airports as part of the LCC and charter market; and
  - Gatwick and Heathrow is the FSC and associated feeder traffic market.<sup>779, 780</sup>
- 9.12 The market shares of both these markets are outlined in Figure 9.1 below.

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<sup>778</sup> The CAA notes that there are different types of carriers – based and in-bound – and although these carriers may face different switching costs, due to differences in their respective business models, it does not necessarily affect the way in which the relevant market for passenger airlines is defined – see chapter 5.

<sup>779</sup> The CAA notes that although Stansted does not currently provide FSC services to any significant degree, under new ownership there may be increased scope for it to attract FSCs and connecting traffic from other airports – see chapter 5.

<sup>780</sup> The CAA notes that the key consideration is the strength of the competitive constraint from Heathrow, rather than whether it is, or is not, part of the relevant market. The competitive constraint from Heathrow is discussed in chapter 7.

**Figure 9.1: Market shares (selected years 2002-2012)**

	2002	2004	2006	2008	2010	2012
<b>MARKET 1: LCCs and charters</b>						
Passenger share						
Gatwick	40%	36%	36%	39%	44%	46%
Stansted	41%	47%	45%	41%	38%	35%
Luton	19%	17%	19%	20%	18%	19%
ATMS						
Gatwick	32%	30%	32%	35%	42%	44%
Stansted	46%	50%	47%	43%	38%	35%
Luton	22%	20%	21%	22%	20%	21%
<b>MARKET 2: FSCs and associated feeder traffic</b>						
Passenger share						
Gatwick	21%	20%	20%	18%	14%	14%
Heathrow	79%	80%	80%	82%	86%	86%
ATMS						
Gatwick	26%	24%	24%	22%	18%	17%
Heathrow	74%	76%	76%	78%	82%	83%

Source: CAA Airport Statistics

Note: Columns may not add up to 100 per cent due to rounding.

- 9.13 Figure 9.1 suggests that, in Market 1: LCCs and charters, Gatwick has:
- 46 per cent of the passenger market in 2012, up from the 40 per cent reached in 2002. This compares with declining market shares for Stansted over the same period (41 to 35 per cent) and a stable market share for Luton (19 per cent).
  - 44 per cent of the market in 2012, when measured by Air Traffic Movements (ATMs), up from the 32 per cent market share it had in 2002. This compares with declining market shares for Stansted and Luton over the same period (46 to 35 per cent and 22 to 21 per cent respectively).
- 9.14 Figure 9.1 also suggests that, in Market 2: FSCs and associated feeder traffic, Gatwick has around:
- 14 per cent of the passenger market in 2012, down from the 21 per cent achieved in 2002. This compares to a growing market share at Heathrow (79 per cent to 86 per cent) over the same period.
  - 17 per cent of the market in 2012, when measured by ATMs, down from the 26 per cent achieved in 2002. This is in contrast to the growth in market share seen at Heathrow (74 to 83 per cent) over the same period.
  - 100 per cent of the market on the narrower market definition of Gatwick only.

### Assessment of market shares

- 9.15 Figure 9.1 suggests that, in the LCCs and charters market (irrespective of whether it is measured by passenger numbers or ATMs), Gatwick's share of over 40 per cent of the market is above the level that at which dominance could be found.
- 9.16 Figure 9.1 also suggests, at first glance, that in the FSCs and associated feeder traffic market (irrespective of whether it is measured by passenger numbers or ATMs), Gatwick would have less than 20 per cent of the market, a level that would not, generally, be consistent with a finding of dominance. However, despite the possible presence of Heathrow in this market, that airport is largely considered to be at full capacity (see Chapter 7) and therefore does not impose

an effective competitive constraint on GAL's behaviour.

- 9.17 In observing these figures there are, however, a number of reasons – including geographic and operational capability and capacity constraints – which suggest that market shares may not be a conclusive measure of the level of market power of airports. These results must therefore be read with that qualification in mind.

## Pricing

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- 9.18 Chapter 4 considered whether GAL's price was below the competitive price. This section considers whether GAL's prices are above the cost-based level or may become so in the absence of regulation.
- 9.19 Based on the additional analysis undertaken since the Initial Views, including independent analysis on price benchmarking and the long run average incremental costs, the CAA considers that GAL's prices are in line with the competitive price (see also chapter 4).
- 9.20 The CAA also notes that:
- GAL considers that the competitive price, in part informed by its LRIC study, is substantially above the current regulated price (see the quotes from GAL outlined in chapter 4). It also maintains that there is excess demand for the airport at current prices so that a market clearing price would exceed the current price.
  - GAL has been pricing at, or close to, the regulatory cap for several years<sup>781</sup> and it has indicated on numerous occasions its strong belief that the current regulated price is (significantly) below the competitive price. This suggests that the cap is currently binding GAL and that a higher cap, or deregulation, would likely lead to a higher price
- 9.21 GAL has also indicated that, based on the expectation that the CAA will not set a licence for Gatwick, the best way forward is:
- ...to allow the competitive market to dictate the service and price levels for the airport. Accordingly, we have developed a commercial approach for our airlines, comprising "Contracts and Commitments."*

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<sup>781</sup> See Figure 2.8, chapter 2.

*As at other non-regulated airports and businesses worldwide, we see a future in which airline-airport relationships at Gatwick are increasingly defined through bilateral contracts. ... Of course, we recognise that some airlines may choose not to enter into bilateral contracts, and will therefore continue to access the airport under the terms of Gatwick's Conditions of Use.*<sup>782</sup>

9.22 And:

*These contracts would be negotiated on an individual airline basis.*<sup>783</sup>

9.23 A key component of GAL's proposed Contracts and Commitments<sup>784</sup> is a price commitment. GAL's preferred approach to pricing appears to be a 7 year commitment to limit price increases in the average aeronautical yield from core airport services to RPI + 1.3 per cent p.a. (following a one-off adjustment of 11 per cent).<sup>785</sup> GAL has also indicated that this limit would be taken into account each year when GAL publishes the tariff for core airport services in its Conditions of Use.<sup>786</sup> GAL suggested that this approach would offer a substantial price improvement relative to its estimate of the RAB-based price control.<sup>787</sup>

9.24 GAL's proposed price commitments are based on its view that it does not have market power. The CAA notes that in the event that the evidence suggests that GAL does have SMP, the merits of such an approach may be more limited.

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<sup>782</sup> Source: GAL.

<sup>783</sup> Source: GAL.

<sup>784</sup> This is an approach that GAL has put forward based on the expectation that the CAA does not find that it has substantial market power and that the CAA does not set a licence for Gatwick.

<sup>785</sup> GAL has indicated that this price path that it has proposed would be the average aeronautical yield from core airport services (and assumes for calculation purposes that all passenger traffic at the airport pays the published tariff).

<sup>786</sup> Source: GAL.

<sup>787</sup> Source: GAL.

- 9.25 A number of airlines expressed views on the prices that GAL charges at Gatwick. However, the CAA notes that:
- airlines' views on prices are explored in chapter 4 and in the section below (engagement with airlines); and
  - government policy is currently restricting the development of new airport capacity around London until at least 2015 (or later), and this reduces the competitive constraint on airports because it stimulates excess demand and creates barriers to switching. Thus, any price that is higher than the competitive price may persist for a significant period of time.
- 9.26 Given the above, the CAA considers that the ability of airlines to negotiate with GAL is, therefore, relatively important in considering whether an airport may have SMP. How GAL has engaged with different airlines in terms of its negotiations on pricing at the airport is the focus of the next section.

## Engagement with airlines

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- 9.27 In the Guidelines, the CAA stated that an airport's conduct, and the effects of such conduct, could be a useful indicator of market power.
- 9.28 In the Initial Views, the CAA examined how GAL had engaged with airlines and noted (among other factors) that:
- While there is some evidence to suggest that Gatwick is competing for passengers and for airlines more than it once did, the airport might still have sufficient market power to require economic regulation.<sup>788</sup>
  - There is difficulty in assessing behaviour related evidence, including the difficulty in distinguishing between:
    - a change in conduct being driven by new owners attempting to maximise their return on their investment; and
    - a step change in the level of competition faced by the airport.<sup>789</sup>

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<sup>788</sup> CAA, Initial Views, p. 8.

<sup>789</sup> CAA, Initial Views, p. 91.

- There is mixed evidence on the extent to which there has been a significant change in the airport's incentive to compete for airline business and whether recent trends represent a clear break from the past. In particular, the CAA noted that:
  - while GAL emphasises its success in attracting a number of airlines to the airport, including a mix of short haul and long haul operators, BAA (as the previous owner) successfully attracted growth from easyJet and other carriers; and
  - a number of incumbent airlines have stressed that they have not been offered the discounts available to new carriers.<sup>790</sup>

9.29 In response to the Initial Views, GAL indicated (amongst other issues) that:

- *[T]he airport's behaviour cannot in isolation provide the basis for judgement on SMP.*<sup>791</sup>
- *The CAA's view, that Gatwick's conduct since the sale by BAA can be ignored or marginalised on the grounds that it may simply reflect a change in ownership, is a highly selective reading of the available evidence.*<sup>792</sup>
- *The CAA has presented no evidence to suggest that the change in behaviours has been driven by anything other than the increase in competitive pressures. To conclude otherwise in the absence of evidence can only be speculation.*<sup>793</sup> It also noted that it was inappropriate for the CAA to refrain from reaching a conclusion as to whether or not Gatwick's behaviours result from a change in competitive conditions.<sup>794</sup>

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<sup>790</sup> CAA, Initial Views, p. 98.

<sup>791</sup> GAL, CAA's market power assessment of Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 3.

<sup>792</sup> GAL, CAA's market power assessment of Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 3.

<sup>793</sup> GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 5.

<sup>794</sup> Source: GAL.

- *Gatwick could lose significant business if FSC airlines were to relocate or reduce their services... [and that it had] ...provided evidence to the CAA relating to the financial contribution from our leading airlines, including from non-aeronautical revenues. This highlights the value of these carriers to Gatwick.*<sup>795</sup>
- *Gatwick is competing much more actively than it has previously to attract airlines to the airport. In any case, mixed evidence of whether or not there is a clear break from the past cannot credibly be interpreted as evidence of dominance.*<sup>796</sup>

9.30 GAL also indicated, since BAA disposed of Gatwick, that:

- *Extensive, detailed senior level attention is now given to the airline retention and attraction.*
- *better and more frequent communication with key airline decision makers, for the first time marketing support for new long haul routes, added to the promotion of key selling points the Airport enjoys, Gatwick has managed to attract new long haul carriers.*
- *[it is n]ow taking measures to address the awareness and standing it enjoys in key overseas markets as well as educating travel bookers to its benefits....the most direct example of the change in emphasis is also shown by Gatwick's attendance at the Routes conference. Attendance in our own right was only allowed from 2009.*<sup>797</sup>

9.31 More broadly, GAL indicated that its conduct since the sale of Gatwick is inconsistent with any finding of SMP.<sup>798</sup> It also indicated that even if the CAA finds SMP, its conduct since the sale of Gatwick suggests that it will not abuse any such SMP.<sup>799</sup>

9.32 The CAA notes that GAL also:

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<sup>795</sup> GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 5.

<sup>796</sup> GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 10.

<sup>797</sup> Source: GAL.

<sup>798</sup> Source: GAL .

<sup>799</sup> GAL, Airport Competition: Competing to Grow and become London's airport of choice, November 2011, Ref: Q5-050-LGW05, p. 74.



- provided a number of case studies and examples which, in its view, demonstrate improved behaviour and performance;<sup>800</sup> and
- argued that its conduct fulfils various Competition Commission (CC) and CAA expectations regarding competition.<sup>801</sup>

9.33 Since the publication of the Initial Views, the CAA has considered a range of additional evidence from both GAL and from airlines to further develop its thinking on this issue. Additional material considered include:

- strategy documents, including board papers and executive committee papers and papers discussing potential and actual strategies for encouraging passenger growth;
- marketing and promotional material;
- offers made to incumbent airlines in response to a threat of switching or actual switching;
- offers made to airlines considering launching new routes; and
- discussions / teleconferences with a range of airlines, including those who have been present at Gatwick for some time and those that are relatively new.<sup>802</sup>

9.34 Given the complexity of this issue, the CAA examined the evidence as it pertains to short-haul airlines, long-haul airlines and charters.<sup>803</sup> The CAA notes that there are limitations associated with this evidence as records of negotiations are often incomplete as discussions often occur face-to-face/on the telephone and recordings and/or minutes are not kept.

9.35 Prior to examining these issues, the CAA does, however:

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<sup>800</sup> Source: GAL.

<sup>801</sup> Source: GAL.

<sup>802</sup> Airlines that the CAA engaged with include short-haul and long-haul carriers, FSCs, LCCs and charters.

<sup>803</sup> The CAA recognises that this grouping is different to how it has defined the markets that Gatwick operates in chapter 4. The CAA notes that it has separated the discussion in this manner as this facilitated the grouping of similar themes coming identified through discussions with stakeholders.

- agree with GAL that the airports behaviour, with respect to its negotiations, is just one aspect of its behaviour that will help the CAA come to its 'minded to' decision on market power;
- note that the evidence submitted by GAL is material that has been prepared by the new management at GAL and that the evidence collected from other stakeholders includes evidence on their experience pre and post the sale of Gatwick (by the then BAA), as this helps provide evidence on how behaviour has changed over time;
- note that this section should be considered in conjunction with the discussion on countervailing market power (see chapter 6, section 5); and
- note that although GAL may be facing more competition since its sale (and may face more competition over time with new ownership at Stansted), increased competitive pressure does not automatically mean that it currently faces, or will face, the level of competition that is seen in a fully competitive market.

### Short haul airlines

9.36 With respect to GAL's behaviour, the CAA notes that Air Malta indicated that:

*it doesn't receive any support from LGW (it hasn't tried to negotiate any discounts, and nothing has been offered) ....From its experience, it knows it is unlikely to receive anything from airports like LGW.*<sup>804</sup>

9.37 easyJet has also noted that '*it has seen monopolistic behaviour at LGW*'. In particular, it noted that:

*LGW has given edicts (such as changing terms of use) which they wouldn't be entitled to do in any other business; and*

*LGW is not listening and is making decisions unilaterally without consulting.*<sup>805</sup>

9.38 In addition, easyJet indicated that it has previously tried to negotiate with GAL but has been relatively unsuccessful (see section 5 of chapter 6 for more information).

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<sup>804</sup> Source: Air Malta.

<sup>805</sup> Source: easyJet.

9.39 Flybe also indicated that:

*Over the last three years, it only had one face to face meeting with GAL (this was before it put its section 41 complaint in). The objective of this meeting was to explain Flybe's business model and how GAL's business charging on landing was having a negative impact on regional connectivity. ... This attempt was unsuccessful and GAL has continued this trend in their charging (splitting them equally over all aeronautical charges instead of loading all charges on landings).<sup>806</sup>*

9.40 However, Wizz Air indicated that in its negotiations with airports that:

*...airlines trade off options against their alternatives. This means that they may play off airports against each other to get the best deal.<sup>807</sup>*

9.41 And

*Overall, the London airport market contains lots of choice for Wizz Air. The airline can play airports against each other during negotiations, and the decision to operate from an airport ultimately comes down to operational considerations.<sup>808</sup>*

9.42 More generally, Norwegian Air Shuttle (a growing airline that has recently agreed to establish a base at Gatwick in spring 2013<sup>809</sup>), indicated that:

*Under new ownership, the airport operator is interested in working with airlines collaboratively, understanding and addressing their needs...' and that '[t]here has been a change in attitude in GAL's wider discussions with airlines as a whole (i.e. ACC).<sup>810</sup>*

9.43 In relation to the point above, the CAA notes that other (non-short-haul) airlines have suggested that GAL's approach at ACC meetings is somewhat different and is better categorised by an approach of 'take it or leave it' – see discussion below for more information.

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<sup>806</sup> Source Flybe.

<sup>807</sup> Source: Wizz Air.

<sup>808</sup> Source: Wizz Air.

<sup>809</sup> GAL, 'Norwegian Air Shuttle to establish a new London base at Gatwick', available at: <http://www.mediacentre.gatwickairport.com/News/Norwegian-Air-Shuttle-to-establish-a-new-London-base-at-Gatwick-7a3.aspx> (accessed 9 April 2013).

<sup>810</sup> Source: Norwegian Air Shuttle.

- 9.44 The CAA considers that the above evidence suggests that the majority of short-haul operators do not receive any discounts to aeronautical charges and there is little scope for negotiation. The evidence does, however, suggest that inbound LCCs, or those that are proposing to expand their operations significantly at the airport, may be relatively well placed to exercise their bargaining power (see also chapter 6 – capacity constraints) as they are more flexible as to which London airport they are willing to operate from.
- 9.45 The CAA has also examined a number of presentations that GAL has offered to airlines to encourage them to operate at Gatwick. The CAA considers that the evidence indicates [redacted]<sup>811</sup> GAL's approach can perhaps be best represented by way of an example. Specifically, in late 2011, in correspondence between GAL and [redacted], GAL noted:  
[redacted].<sup>812</sup>
- 9.46 And:  
[redacted].<sup>813</sup>
- 9.47 The CAA notes, however, that GAL has emphasised in various correspondence to airlines that fit into this category that:
- relative to Heathrow, its charges are low; and
  - its charging regime, including the relatively recent introduction of zero winter charging, makes it a cost effective airport to operate from.<sup>814</sup>
- 9.48 Based on the above evidence, the CAA considers that the majority of short-haul airlines have limited scope to negotiate with the airport on aeronautical charges. The CAA notes that approximately 85 per cent of Gatwick's traffic is made up of short-haul traffic.<sup>815</sup>

### Long-haul airlines (excluding long-haul charters)

- 9.49 The evidence associated with the development of long haul traffic at

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<sup>811</sup> Source: GAL.

<sup>812</sup> Source: GAL. This position was also conveyed to Turkish airlines.

<sup>813</sup> Source: GAL.

<sup>814</sup> Source: GAL.

<sup>815</sup> The CAA notes that this is comprised of 11 per cent for domestic traffic and 74 per cent for short haul traffic, which includes Europe and North Africa.

Gatwick suggests that GAL has been relatively active in looking to establish new long-haul carriers (or new routes from existing long-haul carriers) at the airport. GAL has, for example, provided the CAA with evidence, including presentations and correspondence between it and prospective long haul airlines, on its unique selling points and what incentives it may be able to provide.

9.50 The evidence that the CAA has reviewed also suggests that the incentives that may be made available to these airlines [redacted], although public relations and marketing support varies case by case. Specifically, the evidence suggests that the incentive a new long haul operator will typically be offered by Gatwick will be a [redacted] incentive comprised of the following:

- [redacted]
- [redacted]
- [redacted].

9.51 The CAA notes there are usually conditions associated with these incentives. In particular, conditions associated with the incentives require airlines to [redacted] as well as conditions [redacted] any services covered by the incentive.<sup>816</sup>

9.52 The CAA also notes that incentives of a similar duration and scale may be offered to long haul airlines that are currently at the airport and which are considering expanding their services at the airport.<sup>817</sup> For example, [redacted] indicated that the:

*Long haul growth incentive, is the only discount that has been offered (details to follow) [and that] It has had no short haul marketing interest from GAL.*<sup>818</sup>

9.53 The evidence also suggests that not all long haul operators receive incentives [redacted]. For example, Emirates noted

*It hasn't received any discounts on aeronautical charges.*<sup>819</sup>

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<sup>816</sup> This information is taken from correspondence that the CAA has been privy to – see footnote 50 for the various offers to airlines that the CAA has considered.

<sup>817</sup> The CAA notes that airlines that have been offered this incentive include [redacted].

<sup>818</sup> Source: [redacted].

<sup>819</sup> Source: Emirates.

- 9.54 Similarly, another stakeholder has indicated that it pays list price at LGW and LHR and does not receive any discounts on aeronautical charges or marketing support for its routes at LGW. It also noted that previous negotiations had not come to anything.<sup>820</sup>
- 9.55 Emirates noted that *'[relocating] is not something it had contemplated and it doesn't have a history of pulling out'*, which suggest that there could be scope for the airport to take advantage of it. However, it also indicated that it considers *'there is no SMP at LGW'*.<sup>821</sup>
- 9.56 As noted above, airlines may be eligible for marketing support but that the size (and scope) of this incentive varies on a case by case basis. The CAA notes that some of the marketing promotions that tend to be included as part of any incentive package include:
- [REDACTED]
  - [REDACTED]
  - [REDACTED]
  - [REDACTED]
  - [REDACTED]
  - [REDACTED].<sup>822</sup>
- 9.57 The CAA notes that there appears to be more scope for negotiations around marketing support, although the evidence on this is limited.
- 9.58 The CAA also notes that the airport has been relatively successful in attracting new long-haul airlines, although it has lost a number of such airlines too (the airlines that GAL has managed to attract and to lose are outlined in chapter 2).
- 9.59 Based on the evidence outlined above, the CAA considers that:

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<sup>820</sup> Source: [REDACTED] However, the CAA notes that it has subsequently told it [REDACTED].

<sup>821</sup> Source: Emirates.

<sup>822</sup> Assistance of this sort was offered to Monarch, for long haul services, Lufthansa, Turkish Airlines, Hong Kong Airlines, Air Asia X and Vietnam Airlines.

- while discounts to aeronautical charges are possible for new long-haul traffic, the scope for airlines to actively negotiate with GAL and change the size of these discounts is limited;<sup>823</sup>
- the scope for discounts to aeronautical charges for long-haul airlines already at the airport and not planning on incremental growth is much more limited relative to new long-haul traffic; and
- there appears to be some scope for negotiations around marketing support for all long-haul service, although the CAA would welcome additional views on this from stakeholders.

### Charters (short and long-haul)

9.60 The evidence on negotiations with charters suggests that, due to the maturity of its business model, there is limited scope for charters to effectively negotiate with GAL as levels of incremental growth are limited. Their position is also potentially affected by the limited scope for charters to operate at other London airports (see chapter 6).

9.61 Views expressed by some charters as to how GAL negotiates with them are detailed below. For example, Thomas Cook noted:

*Gatwick is focusing on business passengers rather than leisure passengers, thus there is less incentive to keep Thomas Cook there and seems quite happy for it to leave.*<sup>824</sup>

9.62 Thomson Airways noted that:

*... at airports other than LGW and STN (as they are designated), decisions by it to expand operations at an airport arise from negotiation with the airport. ...[and] LGW and STN would be less likely to offer discount for operators with TUI's type of business model, as it would only bring incremental growth due to its level of maturity.*<sup>825</sup>

9.63 And

*it is to some extent a 'cash cow' for several airports (including MAN and LGW) as it needs to operate from them and its historical presence at the airport. As its prospects for growth, relative to LCCs and start up carriers, are incremental it indicated that it is unlikely to win growth*

<sup>823</sup> The CAA does, however, note that it has seen incentives offered for [✕].

<sup>824</sup> Source: Thomas Cook.

<sup>825</sup> Source: Thomson Airways.

*discounts like those received by low cost carriers.*<sup>826</sup>

- 9.64 Monarch, which operates both scheduled and charter operations, indicated that:

*it pays tariff at Gatwick*<sup>827</sup> [and] *It also does not* [~~✗~~]<sup>828</sup>

*In terms of collaborative partnerships at other airports that it operates from, EMA, BHX and MAN are forthcoming and it is much easier to discuss and work collaboratively at these airports than it is with GAL.*

*GAL negotiations are markedly different and notably more difficult than those with these other airports*

*GAL is not receptive to any joint initiatives suggested by Monarch.*<sup>829</sup>

- 9.65 In addition, Monarch indicated that:

*New carriers get more say than incumbent airlines; for example* [~~✗~~] *[and] GAL's strategy is to focus on attracting new carriers and then once they start operating, it focuses its attention on another new carrier, without maintaining its incumbents.*<sup>830</sup>

## Other issues

- 9.66 The CAA notes that it received some evidence that suggests that the airport is reluctant to move issues forward when they have been identified by airlines in various forums. For example, BA indicated:

*At the moment there is no snow service level agreement in place and it has been on the agenda for nearly two years. [It was also noted that this arose] in 2010, due to the adverse weather and heavy snow, GAL made a public commitment to put better safeguards in place to deal with heavy snow and provide rebates for the delay.*<sup>831</sup>

- 9.67 And:

*In ACC meetings, GAL has a 'take it or leave it' approach and present their price commitments proposals rather than using it as a forum to*

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<sup>826</sup> Source: Thomson Airways.

<sup>827</sup> Source: Monarch.

<sup>828</sup> Source: Monarch.

<sup>829</sup> Source: Monarch.

<sup>830</sup> Source: Monarch.

<sup>831</sup> Source: BA.



*consult.*<sup>832</sup>

- 9.68 The CAA also notes that the issue of airlines failing to gain any traction with GAL with respect to a service level agreement was also raised by a number of airlines during discussions with the CAA's board. During that meeting, airlines highlighted the lack of movement in this area and the apparent unwillingness of the airport to move this issue forward.

### Overall conclusion on engagement with airlines

- 9.69 Based on the evidence outlined above, the CAA considers that GAL largely sets the terms that an airline will receive and that the scope for negotiation is relatively limited.
- 9.70 In particular, the CAA considers that there appears to be limited scope for short-haul airlines to negotiate any discounts to aeronautical charges, [X], and the scope for charters to effectively negotiate with GAL on other issues appears limited. That said, there appears to be some scope for short-haul carriers to enter into joint ventures and for some negotiation on marketing activities. In addition, it appears that short-haul carriers that may be considering entering Gatwick, or who are considering expanding, will have some, albeit limited, ability to negotiate with GAL.
- 9.71 The CAA also considers that the airport appears to have adopted a strategy that it is largely focused on building the number of long haul services operating at the airport. As part of this, GAL appears to be willing to provide [X] incentives to airlines to operate at the airport, although the structure and scope of those incentives are set by GAL and deviation from that appears limited.

### Service quality

- 9.72 In unregulated markets, the presence of market power can lead to reductions in the quality of service offered to consumers relative to that supplied in a competitive market. The CAA recognises that economic regulation can complicate the relationship between the level of service provided and the degree of market power held by an airport. In particular, the CAA recognises that the level of service quality of

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<sup>832</sup> Source: BA.

airports might be an outcome of regulation rather than of market power or competitive pressures, which can reduce the degree to which any analysis of service quality might provide a reliable indicator of market power.

9.73 The CAA notes that in Q4, in response to a public interest finding<sup>833</sup> made by the CC, regulation of service quality under the Service Quality Rebate (SQR) scheme was introduced at Gatwick. Under this scheme, where airport performance falls below certain pre-determined standards, the airport is liable to repay a portion of the charges levied to the airlines. The scheme was expanded for Q5 to include a total of 17 measures<sup>834</sup>, some of which relate directly to passenger satisfaction and some which relate indirectly, through the delivery of services to airlines which, in turn, promote efficient and reliable operations at the airport.

9.74 In the Initial Views, the CAA examined the issue of service quality and:

- noted that, since Gatwick's sale in late 2009, there had been changes in the way the airport was run;
- outlined a number of service quality improvements that GAL had identified, including that Gatwick had consistently met or exceeded the regulatory obligations in respect of security queues and other SQR metrics; and
- articulated its views on some of the improvements seen at Gatwick, including that:
  - in October 2011, it wrote to GAL raising concerns about the security queue measurement which had been identified as part of an audit carried out by consultants for the CAA;<sup>835</sup> and
  - it appeared that some of GAL's arguments suggested that the airport was focused more on satisfying the regulator's targets rather than meeting passengers' expectations.<sup>836</sup>

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<sup>834</sup> 16 at the South Terminal, 17 at the North Terminal.

<sup>835</sup> See: [http://www.caa.co.uk/docs/5/SWingate03102011\\_IO.pdf](http://www.caa.co.uk/docs/5/SWingate03102011_IO.pdf)

<sup>836</sup> CAA, Initial View, pp. 92-93.

- 9.75 The CAA also outlined GAL's argument that it had significantly changed the way the airport was cooperating with its users and other service providers to find solutions to improving passenger experience and operating efficiency.<sup>837</sup>
- 9.76 The CAA concluded that, while GAL's behaviour was consistent with an airport reacting to competitive pressures, the evidence was insufficient to show that the airport did not have SMP. It also noted that the evidence was insufficient to show that the changes seen at the airport were due to more competition rather than being the result of an airport operator with market power that is more focussed on increasing its profits by increasing efficiency or demand for its product ('more customer focused').<sup>838</sup>
- 9.77 In response to the Initial Views, GAL noted (among other issues) that:
- the CAA's view, that it's *'conduct since the sale by BAA can be ignored or marginalised on the grounds that it may simply reflect a change of ownership, is a selective reading of the evidence'*.<sup>839</sup>
  - *a consistent mantra of Gatwick under new ownership is that it is seeking to increase the levels of service at the airport.*<sup>840</sup>
  - the CAA had misinterpreted some of its arguments. In particular, it was not focussed on satisfying regulatory targets but that it was focussed on meeting passenger expectations. In addition, it noted that the evidence suggested that it strove to meet regulatory targets and that it looked to go beyond those by innovating.<sup>841</sup>

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<sup>837</sup> CAA, Initial View, p. 93.

<sup>838</sup> CAA, Initial View, p. 93.

<sup>839</sup> GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 8.

<sup>840</sup> GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, pp. 8-9.

<sup>841</sup> GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 9.

- the change of behaviour at Gatwick is highly correlated with the expectations of airport competition of the CC and the CAA. In addition, the CC and CAT decisions to require divestment of Stansted recognised the change in Gatwick's conduct as being associated with increased competition.<sup>842</sup>

9.78 More broadly, GAL indicated that:

- Its change in behaviour is the result of competition because: (1) its conduct goes beyond what is required by regulatory incentives and (2) increased competition is the '*simplest and most obvious explanation of changed behaviour*', given that these changes occurred at the same time as when competition was introduced.<sup>843</sup>
- The CAA appears to assume the presence of SMP and then requires evidence of "good behaviours" to rebut this assumption. GAL also considers that what is required is evidence of behaviour which would be expected of a dominant firm and the CAA has failed to secure such evidence thus far.<sup>844</sup> GAL also notes that, in certain instances, the CAA appears to improperly rely on evidence which pre-dates the introduction of competition.<sup>845</sup>

9.79 As part of the Q6 process, GAL also indicated that going forward (on the basis that Gatwick is deemed not to have SMP and no licence is subsequently issued by the CAA), a Contracts and Commitments Framework covering a number of issues including service quality (over a seven year period) may be appropriate. Specifically, GAL has suggested that Core Service Standards would include the existing SQR metrics, with a number of additions.<sup>846</sup>

9.80 GAL also proposed (among other things):

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<sup>842</sup> GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 9.

<sup>843</sup> Source: GAL.

<sup>844</sup> Source: GAL.

<sup>845</sup> Source: GAL.

<sup>846</sup> Additions include the inclusion of an outbound baggage availability target and an airfield availability metric (to replace the current airfield congestion metric).

- Airport-wide standards, covering the performance of all stakeholders at the airport, with performance published;<sup>847</sup>
- that its Commitments Framework include an incentive mechanism to deliver a minimum level of performance from all parties at Gatwick; and
- any performance incentives for individual airlines could be contained within any bilateral contracts.<sup>848</sup>

9.81 However, the CAA understands that the potential application of GAL's framework is still being developed and that only preliminary discussions with some airlines as to how this may be implemented have occurred to date.

9.82 A number of airlines have indicated that service quality has improved at the airport since BAA's sale of Gatwick. For example:

- Thomson Airways indicated that '*...following the change of ownership ... the experience of the customer using the airport has markedly improved.*'<sup>849</sup>
- Virgin indicated that '*since the change in ownership [it] ... has noted an improvement in passenger service levels and the airport meeting its SQR targets.*'<sup>850</sup>
- Cathay Pacific indicated that '*LGW has recently improved.*'<sup>851</sup>  
However, the CAA notes that the evidence was unclear as to what was driving this improvement.

9.83 However, there is some evidence that suggests that the impetus to improve efficiency is being driven by the airport, with little consultation with the airlines in terms of what is required and the cost that this imposes. For example, BA noted:

*Although the infrastructure at LGW has improved under new ownership, GAL made these improvements and investments on the basis that they believe they know what pax want and value. In reality,*

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<sup>847</sup> Source: GAL.

<sup>848</sup> Source: GAL.

<sup>849</sup> Source: Thomson Airways.

<sup>850</sup> Source: Virgin.

<sup>851</sup> Source: Cathy Pacific.

*investment in ‘ambiance and high-speculation facilities’ without a proper business case for investment can impose unnecessary and additional costs which pax do not want/value. Airlines are well placed to decide what it is that their pax value because passengers contract primarily with airlines and GAL does not seem to understand this concept.<sup>852</sup>*

- 9.84 This view has been identified by other airlines, including Thomson Airways, which noted that:
- 9.85 *LGW’s ambition is to build as much as possible (“build build build”) to inflate the RAB<sup>853</sup> and LGW’s short-term horizon and strategy [is] to increase the value of the airport as much as possible before selling it. For example, all CAPEX projects seem to be planned to a very high specification.<sup>854</sup>*
- 9.86 The CAA notes that drawing a direct link between increased service quality and increased expenditure per passenger over recent years must be done with caution (as there is a question of the efficiency of that investment), the evidence suggests that this has been beneficial. The efficiency of GAL’s expenditure (as it relates to the market power assessment) is, however, briefly examined later in this chapter.
- 9.87 The CAA also notes that easyJet has indicated that:
- 9.88 *Only when LGW knows it is being watched (by the CAA) or if there is “uproar” does it modify its behaviour.<sup>855</sup>*
- 9.89 The CAA considers that an increase in competition brought about by BAA’s sale of Gatwick could be a driver of the improvements in service quality seen at the airport over recent years. It also notes that BAA’s recent sale of Stansted could further increase the competitive pressures felt by the airport. However, the CAA considers that increased competitive pressure does not automatically mean that Gatwick is facing, or will face, the level of competition seen in a fully competitive market. The CAA notes that GAL’s submissions to it fails to make this important distinction.

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<sup>852</sup> Source: BA.

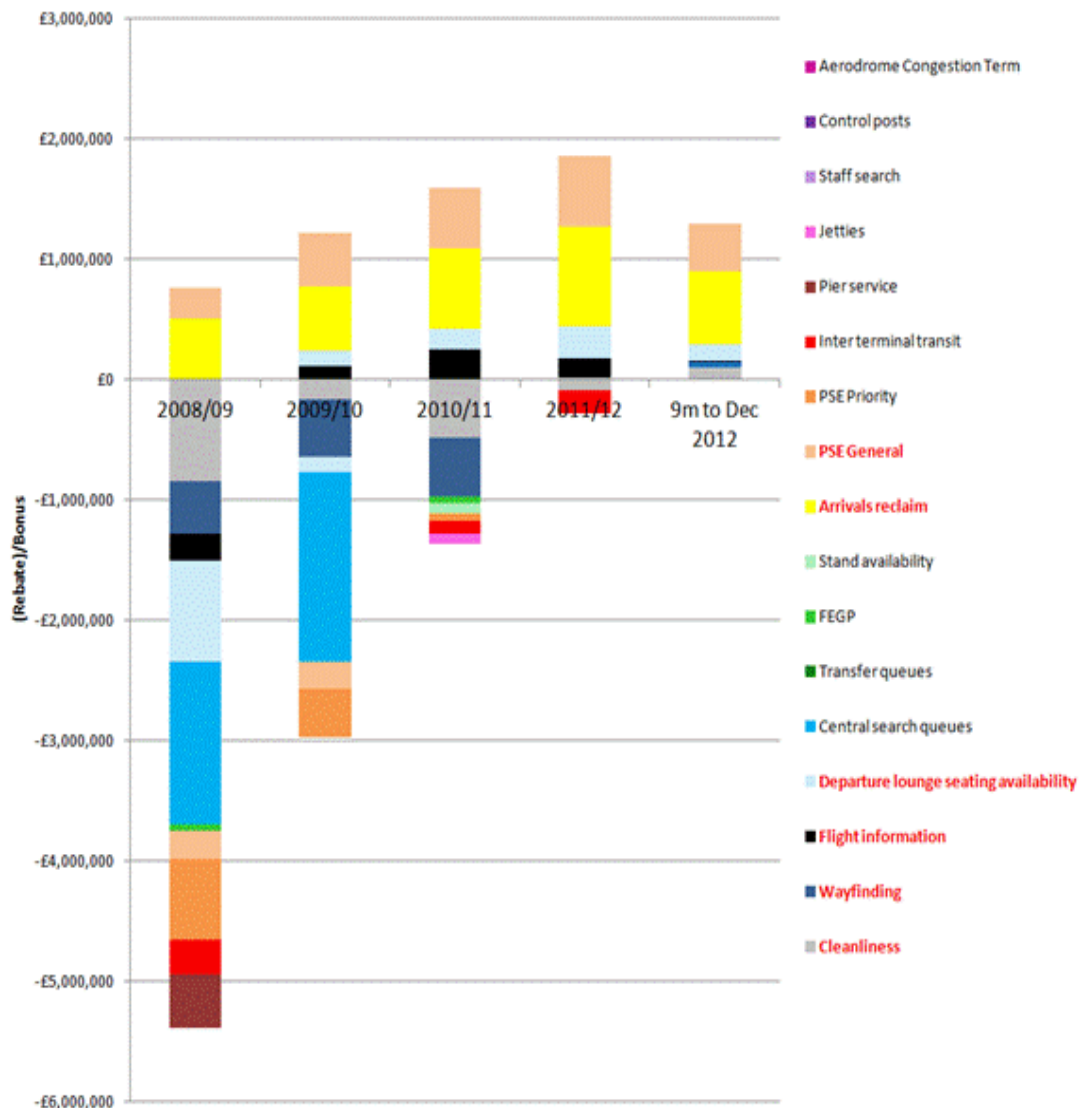
<sup>853</sup> Source: Thomson Airways.

<sup>854</sup> Source: Thomson Airways.

<sup>855</sup> Source: easyJet.

9.90 With respect to empirical evidence on the service quality at the airport, this evidence suggests that there has been an improvement in service quality over recent years when measured by the SQR scheme. Figure 9.2 (below), illustrates the bonuses that have been paid to the airport as well as the rebates that the airport has paid to airlines in Q5.<sup>856</sup>

**Figure 9.2: Performance of the SQR scheme in Q5**



Source: CAA, based on GAL RBP, Appendix 13

<sup>856</sup> The CAA notes that (1) bonuses were introduced in Q5 as an incentive to encourage ongoing service quality improvements at the airport, but were particularly focused on bringing up the performance in the worst performing terminals; and (2) the amount earned in bonuses during Q5 has increased throughout the period as performance has improved in the targeted areas.

9.91 The CAA notes that:

- bonuses were introduced in Q5 as an incentive to encourage ongoing service quality improvements at the airport, but were particularly focused on improving the performance in the worst performing terminal; and
- the amount earned in bonuses during Q5 has increased throughout the period as performance has improved in the targeted areas.

9.92 The CAA also notes that Figure 9.2 shows that:

- since 2010/11, the airport has earned bonuses in excess of the rebates paid, with the bulk of this due to passenger sensitive equipment and arrivals reclaim (baggage carousels); and
- the rebates paid by the airport have steadily decreased over Q5 from over £5m in 2008/09 to £281k in 2011/12, with this being largely driven by improvements in the performance of central search security.

9.93 Having considered evidence from a range of sources, including passenger surveys, direct measurement<sup>857</sup> and evidence from stakeholders, the CAA considers that:

- since the introduction of the SQR regime at Gatwick there has been an improvement in the quality at the airport;
- since the change of ownership there has been a further increase in the quality at the airport. For example, GAL has gone beyond the regulatory targets that were set in a number of areas; and

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<sup>857</sup> The working paper on empirical methods discussed the two main methods by which service quality could be measured: through passenger surveys and direct measurement. It identified the various surveys that are carried out at airports, in particular: ACI's Airport Service Quality Ranking (the ASQ survey); BAA's own passenger surveys called the Quality of Service Monitor (QSM) and surveys carried out by the CAA. It is however important to note that the surveys that the CAA undertakes are not designed to collect information about service quality although a question on passenger satisfaction with the airport experience has been included since July 2012.



- increased competitive pressures may be being felt by GAL (and that this may increase again with Stansted's sale), but it remains unclear if the improvements seen at Gatwick is due to competition or due to an airport operator (potentially with SMP) trying to attract more business. The CAA also notes that, irrespective of the source of improvement seen at Gatwick, an airport operator that is behaving more competitively does not automatically mean that it currently faces, or will face, a level of competition that is seen in fully competitive markets.

9.94 The issue of service quality is also discussed in more detail in the Q6 initial proposals.

## Efficiency

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9.95 The CAA considers that the analysis of relative cost efficiency might provide useful evidence to identify whether an airport is performing in a way that might be expected in a well-functioning market. It also considers that care must be taken to understand the underlying causes of any identified inefficiency, and whether there is evidence to suggest that relatively poor performance is transitory or can be explained by factors that do not relate to market power, for example the effect of regulatory incentives.<sup>858</sup>

9.96 In the Initial Views, the CAA explored the issue of efficiency and:

- Outlined GAL's argument that it had significantly changed the way the airport was cooperating with its users and other service providers to find solutions to improving passenger experience and operating efficiency. The CAA also highlighted a number of specific actions that the airport had undertaken.<sup>859</sup>

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<sup>858</sup> CAA, Empirical methods for assessing behaviour, performance and profitability of airports, p. 13.

<sup>859</sup> Specific examples that the CAA outlined in the Initial views were: Gatwick started measuring check-in and immigration queues to identify and address problems; joint working with UKBA to improve the immigration process; working together with an airline (Norwegian Air Shuttle) to introduce extended and more efficient self-service check-in facilities; publication of ground handler baggage performance to make this part of the process more transparent for passengers and to incentivise service improvements; and the introduction of passenger commitments in 2010, which have been agreed with a number of airport partners.

- Noted that many of the innovations suggested a higher focus on service quality and resilience and behaviour of that kind could be consistent with an airport reacting to more competitive pressures.<sup>860</sup>
- Determined that GAL's evidence was insufficient to demonstrate that the airport did not hold SMP. It also determined that the evidence did not allow the CAA to determine that the changes indicated that there was more competition rather than being the result of a change to a more focused owner.<sup>861</sup>

9.97 In response to the Initial Views, GAL expressed concerns similar to those the CAA outline with respect to service quality (see discussion above). In addition, GAL indicated (among other issues) that, under new ownership, it had looked to:

- *increase the levels of service at the airport. ... This has been done with a focus on efficiency, in terms of our own operating costs as well as seeking opportunities for our partners to increase their own efficiency and through our capital investment programme*<sup>862</sup>
- *place[d] a priority on improving and innovating facilities to attract and retain passengers and airlines*<sup>863</sup>
- *Publishing information for passengers helps passengers make informed choices, as well as driving performance.*<sup>864</sup>

9.98 GAL also indicated that, since the change of ownership, it had demonstrated a track record of operational improvement. By way of an example, GAL noted that:

*Gatwick's investment in people, process, and technology to deliver a modern, efficient, effective and resilient security screening operation*

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<sup>860</sup> Specific innovations that the CAA considered suggested that a higher focus was being placed on service quality and resilience included the security search processes, GAL's more proactive approach regarding the performance of third parties at the airport as well as its flexibility to adjust investment decisions on short notice to improve its operational resilience.

<sup>861</sup> CAA, Initial Views, p. 93.

<sup>862</sup> GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 9.

<sup>863</sup> GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 9.

<sup>864</sup> GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 10.

*in the South Terminal. Since the change of ownership, Gatwick has met its security service metrics every month.*<sup>865</sup>

- 9.99 The CAA notes that GAL has also expressed concern that the CAA had not addressed some of the other service examples it had provided to demonstrate that the airport was competing.<sup>866</sup>
- 9.100 Stakeholders have also highlighted that there has been a change in GAL's efficiency since the change in ownership. In general, stakeholders have suggested there has been an improvement in efficiency. In particular:
- Cathay Pacific indicated that '*LGW has recently improved*'.<sup>867</sup> However (as per the discussion on service quality), the CAA notes that the evidence was not clear as to what was driving this improvement.
  - Norwegian Air Shuttle indicated that it '*noticed dramatic changes in attitudes and improvements since new ownership at LGW*' and that '*under GIP, it is now being approached for new projects and initiatives*'. It also used the analogy of '*day and night*' to describe GAL's approach relative to BAA's.<sup>868, 869</sup>
  - Monarch indicated that '*GAL is trying hard to make the airport in their view, a more efficient place*'.<sup>870</sup>

9.101 Monarch also indicated that:

*On the surface it seems as though the airport is pursuing its aims for*

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<sup>865</sup> Source: GAL.

<sup>866</sup> GAL, CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, p. 9.

<sup>867</sup> Source: Cathy Pacific.

<sup>868</sup> Source: Norwegian Air Shuttle.

<sup>869</sup> Norwegian Air Shuttle also noted that under BAA, NAS was a smaller player and didn't get any attention. BAA's whole focus was on base carriers. BAA's approach was '*this is what we have, take it or leave it*'. It also noted that '*[w]hen BAA was in charge, the airport operator didn't put any money into upgrading the airport's efficiency. The new owners have said they will make changes and have proven it. These changes benefit all airlines operating into LGW*' and '*[t]he way that GAL has run its projects with NAS ensures that airports, ground handlers and airlines all work together collaboratively and produce 'win win situations'. This was a key factor in deciding to base aircraft at LGW*.' Source: Norwegian Air Shuttle.

<sup>870</sup> Source: Monarch.

*efficiency, but this will inevitably have an indirectly impact its own costs. It is good that there is an attempt to improve efficiency (it is the right thing to do), but it is the way that it is being pursued that is difficult (“a take it or leave it” approach)<sup>871</sup>*

9.102 Associated with the above, the CAA notes the comments made by BA in the section on service quality in this chapter, which suggest that GAL’s approach to improving the airport is being set by the airport with little consideration of airlines’ views.

9.103 In addition, Virgin indicated that it had ‘*not noticed significant changes in efficiency at LGW since the change in ownership*’.<sup>872</sup>

9.104 BA also indicated that:

*It broadly supported GAL’s Q5 capital programme. Pier 7, representing £187m of investment (in 2007/8 prices), was cancelled. Improvements to south terminal security are innovative and passenger friendly. However, GAL was already due to spend £1 billion capex under BAA’s ownership and the north terminal extension was already funded by their old budget. This means that the airport did not reduce capex spend (despite the shortfall in pax) or significantly improve overall capex efficiency, but redirected Pier 7 money to other projects.*<sup>873</sup>

9.105 Having examined the evidence outlined above the CAA:

- notes the various examples that GAL has provided the CAA that detail the steps it has undertaken to try and improve its performance and welcomes GAL’s focus on improving efficiency (and service quality, which is discussed later in this chapter);
- notes that some stakeholders have expressed concern with GAL’s approach to implementing some of these changes (see section on negotiations for further information); and
- notes that GAL’s approach to addressing efficiency appears to be much improved relative to that which occurred under previous ownership. The CAA considers this suggests that GAL is looking to differentiate Gatwick from other airports and attract new traffic to it.

<sup>871</sup> Source: Monarch.

<sup>872</sup> Source: Virgin.

<sup>873</sup> Source: BA.

- 9.106 In addition, the CAA notes (as per the Initial Views), that:
- GAL's interest in addressing service quality and resilience issues could be consistent with an airport reacting to more competitive pressures; and
  - these changes could be the result of a more focussed owner.
- 9.107 The CAA considers that the observations it made in the Initial Views, which it has expanded on above, are not contradictory and capture some of the expected benefits that the CC suggested may come with more competition. Specifically, the CAA notes that:
- theory would suggest that the greater the competitive pressures, the sooner any inefficiencies (costs) would be identified and potentially eliminated. As such, GAL's behaviour could be consistent with it facing relatively more competition than it did when it was owned by the then BAA; and
  - it is possible for an airport operator that is facing relatively more competition (from other airport operators, such as those responsible for Heathrow and Stansted), to improve its relative efficiency but still have market power in the market(s) that it is operating in (see chapter 5). That is, increased competitive pressure does not automatically mean that an airport operator currently faces, or will face, a level of competition that is seen in fully competitive markets.
- 9.108 As part of its preparation for Q6, the CAA has undertaken a range of studies to examine the opex efficiency at Gatwick, including engaging a number of consultants to examine opex projections at Gatwick. This work provides useful evidence on the relative efficiency of the airport. Evidence on the relative efficiency of an airport may provide useful evidence to identify whether an airport is performing in a way that might be expected in a well-functioning market.
- 9.109 The CAA notes that there is evidence to suggest that Gatwick is not at the efficient 'cost frontier' and there is likely to be scope for greater efficiency at Gatwick. The CAA considers that this suggests competitive pressures may not be sufficient.
- 9.110 In particular, the CAA notes that it has:

- reviewed several pieces of independent opex benchmarking evidence, which shows that opex per passenger at Gatwick is slightly higher than the average of the samples considered (with the exception of one report).<sup>874</sup>
- undertaken additional analysis of the relative performance of Gatwick based on the latest data, against relevant comparators using adjusted opex per passenger.<sup>875</sup> This evidence suggests that:
  - operating costs per passenger at Gatwick are £7.82, which is slightly below the sample average of £7.95, although higher than a number of comparable airports including Munich, Zurich and Copenhagen;
  - Staff costs per passenger at Gatwick are particularly high at £4.16 (compared to an average of £3.18); and
  - time series analysis indicates that costs at Gatwick have risen much faster than the sample average. Since 2000 opex per passenger has increased by 12 per cent at Gatwick in real terms. In comparison, there was a 19 per cent reduction across the sample.
- commissioned several consultancy studies related to opex<sup>876</sup>, which found:

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<sup>874</sup> The CAA notes that samples included in the studies include a wide variety of airports, some of which are not directly comparable with Gatwick. Gatwick is slightly larger than many of the airports considered, and has a relatively high proportion of long haul flights for example. This is likely to increase costs relative to the sample average. Nonetheless, the sample average is likely to provide a useful performance benchmark.

<sup>875</sup> Adjusted opex excludes costs related to depreciation, retail, rail, ANS and other irregular cost items and is intended to provide a consistent measure of costs across airports.

<sup>876</sup> In particular, the CAA commissioned (1) Employee reward benchmarking study undertaken by IDS. This includes an analysis of Gatwick's total reward against industry benchmarks, and an analysis of roster efficiency and absenteeism; (2) Pension cost scenario testing undertaken by Hymans; (3) Examination of other operating costs at Heathrow and Gatwick covering rent and rates, utilities, ANS, police, rail and other costs, undertaken by Steer Davies Gleave; (4) Examination of central service costs at Heathrow and Gatwick undertaken by Helios; (5) Examination of maintenance and asset renewal costs at Heathrow and Gatwick undertaken by Steer Davies Gleave; and (6) Scope for future efficiency gains at Heathrow, Stansted and Gatwick undertaken by CEPA.

- total staff costs at Gatwick (including all cash payments and pension costs are between 23 per cent and 32 per cent higher than benchmarks (IDS employment cost study).
  - rates of staff absenteeism are very high in comparison with comparative benchmarks (IDS employment cost study); and
  - cleaning costs per metre square of terminal space are relatively high in comparison with benchmarks (SDG Other opex study).
- 9.111 The CAA also notes that evidence suggests that GAL's personnel have relatively high rates of absence, with an average absence rate of ten days per person. This is significantly higher than the economy wide average in the public and private sector of 6-8 days. GAL has, however, stated that it is planning to reduce rates of absenteeism, by reducing the physicality of the security function (for example the need for lower body searches).
- 9.112 The CAA considers that, in combination, the evidence from these studies suggests that there is the potential to reduce opex significantly from the figures reported in Gatwick's initial business plan (and that this saving excludes any changes to pension provision and security process efficiency).
- 9.113 With respect to capex efficiency, the CAA notes that any assessment is relatively more difficult as the actual schemes taken forward by an airport during a control period tend to change from that envisaged at the time of the price control. This is the case for Gatwick, which also changed ownership in late 2009. For example, GAL has indicated that after the sale of Gatwick by BAA it:
- undertook a comprehensive review of the BAA capital investment programme to ensure that it was fit for purpose and delivered in the passenger and airline interests; and
  - identified major cost savings compared to the BAA plan, as well as delivering more projects than the BAA plan and that resulted in the:
    - cancellation of the development of Pier 7 as it was judged too expensive for the increase in pier served stands;
    - cancellation of the refurbishment of Pier 1, with a revised combined Pier 1 and south terminal baggage factory at a significant saving;

- introduction of a new south terminal security project (which was not previously in the BAA plan), to provide a world-class security product;
  - revising the proposals for the south terminal forecourt redevelopment to ensure that it is passenger focussed; and
  - implementing a new car-park construction process that has allowed a faster construction at lower cost.<sup>877</sup>
- 9.114 The CAA notes that GAL concluded that undertaking this review and re-focussing its priorities enabled it to deliver more for less.<sup>878</sup>
- 9.115 To better understand these issues, the CAA engaged a number of consultants to examine capex efficiency at Gatwick.
- 9.116 In 2010, the CAA appointed C&B to carry out a mid Q assessment of capital efficiency and consultation at the airport. In summary, C&B identified shortcomings in the pre-Q5 planning process, including a low level of maturity in risk reporting, limited use of external benchmarks and no evidence of whole life costing.<sup>879</sup>
- 9.117 Towards the end of 2012, the CAA appointed URS to provide a transparent assessment of capital efficiency at Gatwick during Q5 taking into account the criteria established by the CAA for Q5 and the conclusions of C&B at the mid Q review. In particular, URS was requested to examine five specific projects.<sup>880</sup>
- 9.118 The CAA welcomes the work undertaken by URS and notes this work suggests that:
- the issues identified in the mid Q review have started to be addressed; and

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<sup>877</sup> GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, p. 68.

<sup>878</sup> GAL, Airport competition: Competing to grow and become London's airport of choice, An initial submission from Gatwick Airport to inform the CAA's review of airport competition, November 2011, Q5-050-LGW05, p. 69.

<sup>879</sup> CAA, Economic regulation at Gatwick from April 2014: initial proposals, pp. 279-280.

<sup>880</sup> CAA, Economic regulation at Gatwick from April 2014: initial proposals, pp. 279-280.



- in general, GAL has followed the requirements of efficient project management and effective consultation with users.<sup>881</sup>
- 9.119 In addition, the two areas where URS was not convinced that efficient project management and effective consultation with users had not occurred covered, at most £11 million of expenditure, which is relatively small in comparison to the overall capital programme of around £1 billion over Q5.<sup>882</sup>
- 9.120 The CAA also notes that the efficiency of Gatwick's capex and its proposed capex going forward is explored in more detail in the Q6 initial proposals.
- 9.121 Based on the evidence outlined above, the CAA considers that GAL's efficiency has improved under new ownership and that this may reflect an increase in competitive pressures.<sup>883</sup> The CAA also welcomes the attention efficiency issues are being given by GAL. However, the evidence suggests that there are a number of areas of inefficiency. In particular, the CAA notes that it, and a number of independent consultants, has compared the opex performance seen at Gatwick to a number of different airports and found there are a number of areas of inefficiency.<sup>884</sup>
- 9.122 The CAA also notes that one of its working papers, 'Empirical methods for assessing behaviour, performance and profitability of airports', states that an airport with SMP may face insufficient competitive pressures to drive up operating efficiency.
- 9.123 Based on the evidence outlined above, the CAA therefore considers that there may be insufficient competitive pressures at Gatwick both now and going forward.

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<sup>881</sup> CAA, Economic regulation at Gatwick from April 2014: initial proposals, pp. 279-280.

<sup>882</sup> CAA, Economic regulation at Gatwick from April 2014: initial proposals, pp. 279-280.

<sup>883</sup> The CAA notes that irrespective of the source the improvement seen at the airport, an airport that is behaving more competitively does not automatically mean that it currently faces, or will face, a level of competition that is seen in a fully competitive market.

<sup>884</sup> The CAA notes, for example, that several pieces of opex benchmarking evidence that it looked at had been adjusted through various processes to attempt to normalise the indicator. Comparisons between airports are then made using the metric of opex / pax to adjust for airport size.

## Profitability measures

9.124 As noted in the introduction, Gatwick is subject to economic regulation and GAL's behaviour is, therefore, likely to be constrained to a certain extent. The, CAA notes, however, that the Office of Fair Trading (OFT) has indicated that:

*... it is feasible that regulation of the average price or profit level across several markets supplied by an undertaking may still allow for the undertaking profitably to sustain prices above competitive levels in one (or more) of these markets and/or engage in exclusionary behaviour of various kinds.*<sup>885</sup>

9.125 The CAA also notes that in the Initial Views it stated that:

- The financial performance and pricing of a company can often provide evidence regarding the airport's level of market power. However, due to the presence of economic regulation at Gatwick, the level of profits cannot be used as a reliable indicator as to whether Gatwick would enjoy a high level of market power.
- In 2009, BAA (now Heathrow Airport Holdings Limited) disposed of Gatwick but the separation process was not completed until February 2011 and this affected Gatwick's results, particularly its cost base.
- In light of the limited reliance that can be placed on these aspects of behavioural evidence, it did not assess in detail the costs, revenues and profitability of the airport.<sup>886</sup>

9.126 In addition, the CAA noted that while it was not intending to examine these particular issues, by considering GAL's pricing strategy it might be able to identify areas where it may (or may not) have market power.<sup>887</sup>

9.127 GAL did not express concern with the analysis that the CAA undertook with respect to profitability measures. However, GAL did note:

*Competitive companies need to maximise returns on investment also*

<sup>885</sup> OFT, Assessment of market power, Understanding competition law, December 2004, p. 26.

<sup>886</sup> CAA, Initial Views, pp. 94-95.

<sup>887</sup> CAA, Initial Views, pp. 94-95.

[and that] *Competitive companies maximise returns through innovation, better understanding of customers' needs and efficient operations etc.*<sup>888</sup>

- 9.128 With respect to GAL's point above, the CAA agrees that seeking to maximise return on investments (profit) is often an objective of profit seeking businesses, including many airports. However, the CAA also notes that this objective will usually be met irrespective of whether a business is operating in a completely competitive environment or it is operating as a monopoly (or any degree in between).
- 9.129 The CAA maintains its view that analysis of the financial performance of regulated airports is unlikely to provide particularly strong evidence about an airport's market position.<sup>889</sup> This is particularly true if an airport operator chooses to set its prices at, or near to, the allowed price cap (which GAL has done), as economic regulation is designed to prevent excessive returns being achieved.<sup>890</sup>
- 9.130 However, the CAA recognises that there are a number of issues associated with profitability, namely efficiency, service quality and pricing, which, if examined, can help inform an assessment of market power. The CAA notes that these are also issues that GAL has identified as being important.<sup>891</sup>
- 9.131 The CAA notes, however, that as Gatwick is regulated, difficulties will remain in interpreting these other issues. In particular, it may be difficult to establish to what extent improvements in efficiency and service quality are driven by economic regulation or by competitive constraints.

## **'Minded to' conclusion on indicators of market power**

- 9.132 While the individual indicators of market power may each suggest slightly different outcomes, when considered as a whole, the CAA

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<sup>888</sup> Source: GAL.

<sup>889</sup> CAA, Empirical methods for assessing behaviour, performance and profitability of airports

<sup>890</sup> CAA, Empirical methods for assessing behaviour, performance and profitability of airports, paragraph 4.3.

<sup>891</sup> See, for example, GAL's discussion in: CAA's Market Power Assessments for Gatwick, Heathrow and Stansted airports, Ref: Q5-050-LGW09, pp. 7-10.

considers that, on the balance of probability, they suggest the airport has SMP. In addition, the indicators suggest that going forward this will continue, not least due to improving economic conditions and tightening capacity across the London airports.

9.133 In coming to this view, the CAA recognises that relatively more weight can be given to some indicators compared to others. For example, at first glance, the market share analysis suggests that Gatwick has a relatively strong market presence with respect to LCCs and charters. Similarly, the market share analysis suggests that Gatwick has a much smaller presence with respect to FSCs and associated feeder traffic. However, as noted earlier in this chapter, there are a number of limitations associated with market shares analysis, including the lack of due consideration of capacity constraints (or lack there-of) at other airports.

9.134 The CAA considers that the indicators that carry relatively greater weight when considering whether, on the balance of probability, Gatwick has or is likely to acquire SMP is price (see also chapter 4) and GAL's approach to its negotiations. The CAA considers that the evidence on these two issues shows that:

- GAL's current pricing is not significantly above the competitive price nor it is below the competitive price level (although the CAA notes that GAL considers that the current regulated price is too low and there needs to be a significant upward adjustment to bring it to the competitive price).
- GAL largely sets the terms that an airline will receive and that the scope for negotiation is relatively limited.
- GAL is able to price discriminate between existing and new airline customers, allowing it to compete with other airports in London for new business, while exercising SMP over airlines already present at the airport.

9.135 With respect to service quality, the CAA notes that Gatwick is a regulated airport that is subject to a quality scheme. Therefore, quality outcomes are unlikely to provide particularly strong evidence about the airport's market power.

9.136 The CAA notes, however, that GAL's performance has improved in a number of areas since the recent change in ownership. While this is

encouraging, the CAA notes that this has only been occurring for a relatively short time period. The CAA also notes that while this may reflect greater competitive pressures, the airport might still have sufficient market power to require economic regulation.

- 9.137 In terms of efficiency, it also appears that, since the sale of the airport there has been a greater focus on improving efficiency at the airport, which is encouraging. However, several independent studies have identified a number of areas where inefficiency is present.
- 9.138 With respect to the airport's financial performance, the CAA notes that Gatwick is a regulated airport, and it has only recently changed ownership. As such, the CAA considers that its financial performance is unlikely to provide particularly strong evidence about the level of market power that may be present.

**CHAPTER 10****Conclusion on test A**

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**The CAA's 'minded to' view**

10.1 This chapter draws together the CAA's analysis presented in the preceding chapters and concludes on GAL's market power in relation to test A as required by the market power test in the Act. This chapter follows the structure of the report, considering in turn the position that the CAA has come to on:

- the competitive price;
- market definition;
- the competitive constraints facing GAL;
- indicators of market power and a forward look at capacity constraints;

10.2 Each of these contributes to the overall conclusion in relation to test A, which is that GAL currently has market power in two separate markets for aeronautical infrastructure and that its market power is unlikely to be eroded over the Q6 period.

**The competitive price at Gatwick**

10.3 The CAA has assessed whether GAL's airport charges are close to the competitive price because this can be an important consideration when applying the SSNIP test used to define markets, and to the interpretation of evidence more generally. The CAA considers that GAL's charges are close to the competitive price. Even if they were significantly below it, the CAA considers that much of its analysis of the issues contributing to GAL's market power e.g., the difficulty of airlines and passengers switching away from Gatwick would not be substantially altered.

10.4 The competitive price, in strict economic terms, is considered to be the price that leads a firm to make a profit that is equal to a fair rate of return on its investment. The evidence suggests that:

- GAL's current airport charges are close to the CAA's estimate of LRAIC; and

- aeronautical revenue per passenger is marginally above the average of comparable airports and about £2 above those airport operators that are subject to lighter regulation. This suggests that GAL's charges may be slightly above the competitive price rather than below it.

10.5 The CAA considers that this suggests that GAL's current charges are not significantly below the competitive price.

### Market definition

10.6 The CAA has used the standard approach applied by regulators and competition authorities to define the relevant market. The CAA considers that this approach is reliable given, that it has satisfied itself that GAL's charges are not materially below the competitive price. The CAA has applied the principles of the SSNIP test in its consideration of whether alternative products or airports should be included in the relevant market. This approach focussed on examining the substitution possibilities available to airlines and users. The CAA considers that this is more reliable than using airlines' responses to a hypothetical question about their reaction to an increase in airport charges, to which they may make a strategic response. From this analysis the CAA has identified a single product, which it considers to be a core bundle of airport operation services that airlines are required to purchase. These services were described in chapter 5.

10.7 The CAA considers that there are two market segments operating at Gatwick, one consisting of LCC and charter airlines and one consisting of FSCs and associated feeder traffic. Their demands for airport services are different. The CAA considers that LCC and charters demand the core product described in Chapter 5, while FSC and associated feeder traffic make additional demands on airports. The product bundle for FSC and associated feeder airlines therefore consists of the core product bundle plus airport infrastructure and airport operation services for:

- the provision of premium facilities; and
- integrated transfer of passengers and baggage between flights.

10.8 The proportion of connecting passengers carried by an FSC is not relevant to the market definition. If FSCs offer the facility to connect at an airport, then they will demand the infrastructure that allows them to

do so, even if the number of connecting passengers is low.

- 10.9 The most likely geographic market for LCCs and charters is Gatwick itself. A number of airlines have considered and currently operate some services from other London airports. However, overall, the evidence suggested that LCCs do not view the North London airports, Luton and Stansted, as substitutes for Gatwick. It is unlikely that the market includes Luton and/or Stansted on the current evidence, especially that of the airline switching and the analysis of passenger price elasticity of demand. However, to the extent that they impose relevant constraints on Gatwick, the CAA has taken them into account within its market power analysis.
- 10.10 The CAA's current view of the geographic market for FSCs and feeder airlines is that it is likely to comprise of Gatwick and Heathrow. This market definition does not take account of the capacity constraints at Heathrow, which were considered as part of the market power analysis rather than in the market definition. It could be considered (as with LCCs and charters) that the geographic market is Gatwick alone. Indeed the passenger PED analysis does suggest that this is the case for FSCs. However, the CAA considers that there is airline evidence suggesting that, absent capacity constraints at Heathrow, those airlines would prefer to operate from Heathrow over Gatwick. That evidence is sufficient for the CAA to conclude that the exclusion of Heathrow from the geographic market might potentially understate the extent of the relevant market.
- 10.11 Although Stansted has the required facilities for FSCs and feeder traffic and spare capacity, it does not operate with them at present. Currently, Stansted lacks a suitable feed of connecting traffic and it is difficult to see this changing appreciably over the short-to-medium term. FSC airlines stated that Stansted was not a substitute for Gatwick.
- 10.12 Therefore the CAA is minded to consider that there are two, combined product and geographic markets in which GAL operates for the provision of airport operation services to airlines and their passengers within the core area of Gatwick:



- Airport operation services<sup>892</sup> for LCCs and charter airlines covering a geographic market that is limited to Gatwick but may include Luton and Stansted. This market is referred to as the Gatwick LCC and charter market.
- Airport operation services<sup>893</sup> for FSCs and associated feeder traffic. The CAA's current view is that this market includes Heathrow<sup>894</sup>. This market is referred to as the Gatwick FSC and feeder market.

### Current competitive constraints on GAL

10.13 In each of the above markets, the CAA sought to identify how much of the capacity at an airport was marginal, in the sense that it would be likely to switch away if GAL's airport charges were to increase by a small but sustained and non-transitory amount of ten per cent. This analysis included the following:

- The means available to an airline to switch away capacity, and how reasonable and effective different strategies would be in constraining GAL's pricing. For example, airlines might allocate future growth to other airports; reduce the frequency of their service(s); ground marginal aircraft; or switch away their marginal based aircraft.
- The types and size of switching costs airlines might incur. These cost ranges have been considered under two heads, "traditional" switching costs such as the costs of relocating aircraft, crew and facilities<sup>895</sup>; and "strategic" switching costs, for example lost revenue if an airline has to switch away from a preferred market. The latter are considered in a separate section below.

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<sup>892</sup> For LCCs and charter airlines these activities include facilitating the use of runway and taxi-ways, aerodrome ATC, aircraft parking, ramp handling services, fuel and oil handling, and aircraft maintenance, as well as the minimum activities required for the processing of passengers at the airport, the provision of a terminal and the facilities for check-in, baggage handling, security screening and the transit of passengers to and from the aircraft.

<sup>893</sup> FSCs require the services listed in footnote 5 and additional facilities including those required for premium passengers and integrated airside transfer of passengers and baggage between flights.

<sup>894</sup> This market definition does not take account of capacity constraints at Heathrow. These were considered as part of the analysis of competitive constraints.

<sup>895</sup> The integration of services within a carrier's network and the benefits derived from the presence of alliance partners were also considered as a traditional switching cost for FSCs.

- The constraints to airline switching imposed by the availability of spare capacity at competing airports.
- Whether airlines could exercise buyer power to counteract any SMP that GAL might have.

### **LCCs and charter**

- 10.14 Regarding the ways in which an LCC or charter airline might, in principle, be able to ground or switch marginal based aircraft away from Gatwick, the CAA considers that the evidence suggests that a strong disciplinary action that an airline could take is to relocate its based aircraft. In particular, the substitution of a sufficient number of based aircraft away from Gatwick could significantly reduce GAL's profitability and therefore constrain its behaviour.
- 10.15 Based short-haul LCCs at Gatwick would face relatively low traditional switching costs if they were to switch away aircraft from the airport. However, of the traditional switching costs, only the additional marketing costs per passenger of establishing a new route was considered to be significant. Together with the strategic costs outlined below they were thought to be sufficiently high to constrain these airlines' ability to switch away in the short-run.
- 10.16 Inbound LCCs do not have significant investment in infrastructure at Gatwick meaning that they retain greater flexibility in their ability to respond to a price increase by switching away marginal aircraft and services.
- 10.17 Turning to charter airlines, the CAA considers that the evidence suggests that traditional switching costs may not be sufficient to prevent them switching some or all of their services in response to a small but significant increase in airport charges.
- 10.18 Looking at the capacity constraints at the airports that LCC and charter airlines might move to, the substitution possibilities for LCCs appear to be constrained by the limited stand capacity at Luton, which would make it difficult to base significant numbers of additional aircraft there. Stansted has spare capacity although additional capacity at Stansted would have to compete with Ryanair, which would tend to deter an LCC from relocating there.

**FSCs and associated feeder**

- 10.19 For FSCs, the evidence suggests that allocating future growth to an alternative to Gatwick is unlikely to discipline GAL. Grounding or switching marginal aircraft away from the airport is not a realistic response to a ten per cent price increase, while switching marginal aircraft to Heathrow is likely to be severely limited by capacity constraints there and the associated costs of slot acquisition. The scope for opening a new base is also restricted for cost reasons.
- 10.20 Reducing frequencies on the current operations at Gatwick appears to the CAA to be the most feasible means by which FSCs might of discipline an increase in airport charges. The scope for modifying flight patterns (flying "W" patterns) is likely to be limited by cost and operational considerations but reducing frequencies appears to be viable means of switching away in light of a ten per cent price increase. However, the costs of reducing aircraft utilisation might in some cases outweigh the benefits of constraining the airport's pricing.
- 10.21 The CAA considers that FSCs with operations based at Gatwick tend to have greater infrastructure costs than those providing inbound services. It does not appear that either based or inbound airlines are likely to face significant costs of physical relocation to existing bases relocating marginal services (or reducing frequencies to the airport in the case of inbound carriers).
- 10.22 The switching costs implicit in the loss of network-level benefits - as well as the implied reduction in aircraft utilisation - may make a reduction of frequency more costly than absorbing the increase in airport charges. Approximately 55 per cent of FSC and feeder airlines at Gatwick are members of an airline alliance, which promotes a degree of operational alignment between services. This means that the scale of frequency reductions might not be able to be sufficient to constrain GAL in light of a ten per cent increase in airport charges.
- 10.23 Based on the above, the CAA considers that the loss of connecting passenger feed could, in theory, constitute a switching cost for marginal services switching away from Gatwick, particularly when switching to an airport with less connectivity. However, when switching marginal services to Heathrow, the CAA considers that airlines are likely to gain, rather than lose, in terms of network effects.
- 10.24 Looking at the availability of capacity at airports airlines might

consider switching to; Heathrow is effectively operating at full capacity. While arbitrage through strategic partners and slot purchases can, in principle, and in certain cases, facilitate some switching, the magnitude of switching is unlikely to be sufficient to constrain GAL from imposing a price increase.

- 10.25 Stansted is not a suitable alternative despite having available capacity, due principally to its weaker natural catchment and the lack of connecting traffic. Further, the CAA considers that there is an inter-relationship between FSCs and associated feeder traffic such that it creates a “chicken and egg” problem in the case of moving marginal aircraft or services from Gatwick to Stansted: that is, if there is a lack of feeder traffic, FSCs are unlikely to move operations; and if there is a lack of FSCs, associated feeder traffic is unlikely to move operations.

### **Strategic costs to switching**

- 10.26 The CAA considers that all airlines face strategic constraints on switching away from Gatwick to other London airports and from switching away from London. LCCs and charters at Gatwick may face strategic (commercial) switching costs from switching between London airports, or to other non-London airports in the UK or in continental Europe. A report by RBB Economics puts forward some reasons why a strong presence in London might be important:
- *a strong presence in London affects the brand value of an airline;*
  - *the thickness of demand in London allows a large number of routes to be operated from the same base, which results in efficient aircraft utilisation;*
  - *new routes can be launched with lower risk, in regard to profitability, from London airports rather than from non-London airports; and*
  - *significant sunk costs in marketing its London bases. There is a significant option value to a London presence associated with the ability to operate from London in the future.*<sup>896</sup>

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<sup>896</sup> Source: RBB Economics commissioned by Ryanair (page 16), November 2012.

<http://www.caa.co.uk/docs/5/rbb%20stansted%20final%20non-confidential%20version%2029%20Nov%2011.pdf>

- 10.27 The CAA considers that while traditional switching costs may be relatively low for LCC and charter airlines, strategic switching costs appear to reduce the scope for them to switch aircraft serving marginal routes to other airports. This is particularly the case for the charters that have based aircraft at Gatwick, as their business model targets an airport's local core catchment area, which, for Gatwick, is seen as particularly important in terms its strength of demand.
- 10.28 "Traditional" switching costs appear to be relatively low for FSCs too but the CAA considers that the strategic importance of operating from London is a severe constraint on switching to non-London airports for FSCs and feeder airlines. In addition, the CAA considers that the evidence shows that these carriers express a general preference to operation from Heathrow rather than Gatwick or another London airport. However, they are restricted to from doing so due to the severity of capacity constraints and the cost of slot acquisition at Heathrow.

### **Buyer power**

- 10.29 With regards to countervailing buyer power, the CAA has found no evidence of airlines being able credibly to threaten to switch away from Gatwick to discipline GAL's pricing behaviour. This is largely due to the carriers' individually being a small proportion of the airport's traffic, and a lack of alternative airports to which they can threaten to switch.

### **The constraint from passenger switching**

- 10.30 The CAA notes that airlines may not pass on an increase in GAL's charges or may only do so after some time. Passenger switching will only occur to the extent to that any increase in GAL's charges are passed on by the airlines.
- 10.31 GAL has stressed the significant overlaps between passenger catchment areas in the London system, which might suggest that passengers have significant choice. The CAA recognises that there are significant overlaps. However, passengers have preferences that must be taken into account when trying to assess their propensity to switch in response to an increase in GAL's airport charges. Also, in order to exercise that choice some passengers require equivalent flights (sometimes to the same destinations) to be available at other airports. There appears to be more choice available at alternative

London airports to passengers seeking to fly on a short-haul service than for long-haul flights.

- 10.32 Connecting passengers represent around eight per cent of Gatwick passengers. The CAA considers that connecting passengers will also have relatively low sensitivity to increases in GAL's airport charges (as opposed to increases in airfares). Therefore, the CAA considers that the proportion of connecting passengers that might switch in response to an increase in GAL's airport charges appears to be insufficient to widen the geographical market or, when combined with surface passenger switching, to constrain GAL.
- 10.33 Passengers' preferences for a particular destination, limited route availability at other airports, and the lack of full substitutability of different types of service suggest that fewer passengers may be able, or willing, to change the airport they use than is suggested by catchment overlaps. The CAA found that route availability at other airports was relatively high for short-haul services but for long-haul, the overlap was less and much of it was accounted for by services that would not normally be considered to be substitutes, e.g. charter flights and scheduled services.
- 10.34 Analysis suggests that, at most, a ten per cent increase in airport charges would equate to around three per cent on an airfare. The airfare may itself be purchased as part of a bundled product (e.g. a holiday). Therefore, passengers' sensitivity to increases in airport charges is likely to be relatively low.
- 10.35 These factors lead the CAA to consider that only a relatively low proportion of passengers would in practice be prepared to switch to another airport in response to a five to ten per cent rise in GAL's charges. A comparison of an estimate of the likely level of passenger substitution with the level required, suggests that switching by marginal passengers is unlikely to be sufficient to constrain GAL's pricing.

### Indicators of market power

- 10.36 While the individual indicators of market power may each suggest slightly different outcomes, when considered as a whole, the CAA considers that, on balance, they suggest the airport has SMP. In addition, the CAA considers that going forward the indicators suggest that this will continue, not least due to improving economic conditions

and tightening capacity across the London airports.

- 10.37 In coming to this view the CAA recognises that relatively more weight can be given to some indicators compared to others. For example, at first glance the market share analysis suggests that GAL has a relatively strong market presence with respect to LCCs and charters. Similarly, the market share analysis suggests that GAL has a much smaller presence with respect to FSCs. However, as noted earlier in this chapter, there are a number of limitations associated with market shares analysis, including the lack of due consideration of capacity constraints (or lack thereof) at other airports.
- 10.38 The CAA considers that the indicators that carry relatively more weight when considering whether, on balance of probability, Gatwick has or is likely to acquire SMP are price and Gatwick's approach to its negotiations. The CAA considers that the evidence on these two issues suggests that:
- GAL considers that the current regulated price is too low and there needs to be a significant upward adjustment to bring it to the competitive price); and
  - GAL largely sets the terms that an airline receives and that the scope for negotiation is relatively limited.
- 10.39 With respect to service quality, the CAA notes that Gatwick is a regulated airport that is subject to a quality scheme. Therefore, quality outcomes are unlikely to provide particularly strong evidence about GAL's market power.
- 10.40 The CAA notes, however, that GAL's performance has improved in a number of areas since the recent change in ownership. While this is encouraging, the CAA notes that this has only been occurring for a relatively short time period. While this may reflect relatively greater competitive pressures, GAL might still have sufficient market power to require economic regulation.
- 10.41 In terms of efficiency, it appears that since the sale of the airport there has been a greater focus on efficiency, which is encouraging. However, the CAA notes that several independent studies have identified several areas where inefficiency is present.
- 10.42 With respect to GAL's financial performance, the CAA notes that

Gatwick is a regulated airport, and it has only recently changed ownership. As such, the CAA considers that its financial performance is unlikely to provide particularly strong evidence about GAL's market power.

### **The future**

- 10.43 The future traffic demand forecasts, analysed in chapters 6 and 7, suggest that, notwithstanding the relatively limited scope for certain London airports to encourage better utilisation of their runways and the use of larger aircraft, Gatwick is likely to benefit from the expected tightening of capacity constraints across the South East. In particular, this outcome may increase GAL's power in its negotiations with airlines.
- 10.44 The CAA considers that, in the next five years, the further tightening of capacity constraints at Heathrow is likely at least to maintain, if not strengthen, GAL's market position in relation to FSCs and feeder airlines. The CAA also considers that any change in government policy following the release of the Davies Commission final report is likely to take some time to be implemented. As a result, any significant capacity expansion is not expected until 2025, outside the timeframe for the CAA's assessment and beyond the Q6 regulatory period.

### **Overall 'minded to' conclusion**

- 10.45 The CAA appreciates that the evidence does not all point in one direction and a judgement is therefore needed on the balance of the evidence it has reviewed. On this basis, the CAA is minded to conclude that, in relation to the LCC and charter market, GAL has SMP, which is unlikely to be eroded over the period 2014 to 2019.
- 10.46 The CAA's 'minded to' assessment for the Gatwick FSCs and associated feeder market, again, the evidence does not point in one direction. A business would not normally be found to have SMP when it has a low market share and the rest of the market is supplied by one other provider. However, the CAA considers that the conditions of competition on this market are very unusual in having a substantial part of the market supplied by Heathrow, an airport that is severely capacity constrained.
- 10.47 A contrary finding that GAL does not have SMP appears to be inconsistent with the evidence the CAA has obtained from the airlines



and its analysis of passenger switching. In particular, the airlines indicated that they lacked substitution possibilities if GAL were to increase its airport charges or reduce the quality of its offer to the airlines.

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

### **Factors contributing to GAL's market power and future developments**

- 10.49 In both the FSC and associated feeder market as well as in the LCC and charter market, the CAA considers that the likely underlying source of GAL's market power is the inherent attractiveness of the London market and its strategic importance to airlines, combined with capacity constraints in the London system, which limit the number and size of available alternatives.
- 10.50 The CAA notes that the Government has currently put a hold on the expansion of the London airports and that the Davies' Commission is not expected to bring out an interim report until the end of 2013, with a full report in summer 2015. The CAA considers that any change in government policy following the release of the Davies' Commission final report may take some time to be implemented and that any significant capacity expansion would not be expected until 2025.
- 10.51 Gatwick is likely to benefit from the expected tightening of capacity constraints across the South East. Larger aircraft and better utilisation of slots may help to address capacity constraints to some extent. However, based on the DfT's and GAL's passenger forecasts, the CAA is minded to conclude that capacity constraints are expected to tighten further over the Q6 period. This tightening can be expected to reduce GAL's incentive to price to the competitive level.
- 10.52 The CAA acknowledges there are some uncertainties and that in the future its analysis could change over the longer-term. For example, the change of ownership of Stansted could result in it posing a greater competitive constraint on GAL. The outlook for the economy is uncertain and future Government policy in relation to new capacity in the South East could change. Moreover, the airlines operate in a market that is characterised by change and hence the business

models operating at Gatwick could change, as could passenger preferences.

## SECOND PART: TEST B

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**CHAPTER 11****The application of test B to GAL**

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**Introduction**

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- 11.1 This section sets out the CAA's initial consideration of the application of test B to GAL. It is in 5 sections
- Section 1 considers the how test B sits within the legal framework of the Act.
  - Section 2 compares the types of abuse of SMP that might be addressed under ex ante regulation compared with competition law.
  - For the narrower range of behaviour that would be consider an abuse under competition law, and, which the CAA considers are the most likely types of abuse that might be expected in the aviation sector, section 3 considers the relative efficacy of regulation via a licence and competition law.
  - Section 4 considers what lessons can be drawn from other industries where regulation might be an alternative to reliance on competition law.
  - Section 5 assesses the risk that GAL might abuse its SMP if it were to be deregulated.

**Section 1: Legal framework for test B**

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- 11.2 Section 3 of the Civil Aviation Act 2012 ("the Act") prohibits the operator of a dominant area at a dominant airport from requiring payment of charges without a licence. In order to assess dominance, the CAA has to apply the market power test (MPT) in section 6(1) to the airport area, which will be met if the following three separate tests are satisfied:
- test A (section 6(3)): the relevant operator has, or is likely to acquire, SMP in the relevant market for airport operation services;

- test B (section 6(4)): that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that SMP; and
- test C (section 6(5)): the benefits of regulating the relevant operator by means of a licence outweigh the adverse effects.

- 11.3 Although test B is a separate test, it cannot be divorced from the wider regulatory context – i.e. that the CAA has already determined that the relevant operator has SMP in the relevant market. There is therefore a risk of abuse of that position in the relevant market. It is also a precursor to test C – i.e. it is only if *ex post* regulation via competition law is inadequate that the CAA should go on to consider the appropriateness of *ex ante* regulation via a licence.<sup>897</sup>
- 11.4 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 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*"<sup>898</sup>. Further, in so doing, the CAA must, seek where appropriate to "*promote competition in the provision of airport operation services*"<sup>899</sup>.
- 11.5 Importantly, for test B, the CAA must 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 airlines or cargo airlines or other intermediary service providers, such as groundhandling providers, car parking or retail concessionaires.
- 11.6 The CAA's duties, in respect of furthering the interest of users of air

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<sup>897</sup> Although the tests can be considered cumulative, it is not set out as such in statute. The CAA may consider it appropriate in certain cases to consider the application of test C in the first instance in light of the regulatory principles set out in section 1(4) of the Act.

<sup>898</sup> section 1(1) of the Act.

<sup>899</sup> section 1(2) of the Act.

transport services and promoting competition under sections 1(1) and (2), are supplemented with the requirement to have regard to various matters set out in section 1(3) including the need to secure that all reasonable demands for airport operation services are met.

- 11.7 Lastly, in applying test B, the CAA must have regard to the regulatory principles in section 1(4) of the Act, namely that its regulatory activities should be transparent, accountable, proportionate and consistent and targeted only at cases where action is needed. It must also comply with its statutory duty under section 104 of the Act to avoid the imposition of unnecessary regulatory burdens on operators of dominant airports.

## Section 2: Aims of *ex ante* vs. *ex post* regulation

- 11.8 Test B directs the CAA to weigh the comparative merits of *ex post* regulation (through competition law) as an alternative to *ex ante* regulation via a licence. There are two dimensions to this:
- First, abuse of SMP may take in a wider range of behaviour than that defined by competition law. This is the subject of this section.
  - Second, for the narrower range of behaviour that has been defined as an abuse under competition law, *ex ante* and *ex post* regulation may differ in their efficacy. This is the subject of section 3.

### Promoting versus protecting competition

- 11.9 Broadly speaking *ex ante* regulation seeks the development of effective competition in the relevant market by fostering market entry and creating incentives for innovation and efficiency. As far as possible, it seeks to replicate the outcomes that are expected to be seen within an effectively competitive market.
- 11.10 On the other hand, *ex post* regulation is designed to protect the degree of competition that already exists within a market (which may not be perfect or effective). It does this (*inter alia*) through explicit prohibitions set out in the CA98 and Articles 101/102 TFEU, which discipline the actual or potentially abusive exercise of market power. Ofcom have characterised the differences in the following way:

*'Ex-post competition law is [ . . . ] unlikely within itself to bring about*

*effective competition, as it prohibits the abuse of dominance rather than the holding of a dominant position. In contrast, ex-ante regulation is normally needed to promote actively the development of competition. Ex-ante regulation attempts to reduce the level of market power in a market, thereby encouraging effective competition to become established*<sup>900</sup>.

### Wider policy objectives of ex ante regulation

- 11.11 Further, the CAA considers that, from the relevant case law, *ex ante* regulation can be typically distinguished from *ex post* regulation on the basis that they typically have different (albeit overlapping) objectives. In Deutsche Telekom (Case T-271/03) the General Court found that National Regulatory Authorities (NRAs) “*operate under national law which may, as regards communications policy, have objectives which differ from those of Community competition law*”. More recently, the European Commission in Telekomunikacja Polska (Case COMP/39.525), noted the different policy objectives of the Polish *ex ante* regulatory regime for broadband access and EU competition law:

*“The aim of... [European competition law] is to preserve undistorted competition within the European Union, whereas the aim of... [the national regulation] encompasses other objectives such as “development and use of modern telecommunications infrastructure”, “maximum benefits for users in terms of choice, price and quality of telecommunications services” and “net neutrality”. In particular, while imposing access obligations the President of UKE has to ensure the balancing of the following broad criteria: ‘the interests of users of telecoms infrastructure’, ‘promotion of modern telecommunication services’, ‘public interest including protection of environment’, ‘the integrity of network and interoperability of services’ and ‘non-discriminatory access conditions.’”*

- 11.12 The European Commission concluded that the national regulatory regime and Community competition law were not designed to “*protect the same legal asset*” and that even if there was significant overlap in the subject matter, there were “*significantly different policy considerations at play and different emphases in the criteria for*

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<sup>900</sup> Ofcom (2012) Business Connectivity Market Review: Review of the retail leased lines, wholesale symmetric broadband origination and wholesale trunk segments markets, Annex 6: Regulatory Framework.

*remedy selection between the ex post and ex ante regimes to warrant the application of ex post competition rules.”*

- 11.13 *Ex ante* sector-specific national regulation typically pursues different albeit overlapping policy objectives to that of European competition law. In the context of test B the different policy objectives required are specified as protecting passengers and cargo owners from the effects of an abuse of significant market power that is not protected against by European and UK competition law.
- 11.14 Table 1 below summarises the different features of *ex post* competition law and *ex ante* regulation.



**Table 11.14: Features of ex post vs ex ante regulation**

	<b>Ex Post</b>	<b>Ex Ante</b>
<b>Perspective</b>	Backwards-looking – i.e. relies on historical evidence of abuse that has occurred in an otherwise commercially competitive market.	Forwards-looking (insofar as prescribes or controls types of market behaviour regardless of particular circumstances, based on public policy priorities or market failures that are found to exist in the market and need to be remedied).
<b>Market Definition</b>	A relatively narrow view of product markets driven primarily by demand-side substitutability is normally adopted.	Markets are likely to be defined in broader terms than under ex-post competition law. Supply-side substitution is equally as important as demand-side substitution in determination of the relevant market. In the context of airports supply side substitution is unlikely to be viable response.
<b>Focus</b>	On redress for past actions and prohibiting future actions of a similar nature.	Addressing market failures arising from a certain industry structure or history.
<b>Nature of remedies</b>	Results in remedies that are narrow in scope, essentially declaratory in nature and “neutral” in terms of broader implications for industry of the remedies sought in a specific piece of competition litigation.	Remedies generally are very specific in nature but general in scope affecting the majority of customers. Remedies are generally cost based assuming an efficient operator, they are defined in focus by the legislative context. With regards to airports this is in line with the CAA’s section 1 duties.
<b>Enforcement</b>	Through the Courts, the European Commission, the OFT (soon to be CMA), or other relevant designated national competition authority (in the case of airports the CAA).	Generally enforced through independent sector-specific regulators (who are most likely to be able to address complex technical detail and the economic disciplines which characterise a specific industry). In the case of airports the CAA.

Source: CAA

11.15 The CAA considers that Table 11.1 indicates that *ex-ante* regulation is forward-focussed and aimed at remedying some existing market failure in the competitive landscape, as opposed to maintaining the

*status quo* of healthy competition in the market.

- 11.16 The types of abuse of SMP that might be protected against by *ex ante* regulation that would not be entirely protected through competition law might be those that arise from market failures driven by the aviation industry structure, and historical features. These are likely to occur because of a particular market dynamic affecting wholesale relationships between competitors rather than because of the specific strategic practices of any given operator at the retail level of competition.
- 11.17 A wider range of remedies are available in the UK under part 4 of the Enterprise Act 2002 (Market Investigation References, or, MIRs) than is available under Articles 101 and 102 of the TFEU or the CA98. The CC can, at present, and the CMA, when it is established, will be able to impose behavioural and structural remedies that could be similar to those provided for under the Act. However, MIRs are intended to tackle adverse affects on competition arising from particular features of markets that restrict, distort or prevent competition. This was the case in CC MIR into the joint ownership of the airports in the South East of England and Scotland. The review considered the impacts of the joint ownership on competition not any particular behaviours of BAA. The MIR regime is not intended to address the individual conduct of firms. The conduct of individual undertakings is addressed through Articles 101 and 102 or the CA98.
- 11.18 Regardless of whether the statutory test for dominance under the Act is met, such that a licence is required under the national sector-specific regulation, it is clear from the European case law that *ex post* competition rules would continue to apply and essentially “trump” *ex ante* sector-specific regulation. The parallel role of competition law is expressly reflected in the Act. Under s46 of the Act, before taking enforcement action under a regulatory licence, the CAA must consider whether it would be more appropriate to proceed under the CA98 and must not exercise those sectoral enforcement powers where it considers that CA98 is more appropriate.

### Section 3: Competition law

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- 11.19 This section considers the efficacy of *ex ante* regulation for behaviour

that would be considered an abuse of SMP under competition law, compared with the enforcement of competition law.

- First the possibility that airlines or users might be able to enforce competition law by taking private actions is examined:
- Second, the most likely abuses of competition law by airports are identified
- Last, the advantages of addressing these abuses by means of a licence compared with competition law are explored.

11.20 Competition law is defined in the Act (section 6(9) as follows:

*“In test B “competition law” means -*

*Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU);*

*Part 1 of the Competition Act 1998; and*

*Part 4 of the Enterprise Act 2002 (market investigations).”*

11.21 While Part 4 of the Enterprise Act is included, a market investigation under Part IV of the Enterprise Act 2002 is not designed to address conduct-based behaviour by individual businesses: rather it is designed to focus on remedying features of a market that have adverse effects on competition. The provisions of Articles 101 and 102 of the TFEU and the Competition Act 1998 are much more relevant to conduct. Those provisions include not just the CAA’s concurrent competition law enforcement powers under sections 60 to 63 of the Act but also the ability of interested third parties to bring private actions before the courts to enforce directly Articles 101 and 102 and/or the CA98 provisions. These are considered next.

### **Private actions: Power of airlines and passengers to bring actions or complaints**

#### **Airlines**

11.22 Test B requires air transport users (rather than airlines) to be put at the heart of the assessment (see s.1 duty, section 6(5) test C from the perspective of air transport users and the definition of users in section 69(1) of the Act, paragraph 1.5 above). Evidence suggest however that claims are mainly taken forward by competitors rather than

purchasers:

*“Most (but not all) damages actions in respect of harm from exclusionary conduct in member states have thus far been brought by competitors rather than by purchasers.”<sup>901</sup>*

- 11.23 Particularly where airlines are able to pass on an increase in airport charges, they may have little incentive to take private actions that are in users' interests. As the interests of airlines and passengers are not necessarily aligned, it cannot be assumed that airlines will bring claims on the behalf of users as many factors are likely to be involved in the decision to commence complex litigation proceedings and airlines may not want to damage their commercial relationship with the dominant airport operator.
- 11.24 Stand alone<sup>902</sup> actions to enforce competition law are relatively infrequent in the UK. There is often insufficient incentive for an individual business to bring forward such actions due to the uncertainty of outcome and the benefits relative to the costs. Even under proposed reforms to enable opt-out class actions, there are many obstacles to obtaining redress for affected parties after a competition law infringement has been identified. They have been identified to include legal uncertainty, information asymmetry, burden of proof and evidential difficulties and importantly, the low expected payoff to the party taking the action compared with the costs of litigation.
- 11.25 The CAA considers that there are risks in bringing private actions for an alleged breach of competition rules including:
- Cases before the EU and UK courts can take many years and injunctive relief in these types of cases is very rare.<sup>903</sup>

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<sup>901</sup> Komninos et al (2009), Quantifying antitrust damages: Towards non-binding guidance for courts, Study prepared for the European Commission Oxera.

<sup>902</sup> In stand alone actions the defendants are required to establish liability. In follow on actions, liability will already have been established by a competition authority.

<sup>903</sup> The first case to award damages for breach of competition law in the UK was Crehan (Intreprenuer Pub Company and others v Crehan [2006] UKHL 38), which took 10 years and was overturned in the House of Lords.

- Calculating damages is difficult, requiring the use of complex economic models and accountancy evidence for the purpose of quantification. For the purpose of showing loss, the judge's discretion in allowing "loss of profit claims" makes the value of the case uncertain. It could also be argued that where there is cost pass through the damage would fall on passengers and not the airlines, limiting the scope for the claim.
- The "loser pays" principle in the UK courts means that the claimants can be exposed to large financial risk - if they cannot establish a case, they may be required to pay the costs of the defendant (i.e. airport)<sup>904</sup>.

11.26 Against this, it must be recognised that airlines, in general, are large multinational entities that have sufficient financial resources such that they should be in a position to take forward cases that are in their commercial interest. Some airlines have pursued legal challenges against airports or competition authorities and were therefore not apparently deterred by the complexity or expense (Ryanair/ Aer Lingus/ Flybe etc.).

### Air transport service users

11.27 Standalone claims by consumers, in the absence of a decision by a competent competition authority, are rare. It is often difficult to define the relevant market and prove dominance without the powers of investigation available to the competent authority. As air transport users will not have access to confidential cost information, access to relevant confidential files, and wider market data on which to establish a claim of abuse<sup>905</sup>.

11.28 Air transport users are indirect purchasers of airport services; they have no direct contract with the airport and therefore no contractual claim. In these circumstances, establishing a causal link between an increase in the charges by the airport and an increase in tariff faced

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<sup>904</sup> The European Commission established a Green Paper in 2005 on the major obstacles preventing victims from bringing damages in member states, and a White Paper in 2008, as well as a follow-up to the White and Green Papers with a Commission Work Programme in 2012.

<sup>905</sup> EC (2005), Green Paper - Damages actions for breach of the EC antitrust rules {SEC(2005) 1732}, COM/2005/0672 final.

by air transport users and the consequent loss to the user would be complex.

- 11.29 The level of individual damage is likely to be low for an individual user. Users are therefore less likely to bring individual claims, as they may not detect the abuse. Users are not always even aware of the existence of an infringement or of the extent of the losses they suffered due to this infringement.<sup>906</sup> Additionally, even if users are aware of the abuse, the costs, delays and burdens involved in taking such actions, are likely to be significant compared to the value of their individual claim.
- 11.30 There is the prospect of class claims or group representative action. Class actions have not proved easy or effective in the UK as a remedy for breaches of competition law. Which? (currently the only body empowered to bring class actions in this field) dedicated 20 per cent of its legal resource to a class action against sports retailer JJB Sports and incurred significant legal costs. Its view at the time was that it was not likely that it would undertake such a case again.<sup>907</sup> CAA therefore has significant concerns as to whether, in practice, standalone competition law claims will adequately protect passengers.
- 11.31 In summary, the CAA considers that addressing abuses of market power through private actions would be challenging and complex. This is a result not only of the complexity of evidence required in establishing excessive pricing, but also practical challenges resulting from collective action and the low level of damage to any individual user.
- 11.32 The CAA considers that private enforcement of competition law by airlines and users would be ineffective in protecting users from an abuse of SMP by an airport. The rest of this chapter considers the relative effectiveness of regulation and competition law, assuming that enforcement of the latter would be by the relevant competition authority, that is, the CAA.

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<sup>906</sup> EC DG COMP MEMO/08/216, dated: 03/04/2008.

<sup>907</sup> Speech by Deborah Prince, Head of Legal Affairs, Which? at The Lawyer's antitrust litigation conference in 25-26 November 2008.

## Definition of abuse under competition law and relevance to airports sector

### Definition of abuse

11.33 Under competition law, a dominant company has a special responsibility not to allow its conduct to impair undistorted competition in the relevant market<sup>908</sup>. It is not the position of dominance or SMP itself that is prohibited but the dominant undertaking using that position to prevent or distort effective competition in the market.

11.34 The European Court of Justice has defined the term “abuse” in the following way:

*“An objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition in products or services on basis of the transaction of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition.”<sup>909</sup>*

11.35 Section 6(8) of the Act provides:

*“For the purposes of test B conduct may, in particular, amount to an abuse of substantial market power if it is conduct described in section 18(2)(a) to (d) of the Competition Act 1998”*

11.36 Section 18(2)(a) to (d) of CA98 (more commonly known as “the Chapter II prohibition”) contains an illustrative list of exploitative and/or exclusionary behaviour that is capable of amounting to an abuse of a dominant market position:

- directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
- limiting production, markets or technical development to the prejudice of consumers;
- applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

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<sup>908</sup> Case 322/81 *Michelin v Commission* [1983] ECR 3461, paragraph 57.

<sup>909</sup> Case 85/76 *Hoffmann-La Roche* [1979] ECR 461.

- making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts.

- 11.37 This list is not exhaustive and the examples listed there have been supplemented by the case law developed by both domestic and European competition authorities and the courts.<sup>910</sup>
- 11.38 The actual scope of the special responsibility imposed on a dominant undertaking must be considered in the light of the specific circumstances of each case which show that competition has been weakened.<sup>911</sup> This means that the risk of abuse cannot be assessed in isolation from the features of the relevant market.
- 11.39 The essential objective of the Chapter II prohibition and its EU counterpart (Article 102 TFEU) is “the protection of competition on the market as a means of enhancing consumer welfare and ensuring an efficient allocation of resources... This means that it is competition, and not competitors as such, that is to be protected.”<sup>912</sup> The CAA regards the objective of competition law as being compatible with its general duty under section 1 of the Act - in so far as the CAA considers promoting competition is appropriate in furthering the interests of users.

### Abuses that have most relevance to airports

- 11.40 In order to assess whether competition law would adequately protect airport users, it is necessary to consider what types of abuse are most likely in the sector and how effectively they are addressed by competition law. There have been a number of cases taken at both a domestic and European level against airports.<sup>913</sup> This indicates that an

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<sup>910</sup> See, for example, Case 6/72 *Continental Can* [1973] ECR 215, paragraph 26. In particular, the prohibition is not only aimed at practices which may cause damage to consumers directly, but also at those which are detrimental to them through their impact on an effective competition structure. Abuse may therefore occur if an undertaking in a dominant position strengthens such position in such a way that the degree of dominance reached substantially fetters competition.

<sup>911</sup> Case C-333/94 P *Tetra Pak v Commission* [1996] ECR I-5951, paragraph 24.

<sup>912</sup> DG COMP Discussion Paper on the application of Article 82 EC to exclusionary abuses, paragraph 54.

<sup>913</sup> Commission decision 95/364/EC, Commission decision 1999/199/EC, Commission decision 1999/198/EC, Commission decision 98/513/EC; T-128/98, C-82/01 Commission decision



airport is an undertaking for the purposes of competition law and they can be found to be dominant and abusive without any special dispensation. The case law illustrates that competition law has been successfully applied in what could broadly be considered as vertical exclusion cases, where the airport is active in the upstream market for airport operation services but also has a presence in the downstream market for air transport or other services. The defining feature of these cases is that they all involved the airport leveraging its market power to the advantage of either its own subsidiary in a downstream market or a closely aligned party.<sup>914</sup>

11.41 The CAA has not been able to establish that there have been any cases taken against airports in relation to:

- Exclusionary behaviour aimed at foreclosing markets for airport operation services to new market entrants.
- Exploitative abuses relating to restrictions of output, excessive pricing or inferior quality abuses.

11.42 The CAA considers that for exclusionary behaviour there are likely to be sufficient precedents available from other industries including those that are similarly regulated (such as telecoms or utilities) which could be relied on as relevant authorities in challenging this type of behaviour by airports under the CA98 or Article 101/102 TFEU.

11.43 However, it is in relation to exploitative abuses that the CAA considers that there is the greatest likelihood of abuse occurring. Where airports have SMP, the most obvious outlet for that market power is to bring it to bear on their customers; a type of abuse that would affect users to the extent that it was passed on. For excessive pricing and exploitative service abuses the CAA considers that there is insufficient case law to provide sufficient legal certainty for successfully completing an investigation or private action alleging such abuses.

### **Effectiveness of regulation and competition law in addressing abuses**

11.44 For price-based abuses, there have been a number of cases taken forward, such that there is a degree of clarity relating to the test to be

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98/190/EC and Purple Parking & Anor v Heathrow Airport Limited [2011] EWHC 987 (Ch).

<sup>914</sup> The early European cases are typified by a strong single market imperative. These cases in the main consist of a state owned airport supporting state owned airlines.

applied. In *United Brands*<sup>915</sup>, the lead case, the Court of Justice recognised that "*charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied would be such an abuse*".

- 11.45 The court proposed a two part test; it should be shown that i) the price cost margin is excessive and ii) the price imposed is either unfair in itself, or when compared to competing products. However the decision did not provide bounds above which prices would be deemed excessive. This test has formed the framework in the assessment of excessive pricing in the cases that have followed.
- 11.46 The *United Brands* case highlights the key issue of determining the appropriate price against which to measure whether there is excessive pricing above that level. There are a number of issues that affect the accurate measurement of the appropriate price:<sup>916</sup>
- A key challenge is that firms normally record their costs in a format designed for financial presentation rather than economic evaluation. When assessing prices from an economic perspective the CAA is concerned with the marginal costs of production, which is not needed for standard accounting purposes. Therefore cost data from firms may need to undergo some form of transformation.
  - Where a firm supplies a number of products over a number of areas, such as an airport, there is an issue of cost allocation and cost recovery. There is no correct methodology for the allocation of common and sunk costs within a business. Based on two differing sets of clear and objective criteria the costs of a firm may look significantly different. For example airport costs derived from the perspective of passenger use may look different from those derived from the perspective of airline use but may both be based on a rational allocation.

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<sup>915</sup> *United Brand v the Commission*, Case 27/76. The finding of abuse was not upheld on appeal for lack of evidence establishing excessive pricing against the legal test the court had articulated.

<sup>916</sup> Lyons B (2007), *The Paradox of the Exclusions of Exploitative Abuses*, in: Swedish Competition Authority (ed), *The Pros and Cons of High Prices*, pp 65-87 url:

- Finally, few products are charged on a basic unit cost. Costs are often dependent on volume or have multiple components. This is especially an issue at airports given the bundle of goods that are purchased by airlines. The nature of costs at an airport is such that there is a high fixed cost of provision therefore on a unit basis costs can decrease at a significant rate as volume rises.
- A further challenge is that competition law investigations into conduct necessarily focus on a point in time or at least a fixed period. Making a robust assessment of cost information in this context can be difficult. As it may not always be possible to gain robust information on past events.

- 11.47 In such a context a sectoral regulator operating a licence-based regime is more likely to be effective in overcoming the asymmetry of information. A sectoral regulator would have regular access to information and accounts that would allow it to assess the efficient level of airport operators' costs more effectively than a competition authority might when considering them on a case by case basis.
- 11.48 Another key issue that was raised in the United Brands case is that of total economic value. This can take in such matters as brand appeal based on attributes such as the reputation of the airport as a hub or as a holiday, business or low cost carrier airport. Similarly, an airport being situated by a major city provides additional value in terms of access for the airlines' target market. These components add up to the economic value of the service rather than the basic accounting value of the immediate costs of provision. Finding a credible value for these can prove difficult in practice.<sup>917</sup>
- 11.49 Another issue for the consideration of excessive pricing is the role of high prices in the competitive process. High prices can be part of the mechanism of a well functioning market where they encourage entry by equally (or more) efficient competitors and are eventually competed down to the competitive level. A core question is whether it is likely that, given the particular market dynamics, the high prices are likely to drive entry. Therefore an assessment of price over an appropriate time period rather than a simple consideration of the spot price are important. Further, prices play a role in rewarding investment

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<sup>917</sup> See *Scandlines Sverige AB v Port of Helsingborg* Commission Decision of 23 July 2004 [2006] 4 CMLR 1224, paragraphs 241-242.

and innovation, either of which can be damaged if the dominant firm considers it cannot gain the appropriate compensation. The market setting therefore plays an important and variable role in the assessment of excessive pricing. This can mean looking beyond whether a price represents covering costs plus a reasonable rate of return, and taking proper account of the wider market context.<sup>918</sup>

- 11.50 Finally, an issue that has been cited with regards to excessive pricing is the reluctance by competition authorities to prescribe clear upper limits for market prices. This stems in part from the lack of specialised knowledge of specific industries and in part due to a reluctance to set what would effectively be a form of price control. This has traditionally been viewed as a rather different activity from competition enforcement.<sup>919</sup> Given that the CAA will have concurrent powers as well as its responsibilities as the sector regulator it does not consider that this should carry much weight in assessing the merits of competition law in the context of test B. Where appropriate, the CAA would be able to regulate prices if such a remedy was required as part of a regulatory decision made under competition law.
- 11.51 However, it will be important to consider whether the flexibility of a licensing regime may be better adapted to address the full sectoral implications of pricing issues or whether the imposition of fines and/or directions aimed at pricing conduct or price-focussed market investigation remedies are sufficient. To an extent, competition law can still play a part, even where a licence is in place because of the CAA's duty under s.46 to only take licensing enforcement action where it is more appropriate than proceeding under the CA98.
- 11.52 The CAA notes that there have been some infringement decisions with regards to excessive pricing.<sup>920</sup> This highlights that competition law enforcement based on excessive pricing can be the appropriate way to address some types of commercial behaviour. However,

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<sup>918</sup> *AtTheRaces v British Horseracing Board* [2007] EWCA Civ 38, [2007] UKCLR 309. In the original hearing at the High Court excessive pricing was upheld, however it was quashed in the Court of Appeal.

<sup>919</sup> OCED (2011), *Excessive Prices*, Background paper for Working Party No.2 on Competition and Regulation, url:<http://ssrn.com/abstract-1946779>.

<sup>920</sup> Case 2001/893/EC; *Napp Pharmaceuticals Holdings Limited and subsidiaries – OFT CA98/2/2001* decision upheld at appeal CAT/1001/1/1/01, and more recently case brought by the Italian Competition Authority against Roman and Milan airports.

although there is a legal test for excessive pricing, it can be difficult to apply in practice because proving elements such as “excessive” can be challenging. Therefore, the application of the relatively limited available competition law precedents for exploitative abuses, such as excessive pricing, is hard to predict. The CAA considers that, given this uncertainty, cases in this area carry greater risks of failure compared to more common abuses such as predatory pricing and margin squeeze.

- 11.53 The CAA is unaware of any competition law cases that have sought to correct an abuse where a dominant undertaking has exploited its SMP by supplying services of inferior quality compared to those that might be expected in a competitive market. The CAA considered that the issues identified with the assessment of an excessive pricing abuse would equally apply to an abuse of service quality. It is the CAA’s consideration that an abuse based on service quality is likely to be more challenging to tackle through competition law compared to licence-based regulation, given the subjective nature of service quality.
- 11.54 It is important to consider the context in which the CAA would be exercising its powers under competition law. GAL could be said to operate at a “wholesale” level in the sense that the rates it sets will have an impact on the ultimate rates which the airlines charge to the passengers and cargo owners. The CAA considers that GAL could set excessive airport charges, which would affect passengers and cargo owners and which may not be capable of being remedied by competition law. The next section looks at how the balance between regulation and reliance on competition law has been addressed in other industries.

## Section 4: Lessons from other industries

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- 11.55 As part of its submission to the CAA, GAL submitted a report<sup>921</sup>, which seeks to draw lessons from other regulated and deregulated industries around the world and puts forward its view of their

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<sup>921</sup> GAL, Sectoral examples of market power, regulation and deregulation and implication for Gatwick Airport: A report to GAL, London Economics, Q5-050-LGW50, November 2012 submitted March 2013.

implications for the CAA in approaching licence regulation of GAL under the Act. The report was written on the basis of the CAA's market analysis presented in the Initial Views, rather than that presented in the test A section of this report. Further, the report appears to have been written on the basis that GAL will face price cap regulation. This section considers what this analysis implies for the assessment of test B.

- 11.56 The report draws on a number of examples in which, with the exception of UK ports, there is some level of economic regulation above that imposed by competition law alone. The report shows how, for certain industries, regulation has been progressively pulled back. Examples include UK retail energy and Scottish Water. However deregulation in these industries has generally been in the retail segments of these industries, which are akin to the market for air transportation in the aviation industry, rather than the markets for air operation services at airports.
- 11.57 The report also draws on evidence of regulation at Australian Airports which, despite having market power, face a light touch regulatory regime. Test B does not direct the CAA to comment on the form of regulation or the extent to which regulation that may be applied to an airport is intrusive. Its focus is on whether competition law will provide sufficient protection against the risks of the operator that has been found to have SMP abusing that SMP or whether some form of regulation is needed. The Australian example illustrates that there may be benefits to regulation at airports with market power that exceed those offered by competition law alone.
- 11.58 The industry of most relevance to test B, in the GAL report, is that of UK ports, which are largely unregulated, but the report rightly points out that there are a number of key similarities between sea ports and airports. However the CAA notes that there has historically been limited regulation of ports in the UK. As the London Economics report notes *the "UK Government takes a very hands-off approach"*. This is at odds with the approach that the UK Government has taken with regards to airports, where it has historically taken, and continues to take, an active role in aviation policy and the development of airport capacity.
- 11.59 The importance of the planning system for airports creates a level of uncertainty within the market. This is especially the case in the South

East of England, where the government currently has a moratorium for expansion at the three largest airports. This affects both the likelihood and the timeframe for any expansion by an individual airport in the South East of England. The Davies Commission which is currently exploring potential solutions to airport capacity issues, which might serve as an alternative to investment being left to market forces. This is likely to override market-led capacity adjustment over a large proportion of the market. While market conditions may change so as to lessen concerns about constraints on competition, the CAA currently views this as important factor. It also takes into account that airports have a safeguard against ongoing regulation where there is a material change in circumstances, whereby they can ask for CAA to review their position by asking for a fresh market power determination under the Act.

- 11.60 Another notable difference is that the CAA has explicit duties under the Act to further the interests of air transport users. No such duty applies to any statutory body in relation to ports. As noted at the start of this chapter, the CAA's primary duty needs to be taken as the guiding principle in our consideration of test B as it relates to airports.
- 11.61 A key difference between UK sea ports and airports is the level of passenger interaction. GAL's report points out that sea ports focus more on cargo than on passengers. According to the trade body for UK ports, they carry around 30 million passenger a year and 530 million tonnes of cargo.<sup>922</sup> This compares to UK airports through which only 2.3 million tonnes of cargo moved and some 220 million passengers.<sup>923</sup>
- 11.62 It can be assumed that the majority of sea port users with rights in cargo similar to those at airports do not have any contact with the port through which their goods are shipped, therefore the majority of the transactions taking place are between the port and various cargo shippers. Those shipping cargo are also more likely to be businesses rather than individuals. Businesses are generally in a better position from which to consider litigation than private individuals. Passengers, on the other hand, have a significant contact with the airport/port as part of their purchase of air/sea transportation services. In the main

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<sup>922</sup> See <http://www.ukmajorports.org.uk/pages/industry-profile> accessed 17 April 2013.

<sup>923</sup> CAA Airport Statistics 2012.

they will also have purchased their service as a private individual. Passengers are therefore more directly exposed to possible abuses and face certain challenges in asserting their rights within the framework offered by competition law. Airlines are generally well resourced businesses and they may protect passengers using those resources when their interests are aligned. However, if passenger and airline interests are not aligned, the ability of passengers to influence airport decision making (particularly where the airlines have opted to support a decision) will be severely limited and competition law may not offer sufficient protection.

- 11.63 This raises the question of whether the provision of airport operation services to cargo owners should be regulated, given that cargo shippers by sea do not benefit from similar regulation. The CAA notes that the proportions of cargo versus passenger traffic as between ports and airports are not at all similar. Cargo owners using air, therefore, are in a different position to their maritime comparators, as they are using facilities whose primary focus is generally to serve passenger transport. The CAA considers that this is likely to affect the buyer power of cargo owners dealing with airports with SMP. For certain cargo types, access to an airport with sufficient proximity to London is critical for those seeking to serve those markets and they need to secure capacity in competition with passenger traffic. In this context, competition law may not be sufficient to address conduct that is directed against cargo owners. They may feel constrained in initiating and/or providing evidence to support investigations into the conduct of the airport with SMP or the market more generally. There is also the risk that if regulation were to be put in place, which was only directed at the protection of passenger interests, this could lead to unforeseen distortions to the detriment of cargo owners.
- 11.64 The CAA draws the following conclusions from other industries:
- Australian airports, despite the differing policy context, illustrate that where an airport has market power there is benefit in maintain regulation above provision in competition law
  - UK ports although sharing similarities with airports have key difference, which limits the read across to airports. Ports are focussed on the provision of service to cargo operators, where as airports are passenger focussed:



- The CAA has a primary duty to the users of airport services which in the main are individuals rather than companies. Therefore are likely to lack the resource and expertise needed to tackle abuses of SMP. No such obligation exists within the provision of seaport facilities.
- Passengers, as individual users of airport services, are likely to face a greater exposure to possible abuse and be less able to combat any abuse than cargo operators.
- Cargo owners, as individual users of airport services, are in a different position to their maritime counterparts as services provided to them are main a secondary activity to the provision of services to passengers. This is likely to have an impact on their relative buyer power.

## Section 5: Application of test B to GAL

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### Market characteristics

11.65 Airports, in part due to their nature as previously nationalised undertakings, have high and persistent entry barriers.<sup>924</sup> These barriers may result from a number of areas including:

- Government intervention; and
- Bi-lateral agreements.

### Government intervention

11.66 In a properly functioning market, prices would rise as capacity within a market contracts. High prices would stimulate entry into or expansion within the market. The addition of extra capacity would then erode the pricing power of the dominant market participants and prices would start to fall. Where there is an impediment to the functioning of the market such that entry or expansion is not possible, prices will continue to rise to the maximum extent that the market can bear.

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<sup>924</sup> Of the world's 30 busiest airports, 19s are state-owned. Europe, with a large number of airports, still maintains relatively strong airport regulation. Many of the privatised airports in Europe are in the UK. Since the BAA privatisation in 1986, there has been partial privatisation in Austria, Germany and Italy, and it is planned in other EU airports. It is estimated that only 20% of European airport operations are privately owned or public-private partnership.

- 11.67 All major infrastructure decisions within the UK have some degree of government involvement, whether through local councils' planning laws or by Central Government. Since 2003, there has been a case for airport expansion within the South East. Airports have attracted a particular level of intervention from Central Government especially within the South East where there is currently a moratorium on the expansion of airports, which restricts the available capacity.
- 11.68 The level of potential competition has increased due to the recent changes of ownership of Gatwick and Stansted, but even so, given the level of government intervention and the artificial nature of the impediments to competition and the artificial stimulation of excess demand, the CAA considers that this increases the likelihood of exploitative abuses taking place. The market mechanism that would lead the market to invest in new capacity is prevented from operating as a policy choice.

#### **Bi-lateral agreements**

- 11.69 Historically, international flights have been governed by international air service agreements, which limited the level of competition at the airline level on specific routes. This has limited both the airlines, and also the airport from to and from which the airlines could fly.
- 11.70 The single skies initiative in Europe opened up intra-community flying allowing for the development of low cost airlines. Similarly, the open skies agreement with the US opened up flying from the UK to the US. The result of this was that airlines were able to exercise choice over which airports to serve in the UK, US and Europe.
- 11.71 However, there are still a number of countries with which bi-lateral agreements still pose restrictions. For example, the CAA was recently called on by the Secretary of State to adjudicate on capacity on the London to Moscow routes due to the exit of BMI. The CAA award the capacity to BA which continues to serve 21 services a week from Heathrow and to easyJet which can now serve up to 14 services a week to Moscow from Gatwick. No other UK registered airlines (or airlines operating in the UK, other than the Russian counter parts) are allowed to offer these routes from the UK.
- 11.72 These restrictions limit to some extent the competitive pressures that may be felt by airports. Airlines may not necessarily be able to take the commercial actions on operating certain routes that would serve to

discipline its supplier on prices and/or quality.

### **Degree of competition and extent of GAL's market power**

- 11.73 The CAA has found that Gatwick has significant market power in two separate markets
- The provision of airport operations services to LCC and charter airlines from Gatwick airport, the Gatwick LCC market, in which it is the only provider; and
  - The provision of airport operation services including to FSC and associated feeder traffic at Gatwick and those services offered at Heathrow airport, the Gatwick FSC market, in which it holds a 15 per cent share.

### **The Gatwick LCC market**

- 11.74 If Gatwick increased its prices by ten per cent, LCCs and charters at Gatwick all give evidence that they could not switch and would pass on any increase in price to end-users. Heathrow has no available capacity and the other London airports are not substitutes<sup>925</sup>. In a report commissioned by Ryanair, RBB set out reasons why a strong presence in London is a “must have” for the success of the LCC business model<sup>926</sup>:
- *a strong presence in London affects the brand value of an airline;*
  - *the thickness of demand in London allows a large number of routes to be operated from the same base, which results in efficient aircraft utilisation;*
  - *new routes can be launched with lower risk, in regard to profitability, from London airports rather than from non-London airports; and*
  - *significant sunk costs in marketing its London bases. There is a significant option value to a London presence associated with the ability to operate from London in the future.*<sup>927</sup>

<sup>925</sup> Cross ref to Market Definition Chapter.

<sup>926</sup> Cross ref to earlier Chapter as well.

<sup>927</sup> Source: RBB Economics commissioned by Ryanair (page 16), November 2012.

<http://www.caa.co.uk/docs/5/rbb%20stansted%20final%20non-confidential%20version%2029%20Nov%2011.pdf>

- Thus the risk of excessive pricing must be significant

11.75 Charter airline evidence was that:

- Charter airlines appear to be “captive” to Gatwick as they have, over a period of decades, established a sophisticated base at the airport, relying on its reputation as a “holiday destination airport”<sup>928</sup>.
- Scheduled charter airlines are also dependent on support from tour operators, who have developed consolidated operations at Gatwick for chartered and packaged holidays<sup>929</sup>.

### The Gatwick FSC market

11.76 The evidence collected and mentioned in chapter 7 has shown that if GAL put its prices up by ten per cent, while FSCs and feeder airlines might be able to an extent reduce frequencies, the level of switching would be insufficient to make the price rise unprofitable. Further, it appears that airlines tend to absorb increases in costs in the short term, and in the longer term try competitively to pass through the price increase to passengers.

11.77 With regards to countervailing buyer power<sup>930</sup>, the CAA has found no evidence of airlines being able to credibly threaten to switch away from Gatwick to discipline GAL’s pricing behaviour. This is largely due to the carriers individually being a small proportion of the airport’s traffic, and a lack of alternative airports to which they can threaten to switch.

11.78 The costs of physically relocating services are likely to be low for based and inbound airlines, and FSCs and feeder airlines switching to Heathrow are likely to gain from the greater network effects available. Operating to London tends to be of strategic importance and these airlines also typically exhibit a preference for operating from Heathrow. However, the lack of available capacity at Heathrow means that FSCs and feeder airlines seeking to enter or expand services to London are almost entirely limited to doing so from Gatwick. On the whole, the DfT Aviation Forecasts, and GAL passenger traffic forecasts, suggest that the capacity constraints are likely to worsen,

<sup>928</sup> Cross ref to earlier Chapters.

<sup>929</sup> Cross ref.

<sup>930</sup> CAA: Competitive Constraints – FSC and associated feeder traffic (Section 7 – Conclusion).

which are likely to strengthen Gatwick's position further in the short to medium term, assuming no new capacity before at least 2020. With the current moratorium on expansion at the major London airport even in the event that it is lifted it is unlikely that new capacity would come on stream until 2025. These factors confer upon GAL a position of significant market power, which is likely to be maintained until at least 2025.

### The risk of abuse

- 11.79 As identified above the CAA considers that the most likely abuses to occur are those of an exploitative nature. At Gatwick these are likely to manifest as either excessive pricing or abuses through service quality.
- 11.80 Excessive pricing is likely to occur directly in very much the scope of the United Brands test, with the airport setting charges that bear limited resemblance to the economic value of the service. This may occur either universally or in targeted price discrimination. Given the diversity of the airlines, their individually small shares of total passengers at Gatwick, and the fact that Gatwick for many airlines is just a single, albeit important, node in their networks it is likely that such discriminatory abuses may go undetected or unenforced.
- 11.81 Under regulation, abuses from a reduction of service quality are less likely to arise. As discussed in Chapter 9, recent surveys suggest that passengers are in general satisfied with the service they receive from GAL. It is unclear whether GAL's current service levels are attributable to the current regulation of the airport rather than competitive pressure. However given the airport's recent issue with resilience to adverse weather conditions, it may be more likely that any abuse may manifest itself in a lack of resilience.<sup>931</sup>

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<sup>931</sup> A number of reports have been published considering the impacts of severe weather resilience at UK airports including: The Quarmby report Oct & Dec 2010.

(<http://transportwinterresilience.independent.gov.uk/>),

the Transport Select Committee report May 2011.

(<http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtran/794/79402.htm> )

the Begg report on Heathrow, March 2011.

([http://www.baa.com/static/BAA\\_Airports/Downloads/PDF/BeggReport220311\\_BAA.pdf](http://www.baa.com/static/BAA_Airports/Downloads/PDF/BeggReport220311_BAA.pdf) )

CAA's reports ([http://www.caa.co.uk/docs/5/CAA%20review%20of%20snow%20disruption%20-%20Final%20Report%20-%20WEB%20VERSION%20\\_2\\_.pdf](http://www.caa.co.uk/docs/5/CAA%20review%20of%20snow%20disruption%20-%20Final%20Report%20-%20WEB%20VERSION%20_2_.pdf)) and

**Detriment to the user of air transport services (Consumer Detriment)**

- 11.82 The CAA considers that the consumer detriment from the GAL's market power is likely to take effect in a number of areas.
- 11.83 Excessive prices are likely to be passed through to users in the longer term and are likely to have an impact on their ability to travel. 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. Passengers will either suffer detriment from high prices or decide not to fly at all.
- 11.84 Where the prices are not directly passed through, this will have a direct impact on the profitability of the airline sector. This is likely to have an effect on the ability of airlines to innovate their product offer, and is also likely to reduce the viability of the routes offered. This would be likely to, ultimately, affect air transport users, as a reduction in choice of both airlines and the direct destinations available from the airport.
- 11.85 Likewise, it is expected that the ability to charge excessive prices by the airport may lead to degradation or stagnation in the services that the air transport users receive directly from the airport.

## Conclusion

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- 11.86 Based on the above the CAA considers that it is likely that competition law alone will not be sufficient to prevent the risk of GAL abusing its market power in the relevant markets. The reasons for this view include:
- *Ex ante* regulation has a number of advantages over competition law in opening up markets to competition where there is a dominant incumbent.

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<http://www.caa.co.uk/docs/5/CAA%20Issues%20facing%20passengers%20during%20the%20slow%20disruption%20FINAL.pdf>.

- The application of the relatively limited available competition law precedents for exploitative abuses, such as excessive pricing, is hard to predict. CAA considers that, given this uncertainty, cases in this area carry greater risks of failure compared to more common abuses such as predatory pricing and margin squeeze.
- Private actions, especially by passengers are likely to be challenging and complex given the lack of a direct contractual relationship with the airport and the likely low level of damage experienced by an individual passenger.
- The remedies available to the regulator via its power to impose and modify conditions in a licence are more comprehensive and forward looking in terms of scope than those available under competition law.

## THIRD PART: TEST C

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## CHAPTER 12

# Test C

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### Introduction

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- 12.1 This chapter sets out the CAA's assessment of test C of the market power test. It is structured as follows:
- a description of the legal framework for test C;
  - an assessment of the legal framework for accepting GAL's proposed commitments under the Act;
  - a description of the CAA's approach to assessing test C;
  - a summary of the CAA's initial views on test C;
  - an assessment of whether the ACR and AGR provides sufficient protection against the risk of abuse of SMP by the operator of Gatwick;
  - an assessment of the impact of GAL's proposed commitments and licence regulation on:
    - enforcement;
    - price;
    - efficiency;
    - service quality;
    - investment;
    - other potential benefits of licence regulation;
    - direct costs; and
    - other potential distortive effects; and
  - an overall assessment of whether the incremental benefits of licence regulation are likely to outweigh the adverse effects.

## Legal framework for test C

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12.2 As set out in the Act:

*“Test C is that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects”*<sup>932</sup>

12.3 The relevant operator is *“the person who is the operator of the airport area at the time the test is applied.”*<sup>933</sup>

12.4 Users of air transport services are defined in the Act as passengers or those with a right in cargo and includes future users of such services.<sup>934</sup>

12.5 The application of test C necessarily follows the assessment that has already been carried out in part under section 6: test A, whether the relevant operator has, or is likely to acquire SMP; and test B, whether or not competition law provides sufficient protection against the risk that the relevant operator may abuse that SMP. It therefore follows that test C will not fall to be considered unless both test A and test B are met.

12.6 The assessment of test C considers whether licence regulation in general would have net benefits rather than the impact of individual licence conditions. This is because the logical structure of the Act gives the CAA powers to decide what licence conditions to include after it has carried out the three market power tests. These conditions can go wider than the market power test, to include:

*“such conditions as the CAA considers necessary or expedient having 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 operation services (or for services that include airport operation services)”*, and

*“such other conditions as the CAA considers necessary or expedient having regard to the CAA’s duties under section 1”*.<sup>935</sup>

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<sup>932</sup> Civil Aviation Act, Section 6 (3).

<sup>933</sup> Civil Aviation Act, Section 6 (2).

<sup>934</sup> Civil Aviation Act, Section 69 (1) and (2).

<sup>935</sup> Civil Aviation Act 18 (1).

- 12.7 The requirements of test C have to be fulfilled within the wider statutory framework and the CAA's general duties under the Act. Section 1 sets out the CAA's general duty to further the interests of users<sup>936</sup> of air transport services and to do so, where appropriate, by promoting competition.
- 12.8 The CAA also has to have regard to the regulatory principles in section 1(5) and the duty not to impose unnecessary regulatory burdens in section 104 the Act. These provisions, in essence, build in a proportionality exercise to test C to ensure that *ex ante* regulation via a licence is only imposed where it is suitable, necessary and proportionate to the risk of abuse posed by the relevant operator.

## Accepting commitments within the legal framework of the Civil Aviation Act 2012

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### Commitments in lieu of a licence

- 12.9 As an alternative to a licence, GAL has proposed commitments as part of its Revised Business Plan (RBP).<sup>937</sup> These commitments, which GAL is proposing to include in its Conditions of Use, set out caps on airport charges, a service quality regime and commitments on consultation, investment, and operational and financial resilience. GAL considers that these commitments are suitable and sufficient for the CAA to conclude that GAL does not meet the market power test and to reach a negative market power determination in respect of the airport area at Gatwick under section 7 of the Act.

### Overall legal framework

- 12.10 The CAA is a statutory body whose powers are defined by legislation. There is no explicit provision in the Act for the CAA to accept commitments as part of carrying out its functions in relation to the regulation of airport operators with SMP. This contrasts with the

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<sup>936</sup> Users in this instance are passengers and those with an interest in cargo and include future users. In this document where it refers to passengers it also encompasses those with an interest in cargo and future users.

<sup>937</sup> GAL, January 2013, *Revised Business Plan*, [http://www.gatwickairport.com/Documents/business\\_and\\_community/Business%20plan/Gatwick%20ten%20year%20business%20plan.pdf](http://www.gatwickairport.com/Documents/business_and_community/Business%20plan/Gatwick%20ten%20year%20business%20plan.pdf)

Competition Act 1998 and the Enterprise Act 2002, both of which explicitly provide for the acceptance of commitments in lieu of further regulatory action.

- 12.11 Under section 6(5), test C requires a balancing exercise between the benefits of regulation against its adverse effects. The CAA also has to have regard to a number of matters under section 1 of the Act: principally the interests of the users of air transport services but also the need to promote competition and such matters as promoting economy and efficiency and observing certain regulatory principles. The CAA therefore needs to try and ensure that it acts proportionately when conducting the risk/benefit exercise required by test C. It therefore appears to CAA that it should view test C as affording it some discretion to consider an offer of commitments within the overall framework of test C and its duties under section 1 of the Act. The Act intends to create a safeguard against disproportionate regulation in the form of test C and consideration of an offer by an airport operator to moderate its conduct voluntarily would be consistent with that and would facilitate the CAA's task of reaching a conclusion on whether licensing offers the necessary and proportionate net benefits under test C.
- 12.12 However, given the lack of explicit statutory provision for accepting commitments in lieu of licence regulation, the CAA considers that it should exercise caution before reaching a conclusion that the promise of commitments should be a determinative factor as part of its consideration of test C. In particular given the element of discretion, the CAA would want to consider whether commitments would provide material benefits over licence regulation and would avoid imposing any adverse effects of their own.
- 12.13 CAA considers that it does, in principle, have the discretion to take commitments into account under test C as part of the assessment of the relative costs and benefits of regulation by licence. The CAA's discretion is not, however, unlimited but has to be exercised within the confines of the Act and the wider regulatory framework. In particular, the following factors seem relevant.

### **Prioritising the needs of users of air transport services**

- 12.14 The CAA's assessment of test C has to be carried out in a way that is consistent with its general duties in section 1 of the Act. The CAA's

primary duty, therefore, is to satisfy itself that any such assessment that involves effectively accepting commitments as an alternative to regulation must:

*“further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport services”*  
(section 1 (1))

- 12.15 Test C itself is also explicitly drafted in terms of assessing the benefits *“for users of air transport services”* – i.e. passengers and cargo owners, not the operator itself or its airline customers. The CAA will therefore have to ensure that it properly weighs the interests of end-users in its assessment of the commitments as an alternative to a licence.
- 12.16 An offer of voluntary commitments is likely to invoke the application of section 1(5) as there is potential for conflict between the requirements of different classes of users or between different priorities such as costs versus quality, investments and choice of services. Section 1(5) requires the CAA to further such interests as it considers best.
- 12.17 This suggests to CAA that it will need to see a clear justification as to why accepting voluntary commitments will better serve the primary objective than a licence which is backed up by regulatory enforcement mechanisms and that can also include terms aimed not just at market power but also such other terms as CAA considers necessary and expedient having regard to its duties under section 1. This is particularly so where the voluntary undertakings would be in a contractual form which is not enforceable by either the CAA or by the users of air transport services.<sup>938</sup>
- 12.18 In particular, CAA needs to assess the purported benefits of commitments and any negative effects from the perspective of those end user passengers and cargo owners. Neither the airport operator nor the airlines are singled out as the beneficiaries of CAA’s general section 1 duty.

### The duty to promote competition

- 12.19 Where possible CAA must also approach its functions in relation to

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<sup>938</sup> Given their diffuse nature it may be difficult for individual end-users to undertake enforcement action and so it is the lack of CAA’s ability to enforce on their behalf that is likely to be most detrimental to end-users interests.

test C in a way that will:

*“promote competition in the provision of airport operation services”*  
(section 2 (2))

- 12.20 As set out above, test C is the last part of the MPT after the CAA has identified SMP under test A and concluded, under test B, that competition law provides insufficient protection against that SMP. There is therefore an in-built presumption, by this stage, that something more than competition law is required. Test C requires that this presumption should be further tested by reference to the relative costs and benefits of licence regulation. It is against that backdrop that the CAA needs to consider whether the commitments in themselves alter the assessment of the benefits of regulation in terms of addressing the risks already identified under tests A and B.
- 12.21 The CAA is also under a direct duty under EU law to ensure the effectiveness of Article 102 TFEU<sup>939</sup>, and so must ensure that any mechanism under test C achieves that end. The CAA must therefore be confident that the prevention of a strengthening of market power through licence regulation can be replicated through a mechanism involving purely contractual constraints.

### Balancing of better regulation principles

- 12.22 CAA must also ensure that its regulatory activities are (*inter alia*) *“transparent, accountable, proportionate and consistent”* as well as *“targeted at cases where action is needed”* (section 1(4));
- 12.23 There is, as highlighted above, no explicit provision for accepting commitments on the face of the Act. To accept a set of commitments on an ad hoc basis could be seen as being at odds with the requirements of transparency and accountability as it would necessarily introduce a degree of uncertainty around how such a course of action sits with CAA’s statutory functions. The CAA would have no ongoing role in overseeing contractual commitments and could be viewed as having decided against regulatory oversight in a way that was not explicitly envisaged under the statutory scheme.
- 12.24 There would also be a risk of introducing a degree of inconsistency

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<sup>939</sup> Treaty of the functioning of the European Union, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:en:PDF>

and disparate treatment between airport operators if commitments are accepted informally on a case by case basis.

- 12.25 Balanced against this, is the need under section 1(4) to be proportionate, and for regulatory activities to be targeted only at cases where regulation is needed. The CAA is also under a duty not to impose unnecessary regulatory burdens on airport operators under section 104 of the Act. If commitments are offered in a form that could reasonably be regarded as offering a robust alternative to licence regulation, it would, in principle, be open to the CAA to conclude that the commitments are a more proportionate means of regulation than the imposition of a regulatory licensing regime.
- 12.26 The CAA's view is that the principles embedded in section 1(4) would require a strong case establishing that regulation would be disproportionate to the risks, and that adopting GAL's commitments would be a more suitable and effective alternative. That is particularly so when the CAA has already found that the various forms of *ex post* control offered by competition law are insufficient as a safeguard (i.e. test B).

### Broader legal considerations

- 12.27 The CAA (as an organ of the State) is under a direct duty to ensure the effectiveness of EU law and must avoid taking steps that might jeopardise the attainment of general EU objectives.<sup>940</sup> This means ensuring that regulatory decisions do not cut across the fundamental principles of EU law such proportionality and equal treatment.
- 12.28 This duty also means keeping in line with the objectives of Article 102 TFEU which extend not just to *ex post* punishment but also *ex ante* prevention of a strengthening of market power.
- 12.29 More particularly, the CAA must ensure that commitments are consistent with and do not undermine the aviation specific EU obligations set out in the ACD and GHD.
- 12.30 In relation to the ACD, the CAA will need to satisfy itself that, for instance, the commitments are consistent with the requirement that charges are non-discriminatory (Article 3 ACD), transparent (Article 7 ACD), provide effective consultation over changes to charges (Article

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<sup>940</sup> Article 1(3) TFEU.

6 ACD) and, importantly, provide an opportunity for negotiation between the airport operator and users over quality standards (Article 9 ACD).

- 12.31 The CAA also has to be mindful of the role its new licensing powers have in delivering compliance with requirements of the ACD in relation to resolving disputes over airport charges. The ability for the CAA to carry out market power assessments and take appropriate regulatory action in relation to pricing in response to the findings is necessary to fulfil the requirements for the current UK derogation from the dispute resolution obligations on national independent supervisory authorities under Article 3 and 4 of the ACD. The UK derogation is based on the fact that there is a mandatory procedure under national law whereby the independent supervisory authority (namely the CAA) determines, in response to requests from interested parties, whether such an airport is subject to effective competition. Whenever warranted on the basis of the review, airport charges, or their maximum level, are determined or approved by the independent supervisory authority. This was formerly delivered by section 40 of the Airports Act 1986 (as amended) and is now delivered by the regulatory regime set out in Part 1 of the Act.
- 12.32 The ACD, therefore, imposes an ongoing requirement on the UK to have a regulatory system capable of addressing competition concerns and responding with price controls where appropriate. Any decision in relation to commitments within the framework of Part 1 of the Act has to be consistent with that ongoing obligation.
- 12.33 In relation to the GHD, the commitments will need to be consistent with the requirement placed on airports to ensure that the conditions and fees relating to access to groundhandling services are relevant, transparent, objective and non-discriminatory (Article 6 and 16 GHD). The CAA has an ongoing duty to hear appeals against measures which breach this obligation under the UK Groundhandling Regulations. Any regulatory decision CAA takes in respect of commitments will need to be compatible with its role as an appeal body under those Regulations.

### Conclusions on legal factors

- 12.34 The CAA's conclusion is that there is some margin of discretion for it to assess an offer of commitments as a relevant factor in weighing the



counterfactual to the cost/benefit analysis required in test C. However, a considerable degree of caution should be exercised because of the following factors: the lack of clear statutory grounds to do so; the need to ensure that test C is applied in a way that is compatible with its section 1 duties; and the need for the CAA to carry out its functions in a way that is compatible with wider European law rules (both competition and sectoral).

- 12.35 The CAA's view is that any offer of commitments would therefore have to be very carefully assessed by reference to the risks posed by the operator holding SMP and, in particular, whether commitments could be fairly said to offer a better way of addressing those risks, particularly in relation to pricing, than a licence issued under the Act. Given the issues identified above, the CAA considers that the commitments must offer net benefits to users over and above those presented by a licence so that they amount to a more proportionate means of constraint on the operator's SMP.
- 12.36 This seems to the CAA to require it to be satisfied that the commitments contain sufficient constraints on GAL's ability to abuse the SMP identified in our findings under test A. This means examining both the enforceability of the commitments and the precise nature of the constraints that they would place on GAL's conduct.

## The CAA's approach to test C

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- 12.37 The assessment of test C considers the incremental benefits and costs of regulating an airport operator by way of a licence, which seeks, via appropriate conditions, to mitigate the risk of the abuse of SMP. In general the abuse of SMP can arise in many areas, but for the purposes of test C, the CAA's assessment focuses on the areas that are most commonly recognised as affecting users' interests:
- price;
  - efficiency (which affects future prices);
  - service quality, in terms of the range and level of services; and
  - investment, which in capital intensive industries such as aviation, can impact on future levels of service quality.

- 12.38 The assessment also considers areas where specific additional concerns have been identified in relation to the behaviour of GAL, in particular to discrimination and a refusal to supply.
- 12.39 As part of this assessment the CAA has considered whether there would be a differential impact across the LCC/charter and FSC/feeder markets identified for GAL. Under test A the CAA is minded to conclude that GAL has SMP in both markets. In addition, many passengers travelling via LCC/charter airlines use the same airport operation services as those in FSC/feeder services. Consequently it would seem reasonable to presume that the same form of licence regulation, if any, would apply to both markets. The CAA has therefore considered the regulation of GAL as a whole, while taking account of the potential benefits of service differentiation across markets, where appropriate.
- 12.40 The assessment also considers whether users may benefit from other additional licence requirements that are not directly related to market power but that the CAA may consider necessary to fulfil its duties under section 1, for example on operational resilience<sup>941</sup>.
- 12.41 Against the potential benefits, the assessment has considered the adverse effects of licence regulation in terms of:
- the direct costs to the CAA, which are paid for by the industry and are likely to be passed on to end-users in the form of higher charges;
  - direct costs imposed on regulated operators (including, for example, manpower, accounting and other expenditure) which are likely to be passed on to airlines and ultimately, end-users, and
  - the distortive effects such as:
    - management distraction, for example from a focus on the regulator and maximising the potential benefit from a regulatory settlement rather than on the needs of customers;
    - distortions to incentives, for example it has been argued that a RAB based licence regulation can create over investment;

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<sup>941</sup> See section 18 of the Act.

- crowding out of a more commercial approach, for example in the absence of licence regulation the airport operator and airlines may enter into bilateral contracts;
- distortions to competition more widely, for example if a licence regulation included a price cap set too low then this could distort competition and investment at other airports; and
- other potential distortive effects such as those on consumers, for example through regulation setting service quality standards higher than demanded by customers.

- 12.42 These potential effects need to be considered in the context of what would happen in the absence of licence regulation, namely that the impact on users would be left to market forces, where, as identified under test A, the airport operator is likely to have SMP.
- 12.43 Test C entails a balancing exercise where the benefits are weighed against the adverse effects to ascertain whether licence regulation, as a whole, has net benefits. Consequently the impacts of licence regulation have been assessed in aggregate rather than assessing the impact of individual measures.
- 12.44 The incremental impact (i.e. the benefits and adverse effects) of licence regulation will depend on the form of regulation. Different forms of regulation will address possible abuses of SMP differently and will have different potential adverse effects. However the purpose of test C is to ensure that the CAA is satisfied that there is a form of licence regulation that has net benefits compared to the situation where there is no licence regulation. The purpose of test C is not to specify exactly the precise form of licence measure that is most appropriate<sup>942</sup>. This assessment therefore does not require the CAA to set out in detail how precise licence conditions might operate, but rather to consider whether key forms of licence regulation that might be applicable to GAL may have net benefits. Based on the Q6 policy update, the following forms of regulation have been considered.<sup>943</sup>

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<sup>942</sup> The CAA will set out its decision on the most appropriate form of regulation at each airport operator subject to licence regulation in January 2014.

<sup>943</sup> Further details on these forms of regulations are contained in the Q6 Policy Update, CAA, May 2012. This document can be accessed at: <http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf>

- Flexible or enhanced RAB-based price caps – where the current RAB approach is amended to increase flexibility, for example through a flexible capital programme or a different duration to five years.
- Long run incremental cost (LRIC) price caps – where a price cap is established based on the incremental unit cost of additional output over the long run when all costs are assumed to be variable.
- Pegging price caps to tariffs at comparator airports – where the price cap is pegged to a level (and/or changes) in the charges of an index of comparator airports.
- Price cap based on some other basis such as constant in real or nominal terms or based on voluntary undertakings from the airport on the future price path (in this case GAL's proposed commitments) which is incorporated into a licence.
- Price monitoring – where the price is monitored *ex-post*, with regulatory discretion on when to intervene (where airport prices or performance could harm user interests) or triggered by pricing or quality meeting certain thresholds requiring a detailed review by the regulator.

12.45 Where price caps are included in the form of licence regulation, the CAA has considered whether there would be any incremental impact<sup>944</sup> if these price caps were based on a default settlement, where the price cap is based on a minimum level of service with airlines able to purchase a higher level of service quality as required. The CAA's assessment of the applicability of these forms of regulation to GAL is set out in its Q6 initial proposals.

12.46 Where possible, the assessment has sought to quantify the impact of licence-based regulation. This is easier for some measures, such as the CAA's direct costs of RAB-based regulation, than others, such as the impact of future alternative forms of regulation where there are practical difficulties in defining the precise effects in the abstract given that they are not currently in place. The assessment also has to take into account the incremental benefits and adverse effects of licence regulation over and above other forms of regulation that currently exist, most notably the Airport Charges Regulations 2011 (ACR) and

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<sup>944</sup> I.e. the incremental impact above the method for setting the price cap such as RAB or LRIC.

Airports (Groundhandling) Regulations 1997 (AGR).

- 12.47 Under test C, the benefits of a licence have to be considered against the 'counterfactual' of the situation in the absence of a licence and the existing constraints upon the ability of the relevant operator to abuse its SMP. The existing constraints may, in theory, arise as a result of competitive forces in the market or as a result of other forms of regulation or legal restraint (such as the ACD, GHD or competition law). Where GAL has proposed commitments as a potential form of constraint, the CAA considers that it is entitled to take account of them as part of that counterfactual under test C. In such a situation, the CAA needs to assess the degree of additional benefits and costs offered by licensing over and above the situation under the proposed commitments. This assessment needs to take into account the benefits of the commitments for end users, for example in terms of protection against the potential abuse of SMP, and any negative effects of the commitments on end users. For licence regulation to be beneficial it would need to have incremental net benefits for end-users over the likely results of GAL's proposed commitments.
- 12.48 It should be noted that GAL's proposal to incorporate voluntary commitments into the Conditions of Use creates a new regime that is untested. The CAA has taken this uncertainty into account when assessing the relative benefits of the proposed alternative to licence regulation.
- 12.49 Where appropriate, the assessment draws on the previous assessments on de-designation of Stansted airport undertaken by the CAA in 2007<sup>945</sup> and DfT in 2008<sup>946</sup> as these considered many of the same issues raised by test C. However it is important to emphasise that this assessment takes place under different legislation and under different circumstances.

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<sup>945</sup> De-designation of Manchester and Stansted airports for price control regulation: The CAA's advice to the Secretary of State, July 2007. This document can be accessed at:

[http://www.caa.co.uk/docs/5/ergdocs/de-designation\\_advice.pdf](http://www.caa.co.uk/docs/5/ergdocs/de-designation_advice.pdf)

<sup>946</sup> Department for Transport, 2007, Decision on the regulatory status of Stansted airport, <http://webarchive.nationalarchives.gov.uk/20081231144027/http://www.dft.gov.uk/consultations/archive/2007/consultstatusstansted/decisionstanstedairport.pdf>

## The CAA's initial views on test C

12.50 The CAA's initial views on test C were set out in the Q6 policy update document<sup>947</sup> and are set out in figure 11.1 below.

### Figure 12.1: CAA's initial views on test C – May 2012

The CAA acknowledged that it was difficult to reach a firm conclusion on test C in the absence of a clear package of measures developed for regulating each of the airports. However, the CAA considered that the Bill (and its licensing regime) would significantly help to improve the situation compared to current legislation because it would:

- enable key passenger priorities to be addressed, e.g. operational resilience;
- allow regulation to be more tailored to the circumstances of the airport and avoids the 'one size fits all' 5-year price cap approach under the current AA86;
- allow more proportionate forms of regulation, such as price monitoring, and regulation to be time limited and more flexible;
- reduce potential investment distortions, for example by allowing a rolling capex programme and 'at risk' projects;
- allow variation in duration, with no need to necessarily follow a five-year price cap; and
- enable a review of issues within the price control period, and not just once every five years.

Compared to the context for the CAA's unsuccessful de-designation request for Stansted in 2007, the CAA considered that the potential distortion and costs of regulation may be lower now given that airlines at Stansted are not being asked to fund the significant costs of a new runway and terminal through a Regulatory Asset Base (RAB).

Given its initial views on test A, and exploratory views on Tests B and C, the CAA does not currently consider that any of the airports ought to be removed from economic regulation before April 2014. The CAA will, however continue to keep the situation under review and engage with stakeholders on the issues.

The CAA's initial view is that there is a strong case for continued economic regulation at

<sup>947</sup> Paragraphs 4.20 to 4.23 of Q6b Policy Update, CAA, May 2012. This document can be accessed at: <http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf>

Heathrow and to a less extent at Gatwick for a time beyond April 2014. Given the relatively weaker market position of Stansted compared to the other two airports, the CAA's initial view is that if it confirms that Stansted has substantial market power, there is a reasonable prospect that some form of economic regulation beyond April 2014 will be required, although the CAA recognises the need to ensure that continuing regulation creates more benefits than costs and this will influence the choice of regulatory approach

Source: CAA Q6 Policy Update

## Airport Charges Regulations

12.51 GAL will remain subject to the ACR regardless of whether they are removed from the licensing regime under the Act.<sup>948, 949</sup> The ACR came into effect in November 2011 which reflects the provisions of Directive 2009/12/EC of the European Parliament and of the Council of 11th March 2009 on airport charges (“the directive”). The ACR provides airlines (but not directly passengers) with a number of protections, which include the following requirements:<sup>950</sup>

- airport operators must consult annually with airlines on airport charges and service quality;<sup>951</sup>
- airport operators must provide airlines with information about the overall cost structure and revenues relevant to charges;<sup>952</sup>
- four months’ notice of changes to the system or level of airport charges or to the quality of service associated with an airport charge;<sup>953</sup>

<sup>948</sup> The airport charges directive can be found at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:070:0011:0016:EN:PDF>

<sup>949</sup> The airport charges regulations can be found at: [http://www.legislation.gov.uk/ukxi/2011/2491/pdfs/ukxi\\_20112491\\_en.pdf](http://www.legislation.gov.uk/ukxi/2011/2491/pdfs/ukxi_20112491_en.pdf)

<sup>950</sup> The Regulations apply to airport with over 5m annual passengers. Heathrow, Gatwick and Stansted are all subject to the Regulations.

<sup>951</sup> Article 6 (1) of the directive, regulation 8 (1) of the regulations.

<sup>952</sup> Article 7 (1) of the directive, regulation 8 (2) of the regulations.

<sup>953</sup> Article 6 (2) of the directive, regulation 9 (1) of the regulations.

- airport charges may differentiate between airport users provided the reason for the differentiation is relevant, objective, and transparent,<sup>954</sup> and a reason may (but need not) relate to quality, scope or costs of services associated with the airport charge;<sup>955</sup> and
- airport operators must consult airlines on major infrastructure projects.<sup>956</sup>

12.52 If an airline considers that an airport operator has breached one of these requirements, it can take action in the Courts to recover loss or damage, or complain to the CAA. If the CAA receives such a complaint it must investigate and can impose a compliance order on the airport operator and order any damage or loss be remedied.

12.53 There are, however, a number reasons for considering that the ACR may not provide sufficient protection for passengers<sup>957</sup> and other users of Gatwick airport, in a situation where GAL is found to have SMP:

- The ACR does not require charges to be cost reflective. The ACR requires that where charges are varied across users, such modulation is based on transparent criteria. The criteria can include costs and quality of service but there is no requirement for the criteria to include these issues. Furthermore the ACR does not seek to control the overall level of charges, just the differentiation of charges across users.<sup>958</sup> Consequently the ACR is unlikely to provide sufficient protection against the risk of excessive prices<sup>959</sup> given the degree of market power held by GAL.

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<sup>954</sup> Article 3 of the directive, regulation 14 (3) of the regulations.

<sup>955</sup> Article 10 (1) of the directive, regulation 14 (4) of the regulations.

<sup>956</sup> Article 8 of the directive, regulation 27 of the regulations.

<sup>957</sup> “Passengers” refers to current and future passengers and those with a right in cargo.

<sup>958</sup> Paragraph 3.10 of the CAA’s emerging thinking on ACD implementation states that licence regulation is able provide additional protection against anti-competitive behaviour above that provided by the ACD. It is also worth noting that DfT did not take the opportunity afforded by the ACD to allow the CAA to adjudicate on disputes in airport charges as the CAA has the opportunity to “examine whether such airports are subject to effective competition” and whether they should be subject to licence regulation, although the CAA does have power to assess complaints on whether airports are complying with the ACD.

<sup>959</sup> The ACR includes provisions for overall cost transparency, however there is no requirement for



- The ACR is likely to provide limited incentives for the airport operator to be efficient. Recital (1) of the preamble to the directive states that airports should endeavour to operate on a cost efficient basis. The mechanism for how this should be achieved is not discussed. One way incentives to be efficient might increase is through the requirement for increased cost transparency.<sup>960</sup> Under the ACR, the airport operator is required to provide details of the overall cost structure and details of costs associated with different airport charges. This information, however, is unlikely to be sufficiently detailed to allow airlines to robustly challenge the efficiency of airport costs to gain sufficient assurance where an airport operator has SMP, like GAL. Consequently the ACR is likely to provide only limited incentives for GAL to be efficient.<sup>961</sup>
- The ACR is likely to provide limited incentives to provide an efficient level of service quality where an airport operator has SMP.. The ACR requires the airport operator to consult on the level of charges and, where appropriate, service quality. It also allows the airport operator and airlines to negotiate levels of service quality.<sup>962</sup> However, where an airport operator holds SMP these negotiations may not approximate those that would be conducted in a competitive market and so the level of service quality and charges may not be efficient.
- The ACR may provide some incentives to invest. The ACR requires an airport operator to consult on investment. However there is no requirement on an airport operator to undertake an efficient level of investment. Consequently where an airport operator has SMP, it may undertake investment inefficiently (as the costs can be passed on to users) or delay the required investment, reducing future service quality.

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charges to be based on a single (or dual) till basis, or the appropriate level of profitability.

<sup>960</sup> Article 7 of the ACD and Article 8 of the ACR.

<sup>961</sup> See paragraph 5.9 of CAA emerging thinking on ACD implementation, CAA, December 2010. This document can be accessed at:

<http://www.caa.co.uk/docs/5/ergdocs/20101207ACDEmergingThinking.pdf>

<sup>962</sup> Article 9 of the directive and Article 12 of the regulations.

- The ACRs impose a duty on the CAA to investigate whether any of the obligations in the ACRs have been breached only where there has been a complaint by a person on whom airport charges are levied (that is, an airline) or another airport. While the CAA could investigate at its discretion on a complaint from another party such as a user, it has no duty to do so.
- The CAA can make a compliance order and can take action to enforce such an order. This can cover remedial action aimed at 'any person'. However, it is likely to be difficult to make an order aimed directly at any losses sustained by end users because of the challenge of identifying those affected and quantifying their losses. The more likely outcome would be a compliance order that contained remedial measures aimed at rectifying the losses caused to a qualifying complainant. This might, for example, be aimed at restoring any overcharging that occurred as a result of charges that were found to be discriminatory under the ACR.

12.54 The degree to which the ACR provides adequate protection to airlines will, to some extent, depend on the degree of market power found in relation to the airport. The CAA's assessment of test A was 'minded to' conclude that, in relation to both the LCC/charter and FSC/feeder passenger markets, GAL has SMP. Under test B the CAA identified that the most likely potential forms of abuse are excessive prices and/or reductions in service quality. Consequently there may be a need for additional regulation, over and above the ACR, to provide adequate protection for both passengers and cargo owners. This would be consistent with our primary duty under the Act to further the interests of users of air transport services in the range, availability, continuity, cost and quality of airport operation services.

## Airports (Groundhandling) Regulations

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12.55 The Airports (Groundhandling) Regulations SI 1997/2389<sup>963</sup>, (AGR) transpose the European Groundhandling Directive 96/67 into the law in England and Wales. Groundhandling is defined in the Annex to the Directive and covers a number of activities including check-in,

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<sup>963</sup> The Airports (Groundhandling) Regulations 1997, Statutory Instrument 1997, 2389, <http://www.legislation.gov.uk/ukSI/1997/2389/made>

handling baggage, cargo and mail, re-fuelling aircraft, and transporting passengers and crew to aircraft.

- 12.56 Under the AGR, airport operators with more than 2 million annual passengers cannot restrict the numbers of self handling airlines or third-party groundhandlers that operate at the airport without a determination from the CAA. There are currently no restrictions on the number of handlers in the UK.
- 12.57 Where handlers use aircraft facilities, such as check-in desks, baggage belts and fuel hydrant systems, the airport operator must set its charges according to relevant, objective, transparent and non-discriminatory criteria. The CAA can investigate alleged breaches of the AGR following a complaint.
- 12.58 While the AGR provides some safeguards for users of groundhandling facilities in terms of consultation and equal treatment, the protections for passengers and cargo owners (as users of air transport services) is likely to be limited in a situation where the relevant airport operator has SMP. For example, there is no requirement in the AGR for charges to be cost based<sup>964</sup> and therefore the protection against the risk of excessive or unfair pricing may be limited, although in practice case law has tended to focus on the cost-reflectivity of charges. Furthermore, groundhandling facilities are only a small part of overall airport operation services and so the additional protection is likely to be required where an airport operator has SMP. As with the ACR it may be difficult to provide direct relief for end-users.

## Assessment of GAL's proposed commitments and licence regulation

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### GAL's proposed commitments

- 12.59 Under test C of the market power test, the CAA must consider whether, for passengers and cargo owners, the (incremental) benefits of licence regulation outweigh its potential adverse effects. GAL's commitments could in principle be relied on within this legal

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<sup>964</sup> According to the case-law to date, Regulation 16, Airports (Groundhandling) Regulations, 1997. only requires that charges are based on relevant criteria and calculated in an unbiased manner. However, in practice, the CAA has tended to focus on the cost reflectivity of charges.

framework as counterfactual evidence to support a conclusion that it was not appropriate to introduce licence regulation. However, in the absence of explicit provision within the scheme of the Act to accept commitments as an alternative to regulation of an operator with SMP, CAA would need to be satisfied that accepting commitments was a suitable exercise of its discretion under the CAA 2012. Most critically, such a course would need to be consistent with CAA's statutory duties under section 1 of that Act. In particular, CAA would need to be satisfied that the commitments proposed address the risks to the interests of passenger and cargo owners from the abuse of the SMP identified under test A in a way that compares favourably with addressing these risks via a regulatory licence. It would also need to ensure that the commitments do not result in adverse effects over and above those that would be created by licence regulation.

- 12.60 The CAA considers that GAL's voluntary commitments are a positive step. The commitments could potentially provide a number of safeguards against the potential abuse of SMP, which are similar to those normally found in licence regulation. The key features of GAL's proposed commitments are set out in figure 11.2. Further details are set out in appendix 1 of GAL's RBP and appendix 2 of this document.

<sup>965</sup>

**Figure 12.2: Key features of GAL's airport commitments**

Issue	Commitment proposal
Contractual basis	GAL commits to include the commitments in the Conditions of Use
Duration	7 years, with GAL providing 2 years notice if it wishes to extend commitments
Change mechanism	Following consultation and if agreed by GAL and at least 51% of airlines paying published charges
Price	Price cap on airport charges based on published charges with discounts only available in bilateral contracts not included. No regulation of other charges. Variations to price cap for changes in security costs, second runway development and allow under and over recovery to be balanced over the

<sup>965</sup> GAL, January 2013, *Revised Business Plan*, [http://www.gatwickairport.com/Documents/business\\_and\\_community/Business%20plan/Gatwick%20ten%20year%20business%20plan.pdf](http://www.gatwickairport.com/Documents/business_and_community/Business%20plan/Gatwick%20ten%20year%20business%20plan.pdf)

	seven years
Consultation	Consult on charges in accordance with the Airport Charges Regulations (ACR) and publish pricing principles (initial version included in commitments)
Service quality regime	Same rebate and bonus scheme as Q5, with bonus scheme extended to cover all elements and to be equal in scale to rebates at 7% of revenue at risk. Airfield availability measure to replace aerodrome congestion charge and airline service quality targets on check-in and arrivals bag performance, which would be funded by netting off airport rebates.
Investment	Consult (in accordance with ACR) and publish rolling five-year investment plan.
Operational resilience	Develop and maintain an operational resilience plan and use best endeavours to minimise detriment to users
Financial resilience	Not to take action to lose investment grade rating and provide an annual confirmation of adequate financial resources
Accounts	Publish annual statutory accounts

Source: CAA analysis of GAL RBP

12.61 GAL has indicated that these commitments would be combined with bilateral contracts for some individual airlines, and would provide protection to airlines that choose not to enter into bilateral contracts. Bilateral contracts may be more likely with airport commitments than under a traditional price cap as the commitment is longer term (7 years compared to a traditional 5 year price cap). Price cap regulation has tended to be based on five year control periods as regulators have felt that this is a long enough period to provide appropriate incentives on the regulated company to outperform, while providing certainty for customers over the charges that they pay, and being short enough to reflect the difficulties in forecasting costs and revenues over long time horizons.<sup>966</sup> GAL may feel able to provide greater surety under a commitments and contracts approach as it may be able to reduce its forecasting risk, for example by obtaining volume commitments from airlines under bilateral contracts. As commitments could be over a longer duration and would be between the airport and airlines rather than through the regulator, this would reduce the risk to GAL and the airlines concerned that the terms offered in a typical 10

<sup>966</sup> This may not necessarily be the case for all types of licence regulation, for example the greater flexibility available under price monitoring may allow a longer duration control period. A commitments and licence regime may also not need to be limited to five years.

year bilateral might not be consistent with regulation over more than one control period.

- 12.62 Airlines and passengers at Gatwick are more diverse than at other airports subject to economic regulation. It is therefore unlikely that “one size would fit all” and the commitments may provide benefits over a licence in the form of additional flexibility, for example given the greater likelihood of bilateral contracts. GAL has argued that a combination of airport commitments and bilateral contracts would further the interests of passengers better than regulation as it could be tailored to the business needs of individual airlines and their passengers, providing greater flexibility and promoting competition. GAL states that there could also be advantages from a reduction in complexity and a refocus of relationships towards airlines and away from the CAA.
- 12.63 The CAA’s understanding is that GAL has been discussing bilateral contracts with some airlines, however, progress has been mixed and no bilateral contracts have so far been agreed. There is no guarantee that bilateral contracts will be agreed going forwards. It is also unclear whether such contracts would only be agreed if commitments rather than licence regulation were in place; a licence under the Act need not place restrictions on the making of bilateral contracts. There may also be benefits from introducing licence regulation earlier rather than later if commitments were found to be ineffective, as there would be less risk of cutting across any bilateral contracts that may have developed. In any event, the CAA’s duties under the Act direct it to act in the interests of all users of airport transport services.<sup>967</sup> Bilateral contracts may only be agreed with some airlines. The CAA’s assessment has accordingly focused on the protections in the commitments rather than any additional benefits that might occur from bilateral contracts.
- 12.64 The following sections therefore consider the protections provided by the commitments against the risk of abuse of SMP, and the incremental benefits and adverse effects, if any, from licence regulation.

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<sup>967</sup> Under section 1 (5) if the CAA considers that there is a conflict between the interests of different classes of user, or between the interests of users in different matters, its duty is to carry out the functions in a manner which it considers will further such of those interests as it thinks best.

## Enforcement of commitments via the Conditions of Use

- 12.65 For commitments to be an effective substitute for licence regulation they must be clear and enforceable so that airlines and other stakeholders have confidence that the benefits GAL say would accrue from the commitments would be delivered in practice. The benefits must accrue to users (i.e. passengers and cargo owners); whether this regime is advantageous or convenient to GAL and its commercial counterparties is irrelevant.
- 12.66 GAL has proposed that the airport commitments are included within its Conditions of Use and are therefore available to all airlines using the airport. This raises two questions in relation to enforcement:
- Whether the airlines and users can effectively enforce the Conditions of Use; and
  - Whether the resulting contractual framework operates to constrain GAL as an operator holding SMP to the degree necessary to protect the interests of passengers and cargo owners.

### Are the Conditions of Use a contract?

- 12.67 GAL's Conditions of Use have historically been "one-sided" in that they have set out the obligations on airlines in terms of the prices to be paid for access to the airport as well as limiting the airport's liabilities in the event of damage to aircraft while on airport land. The current Conditions of Use at Gatwick state that "*The use of any facilities at the airport whether airside or landside other than as a passenger constitutes acceptance of these Conditions of Use*". This suggests that GAL regards any airline conduct amounting to "use" (i.e., landing at the airport) as constituting acceptance of the terms of the "contract". These factors might raise issues of whether the "contract" is legally enforceable.
- 12.68 GAL has stated that there is well established legal precedent establishing that the Conditions of Use are a contract between GAL and the users of the airport. GAL is proposing to extend the Conditions of Use to include obligations on the airport in terms of maximum prices, service and investment, and so it does not see the contract as one-sided. The CAA considers that the Conditions of Use are in principle capable of amounting to a binding contract.
- 12.69 If the Conditions of Use are a contract then they should be

enforceable under normal contractual law. Airlines at competitive airports are content to rely on bilateral contracts and some airlines have been keen to take forward discussions on bilateral contracts with GAL. In theory therefore the commitments should be enforceable. However there could be concerns over the effectiveness of the threat of commercial litigation to enforce the commitments, where the airport operator holds SMP. Parties may be reluctant to litigate for fear of damaging their commercial relationship with GAL or of bearing the risk of an adverse costs order in the event that the litigation was unsuccessful. Smaller airlines may hesitate to commit unpredictable levels of resource into such private enforcement action. The CAA notes that GAL's SMP has not stopped airlines, for example FlyBe and Ryanair from pursuing cases under Section 41 of the 86 Act or the AGR although it is not clear whether these are perceived as presenting comparable risks to taking action to enforce terms of the Conditions of Use. Much is likely to rest on the enforceability of the terms in the Conditions of Use and the costs of enforcement.

### **Enforcement of the terms in GAL's proposed Conditions of Use incorporating Commitments**

- 12.70 As the Conditions of Use are capable of being a contract the critical question therefore becomes whether the terms in the Conditions of Use and the commitments within them are sufficiently clear, balanced and comprehensive to be realistically enforceable by airlines and their customers so as to protect their legitimate interests.
- 12.71 The CAA has identified a number of concerns as regards the enforcement of the commitments as currently proposed by GAL: that is, as a set of promises in relation to conduct incorporated into the Conditions of Use.

### **Balance of obligations**

- 12.72 The Conditions of Use place a series of obligations on airlines and there is insufficient assurance they these would be appropriately matched by appropriately demanding obligations on GAL. Much would depend on the standards (both in terms of scope and content) to which GAL will ultimately commit as regards the provision of facilities under the Conditions. There is nothing in the Conditions generally which sets out how and to what level GAL is to provide the facilities covered by the Conditions. While it is envisaged that there will be an



annex which sets out the thresholds and levels of service quality penalties and bonuses, there is nothing to define the facilities that GAL will deliver and that failure will be a breach of the conditions and actionable by any parties affected.

### Unilateral variation or contracting out

- 12.73 The existing terms in the Conditions of Use reserve the right to GAL to unilaterally vary terms or to contract out of terms. The proposed commitments with regard to service quality and price are subject to a consent process but these are nonetheless set within an overall contractual framework which allows GAL at its sole discretion to alter the Conditions of Use. This allows GAL the freedom to introduce new terms or alter existing terms in ways that may undermine the expected protection of the actual commitments. It also means airlines have no certainty about the future form of their contractual obligations particularly where there is SMP in the hands of the other party to the contract.
- 12.74 GAL is free to contract out of any terms of the conditions which, creates a further notable imbalance in the rights and obligations of the parties to the conditions to the advantage of GAL.
- 12.75 The conditions also give an unconditional right to GAL to close the airport or restrict access to passengers without incurring liability to its airline customers. When viewed in the context of ensuring operational resilience in the interests of users, this seems to give GAL considerable freedom to act independently of those interests, should it have a sufficient incentive to do so.

### The position of passengers

- 12.76 CAA must, under section 1(1) of the Act, apply test C, including the evaluation of the offer of commitments, in a manner which will further the interests of users of air transport services (i.e. passengers and cargo owners). The commitments contain no obligations directed specifically at passengers and it does not appear to the CAA that end users would have any right to enforce such obligations that are placed on GAL with the ultimate aim of protecting their interests. Passengers would therefore need to rely on airlines to enforce their interests. As stated in the Q6 Policy Update, the CAA has a working assumption that in many, but not all, cases the interests of airlines and passengers are aligned. Airlines purchase services from the airports

for charges set by the price control, given these services feed into the competitive offering the airlines make to their customers, it is reasonable to adopt a working assumption that the airlines will want the price and quality of these services to reflect their passengers' requirements. Stakeholders have identified a number of areas where interests might not align:

- Some current airlines may place insufficient weight on the interests of future passengers (GAL has raised this as an issue in relation to capital expenditure schemes) and passengers that are either not their core target market, or smaller passenger sub-groups whose particular needs do not represent a commercially attractive proposition, for example some passengers with reduced mobility.
- Some airlines may put more focus on passengers at certain points in their journey. For example, a passenger having to queue at the airport during the departures process is more problematic for the airline than a delay once they have disembarked on arrival. Both these eventualities are likely to be matters on which passengers would like to see improvement.
- Major disruption events may give rise to misaligned incentives among the various parties which may not result in the interests of passengers being put to the fore.

12.77 The absence of any direct enforceability for passengers raises a concern that the commitments do not adequately protect their interests when compared with a licence overseen by a regulator with specific statutory duties framed around user interests.

### Service quality

12.78 GAL envisages offering a percentage rebate for failures in service quality as an incentive for it to ensure that such standards are maintained. However, the CAA would need to be satisfied that this was a sufficient deterrent against repeated failures to come up to the specified service quality standards. Where the cost of paying the rebate provided in the commitments is less than the cost of achieving the standards then GAL may have a financial incentive not to meet the standards. This may not be in airlines' or passengers' interests, as the rebate may be insufficient to compensate them for the reduced service quality. While the impact on an airline from a service quality failure could be considerable, for example long security queues could

lead to flight delays or passengers missing flights (with associated rebooking/compensation costs), the cost to passengers could be substantial, for example missing a critical business meeting or the loss of a substantial part of an annual holiday.

- 12.79 Beyond the payment of rebates, the Conditions of Use do not provide a recourse for airlines to address repeated failures in service quality or the temporary closure of the airport. In addition, under the commitments passengers (or the CAA on their behalf) would not have the opportunity to undertake enforcement themselves but would have to rely on enforcement by airlines, where in some circumstances their interests may not align. Consequently, given the SMP of the airport operator, there may not be sufficient incentive for it to continue to meet the specified standards. A licence would allow both airlines and passengers to have recourse to the regulator, the CAA could enforce on behalf of airlines and passengers, and provisions could be included where repeated failure to meet service quality standards could lead to enforcement action.

### Dispute resolution

- 12.80 The current proposals commit parties to a form of dispute resolution which seems to the CAA to present a risk to any users who need the urgent intervention of the courts where there is the risk of irreparable harm to their interests. As the findings of the dispute resolution process are not binding there is the risk that in high value disputes, the matter would still require resolution by the courts with the dispute resolution merely adding to the overall cost and time.
- 12.81 Under a licence, the CAA would have the ability to take enforcement action in the event of a breach of the licence conditions, and use the sanctions provided in the Act to secure compliance.

### Options for regulatory action to 'enforce' commitments

- 12.82 Accepting commitments embedded in the Conditions of Use as an alternative to regulation by a licence places the primary burden of enforcement on the parties to the contract (and those parties' interests may not always be directly aligned with those of users, as discussed above). Enforcement of the commitments would therefore be undertaken by individual airlines on a case by case basis.
- 12.83 If GAL repeatedly fails to comply with the commitments or there are

individual instances of significant non compliance, then this could constitute a material change in circumstances allowing the CAA to undertake a new market power assessment and subsequently introduce licence regulation if the market power test was met. It should be noted that due to the way that the Conditions of Use are drafted, in particular as they allow GAL to unilaterally change the terms, then it may in practice be difficult for GAL to breach the contract.

- 12.84 It could also be argued that there was a material change of circumstances if commitments do not, in practice, work as expected to address the risks of abuse of SMP. For example, if the commitments lead to numerous challenges under the ACD and competition law, then the commitments regime might reasonably be viewed as having failed, as airlines would be using alternatives to the commitments to enforce their rights. In these circumstances, the CAA would need to reconsider licence regulation.
- 12.85 The process of introducing licence regulation would involve undertaking a market power test and developing and consulting on new licence conditions. While the CAA is considering whether could be treated as an acceptable substitute for a licence within the framework of the cost/benefit analysis required by Test C, it is mindful that if there was a failure to comply with the commitments, interested parties are likely to ask the CAA to undertake a fresh market power test in reliance on section 7 (2) of the Act. The CAA's assessment against the market power test may also be appealed to the Competition Appeals Tribunal. Any subsequent decision by the CAA on the form of licence conditions could be appealed to the Competition Commission. The whole process of re-introducing a price control is likely to take at least two years including appeals.
- 12.86 Some stickiness in re-introducing *ex-ante* licence regulation could be beneficial. It would encourage both sides to engage rather than going immediately to the regulator, and the resolution of disputes will be bound up with on-going development of the commercial relationships. This could potentially reduce costs and lead to more creative outcomes to disputes. It may also be advantageous from the passenger point of view in avoiding over intervention.
- 12.87 However at the same time, a protracted regulatory response process triggered by an emerging problem could mean that abuses go

unchecked for some time. This could allow significant user detriment, for example in terms of higher prices or reduced service quality, to occur while regulatory action is undertaken. This would not be consistent with the section 1 duties nor the CAA's duties to ensure the effectiveness of Article 102 TFEU.

### **Conclusions on the enforcement of the commitments**

- 12.88 Licence regulation is likely to provide a better method of enforcement than relying on the commitments alone. While airlines have shown willing to pursue cases against GAL to the CAA, these cases may be less costly than going through the dispute resolution process and any subsequent legal proceedings under the commitments. Consequently even a licence with a sole condition requiring compliance with the terms of the commitments would appear to offer a more credible enforcement route. It would also avoid the delays built into the commitments through the requirement to refer the matter through the dispute resolution process. A licence would allow the CAA to intervene quickly (if necessary via urgent injunctive relief) if it considered this was in the passenger interest, an option not available under the commitments. A licence could avoid some of the additional problems created by the inclusion of the Commitments in the Conditions of Use, in particular the potential for GAL to make unilateral changes to the Conditions of Use.
- 12.89 A licence could also reduce the time taken to reintroduce tighter controls, should they be required. For example the CAA would have the power to introduce a price cap condition under section 22 of the Act and could therefore avoid re-undertaking a full market power assessment (although the CAA would need to take proper account of cutting across existing commercial relationships). The CAA could also include licence conditions so that no consumer detriment could occur while new controls are introduced.
- 12.90 While a simple licence allowing the CAA to enforce the commitments may have benefits, the CAA would need to be assured that the terms included in the commitments are appropriate. GAL has also indicated that it may only be willing to make the commitments if there is no licence. If the CAA is not assured that the terms in the commitments are in the passenger interest then the CAA's fall-back position would be full licence regulation, whether this is through price monitoring or some form of *ex-ante* control such as price caps. These options would

offer similar benefits in terms of enforcement to those described above for the simple licence. The CAA's view on the protection provided by individual elements of the commitments against the risk of abuse of SMP is considered further below.

## Excessive prices

### **GAL's proposed commitments: Protection on airport charges**

- 12.91 The current regulatory framework sets a cap on airport charges per passenger based on the published charges. Charges on non-passenger traffic are limited to be no more than those for the equivalent passenger aircraft. Discounts that were included in the published airport charges, for example for growth traffic, are included in price cap calculations. However, discounts that are negotiated between individual airlines and the airport operator are not. Further details on the operation of the price cap are given in section 6 of test A.
- 12.92 Since 2003, when GAL was subject to a separate price cap, GAL was pricing up to the cap until 2011/12. In 2011/12 GAL offered unpublished discounts to new long haul routes subject to certain criteria. In 2011/12, these discounts appear to have been relatively small scale, amounting to £0.7 million, out of total revenue from airport charges of £271.3 million. As GAL is pricing to the cap for the vast majority of traffic then there is a reasonable expectation that, if the price cap were removed, charges would increase.
- 12.93 GAL's proposed commitments include a price cap on airport charges of RPI +4% per year for seven years. The price cap can also be increased to allow increases in the costs of security provision and second runway costs to be passed on to airlines, and can be profiled across the seven years. Check-in and baggage charges would remain subject to the AGR. Other currently Specified Activities outside of the AGR: namely utilities, fixed electrical ground power, bus and coach services, staff car parking, ID pass and airside vehicle licensing would be subject to fair, reasonable and non discriminatory provisions.
- 12.94 GAL's proposed price cap on airport charges of RPI +4% per year over seven years provides a discount compared to its RAB-based calculation of RPI +6.9% per year over 5 years. Using GAL's assumptions the CAA has calculated that the equivalent RAB-based price cap would be RPI+5.6% per year over seven years. To check

whether this price is reasonable and fair to users, the CAA has carried out detailed RAB-based calculations, using its own assumptions, which are included in its Q6 initial proposals. These give a much lower RAB-based price cap of RPI +0.0% over 7 years. Based on CAA's traffic forecasts for GAL, using GAL's proposed price cap would result in an increase in GAL charge revenue of £12 million in 2014/15 rising to £104 million in 2020/21, or £382 million over the 7 years of the commitments.<sup>968</sup> Consequently while GAL's commitments provide a degree of protection in the form of an upper limit on prices, they do not secure prices that are cost reflective. The commitments, as currently offered by GAL, could lead to significant user detriment compared to RAB-based regulation through a licence.

**Figure 12.3: Comparison of price cap proposals (change in each year relative to RPI)**

	5 years	7 years	10 years
GAL commitments		+4.0%	
GAL RAB	+6.9%	+5.6%	+4.4%
Airlines RAB	-9.0%		
CAA RAB	+1.0%	+0.0%	

Source: CAA analysis, GAL RBP, ACC report on Gatwick airport business plan for Q6

### **GAL's proposed commitments: Traffic risk and the correction factor**

12.95 GAL's proposed commitments include a provision which allows GAL to pass through the cumulative difference in airport charge revenues from indicative yield profile. The indicative yield profile is effectively the per-passenger airport charge price cap. Under the commitments GAL can recover the cumulative revenue difference in any future year, although with the proviso that the cumulative revenue difference must be zero after seven years and that any over recovery is charged at the interest rate of the Treasury Bill Discount Rate, plus 3% for over recovery and plus 0% for under recovery.

12.96 The current price cap has a similar arrangement where any under or

<sup>968</sup> Taking into account GAL's proposed P0 adjustment of 11% and subsequent price increase of 1.3% reduces the increase in GAL charge revenue to £367 million over the 7 years of the commitments. The difference would be £36 million in 2014/15 rising to £71 million in 2020/21.

over recovery in the per-passenger airport charge can be recovered two years after the original charges, with over recovery charged at the Treasury Bill Discount Rate plus 3% and under recovery at the Treasury Bill Discount Rate. However there are there are two important differences, one of which critically impacts on the potential price.

- 12.97 The correction factor in the price control allows under and over recovery to be undertaken once, two years after revenues have accrued. This time period has been set to ensure actual revenues from airport charges are known. Regulatory accounts tend to be published in July after the end of the regulatory year in question. Consequently, differences in actual and forecast airport charges will only be able to be taken into account in the subsequent regulatory period, i.e. two years after the year in question. An adjustment is only allowed once to avoid potential financial gains by profiling charges across the control period, although it does not appear that this has taken place in practice. Nevertheless, it does not appear possible for GAL to be able to correct charges to allow for under and over recovery as quickly as assumed in the commitments as actual revenues and traffic would not be known at the time the cumulative revenue difference would need to be calculated, commonly 5 months before the end of the financial year in question<sup>969</sup>. For similar reasons it may not be possible to ensure that any under or over recovery nets out over the seven year commitments period. Consequently the cumulative revenue difference calculations may need to be based on estimates rather than outturn revenues and traffic. There also does not seem to be a wash-up mechanism to adjust for any differences between the outturn and estimate (as there is in the existing price cap formula). This could impact on the risk that GAL is exposed to (and potentially the cost of capital and the fair price under the commitments).
- 12.98 Under the commitments GAL would be able to profile the yield across the seven years period subject to overall neutrality over the seven years and a maximum variation in any one year. As the maximum variation is yet to be specified this could potentially lead to large

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<sup>969</sup> The cumulative revenue difference requires an estimate of the difference for the next year (where charges would apply) and the current year). In both circumstances the actual revenues and traffic would not be known.



variations in the price paid by airlines and their customers in individual years. These issues could be avoided with a licensing regime (and would need to be examined in more detail before commitments could be accepted as part of any licensing regime).

### **GAL's proposed commitments: Protections on other aeronautical charges**

- 12.99 In 1991 the Monopolies and Mergers Commission made a public interest finding that GAL provided inadequate information to airlines and other companies based at the airport. The finding led to the CAA imposing a transparency condition on GAL. In Q5 this condition required GAL to provide information on costs and revenues for a number of specified activities that are not included within the price cap which is limited to 'airport charges'. The public interest conditions cover charges on airlines and other companies for facilities and services that are essential for their operations at the airport. The public interest condition covers: check-in desks, baggage systems, other desks, staff car park, staff ID cards, fixed electrical ground power, hydrant refuelling, airside parking, airside licences, airside licences, aviation fuel, electricity, water and sewerage, heating, gas and bus and coach facilities. Historically these charges have been referred to as non-regulated (aeronautical) charges. The transparency condition was reinforced by statements made by the CAA at the Q5 review about the cost-reflectivity of these charges, which set an expectation that the CAA would consider at the Q6 review whether it should take account of any excess revenue covered by these charges in the Q6 price control.
- 12.100 Under test A the CAA is minded to find that GAL has SMP over the core airport area. The core airport area is defined by the Act as the *“land, buildings and other structures used for the purposes of the landing, take off, manoeuvring, parking, and service of aircraft at the airport, the passenger terminals and the cargo processing areas”*. If an airport operator has SMP over the core airport area, it would therefore have SMP over airport charges and other aeronautical services. Consequently, without adequate protection on the charges currently covered by public interest conditions, there is a risk that prices could rise, causing a detriment to passengers.
- 12.101 GAL's proposed price cap covers the same activities that are currently included within “airport charges”. For charges currently covered by public interest conditions, GAL proposes that these charges would be

fair, reasonable and non-discriminatory (FRAND). In some ways FRAND provisions go beyond the requirements of the AGR as the AGR requirements are closely linked to the Article 102 TFEU concepts of excessive pricing and unfair pricing.

- 12.102 While the commitments, through the FRAND requirements provide some protection to passengers in this area, they do not place specific consultation and notification requirements on GAL. Consequently, while GAL is required to set prices on a FRAND basis, without additional information, it will be difficult for airlines to satisfy themselves that GAL is indeed pricing on this basis. The CAA considers that licence regulation could therefore provide additional benefits by requiring GAL to be transparent over the costs of the activities which are currently covered by public interest conditions. The CAA does not consider that a licence would need to cover check-in, baggage handling and hydrant refuelling charges which are covered by the transparency conditions in the airport groundhandling conditions.

**GAL's proposed commitments: Changes to the cap on airport charges**

- 12.103 The commitments allow GAL to change the price cap if there is agreement from airlines representing 51% of passengers operating on the published price list. This allows GAL some flexibility to pass on additional costs.
- 12.104 GAL's commitments also include a pass through for costs of changes in security requirements, changes to taxation that have a material impact on GAL and/or operations at the airport, and, if supported by the Airports Commission, the reasonable costs of applying for and implementing planning permission for a second runway.<sup>970</sup>
- 12.105 The CAA currently only allows 90% of the costs of changes of security requirements to be passed on to airlines (subject to a deadband), to encourage the airport to implement changes to requirements efficiently. The commitments could therefore reduce the incentive on GAL to implement changes efficiently.
- 12.106 Regarding second runway costs, in the past the CAA has only allowed the preliminary expenditure on new runway capacity to be added to the RAB after a government decision was made to support such

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<sup>970</sup> Draft Conditions of Use supplied by GAL on 8 March 2013.

expansion. The Airports Commission will make recommendations to government, however it will not constitute a government decision. Consequently spending on a second runway could be nugatory if government decides not to implement the Airports Commission's recommendations. It does not appear to be in users' interests to pay for nugatory expenditure, particularly where GAL and its shareholders could gain considerably from the development of a second runway. A licence could therefore have additional benefits in this area. The CAA also notes that, under the commitments, GAL can change the price cap if there is agreement with airlines, potentially allowing GAL to pass on expenditure, if airlines considered that it was in their interests.

- 12.107 The commitments also allow the price cap to be amended if there is a change in taxation legislation which has a material impact upon GAL and/or its operations at the airport. This appears to be at odds to what would happen under a price control, where the business would be expected to take the risk of taxation changes within the period, rather than users. Furthermore, the scope of the provision is currently unclear in terms of which changes in taxation legislation are covered. For example, it is not clear whether the provision covers corporate tax and/or changes to employment tax and national insurance contributions. In addition the level of materiality is not defined which could lead to uncertainty for airlines regarding when they should be challenging GAL to reduce charges due to beneficial taxation changes, as opposed to allowing an increase in airport charges from a move in taxation in the opposite direction.
- 12.108 The CAA considers that licence regulation could have benefits from removing the elements of the cost pass through identified above that would not be in users' interests.

### **Impact of licence regulation on excessive prices**

- 12.109 Licence regulation may be a good way to limit excessive prices through price caps or price monitoring. Price caps can limit excessive prices by placing a limit on the level of prices during a control period. However, there is a risk that the price cap is either set too high or too low. The CAA has stated in 2007 that the risk that the price cap is set too high could to some extent be mitigated by the presence of competition law<sup>971</sup>, however as set out in test B the CAA does not

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<sup>971</sup> This is based on a CAA statement from 2007. In practice the presence of a high price control

consider that competition law would provide adequate protection against excessive prices where an airport has SMP. If the price cap is set too low then this could affect the prices of the airport's competitors, reducing the incentives for the operators of these airports to invest or their ability to make adequate returns. This may affect the development of the market over time, potentially to the detriment of consumers. It may also adversely affect airline locational or investment decisions.

- 12.110 The drawbacks of price caps highlighted above do not apply to price monitoring which can limit excessive prices by encouraging more moderated price increases through, for example greater transparency and/or the threat of more prescriptive regulation. However, price monitoring requires some level of self-control from the airport operator and so is likely to be most appropriate where the risks of abuse are more moderate.
- 12.111 As described above, under GAL's proposed commitments there is a risk that GAL will be able to increase prices above what might be considered fair. The CAA considers that a fair price is the price required by GAL to cover its efficient net costs and a reasonable return.
- 12.112 Licence regulation would provide benefits by limiting GAL's ability to increase prices.
- A RAB-based price cap could provide additional protection to consumers compared to GAL commitments. As described above a RAB-based price cap would cap prices below those in the commitments, and also include protections on other charges. Such protections could also be included in other forms of price cap regulation.
  - A price cap set through an alternative means may also provide better protection to users than GAL's commitments, although the CAA notes the sensitivity of both Long Run Incremental Cost (LRIC) and price comparator estimates to key assumptions.

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could make the case against excessive prices more difficult to make as competition authorities may be more reticent to find against an airport that was charging in accordance with a regulatory settlement. The potential for a competition law claim of excessive pricing to mitigate a high price may therefore be very low.

- Price monitoring under a licence might not, on its own, be a sufficient response to the degree of market power CAA considers may exist at Gatwick. Price monitoring involves the *ex-post* monitoring of price and service quality performance of the airport. As the airport operator is free to set prices and service quality, subject to *ex-post* review, the effectiveness of the regime is dependent on the airport not abusing its market power due to the reputational and financial consequences of the re-introduction of *ex-ante* regulation. Consequently price monitoring is likely to be most effective where the risk of abuse is relatively low. As stated in test B, the CAA does not consider that the risk of abuse is low in the case of GAL.
- Including the commitments in a licence could provide reasonable protection if the commitments included a price that was fair, as a licence would improve and speed up the enforcement process and minimise the scope for abuse while enforcement action is considered.

12.113 Consequently the CAA considers that, absent some form of licence regulation, there is a risk that GAL may be able to raise prices above a fair level. A number of different forms of regulation may be able to provide adequate protection to users if suitably developed, for example a price cap would set a limit on price increases and even price monitoring conditions would allow the CAA to take timely action to adjust the licence to constrain prices more closely if it considered they had risen (or might rise) excessively.

#### **Potential distortions from price cap licence regulation**

12.114 One of the key concerns in earlier CAA analysis, and to some extent the DfT analysis on de-designation, was the risk that the CAA may set the price cap too low, distorting competitive and investment decisions at other airports. The CAA considers that the risk of distorting competition by setting prices too low at Gatwick is reduced compared to the case for Stansted in 2007. The CAA also notes that even if prices are set too low then, as stated by DfT in 2007, there would be benefits to users from lower prices.

12.115 Distortion of competition and investment decisions is most likely to take place in airports in the same relevant market. Test A of this market power assessment indicated that, for LCC and charters, the

relevant market was most likely to be Gatwick itself but may possibly include Stansted and Luton airports.. In the FSC and feeder traffic market, the CAA considers that Gatwick is potentially in the same market as Heathrow. However given the nature of the constraint that Heathrow imposes on GAL (as discussed in test A) GAL's charges are unlikely to impact on HAL's investment decisions. Consequently, the impact of GAL's charges is likely to be focused on charges and investment at Stansted and Luton airports.

- 12.116 Uncertainty over charges at Gatwick does not appear to have affected the investment plans at Luton or the sale of Stansted. Luton has recently submitted a planning application to expand from 10 to 18 mppa<sup>972</sup>, and Stansted sold for a 10% uplift on the RAB<sup>973</sup>, with the new owners stating that they have significant investment plans.<sup>974</sup> In addition the CAA considers that it has better information on the competitive price than was the case for Stansted in 2007.
- 12.117 When setting price controls, the CAA would need to take care to ensure that an efficient business can finance its activities. This may be a particular issue for market-led price caps such as LRIC and pegging to comparators as there may be no direct link between the price cap and the current costs of the airport operation. However to the extent that there is such a risk, it is likely to be substantially outweighed by the benefits of setting some form of price control or monitoring through a licence.
- 12.118 In 2007 the CAA argued, in relation to Stansted, that it might set a high price cap to avoid distorting competition and allow users to challenge excessive prices, even if the charges were below any price cap. In the light of the CAA's new primary duty towards users, the potential costs to users of allowing prices above the competitive level and the difficulties users may have in making a case on excessive charges if the airport operator was pricing within its regulatory cap, the CAA does not consider this approach to be appropriate for GAL in Q6.

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<sup>972</sup> <http://www.luton.gov.uk/news/Pages/Planning-application-received-from-London-Luton-Airport-Operations-Ltd.aspx>

<sup>973</sup> PwC, April 2013, Cost of capital For UK Designated Airports: Paper on the split cost of capital and skewed returns – prepared to the Civil Aviation Authority, <http://www.caa.co.uk/docs/78/Q6PwCCofCapitalSplitSkewed.pdf>, page 18.

<sup>974</sup> <http://www.hertsandessexobserver.co.uk/News/Uttlesford/New-owners-celebrate-acquisition-of-Stansted-Airport-20130329112518.htm>

- 12.119 GAL states that RAB-based regulation equalises the financial advantages/disadvantages obtained by users of the airport, dulling any incentive to compete. The CAA acknowledges that current RAB based regulation (and it is likely any form of price cap regulation) provides a level of backstop protection by ensuring that all users have the option of paying the published price list. GAL has effectively argued that bilateral contracts may enhance competition between airlines by providing a way for airlines to obtain a differentiated price and service offering at an airport. Even under a licence-based approach, GAL has the opportunity to enter into mutually beneficial bilateral contracts or to levy additional charges on airlines for additional services. These same opportunities and constraints would also be available under GAL's commitment proposals. As discussed earlier, the CAA acknowledges that bilateral deals may be more likely under the commitments framework.
- 12.120 GAL has stated that tightly binding regulation would tend to undermine the evolution of bilateral contracts as airports would have limited incentives to offer discounts against a binding cost-based price cap, especially where the benefits of doing so (such as increased volumes) may materialise primarily in the medium-term and may merely fall into the regulatory till, and as such not flow to the airport, or airlines contracting in this manner. Further GAL states that management focus on time consuming regulatory processes may also significantly reduce or crowd out the scope for bilateral contracts.
- 12.121 The CAA notes that GAL, despite discussions, is yet to agree any bilateral contracts. The CAA acknowledges that this could be associated with uncertainty over the future regulatory regime although, following a request from GAL the CAA has, since 2011, structured its process to allow time for bilateral negotiations to take place and no bilateral contracts have been concluded. Consequently the CAA considers it is difficult to argue that management distraction due to regulatory processes has crowded out bilateral contracts in this instance. Furthermore a licence regime does not rule out GAL continuing to negotiate and secure bilateral contracts both in the lead up to April 2014 and after this date. Under both the commitments and a licensing regime the scope for agreeing differentiated charges and service quality would be limited by the ACR/AGR.
- 12.122 The CAA is mindful that in the absence of a fair default price, any

bilateral contracts that airlines may enter into may not be fair or in the interests of users. The CAA also notes that as part of its calculation of a fair price its traffic forecasts are based on short term airline plans and medium term GDP trends and so do not reflect any potential volume growth generated through bilateral contracts. The CAA also notes that duration of a licence-based price control is not fixed at five years and that GAL has not requested a longer duration price control to allow it to take advantage of any discount led growth.

- 12.123 The CAA acknowledges that licence regulation necessarily imposes some rigidity: for example through price caps, correction factors or the security cost pass through. However, the same rigidities are included in GAL's commitment proposals. The inclusion of correction factors and security cost pass through reduce the risks to the airport operator and consequently, while this increases complexity, can reduce overall costs. Furthermore, the ability to modify the price cap under a licence allows some additional flexibility to deal with unforeseen changes in costs, which might not be capable of being agreed within the GAL commitment regime.

### **Summary of impact of licence regulation on excessive prices**

- 12.124 In summary the CAA considers that licence regulation provides benefits over GAL's proposed commitments in terms of ensuring that prices charged are in users' interests. While the CAA acknowledges that there are risks from a licensing regime, for example from the potential impact on agreeing bilateral contracts, the CAA considers that these risks are outweighed by the potential benefits.

### **Inefficiency**

- 12.125 The current price cap regime provides incentives for GAL to be efficient. By including efficiency assumptions in the individual building block assumptions that go into the price cap calculations, the airport has an incentive to outperform as it retains the gains from outperformance during the control period. Gains made earlier in the control period are retained longer and so the incentives can diminish during the control period.

### **GAL's performance on efficiency**

- 12.126 The CAA's analysis of operating expenditure in the Q6 initial proposals indicates that following the change in ownership in 2009, GAL was initially successful in reducing operating expenditure, with



the reduction in intra-group charges, less than offset by smaller increases in costs in other areas.<sup>975</sup> While this improved efficiency is welcome it could be due to greater management focus rather than an increase in competition. The CAA also notes that since the initial reduction in costs there has been limited subsequent improvement.

12.127 The CAA has commissioned a number of studies into GAL's operating and capital expenditure.<sup>976</sup> These studies, which are described in detail in the initial proposals, identify significant scope for further improvements in efficiency, including :

- reductions in GAL's staff cash costs - these would need to be reduced by 9 to 13% to be in line with benchmarks;
- reductions in the cost of the pension scheme;
- improvements to absence management;
- reductions in rates, utility, cleaning and police costs; and
- reductions in maintenance unit costs.

12.128 The CAA's working paper on Empirical Methods<sup>977</sup> stated that in principle the analysis of relative cost efficiency might provide useful evidence to identify whether an airport operator is performing in a way that might be expected in a well functioning market. However, care must be taken to understand the underlying causes of any identified inefficiency, and whether there is evidence to suggest that relatively poor performance is transitory or can be explained by factors that do not relate to market power. The Empirical Methods paper also recognised that operating efficiency may not be created by competitive pressure but could be the result of regulatory incentives.

12.129 While the change in ownership has undoubtedly had a beneficial

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<sup>975</sup> CAA, April 2013, Economic regulation at Gatwick from April 2014: initial proposals, <http://www.caa.co.uk/docs/33/CAP%201029%20Economic%20regulation%20at%20Gatwick%20from%20April%202014%20initial%20proposals.pdf>, chapter 6

<sup>976</sup> The use of a variety of approaches to assess efficiency addresses a number of concerns with individual methods identified on pages 14 to 16 of Empirical methods for assessing behaviour, performance and profitability of airports, CAA, June 2011. This document can be accessed at: <http://www.caa.co.uk/docs/5/Performance&BehaviourWP.pdf>.

<sup>977</sup> CAA, June 2011, Empirical methods for assessing behaviour, performance and profitability of airports, <http://www.caa.co.uk/docs/5/Performance&BehaviourWP.pdf>

impact on GAL's efficiency, given the scale of potential efficiencies identified in the initial proposals (4 to 9% compared to a 2013/14 base<sup>978</sup>) it is difficult to accept that GAL is currently operating at the same efficiency as might be expected from a company in a fully competitive market. There therefore appears to be little evidence to suggest that competition has, so far, driven improved efficiency. This does not provide strong grounds for assuming that, in the absence of some constraining mechanism either via commitments or licence regulation, market pressure alone would lead to an improvement in efficiency. Given the reduction in competitive pressure forecast during Q6, the incremental benefits of licence regulation on efficiency may increase.

### **Efficiency incentives under GAL's proposed commitments**

- 12.130 GAL's proposed commitments could, in principle, provide an incentive for efficiency in both capital and operating expenditure. The commitments include a price cap therefore, as with a regulatory settlement, GAL will have an incentive to outperform the cost assumptions underpinning the price cap. The strength of these assumptions will depend, to some extent on the level of the price cap, with a tighter price cap likely to increase incentives to reduce costs. As the commitments do not include a mechanism where capital expenditure is recompensed through the RAB, GAL is likely to have an incentive to undertake any expenditure efficiently. The power of efficiency incentives under GAL's proposed commitments is likely to be significantly weakened as GAL's proposed price cap is far above what the CAA considers to be a fair price.
- 12.131 GAL's proposed commitments do however allow the costs of changes in security requirements and the development costs of a new runway to be passed on directly by an increase in charges. Consequently, unlike potential licence regulation GAL will have less incentive to undertake such expenditure efficiently.<sup>979</sup>

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<sup>978</sup> This is based on an inefficiency of £11 to £27 million (paragraph 6.78 of the initial proposals) compared to a cost base of £286 million in 2013/14 (figure 6.1).

<sup>979</sup> The current regulatory settlement only allows GAL to pass on 90% of the costs of additional security requirements, subject to a de-minimus threshold. Investment costs are only included in the RAB if they have been effectively consulted on and been subject to efficient/best practice project management.

### Efficiency incentives under licence regulation

12.132 Licence regulation can be an effective way of promoting operating and capital expenditure efficiency. The strength of efficiency incentives will depend on the type of licence regulation. Licence regulation can also create adverse effects in particular through the distortion of incentives between opex and capex efficiency. In general it appears that a variety of forms of licence regulation could provide incentives for efficiency.

- A RAB approach provides incentives to outperform the regulatory settlement, and a flexible RAB approach with core and development capex may improve incentives for the planning and efficiency of capex.
- A market based price cap (such as one based on LRIC or airport comparators) should provide incentives for efficiency as the price cap would be delinked from expenditure, although the power of these incentives would depend on the accuracy of the calculations and the level of the price caps.
- other forms of price caps such as constant real or nominal prices or voluntary undertakings on prices (which are incorporated into a licence) are likely to provide incentives for efficiency in the same way as a market based price cap, as the link between expenditure and prices would be removed, but again the strength of incentives would depend on the level of the cap.
- Price monitoring, in the right circumstances, could provide incentives for efficiency as prices would be delinked from expenditure, with the strength of incentives dependent on the strength of competitive pressure and the perceived impact of any threat of more prescriptive regulation should prices move out of line with expectations.

12.133 Any form of licence regulation can also include requirements for transparency, for example through the publication of detailed financial performance data in the regulatory accounts. Such transparency can provide a strong incentive on airport management to be more efficient.

12.134 GAL has stated that RAB-based regulation places undue management focus on making gains in those areas or periods where

savings can be retained, at least for a period.<sup>980</sup> The CAA acknowledges that the current regulatory framework can skew incentives for efficiency gains towards the start of the control period.<sup>981</sup> Nevertheless, these incentives do not appear to have prevented GAL from making efficiency gains since ownership despite taking over part way through a control period. Furthermore the strength of the incentive for the airport to be efficient will depend on the level of the price cap. Where an airport has SMP and if the price cap is set too loosely, there may be less of an incentive to be efficient as the airport will already be making reasonable profits<sup>982</sup>, particularly where such efficiency gains may be used by the regulator to set tighter price controls in the future.

12.135 GAL has stated that RAB-based regulation can lead to incentives for regulatory gaming for airports and airlines which, as well as failing to ensure the best delivery of outputs, may end up generating perverse incentives to under-perform in some circumstances. GAL states that incentives to game are a generic effect of regulation and apply to airlines as well as airports. They also undermine airport-airline relationships by encouraging the adoption of 'extreme' positions to put before the regulator and focussing energies on the regulatory 'contest' rather than allowing the inter-dependent interests of airports and airlines to be properly realised. GAL cites the example of the on-going negotiation about, and revision to capex triggers and whether they have been met or not. GAL states that they have been resisting these problems to the best of their ability.

12.136 As part of the development of Q6, the CAA extended the scope of constructive engagement (CE) to cover all items relevant to calculating a regulatory price cap (including operating expenditure and commercial revenues). The aim was to develop CE to reflect what would happen in a well-functioning market, where parties would seek to agree commercial outcomes, removing some of the gaming that can potentially occur under a regulatory settlement. While CE has had some success at agreeing outputs at some airports, agreements have

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<sup>980</sup> GAL, October 2012, Assessing the adverse effects and benefits of regulation, page 19.

<sup>981</sup> As part of the Q6 Policy Update the CAA consulted on amendments to efficiency incentives to remove the potential bias towards making gains at the beginning of the control period.

<sup>982</sup> This is called X inefficiency and was first defined by Leibenstein, Harvey (1966), "Allocative Efficiency vs. X-Efficiency", *American Economic Review* 56 (3): 392–415.

been limited at Gatwick, in part due to airport concerns over the release of data. The CAA acknowledges that there is some distance between the airport and airline positions at the current time and will seek to close this gap going forwards.<sup>983</sup> The CAA also acknowledges that this sort of bid and counter bid approach with a narrowing of positions over time often occurs in commercial negotiations between equally balanced parties and does not consider that regulation should necessarily lead to increased gaming. The position at Gatwick may be a reflection of the approach taken by the parties rather than regulation *per se*.

### **Summary of impact of licence regulation on efficiency**

12.137 Based on this analysis, given the potentially tighter price cap and the removal of full cost pass through elements, licence regulation is likely to provide stronger efficiency incentives than those in GAL's proposed commitments. Consequently licence regulation is likely to have additional benefits in this area.

## **Range and level of service quality that passengers require**

### **GAL's service quality performance**

12.138 In line with the Empirical Methods paper<sup>984</sup>, the CAA has considered GAL's performance against both direct objective measurement, using the Q5 service quality incentive scheme, and qualitative assessment through passenger satisfaction surveys such as the ASQ and QSM.<sup>985</sup>

12.139 Following a public interest finding by the Competition Commission the CAA introduced a service quality regime at Gatwick. The Q5 regime incorporates a service quality rebate scheme, with targets and rebates paid, set at a maximum of 7% of airport charges, for underperformance across 17 passenger and airline facing metrics, and a service quality bonus scheme, with bonuses paid, set at a maximum of 2.24% of airport charges, for outperformance across 6 passenger facing measures.

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<sup>983</sup> For example GAL's proposed price cap under a RAB-based approach was RPI +6.9% per year, which compared to an airline view of RPI -9% per year.

<sup>984</sup> See page 23, Empirical methods for assessing behaviour, performance and profitability of airports.

<sup>985</sup> QSM is the Quality of Service Monitor which is customer satisfaction survey data collected by BAA. ASQ is an international customer satisfaction survey overseen by the Airports Council International which enables the benchmarking of STAL's performance with other airports.

12.140 During Q5 GAL has been successful in reducing the level of rebates paid and increasing the bonuses awarded, see figure 11.4.

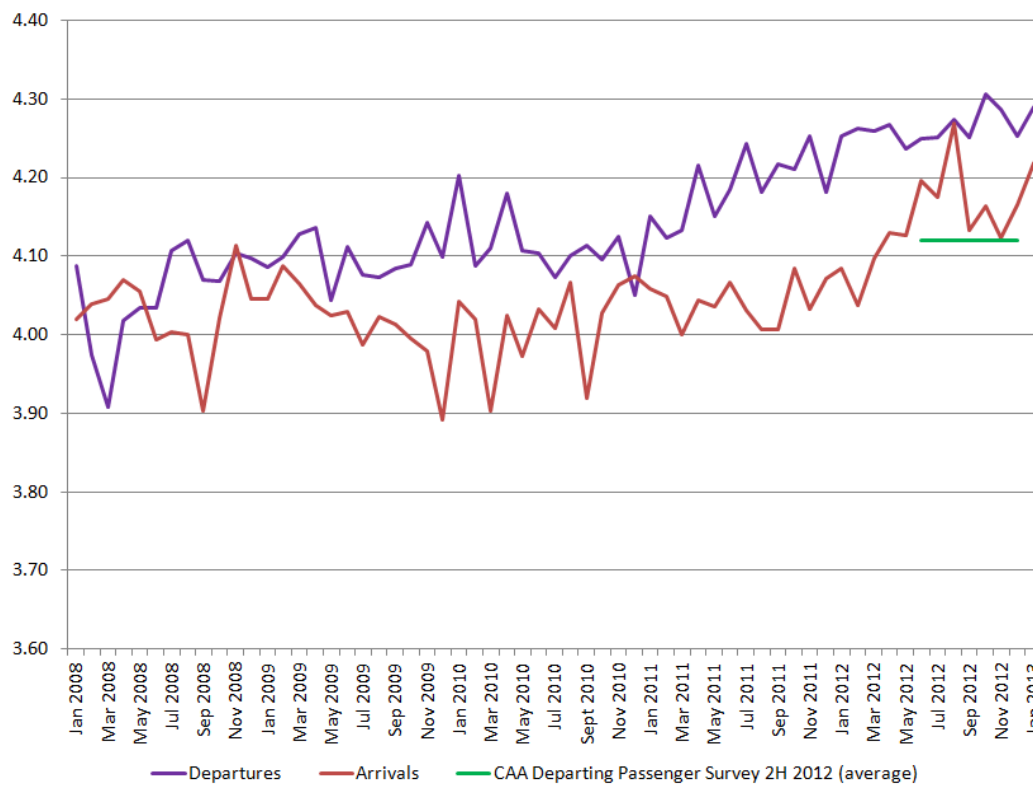
**Figure 12.4: Q5 service quality rebates and bonuses**

	Total airport charges	Rebates	Rebates as % of airport charges	Bonuses	Bonuses as % of airport charges
2008/09	£234.5m	£5.4m	2.30%	£0.8m	0.32%
2009/10	£241.6m	£3.0m	1.23%	£1.2m	0.41%
2010/11	£241.9m	£1.4m	0.56%	£1.6m	0.66%
2011/12	£271.3m	£0.3m	0.10%	£1.9m	0.68%
Apr 12 – Dec 12		£0m		£1.3m	

Source: GAL Regulatory accounts, GAL Revised Business Plan

12.141 The GAL QSM survey includes the question *"how would you rate your overall experience in the airport terminal today?"* Reviewing the time series of average responses, figure 11.5, indicates that there has been a steady increase in the level of passenger satisfaction since early 2008. The CAA's ongoing Passenger Survey, which asks the same question, shows similarly levels of satisfaction over recent months.

**Figure 12.5: Passenger satisfaction with Gatwick (QSM survey)**



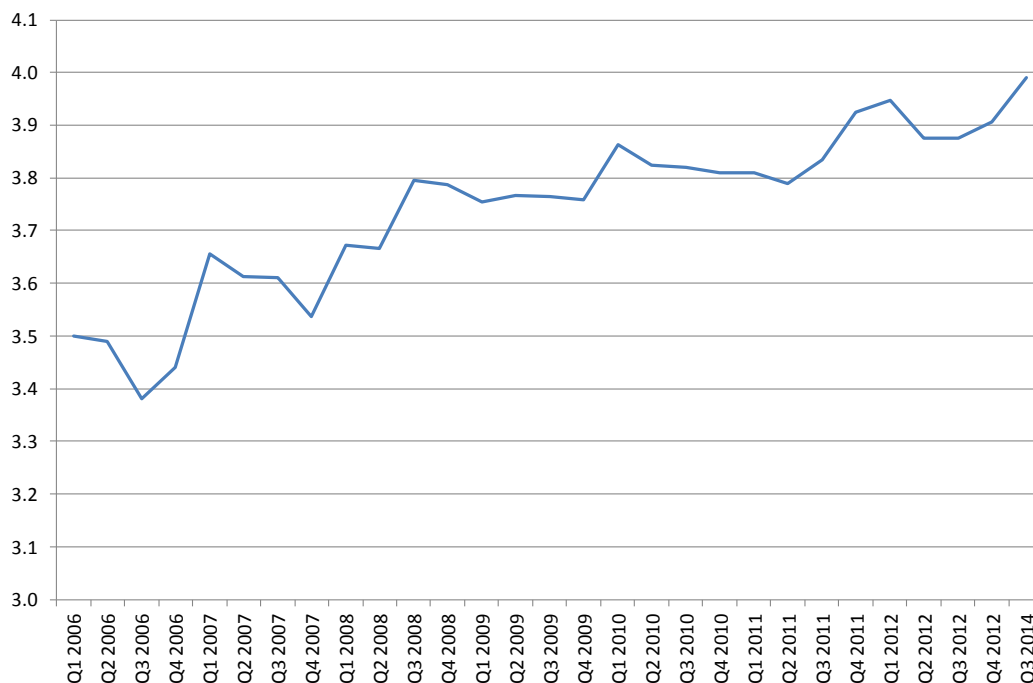
Source: GAL QSM data (monthly scores), CAA Departing Passenger Survey, July – December 2012 (provisional).

Note: Responses are scored, 5 = excellent, 4 = good, 3 = fair, 2 = poor, 1 = extremely poor.

12.142 The ASQ survey which has a smaller sample size, but is based on an independent passenger survey of overall satisfaction with the airport, shows a similar profile, showing increasing passenger satisfaction during Q5, as shown in figure 11.6. As with the QSM survey results, passenger satisfaction has improved throughout Q5, and not simply after the airport ceased to be under BAA control in December 2009.

GAL's ASQ ranking compared to other airports that participate in the survey has tended to fall as more airports have joined the sample (shown in figure 11.7), however it has moved from being in the fourth quartile to the third quartile of reporting airports.

**Figure 12.6: Passenger satisfaction with Gatwick (ASQ survey)**

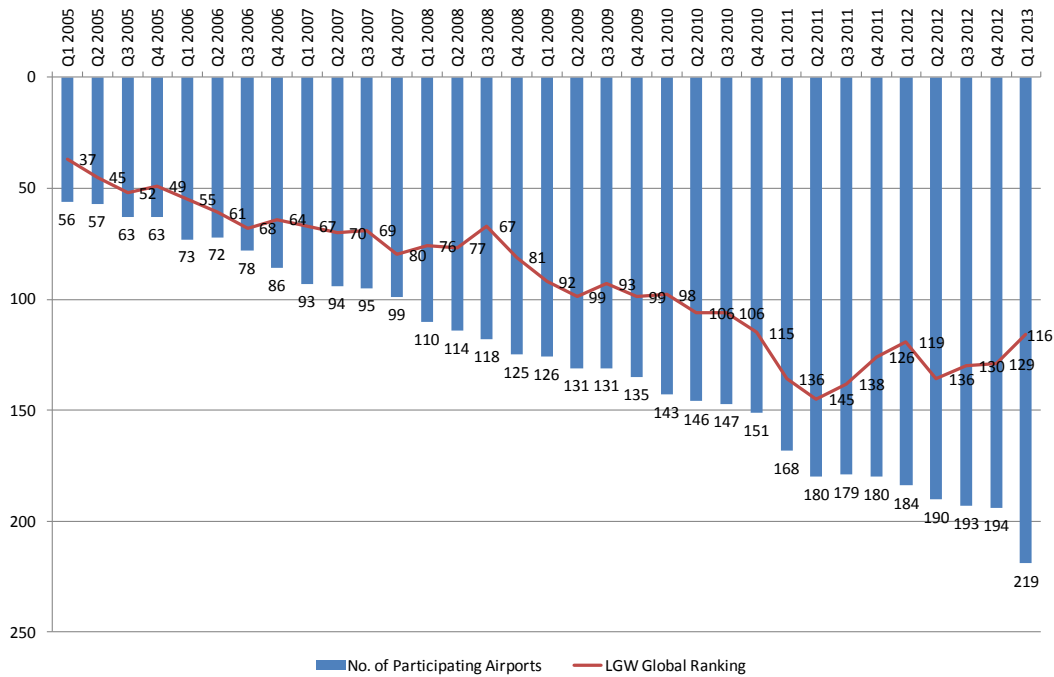


Source: GAL ASQ data (quarterly scores).

Note: Responses are scored, 5 = excellent, 4 = good, 3 = fair, 2 = poor, 1 = extremely poor.

**Figure 12.7: Gatwick's ASQ ranking out of all airports surveyed**





Source: GAL ASQ data (quarterly scores).

Note: Responses are scored, 5 = excellent, 4 = good, 3 = fair, 2 = poor, 1 = extremely poor.

12.143 There is little doubt that GAL’s service quality performance has improved during Q5. It is difficult to judge whether the improved performance reflects the impact of regulation or competitive pressures. For example, the improved performance against the Q5 service quality regime could reflect GAL responding to regulatory incentives rather than competitive pressure. The improvement in ASQ and QSM scores could also reflect the increased focus driven by regulatory incentives (and performance in areas measured by regulatory incentives, or delivered by investment during Q5) rather than competitive pressure.

**Service quality incentives under GAL's proposed commitments**

12.144 GAL’s proposed commitments include the same rebate and bonus scheme as Q5, with the bonus scheme extended to cover all elements and to be equal in scale to rebates at 7% of revenue at risk. An airfield availability measure would replace aerodrome congestion charge and airline service quality targets would be set on check-in and arrivals bag performance, with airlines receiving lower airport rebates if performance does not meet targets.

12.145 The CAA has a number of concerns that the service quality proposals

in the commitments may not be in users' interests, which are discussed below.

- 12.146 While GAL has proposed a similar structure to the service quality regime to Q5, the CAA is concerned over the thresholds proposed by GAL for rebates and bonuses. CAA research indicates that passengers are broadly content with the current level of performance at the airport. GAL is proposing that the rebate threshold is set below current performance. This could allow GAL to reduce performance, to the potential detriment of user interests, without having to pay rebates. GAL's proposed threshold for bonuses are, in a number of cases, equivalent to current performance. So GAL could receive bonuses for simply maintaining existing performance. This would be equivalent to an increase in charges for the same level of service. If the airport achieved bonuses on all metrics, with bonuses set at 7% of airport charges, then this could lead to an increase in income of £21m per year<sup>986</sup>, although the CAA notes that in some cases this would reflect improved performance levels, albeit above those passengers currently appear to consider acceptable.
- 12.147 In addition, and noted previously, the CAA has concerns over two issues related to enforcement of service quality in relation to GAL's proposed commitments, firstly that there is a lack of enforcement mechanism for repeated failure in relation to the service quality metrics, and that there is a lack of enforcement mechanism for passengers. The former is an issue as rebates are not set at a level which is intended to compensate airlines, or indeed passengers, for service quality failures, but are instead meant to be sufficient to incentivise GAL to improve performance. Without a regulatory backstop there may be less incentive for an airport with SMP to meet service quality requirements.
- 12.148 GAL's proposed commitments include the introduction of airline minimum standards and financial incentives for check-in queue times and arrival bags wait time and baggage. GAL proposes that these measures will be monitored and failure of an airline to meet these standards in any month will reduce any potential rebates payable by the airport related to its own performance. Airlines have suggested

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<sup>986</sup> In the Q6 initial proposals the CAA forecasts a net revenue requirement of an average of £307 million per year during Q6, see figure 11.2.

that a key part of their competitive service offering is the differentiation on check-in and baggage queue times and therefore it is unnecessary for this to be imposed by an airport and indeed it could adversely affect their commercial flexibility. Airlines also noted that the SQR scheme allows for a rebate of a proportion of charges paid by the airlines for services provided by the airport operator. The airlines are not providing a service to the airport operator but to their passengers. On this basis, the airlines do not see an argument for placing such a requirement on the airlines.

- 12.149 The CAA recognises that airline service differentiation is part of competition. By setting standards on airline services, the airport operator has the potential to reduce competition between airlines, which may be detrimental to users' interests. However such differentiation should be within reasonable limits, and it is in principle reasonable for the airport operator to indicate baseline levels of service expected from all airlines at the airport. The CAA considers that further work is required on issues of measurement and incentives before airline measures could be introduced.

### **Service quality incentives under licence regulation**

- 12.150 Licence regulation can address service quality issues, although it could also impose risks. These risks centre around setting the wrong set of service quality requirements, for example, if the elements of service quality measured and the associated financial incentives do not match passengers' priorities, or there is a focus on attributes that can be easily measured. There is also a risk that licence regulation can fix service quality requirements at a particular level during a control period when circumstances and requirements may change.
- 12.151 GAL has suggested that RAB-based regulation provides a reduced incentive to innovate, with the change in ownership of Gatwick demonstrating that, once released, the forces of competition can deliver innovation far beyond that previously achieved through regulation.<sup>987</sup> GAL has reiterated many of these concerns stating that:
- as the SQR regime is fixed for five years it is not able to respond to changing passenger needs;

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<sup>987</sup> Page 19, GAL, Assessing the adverse effects and benefits of regulation.

- the focus on certain specified targets, potentially to the detriment of other worthy important service objectives;
- can distort behaviours if incentives are set incorrectly; and
- can have multiple unintended consequences.<sup>988</sup>

12.152 GAL states that without regulation it would be incentivised, like any other company, to understand passengers' needs and to provide the relevant service, responding flexibly. GAL also states that without regulation, service would not be a 'one-size-fits-all'. GAL states that, if the commoditised service quality regime was removed, it would be free to meet the expectations of service sensitive passengers, and improve efficiency by ensuring that the service regime is continually responding to passenger needs. GAL does not provide further details of how the current service quality regimes have unintended consequences or distort behaviours.

### **Impact of service quality regime on GAL's ability to respond to the needs of passengers**

- 12.153 The CAA notes that GAL's statements are based on an assumption of fully effective competition. However the CAA considers, GAL has SMP and therefore, absent some form of regulation, may have limited incentive to respond to airlines' or users' interests.
- 12.154 It is important to consider whether GAL's proposed commitments or a licensing regime would better address the risk that the service quality does not match passenger priorities. As previously stated, the level of service quality at Gatwick does not appear to be misaligned with passenger preferences. CAA research indicates that 84% of passengers rated the overall experience of Gatwick airport terminals as "good" or "excellent".<sup>989</sup> Passenger ratings under the airport's QSM surveys are even higher, with a steady increase in passenger perception since 2008. Consequently it does not appear that the existing service quality regime is focusing on the incorrect elements.
- 12.155 GAL has also raised concerns that RAB-based regulation dulls incentives to deliver outputs and service quality which do not cover all areas of passenger experience (in particular those under airline

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<sup>988</sup> Page 22, GAL, Assessing the adverse effects and benefits of regulation.

<sup>989</sup> CAA ongoing passenger survey.

control) and do not encourage or reward innovation. The current service quality regime does not appear to have prevented the airport from increasing passenger satisfaction, as evidenced by the increase in overall passenger satisfaction scores over the Q5 period. The regime also does not appear to have prevented the airport from measuring service quality performance of Border Control, or the baggage performance of airlines and their handlers. The CAA therefore considers that GAL's concerns are only supported by evidence up to a point. On the other hand, and as mentioned above, regulation may prevent the airport from using its market power over existing users to reposition the airport rather than improving service quality in response to the priorities and needs of airlines and their customers.

### Impact of licence regulation on rigidity

- 12.156 Given that broadly the same service quality regime could apply under both the proposed commitments and licence regulation, the main potential issue associated with the rigidity of licence regulation is likely to be the change mechanism. Under the commitments the service quality regime can be changed with written agreement from airlines representing 51% of passengers on the published price list. For licence regulation, while different requirements could apply in future, currently changes require agreement from GAL, the AOC and the CAA, or by the CAA itself. Both schemes are therefore likely to have some rigidity. Given that the commitments only require agreement from airlines representing the majority of passengers, this regime could potentially be more flexible, although if many airlines are on bilateral contracts, obtaining written approval from smaller airlines may prove more difficult, given the competing demands on their time.
- 12.157 There is likely to be a trade-off between increasing rigidity and greater protection to users, with potentially greater protection to passengers provided where there is a degree of rigidity. A greater degree of rigidity can provide benefits as, in the absence of regulation, service providers may have a financial incentive to provide less and remain profitable, particularly if they have SMP. Under a licensing regime the ability of the CAA to make changes in users' interests, may therefore provide additional benefits.

### Impact of service quality regime on a 'one-size fits all' approach

- 12.158 GAL has argued that the existing service quality rebate regime

enforces a 'one size fits all' approach, which might not reflect the needs of different users. Service quality standards are set uniformly across the airport offering to users, and there are variations in passenger satisfaction most notably between business and leisure passengers (78% of business passengers are satisfied compared to 87% of leisure passengers)<sup>990</sup>, and there are wide variations in willingness to pay for further improvements to the airports across different types of passengers or airlines. Given the default nature of the price cap, airlines can always agree to pay for some items of higher service quality, for example lounges. However given the configuration of Gatwick, with a mix of airlines in each terminal, it can be difficult to vary some service quality requirements across airlines: for example security queue lengths, wayfinding or cleanliness. As discussed previously, bilateral contracts, which could allow some greater service quality variation, may be more likely under the commitments, although there is nothing to stop them being agreed under a regulatory settlement. Consequently there may be some additional benefit from commitments in this area, although it is likely to be limited by the potential scope for varying service across airlines and passengers across a two terminal airport.

### **Summary of impact of licence regulation on service quality**

- 12.159 The CAA does not consider that the current service quality regime has stopped GAL from responding to passenger needs, and in many ways has provided protection to users where, absent regulation, there may have been an incentive to allow service quality to decline.
- 12.160 A service quality regime of the type in place at Gatwick could be included in any of the forms of licence regulation that are being considered for GAL. As GAL's proposed commitments include a similar service quality regime to that in Q5, the incremental benefits of licence regulation are likely to be focused around:
- incremental user benefits from fine tuning the service quality regime;
  - financial benefits from reducing the scope of bonuses and increasing the level where they might be acquired; and

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<sup>990</sup> CAA ongoing passenger survey.

- the ability of the CAA to make changes to the regime in users' interests and to take enforcement action where there might be repeated failures.
- 12.161 Potentially partially offsetting this may be the loss of some benefit from the reduced likelihood of bilateral contracts, although the CAA notes that licence regulation does not rule out such contracts being agreed. Licence regulation could also dull incentives to deliver service quality, although this appears to be more a potential rather than actual issue in recent times.

## Investment incentives

### Investment incentives under GAL's proposed commitments

- 12.162 GAL's commitments include a commitment to:
- consult on capital expenditure in accordance with the consultation requirements of the Airport Charges Regulations 2011 (in lieu of Annex G of the March 2008 CAA Decision);
  - annually publish a rolling five year Capital Investment Programme;
  - publish every five years an Airport Master Plan;
  - maintain the airport to comply with all applicable safety and environmental requirements; and
  - maintain the fabric of the airport to the standard required under the airport-wide service standards
- 12.163 The ACR requires the airport operator to:
- provide users with the predicted outcome of any major proposed investments in terms of their effect on airport capacity;<sup>991</sup> and
  - where the airport operator plans to undertake a major infrastructure project at the airport it manages, the airport operator must consult the airport's users about the plans before they are finalised.<sup>992</sup>
- 12.164 Even without commitments, GAL will need to comply with the ACR and applicable safety and environmental legislation. Consequently the additional requirements are the publication of a rolling five year CIP

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<sup>991</sup> Regulation 8 (2) (h) of the Regulations.

<sup>992</sup> Regulation 27 of the Regulations.

and a masterplan and to maintain the service quality standards (the commitment to which is also set out elsewhere in the commitments). The publication of the CIP could also be thought of as a means to comply with the requirements of the ACR.

- 12.165 GAL considers that the advantages of the commitments are that it removes the link between capital investment and price. This would shift detailed scrutiny of projects to the airport management and its shareholders, who would be bearing the investment risk. GAL considers capital planning and development would take place through normal commercial discussions.
- 12.166 As stated earlier, the CAA does not consider that the ACD provides sufficient protection to users where an airport has SMP. A lack of investment is one of the areas where potential abuse could occur. The maintenance of the service quality standards would provide some protection in this regard. The publication of a CIP and a five yearly airport masterplan may provide users with some clarity as to future investment, but as the airport would be able to change these plans this may provide little protection over investment levels and outputs (over and above those included in the service quality regime), where an operator had SMP.
- 12.167 GAL has stated that it has taken forward a number of projects that are in the interests of passengers without support from airlines, for example on ST Border Zone improvements<sup>993</sup> and provision of A380 capability. GAL proposes that the cost of these projects would be included in the RAB, which would affect the price of a RAB based comparator going forwards, i.e. the costs would not affect the differential between a RAB-based price and commitments. Without the assurance that the costs of investments would be recouped then the risks to shareholders are likely to increase and so GAL may be less rather than more likely to undertake new investment, particularly without the agreement of customers that would ultimately pay for the improvements.
- 12.168 GAL has stated that if binding regulation continues then competition in the pursuit and delivery of new airport capacity would be unlikely to transpire. GAL states that investment would not occur unless the

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<sup>993</sup> The airlines supported phase 1 work but have not supported the purchase and installation of second generation of e gates.



regulator gives clear and credible commitments that it would be remunerated. In addition, continued regulation caps the upside while leaving GAL to deal with the downside.<sup>994</sup> The CAA has been clear that investments that meet its criteria can be included in the RAB and, for example, on this basis allowed the (subsequently aborted) costs of the development of the second runway to be included in the price cap at Stansted. STAL has not in recent years found it difficult to price up to the cap to recover these costs, despite a lower level of market power than GAL. Furthermore, when significant new airport capacity is being developed or realised, then the capacity constraints that contribute to GAL's market power may be reduced, potentially leading to a reconsideration of the need for regulation. Continued regulation during Q6 may therefore not prevent GAL from benefiting from the upside of new capacity, which is unlikely to be delivered until well after the Q6 period. The CAA notes that, under GAL's proposed commitments, GAL has included a pass through for the costs of the development of the second runway, effectively protecting GAL from the downside risk of the development of new capacity, while still allowing it the potential to benefit from any upside.

### **Impact of licence regulation on investment incentives**

- 12.169 Licence regulation can provide incentives to investment, for example by ensuring investment can be recouped, but it can also distort investment incentives by encouraging too much or too little investment.
- 12.170 In 2007 the CAA stated, with respect to Stansted, that:
- RAB-based regulation provides an incentive to invest by providing comfort to the regulated company that efficient and economic investment can be recouped, however it could distort incentives and could, in certain circumstances, lead to too much investment too soon which could give rise to a major cost to consumers, and distort the incentives of airports;
  - a market based price cap would not provide strong incentives to invest as the regulatory commitment that efficient and economic investment could be recouped would no longer apply;

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<sup>994</sup> Pages 24 and 25 of GAL, Assessing the adverse effects and benefits of regulation.

- competition would be a spur to investment, as there would be strong incentives to enter into long-term contracts which could allow better tailoring to customer requirements;
- regulation can also affect investment incentives across airports as competing airport operators will need to respond and compete with any new investment, irrespective of whether the new investment was efficient; and
- under-investment could be protected against through competition law, as actual airport investment could be compared to relatively well-developed airport expansion plans, allowing under-investment to be identified.

12.171 In 2008 DfT stated that:

- RAB-based regulation could distort new investment incentives, although the impact of distortions from regulation was difficult to separate from other factors affecting investment decisions such as the planning process;
- the cost of regulation is likely to be greatest where an airport operator does not possess market power; and
- given the scale of investment being considered at Stansted and the options available to the CAA to address the distortions to incentives through different approaches to price regulation, the impact of the distortions to incentives are unlikely to outweigh the beneficial effects of regulation.

12.172 GAL has suggested a number of biases from RAB-based regulation, for example:

- an excessive focus on inputs rather than outputs, since inputs are easier to measure, for example capital expenditure triggers may be defined in terms of £ million, or more usually on project delivery rather than on the improved services intended to be delivered;
- dulled incentives to deliver outputs efficiently, with skewed incentives to substitute operating expenditure with capital expenditure;
- RAB-based regulation requires capital expenditure to be effectively set seven years in advance;

- mixed incentives on capital expenditure with, on the one hand, RAB-based returns potentially encouraging airports to build bigger and earlier than required but, on the other, the lack of a long term framework (given the periodic review of returns) meaning that there may, in practice, be more focus on lower risk, incremental investments; and
- distortions to airline incentives, particularly over capital expenditure, where consultation provides an opportunity for airlines to influence the services their competitors receive.

12.173 The CAA has considered each of GAL's concerns and whether they, in fact, apply to RAB-based regulation and would necessary apply to other types of licence regulation.

#### Impact of RAB-based regulation on the focus of inputs and outputs

12.174 GAL has suggested that RAB-based regulation leads to an excessive focus on inputs rather than outputs. The RAB-based framework is necessarily based on a building block approach. This ensures that users only pay for the efficiently incurred net costs of airport operations. While the overall RAB-based price cap can be described as input led, the enhancements that the CAA has made to price cap regulation over successive control periods have increased the focus on outputs. For example, the service quality regime provides users with an expected level of service for the price that they pay, with rebates if they do not receive it. Capital expenditure triggers have been developed so that users can be sure that specific outputs that they have paid for are delivered.<sup>995</sup> When developing triggers for individual projects, the CAA, in consultation with users set out a set of criteria for triggers including that they should be based on events with demonstrable benefit to users, they should be objectively measured and that the airport should have management control or substantial influence over the success. Clearly there is nothing inherent in licence regulation to stop CAA from developing triggers to be even more output focused, although the CAA will need to weigh up the potential risks to the airport operator from the delivery of this output. Other forms of licence regulation such as setting price caps based on airport comparators would be even less input based.

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<sup>995</sup> CAA criteria for setting capital expenditure triggers is set out in paragraph 13.13 of CAA decision: [http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision\\_mar08.pdf](http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision_mar08.pdf).

### Impact of RAB-based regulation on the incentives to deliver outputs efficiently

12.175 GAL has suggested that RAB-based regulation dulls incentives to deliver outputs efficiently, with skewed incentives to substitute operating expenditure with capital expenditure. RAB-based regulation provides an incentive to invest by providing comfort to the regulated company that efficient and economic investment can be recouped. As part of Q5 the CAA set out a twin test for allowing capital expenditure to be included in the RAB:

- efficient project management; and
- consultation with users (in accordance with Annex G of the price control decision).

12.176 The efficient project management criterion provides a test for efficiency for capital expenditure. Nevertheless the CAA acknowledges that this test does not require the user to identify the lowest cost solution, rather to deliver the chosen project efficiently. There will be a trade off between providing surety to investors that investment will be recompensed and increased incentives to deliver outputs efficiently. The more stringent the tests for efficiency, the greater the risk of not making the desired returns on investment, and the less investment that is likely to be realised.

12.177 The CAA commissioned consultants to assess the capital efficiency of GAL's Q5 expenditure taking into account the criteria established by the CAA for allowing expenditure to be included in the RAB.<sup>996</sup> In particular the review examined five specific projects. The main findings of the review were that:

- each of the specific projects appears to have delivered an effective solution and the processes for specific projects have been reasonably applied when account is taken of the change of systems part way through the cycle; and

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<sup>996</sup> URS, March 2013, *Gatwick airport - review of Q5 capex*, <http://www.caa.co.uk/docs/78/Q6URSGwCapexConsult.pdf>

- the specific projects reviewed all contained periods where costs have increased substantially and this has been the subject of detailed review and almost all of the changes are explicable in the light of the circumstances described.

- 12.178 The study found that, in general, GAL had followed the requirements of efficient project management and effective consultation with users. The study identified two areas where this might not be the case: North Terminal extension and crew reporting. The total expenditure in question was at most £11 million, which is relatively small in comparison to the overall capital programme of around £1 billion over the control period. The CAA is consulting on whether this expenditure can be included in the RAB as part of the Q6 initial proposals. The CAA does not therefore consider that the current regulatory regime incentivises GAL to deliver capex inefficiently.
- 12.179 The CAA acknowledges that other regulators (and previously the CAA) have stated that RAB-based regulation distorts investment incentives.<sup>997</sup> For example it can lead to too much investment where the allowed cost of capital exceeds the company's cost of capital. Within previous regulatory controls the main push against these incentives has been the requirement to deliver the outputs required in the settlement, whether set through the service quality regime or capital expenditure triggers, and the need to meet the twin tests of efficient project management and consultation with users. Nevertheless the CAA acknowledges that, due to the surety provided to investors, some incentives for capital over operating expenditure may remain.

### Impact of RAB-based regulation on setting capital expenditure in advance

- 12.180 The CAA acknowledges that the current regulatory framework requires a capex allowance to be set up to 7 years in advance. GAL has suggested that this creates inflexibilities which are rarely seen in competitive sectors. While the capex allowance is set in advance, capex schemes can change, and there have been a number of changes to Q5 schemes made by GAL. Regardless of the changes to

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<sup>997</sup> See paragraph 5.8 of CAA, May 2012, Q6 Policy Update, and for other regulators views see for example Section 6.6.3 of Future Price Limits – A consultation on the Framework, Ofwat, November 2011. This document can be accessed at:  
[http://www.ofwat.gov.uk/consultations/pap\\_con201111fpl.pdf?download=Download#](http://www.ofwat.gov.uk/consultations/pap_con201111fpl.pdf?download=Download#)

the mix of projects during the control period, airport operators, including GAL, have tended to keep to this expenditure allowance during the control period. In part to address the concern over early detailed planning, as part of the Q6 policy update the CAA proposed a core and development approach to capex over the next control period, where core projects would be fixed but development projects would be progressed during the control period, with development expenditure either included in the original price cap or adjusting the price cap during the control period as it is incurred. This should go some way to addressing GAL's concerns in this area.

### Impact of RAB-based regulation on incentives on capital expenditure

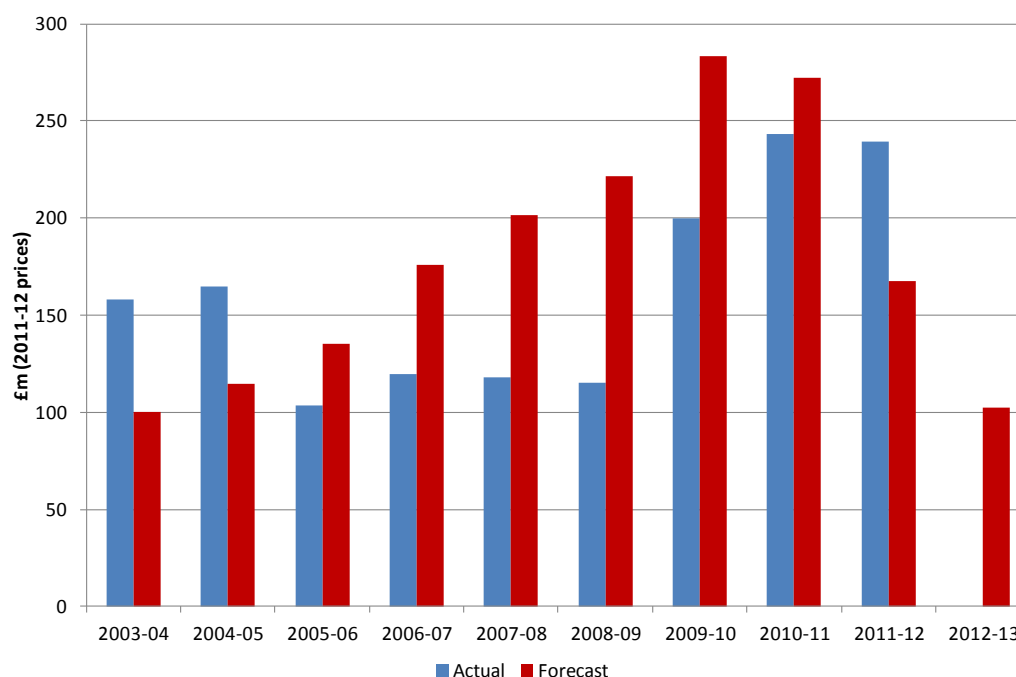
- 12.181 GAL has suggested that the RAB-based framework potentially encourages airports to build bigger and earlier than required but that the periodic review of regulatory returns, means that airport may in practice focus more on lower risk, incremental investments. The CAA acknowledges that a RAB-based framework provides strong incentives to invest (and this is one of the main advantages of the framework). The CAA acknowledges that there is an incentive for a regulated airport to bid to the regulator to build bigger earlier. Once the regulated period starts, in the absence of triggers, there may be an incentive to deliver later, as the regulated company could gain as the capitalised interest allowance included in the price cap is based on an assumed capital spend profile.<sup>998</sup> When undertaking the periodic review it is the job of the regulator, in consultation with users, to decide the capital expenditure allowance to include in the price cap.
- 12.182 While the reverse appears to have occurred in Q4, for Q5 Gatwick has forecast high capex in the early part of the control period but the actual capex did not meet these forecast expectations, see figure 11.8. For the most part GAL has met the required capex triggers, although, as triggers tend to be at the completion of projects, they may do nothing to prevent reprofiling of capex during a control period. A move to core and development capex may reduce the potential to reprofile expenditure as the price cap can be adjusted if development capex expenditure is higher or lower during an individual year. As part of the Q6 initial proposals, the CAA is consulting on further ways to remove

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<sup>998</sup> See paragraph 6.20 of the CAA Q6 policy update.

the potential incentive to defer spending during a control period.<sup>999</sup> The CAA therefore does not consider that the incentive to reprofile capex is generic to RAB-based regulation or other forms of licence regulation.

**Figure 12.8: Actual and forecast Gatwick capital expenditure**



Source: CAA analysis of GAL regulatory accounts

12.183 Once the capex has been incurred and included in the RAB, it is recompensed at the cost of capital. The CAA updates the cost of capital at each review, for example to reflect changes in the cost of debt and equity. Rather than increasing uncertainty, this to some extent, protects the regulated company against economy-wide changes that could make it difficult to finance its activities. The periodic review also updates assumptions over the traffic forecasts and other building block assumptions. If the CAA did not update assumptions then this could impose significant risks on the company, for example traffic at Gatwick is 9% below the forecasts made at the last periodic review.<sup>1000</sup> The CAA therefore considers the update of

<sup>999</sup> CAA, April 2013, *Economic regulation at Gatwick from April 2014: initial proposals*, paragraphs 15.20 to 15.24.

<sup>1000</sup> In 2012/13 passenger traffic at Gatwick was 34.3 mppa (source CAA airport statistics) compared to a CAA central forecast of 37.7 mppa at the time of the Q5 decision.

the cost of capital and other assumptions as part of the periodic review should reduce rather than increase uncertainty.

### Impact of RAB-based regulation on airline incentives

- 12.184 GAL states that RAB based regulation equalises the financial advantages/disadvantages obtained by users of the airport, dulling the incentive to compete. GAL states that the permission stage in the consultation on capex gives rise to significant inefficiency as it presents an opportunity for airlines to influence the service their competitors receive, and potentially to prevent, or delay desirable investments directed at their competitors at the ultimate expense of passengers. GAL states that this prevents the airport innovating on a bilateral basis with individual airlines and has the effect of restricting airline competition.
- 12.185 The CAA acknowledges that under a RAB-based framework in particular, airlines may oppose new investment that could facilitate entry of potential competitors, especially as they will initially be facing higher charges to pay for the investment. However, the current regulatory framework does not require the airport operator to agree investment plans with users but to consult with them and reach agreement where possible.<sup>1001</sup> GAL is also able to propose investment plans to the CAA as part of the periodic review, where the CAA will need to take into account its new duty to current and future users.
- 12.186 The airport's consultation requirements are set out in Annex G of the CAA's Q5 decision. These requirements followed an earlier CC finding that existing consultation arrangements were inadequate.<sup>1002</sup> The rigidity included in the current regime is a direct consequence of these findings. In the absence of licence regulation, under the ACR, GAL would still have a requirement to consult with users, although the requirements of this consultation are less onerous than those set out in Annex G. Some of the additional requirements included in Annex G, which reflect concerns highlighted by the CC, and not covered by the

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<sup>1001</sup> Paragraph G.23, CAA, March 2008, *Economic regulation of Heathrow and Gatwick airports 2008-2013*, CAA decision, [http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision\\_mar08.pdf](http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision_mar08.pdf)

<sup>1002</sup> Paragraph 4.19, Competition Commission, November 2007, *BAA Ltd - A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd)*, <http://www.caa.co.uk/docs/5/ergdocs/ccreport.pdf>



requirements of the ACR or the commitments are:

- the requirements of the capital investment plan in terms of setting out forecast demand, options for development, the capacity expected to be delivered and the overall costs of the plan and the implications for prices;
- for individual projects, a breakdown of costs and details of the incremental impact of individual projects on operating costs and outputs;
- consultation on key projects, which encompass the progression of the design and delivery of the project, structured to support key project decision gateways; and
- change control process setting out changes to the capital investment plan and the reasons for the change, with detailed reasons provided for significant changes made in the face of airline opposition.

12.187 The CC's stated aims of these consultation arrangements included: addressing the significant information asymmetry between airlines and the airport; allowing airlines, including those not heavily involved in the process, to provide properly informed views on the capital programme, the changes made to the programme and their implications; and increasing clarity over how the airport operator made decisions in contentious areas.

12.188 Given the CAA's 'minded to' finding under test A, that GAL holds SMP, then there is a risk that, absent such arrangements, that GAL could abuse its market position, in particular by focusing capital development on the needs of new customers at the expense of those already operating at the airport. The CAA is however mindful that such arrangements can have significant costs and would need to be cost effective to be included in a licence.

### **Impact of other forms of licence regulation on investment incentives**

12.189 The above discussion focuses on the impact of the current, RAB-based approach, on investment incentives. Compared to a RAB approach, market based approaches such as price caps based on LRIC or comparators, or price monitoring are likely to have a different impact on investment compared to a RAB approach. In general market based approaches are likely to lead to weaker investment

incentives than a RAB-based approach, in particular as they remove the link between investment and future returns as prices are based on a market proxy rather than costs. This could discourage investment that would be economic and efficient. This could, in part, be addressed by including a service quality regime within a market based approach, which could be used to drive necessary investment, or require a minimum level of investment in line with airport masterplan requirements.

- 12.190 In summary, licence based regulation could distort investment incentives, with a RAB potentially leading to too much investment and market-based approaches leading to too little investment. The current regulatory framework does not appear to have resulted in too much investment in the current control period and there is the potential to strengthen investment incentives under market-based regimes by putting in place additional regulatory requirements. It should be possible to use the flexibility of a licensing system to address other concerns with licence regulation such as fixing investment too far in advance and disincentivising investment for new customers. Nevertheless, licence regulation will necessarily lead to some costs in terms of rigidity particularly in terms of investment consultation, which appear to be required to address potential primary duty concerns.

### Other potential benefits of licence regulation

- 12.191 A licence can also be used to provide additional benefits. For example the Act allows the CAA to include other conditions that it considers necessary and expedient so as to further the interests of users of airport transport services in the range, availability, continuity, cost and quality of airport operation services. Two key areas where licence conditions might be used to address this primary duty towards users' interests are operational and financial resilience.

### Operational Resilience

- 12.192 The CAA considers that good operational resilience plans are needed to protect the interests of end users. The consequences of severe disruption due to snow in January and December 2010, as well as severe disruption due to the Icelandic ash cloud, highlighted the lack of adequate emergency planning at many airports. A number of reports<sup>1003</sup> looked at operational aspects of winter resilience and the

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<sup>1003</sup> The Quarmbay report October and December 2010, *The Independent Review of Winter*.

impacts on passengers and made a number of recommendations. In response to these, the Government tasked a subgroup of the South East Airports Taskforce (SEAT, set up in June 2010) to propose ways in which the operational performance of Heathrow, Gatwick and Stansted could be improved within the constraints of the current capacity caps.<sup>1004</sup>

- 12.193 How disruptive incidents are managed and how passengers are treated is affected by a large number of different organisations, each with their own commercial interests and legal obligations. This has made it difficult to reach consensus. The CAA's report on the work undertaken through the sub-group<sup>1005</sup> in November 2012 noted that, so far, the three major London airport operators (GAL, HAL and STAL) have worked on developing these charters with their stakeholders, but progress has been slow and more could be done. The CAA notes that GAL has made more progress than others in a number of areas.
- 12.194 Within the proposed commitments, GAL has included a commitment to develop operational resilience plans and to use best endeavours to minimise detriment to users. This would build on work that GAL has already done with its stakeholders over the last few years.
- 12.195 GAL's proposed commitments create some accountability to airlines but not to end users themselves, either directly or through the CAA.

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*Resilience*, <http://transportwinterresilience.independent.gov.uk/>,

Transport Select Committee 13th Report, May 2011, *Keeping the UK moving: The impact n transport of the winter weather in December 2010*,

<http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtran/794/79402.htm>,

Begg, March 2011, *The Heathrow Winter Resilience Enquiry*,

[http://www.baa.com/static/BAA\\_Airports/Downloads/PDF/BeggReport220311\\_BAA.pdf](http://www.baa.com/static/BAA_Airports/Downloads/PDF/BeggReport220311_BAA.pdf),

CAA, *Aviation's response to major disruption*,

[http://www.caa.co.uk/docs/5/CAA%20review%20of%20snow%20disruption%20-%20Final%20Report%20-%20WEB%20VERSION%20\\_2\\_.pdf](http://www.caa.co.uk/docs/5/CAA%20review%20of%20snow%20disruption%20-%20Final%20Report%20-%20WEB%20VERSION%20_2_.pdf),

SHM, April 2011, *Issues facing passengers during the snow disruption*,

<http://www.caa.co.uk/docs/5/CAA%20Issues%20facing%20passengers%20during%20the%20snow%20disruption%20FINAL.pdf>.

<sup>1004</sup> Reports and minutes of the SEAT sub group, the Airport Performance Facilitation Group (APFG) meetings can be found on the CAA website at <http://www.caa.co.uk/apfg>.

<sup>1005</sup> CAA, November 2012, *Progress report for the Minister of State on the APFG*.

<http://www.caa.co.uk/default.aspx?catid=589&pagetype=90&pageid=14206>.

As noted in the section on the enforceability of GAL's proposed commitments, the CAA would have no ability to step in to protect end users if things went wrong. The disruption in 2010 showed that the airlines have not always fulfilled their obligations<sup>1006</sup> and the CAA does not consider that the interest of airlines and those of passengers are fully aligned in these situations. Creating accountability through the airlines rather than through the CAA may not therefore give adequate protection to end users.

- 12.196 Consequently, the CAA considers that a licence condition can give greater protection to end users, than would be available under GAL's proposed commitments. A licence can be used to compel or incentivise GAL to adopt certain behaviours regarding the needs of the end users (passengers and cargo owners) that, as a provider with SMP does not have a direct contractual relationship with the end user, it otherwise might not consider necessary by making GAL fully accountable to passengers through the CAA.
- 12.197 A licence condition could also be useful in situations where there is no agreement between the stakeholders to facilitate greater progress to incentivise a greater willingness, or even requiring them, to take their stakeholders' needs into account as well as encouraging them to use the levers at their disposal to encourage and co-ordinate the relevant stakeholders to greater effect.
- 12.198 There is a risk that a licence condition could create perverse incentives, by limiting the ability of the licence holder to negotiate effectively or by adversely altering the balance of risks that have already been agreed between the various parties. However, in situations where there is stalemate, a licence may have benefits by changing this balance. A licence condition may also impose costs from developing the associated resilience plans but these are likely to be relatively small and be outweighed by the efficiency savings and reputational benefits to the industry from managing emergencies more effectively. Such conditions can also be modified in response to changed circumstances or concerns.
- 12.199 Clearly, there is a benefit to the users of air transport services by

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<sup>1006</sup> CAA, *Aviation's response to major disruption*,  
[http://www.caa.co.uk/docs/5/CAA%20review%20of%20snow%20disruption%20-%20Final%20Report%20-%20WEB%20VERSION%20\\_2\\_.pdf](http://www.caa.co.uk/docs/5/CAA%20review%20of%20snow%20disruption%20-%20Final%20Report%20-%20WEB%20VERSION%20_2_.pdf), pages 16 and 19.

protecting their interests in terms of improved resilience, however, such protections must not be too onerous for the airport operator (as this would unduly increase costs which would be passed on to end users). Consequently, before imposing licence conditions the CAA would need to consider its duty not to impose unnecessary regulatory burdens on the airport operator, that regulation should be proportionate and that it should only target those areas where action is needed.

- 12.200 In summary, there are benefits to passengers and cargo owners of having good operational resilience plans for times of disruption and there could be a role for a licence condition to facilitate this.

### **Financial resilience**

- 12.201 The government has been keen for the CAA to consider whether the licence could be used to strengthen the financial resilience of airport operators in line with the approaches commonly seen in other regulated sectors. Financial resilience is important as financial distress could cause detriment to users' interests in both the short and longer term. The economics of an airport whose operator has SMP suggest that, even in a time of financial distress, the airport is likely to remain open because it would generate a positive cash flow however, there could be a temporary closure, for example, while an administrator resolves legal and operational issues. Financial distress may also lead to reduced expenditure on the airport with implications for future service quality.
- 12.202 GAL's proposed commitments include a commitment not to take any action which would result in the loss of an investment level credit rating for GAL and to provide an annual confirmation of adequate financial resources to operate the Airport, including the provision of those services in respect of which the Core Service Charges are raised.
- 12.203 The CAA's initial proposals set out a number of additional requirements that the CAA considers are necessary to facilitate financial resilience, including:
- restriction on business activities;

- parent company undertakings;<sup>1007</sup>
- continuity of service plan;<sup>1008</sup> and
- reporting of any changes in the banking ring fence.

12.204 The initial proposals note that because aspects of a utility style ring fence would conflict with current financial arrangements at GAL, then it would be unlikely to be in the passengers' interest to introduce a full ring fence on commencement of the licence. However, in a licence-based approach, if there is a change in circumstances and the CAA considers that it is in the passenger interests (i.e. the benefits outweigh the costs), then consistent with the DfT's policy, the intent is, if possible, to move towards a complete ring fence over time. Under GAL's proposed commitments, it is not possible for the CAA to move towards a full ring fence, or for the CAA to require amendments to the financial resilience conditions in the commitments.

12.205 GAL's proposed commitments include an obligation on GAL to certify on an annual basis that it has adequate resources. However, unlike the condition in the CAA's initial proposals, the commitments restrict this to core activities only.<sup>1009</sup> The CAA welcomes this commitment, but has two concerns: first that GAL provides important services to users beyond core services and this commitment provides no reassurance that it will have adequate resources to provide such services, and second there are no obvious consequences of not having a clean 'adequate resources' certificate.

12.206 GAL's proposed commitments do not include an obligation on GAL to produce regulatory accounts, and therefore the CAA would have no ability to collect financial information about assets employed or income and costs other than that required by statutory account

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<sup>1007</sup> For a licence-based approach this is a parent company undertaking not to do anything that would be likely to make the licence holder do anything to breach its licence. For a commitments-based approach the parent undertaking would be not to do anything that would be likely to make the airport breach the commitments.

<sup>1008</sup> The continuity of service plan in the commitments focuses on operational resilience. The CAA IPs propose a continuity of service plan that would minimise the risk of airport closure in financial distress.

<sup>1009</sup> Core activities do not include, inter alia, cargo, PRMs, check-in and baggage, staff ID, FEGP, facilities for bus and coach operators, maintenance, heating and utilities, cable routing, airside parking and hydrant refuelling.

reporting requirements. This is likely to make monitoring the performance of the commitments regime more difficult, to the CAA, to airlines and to end users. It could also make it more difficult for the CAA to subsequently introduce licence regulation should the commitments found to be inadequate.

- 12.207 The CAA therefore considers that, in terms of financial resilience, licence regulation would have a number of potential benefits over GAL's proposed commitments.

## Direct costs

### CAA direct costs

- 12.208 Licence regulation will undoubtedly have costs. These costs can include indirect costs, such as the impacts on incentives, set out above, and direct costs, such as the CAA's costs and the time and expenditure of management and regulation staff at regulated airports and their airlines.
- 12.209 In 2007 the CAA estimated the CAA's and CC's costs for the Q4 review (covering all three designated airports) was around £3 million and acknowledged that there would be additional costs for the airport and airlines.
- 12.210 The CAA's annual charges for economic regulation at Gatwick are around £0.8 million per year, with additional costs of around £0.5 million per year during the periodic review.<sup>1010</sup> In addition there are likely to be the costs of any appeals to the Competition Appeal Tribunal and the CC under the new appeals processes set out in the Act. The extent and cost of these appeals are unknown. The direct costs at Gatwick compare to an annual charge for Luton, which is unregulated, of less than £0.1 million per year.<sup>1011</sup> Based on the same charge per passenger would give a charge of £0.25 million per year

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<sup>1010</sup> This is based on around 17 million arriving passengers at Gatwick (CAA airport statistics) and a charge of 4.75 pence for designated airports and 3.12 pence per arriving passenger for the Q6 review for Gatwick. Source: CAA charges 2013/14 consultation document. This document can be accessed at: <http://www.caa.co.uk/docs/1352/CAACHarges1314ConsultationDocWebFinal.pdf>. In this consultation document the CAA notes that there is still a degree of cross subsidy from designated airport to non designated airports.

<sup>1011</sup> For non-designated airports the charge is 1.49 pence per arriving passengers. There are around 5 million arriving passengers per year at Luton. Source: CAA charges 2013/14 consultation document and CAA airport statistics 2012.

for an unregulated Gatwick.<sup>1012</sup> Based on this, the CAA costs could be argued to be around £1 million per year on average during a five year control period.<sup>1013</sup> The incremental costs of designation (or licence regulation) would be around £0.8 million per year. As RAB-based regulation is resource intensive some of the alternative forms of regulation may be cheaper, for example there will not be a requirement to estimate individual building blocks and the expensive consultancy that this entails. However a LRIC approach is likely to be resource intensive as it requires the calculation of forward-looking or modern replacement costs. Even a price monitoring regime could require some regulatory involvement from an annual review of costs and performance, with these costs likely to be in excess of £0.2 million per year.<sup>1014</sup> CAA charges are levied on airport operators who then take into account these costs when levying airport charges to airlines, who will in turn pass on the costs to their passengers.

- 12.211 Even under a commitments approach, as GAL would still have SMP, CAA's costs are likely to be higher than for a competitive airport, in particular due to the need for continued monitoring in case re-regulation is required, and to deal with any ACR or CA98 complaints that might arise (which might be more likely under a commitments framework). These costs are hard to estimate but could be considerable if the regime breaks down into repeated ACR or competition law complaints.

### **Costs to airports and airlines**

- 12.212 In addition to the costs of the CAA there will be the cost of management and regulation of staff at the airport and airlines as well as the direct costs of compliance with regulatory measures. GAL has estimated that the total costs to the airport of the existing regulatory regime are around £5 million per year. GAL has included CAA costs of

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<sup>1012</sup> For non-designated airports the charge is 1.49 pence per arriving passengers, with 17 million arriving passengers at Gatwick, gives an annual charge of £0.25 million.

<sup>1013</sup> Assuming a two year review period would mean that the periodic review would lead to additional CAA charges of £1 million over a five year control period, or £0.2 million per year if spread over the five years. This would be in addition to the charge of £0.8 million per year, to give a total annual charge of around £1 million per year.

<sup>1014</sup> This is based on three staff with a cost of around £80,000 per year. Average staff costs are taken from note 3 of the financial statements in the CAA Annual report and accounts 2012. This document can be accessed at: [http://www.caa.co.uk/docs/2474/CAA\\_AR2012.pdf](http://www.caa.co.uk/docs/2474/CAA_AR2012.pdf).



around £2 million per year in this estimate which would give net costs to GAL of around £3 million per year.<sup>1015</sup> GAL acknowledges that this is a high-level estimate. GAL states that the cost estimate includes the cost of the regulation team and a proportion of the costs of the legal and development team.

- 12.213 In addition, GAL estimates that they incur significant capital expenditure overheads compared to non-regulated airports primarily related to the form of consultation required by the CAA, which equate to a further £5 million per year. In support of this, GAL cite the 23 meetings of the constructive engagement working group and 5 meetings of the oversight Joint Steering Group, which took place in 2012. GAL state, under the commitments framework, while GAL will still be required to consult with users under the ACR such consultation would be of a different order than required under consultation requirements under the current regulatory regime.
- 12.214 In total, GAL estimates that the direct costs of regulation to be £10 million per year, on average over a five year period. This equates to a net cost to the airport of around £8 million per year, after allowing for CAA costs.
- 12.215 The CAA has reviewed GAL's cost estimates. The CAA notes that GAL's strategy and regulation team costs are between £1 million and £3.5millionper year. These costs appear to be high compared to other airports and on a cost-per-member-of-staff basis.<sup>1016</sup> GAL has used 2012/13 as its base year for its estimate of the costs of regulation, where costs are over £3 million. The CAA notes that GAL's average cost of regulation over five years is around £1.5 million per year. While GAL notes it has taken into account the impact of averaging across the control period, this would mean that half of the management and regulation costs would occur outside the strategy and regulation department. The CAA notes that the strategy and regulation team also deals with issues other than the regulatory review, for example the input to the CAA's market power assessment, which the CAA considers is not a direct part of licence regulation, and also to the Davies Commission. The CAA also notes that GAL's legal team costs increased by around 70% in 2012/13, the base year for GAL's

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<sup>1015</sup> Correspondence from GAL.

<sup>1016</sup> Helios, forthcoming, Assessment of central support costs at Heathrow and Gatwick airports.

estimate.. GAL states that this increase was due to an increase in the legal requirements from regulatory challenges. The CAA notes that these challenges related to the AGR and section 41 of the Airports Act (1986). Going forward section 41 complaints are likely to be taken forward under competition law or the ACR and so neither of these challenges are likely to be related to licence regulation. This raises further concerns that GAL's estimates appear high.

12.216 GAL state that the main cost associated with the current regime is the cost of consultation. These costs are driven by a combination of the consultation requirements of Annex G and GAL's response to those requirements. GAL's estimate that these incremental costs are around £5 million per year. This compares to annual capital expenditure over Q5 of around £200 million per year. This gives an incremental cost of around 2.5%. It is worth noting that a significant proportion of GAL's capex expenditure relates to renewals, where consultation requirements are reduced. For Q6 GAL state that 36% of expenditure relates to asset stewardship (essentially renewals).<sup>1017</sup> Taking the proportion of renewals into account could increase the incremental costs of the existing consultation arrangements to 3 to 4% of enhancement scheme costs. It is important to compare this cost to GAL estimates of on-costs. On-costs are generally defined as the internal GAL management costs and external design and commercial management consultancy costs required for the definition and delivery of a project. The CAA's consultants Davis Langdon, identified that GAL typically includes an on-cost allowance of 18 to 21% for enhancement schemes, which was well above external market benchmarks which range from 9.5% to 15%.<sup>1018</sup> DL suggested that GAL's on-costs were likely to be higher than typical market rates given the complexity of delivering projects in an operational airport environment, although they considered that they could be reduced. The CAA notes that GAL's estimates of the incremental costs of the existing consultation arrangements are between 10 to 20% of on-costs. This appears high, given that the majority of on-costs are typically accounted for by design and specialist consultancy support.

12.217 The CAA notes that GAL's consultation arrangements appear to be

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<sup>1017</sup> GAL, January 2013, Revised business plan.

<sup>1018</sup> Davis Langdon, March 2013, Gatwick Airport, Q6 capex review: Phase Two report, <http://www.caa.co.uk/docs/78/Q6DLangdonCapex.pdf>

more onerous than those at the other currently designated airports, which are subject to similar requirements, for example in terms of the level of sign off Gatwick requires from airlines.

- 12.218 The CAA also notes that airports that operate competitively are likely to undertake more extensive consultation than directly required under the ACR. For example if a competitive airport wants to undertake an enhancement that increases the quality of the airport but increases costs, it is likely to want to make sure that its customers will pay for the enhancement through additional charges. In addition an airport in a competitive market is also likely to want to ensure its airline customers are content with the operational impacts during and after enhancement works are carried out, again going beyond the direct requirements of the ACR.
- 12.219 GAL's estimates of the direct costs of regulation relate to the existing RAB-based arrangements, rather than licence regulation per se. GAL states that any further requirements or mechanisms (such as compliance with a licence regime) would be in addition to these estimates. As part of the Q6 initial proposals the CAA is consulting on whether the existing consultation requirements at Gatwick can be improved while still meeting the requirements that underpin the CC's original public interest finding. The CAA also notes that:
- while the CAA mandate sets out the requirements for constructive engagement (CE), the level of meetings was a choice for GAL and the airlines and each of the designated airports approached CE differently while the mandates were similar, at Gatwick the focus of CE was on capex schemes;
  - CE was a one-off cost incurred in 2012 and is not replicated in other years, and so if this cost is included in GAL's estimate it should be spread over the five year regulatory period; and
  - licence regulation does not necessarily involve CE and the CAA only undertook CE as it felt that outcomes were often better if they were agreed between the airport and airlines rather than imposed by the regulator.
- 12.220 The CAA considers that GAL's estimate of its own costs of £8 million per year is likely to overstate the costs of existing arrangements. Without a more detailed breakdown of GAL's estimate it is difficult to

judge the degree to which costs are overstated, although based on the above analysis the CAA considers that GAL's actual direct costs could be half those that it has estimated.<sup>1019</sup>

- 12.221 In addition to GAL's costs are the costs of licence regulation to airlines. Airline involvement in regulation varies. Apart from the permanent role of the ACC at Gatwick, most airline representatives are spread across a number of airports and issues. In general three airlines tend to be most heavily involved in regulatory matters at Gatwick: easyJet, BA and Virgin, with other airlines having varying levels of involvement, in particular Thomson and Aurigny. On this basis the CAA considers a high level of airline costs from the current regulatory arrangements to be, at most, an average of £1 million per year during a regulatory cycle.<sup>1020</sup>
- 12.222 The CAA considers that the costs to airports and airlines could be substantially reduced under other forms of licence regulation and could be less than £1 million, particularly under a de-minimus licence framework that could operate under a commitments and licensing regime.
- 12.223 Airport commitments are unlikely to be costless. For example there will be costs from compliance with the regime, particularly in terms of the service quality regime, and costs to users from enforcement. Based on GAL's estimates above, the CAA considers that these costs could be £1 to £2 million per year.
- 12.224 There are also the unknown litigation costs that might be incurred by airlines/GAL where they feel it necessary to have recourse to court action in respect of any breaches of the commitments.

### **Overall direct costs**

- 12.225 Overall the direct costs of regulation of the existing regime might be as much as £10 million per year (based on GAL's estimates of its own costs). CAA charges and the costs of regulation are paid for by airlines in the airport charges levied by GAL. The CAA notes that

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<sup>1019</sup> In addition the CAA notes that HAL have estimated that the direct costs of regulation are more than £10 million per year, however the HAL capital programme has been around five times bigger than at GAL and the airport handles more than twice the number of passengers.

<sup>1020</sup> This is based on an average involvement of 3-10 FTE, with an additional allowance for consultancy costs and management time.

airlines, in general, have supported a continuation of the RAB based framework, and consequently must therefore consider that there is a net benefit from doing so.

- 12.226 It might be possible to substantially reduce the direct costs of regulation through refinements to the existing regime or alternative forms of regulation. The commitments themselves are unlikely to be costless and the direct costs could be up to £3 million per year (including CAA costs from, for example, dealing with complaints), although any cost savings from the commitments would be substantially reduced but perhaps not eliminated if there is not effective partnership working between GAL and the airlines, and if there were numerous complaints to the CAA under competition law or the ACR.

### Other potential distortive effects

- 12.227 The discussion above has highlighted a number of potential distortive effects from regulation, including:
- the price cap could be set too low, distorting competition and investment decisions at other airports;
  - the increased rigidity of a regulatory system in particular in relation to consultation requirements and changes in charges and service quality;
  - the distortions to incentives on opex, non-aeronautical revenue and investment;
  - the disincentive to invest for new customers;
  - the requirement for capex plans to be set too far in advance.
- 12.228 These adverse effects could result from RAB-based regulation, but as discussed above could also occur with other forms of regulation. Two further potential distortive effects from licence regulation are: the crowding out of a more commercial approach and management distraction. GAL states that the indirect costs of regulation from distortions are in excess of the direct costs.<sup>1021</sup> The CAA notes that GAL has not provided estimates of these indirect costs.

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<sup>1021</sup> This point was also recognised by the CAA in its recommendations to the Secretary of State in the de-designation of Manchester and Stansted airports.

### Crowding out of a more commercial approach

12.229 One of the key areas where licence regulation could create distortions is through crowding out of a more commercial approach. In the absence of regulation, airport operators and airlines would have an incentive to enter into bilateral contracts or deals. These deals could vary in terms of the duration, scope and service requirements depending on the needs of individual users and characteristics. Bilateral contracts can also provide benefits to airport operators from traffic and growth commitments and the utilisation of new facilities. Such bilateral contracts characterise much of the competitive airport sector in the UK. The desirability of such deals has been recognised by the CC.<sup>1022</sup> The CAA has also recognised the potential benefits of bilateral contracts and the airport operator's commitments at Gatwick, stating that:<sup>1023</sup>

*"In the right circumstances, bilateral contracts and airport commitments could be capable of providing protection that is at least as good as what regulation can provide, while also allowing more diversity and flexibility of provision than regulation easily allows. At its best, such a system could be better than regulation, and therefore be in the interests of passengers".*

12.230 A regulatory settlement can crowd out such contracts as both the airport operator and airlines will want to know what the potential settlement is before agreeing to any deal. This is why the CAA has been keen to encourage commercial agreements where possible, for example on the extension of the Heathrow and Gatwick price controls<sup>1024</sup> and by encouraging a similar arrangement for Stansted (which did not reach agreement). The current regulatory framework has not, in the past, been a block on STAL reaching a commercial bilateral contract with some airlines. The regulatory regime has also not prevented GAL from attracting new airlines, for example by providing a discount to the operation of new long-haul routes. Nevertheless the CAA recognises that bilateral contracts may be more likely under a commitments regime, not least as the regulated

<sup>1022</sup> Paragraph 5.16, Competition Commission (March 2009).

<sup>1023</sup> CAA, October 2012, *Gatwick Airport Mid Constructive Engagement (CE) Review*, <http://www.caa.co.uk/docs/5/121005LGWKCJSG.pdf>

<sup>1024</sup> The extension of the Gatwick Q5 price control was itself partially to allow the airport to reach commercial agreements with its airlines.

company would not be looking for the regulator to stand over any arrangements. Indeed CAA recognises that in some circumstances bilateral contracts may not be good for passengers; for example where the contract would not have been signed but for the airport exercising its SMP. That is why when discussing bilateral contracts and airport commitments at Gatwick the CAA stated that:

*“if a commitment/contract regime were to be a main reason why a price control would not be put in place (when it otherwise would be), that regime would also need to be fair to airlines. This means the overall deal would have to be reasonable compared to a potential regulatory settlement, and that non-discrimination was observed”.*

- 12.231 Consequently, while a regulatory settlement can create distortions by discouraging bilateral contracts from being agreed, it does not stop such agreements and, in cases where the airport operator has SMP, like GAL, it can prevent the airport operator from abusing its market power in such agreements.

### **Management distraction**

- 12.232 GAL has stated that licence regulation could distort incentives by distracting management by focusing the regulated company more on maximising the value from a regulatory settlement rather than focusing on improved efficiency or service quality. GAL states that the diversion is not limited to senior management and regulatory staff but is now pervasive and involves many operational managers in the extensive consultation processes and in preparations for them, and involves the airlines as well as the airport.
- 12.233 The CAA agrees that management distraction is a potential impact of regulation. The CAA recognises that the existing regulatory regime has involved the distraction of regulatory and management staff. However the CAA does not consider the distraction to operational staff at GAL has been significant given that both opex and commercial revenue discussions during CE have been high level and most of the involvement has been associated with one-off consultancy studies.
- 12.234 The CAA considers that while some management distraction from regulatory process is still likely from licence regulation the scale of regulatory distractions could be reduced through more flexible forms of regulation, for example:

- a more flexible RAB-based approach could involve more airport operator and airline engagement for example on capex plans, reducing the scope for regulatory distraction;
- a market led price cap, could focus discussions on the level of the price cap rather than on individual RAB-based building blocks;
- price monitoring, could focus the airport into behaving competitively rather than trying to outperform a regulatory settlement;
- a licensing framework around the commitments which could simply allow the CAA to enforce the commitments and speed up the potential reintroduction of tighter regulation and so could minimise the potential distortions from a licence.

## Summary

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12.235 Test C requires the CAA to assess whether the benefits of a licence regime are likely to outweigh the adverse effects. It is not necessary, in assessing whether test C is met, to define precisely the type of regulation that would apply; only whether the benefits of some form of licence-based regulation are likely to outweigh the potential adverse effects. The CAA has a duty to perform its functions having regard to good regulatory principles, including the proportionality of any licensing proposals and targeting them only where action is needed. In order to assess the potential benefits of a licence, it is necessary to form a view of the counterfactual to a licence regime i.e. what conditions of regulation would exist in the absence of a licence.

## The regulatory counterfactual

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



## Enforcement risks of commitments

- 12.237 The CAA has considered whether GAL's commitments are sufficient and that the incremental benefits of licence regulation are likely to be outweighed by the adverse effects and so test C would not be met. In undertaking this assessment the CAA has been mindful of the lack of explicit statutory provision for the acceptance of commitments in lieu of licence regulation. Consequently, the CAA considers that it should exercise caution and would want to consider whether commitments would provide material benefits over licence regulation, in particular in relation to the CAA's statutory duties.
- 12.238 For commitments to be an effective substitute for licence regulation they must be clear and enforceable so that airlines and other stakeholders have confidence that the benefits GAL say would accrue from the commitments would be delivered in practice, and would accrue to passengers and cargo owners.
- 12.239 The CAA considers that GAL's current proposal to include commitments in the Conditions of Use raises a number of concerns about the substance and enforceability of the provisions. In particular, the CAA is concerned that the Conditions of Use (including the commitments) would be unbalanced, with insufficient clarity over the facilities that GAL would provide. It would allow GAL to undertake unilateral variation or contracting out. As they would be enforced by airlines they may not offer the same protection to passengers and cargo owners as compared to a licence enforceable by CAA which has a statutory duty to protect their interests. Furthermore, the commitments commit parties to dispute resolution which could unduly delay airlines from taking enforcement action, and they provide no explicit protection from repeated failure against service quality standards.
- 12.240 In addition, the CAA is concerned that in the absence of a licence, if there are repeated failures to comply with the commitments, then while this may constitute a material change in circumstances, the process of re-introducing licence regulation may take two to three years, allowing significant passenger detriment to occur during this time. These issues could be avoided under licence regulation.

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

### Benefits

- 12.241 **Price:** As highlighted earlier, the CAA considers that the current cap is not significantly below the competitive price. Consequently the CAA is concerned that GAL's commitments propose to increase the price cap by an equivalent of RPI+4 per cent per year over seven years. This is in excess of a reasonable price as judged by a RAB-based comparator, which gives a price of RPI+0 per cent, over the period. Consequently, licence regulation is likely to provide additional benefits in this area.
- 12.242 **Efficiency:** The impact on efficiency of the commitments is likely to be mixed, with potential benefits from retaining the benefits from efficiency improvements for longer (at least seven years, compared to typically five years from licence regulation), offset to some extent by the looser price cap providing less of an incentive to be efficient, and the pass through of full operational costs.
- 12.243 **Service quality:** The commitments include much the same service quality regime as used for Q5. However, the extension and the increased money at risk for bonuses could provide gains to GAL, and the inclusion of airline facing service quality targets has the potential to distort competition to the detriment of passengers. Again it may be possible to avoid these issues under a licensing regime.
- 12.244 **Investment:** The commitments do not include capital expenditure commitments or triggers. Instead, investment would be driven by the service quality regime and GAL's vision for the airport in the future. Given the position of the SMP of the airport operator there is a risk that some beneficial enhancements for users would not be taken forward. The consultation arrangements under the commitments would be based on those under the ACR. While this may save costs and speed processes, for an airport operator with SMP this means that users' interests may not be fully taken into account.

### Adverse effects

- 12.245 The commitments would have benefits over a licence approach, in that they would avoid the direct costs of staff and consultancy associated with a regulatory review. GAL estimates that these costs of

the existing regulatory regime are around £8 million per year, mainly around consultation. In addition there would be CAA costs, estimated to be around £1 million per year, and airline costs of up to £1 million per year. These costs may be reduced under alternative forms of regulation. Commitments themselves are unlikely to be costless and potential cost savings would be significantly reduced but perhaps not eliminated if there is not effective partnership working between GAL and airlines, and if there were numerous complaints to the CAA under competition law or ACR. Airline feedback on the commitments has been mixed.

- 12.246 The commitments would also have benefits in terms of avoiding the potential distortions from licence regulation: avoiding management distraction, as the enforcement of the commitments would be linked to commercial negotiations; and removing some perverse incentives that may occur under a regulatory regime, for example potential distortions to capital expenditure incentives under a RAB-based framework, or the potential for regulatory “gaming”. Commitments could also avoid potential distortions to competition, for example a price cap set too low could distort charges and investment at other airports and bilateral contracts could be more likely under commitments, although GAL would be free to pursue these under licence regulation.

### Assessment

- 12.247 In addition to the concerns highlighted above, the CAA has reviewed whether the provisions in the commitments would provide sufficient protection against the potential abuse of SMP, across the focuses on the topics most commonly addressed by economic regulation.
- 12.248 Overall, the CAA welcomes GAL's commitment proposals. However the CAA is not sufficiently convinced that the enforceability of and the terms within the current commitment proposals provide sufficient protection to passengers and cargo owners. Overall, the CAA is minded to find that test C is met and that some form of licence regulation should apply to GAL. Consequently the CAA considers that there would be significant incremental benefits from licence regulation, which are likely to outweigh the adverse effects and that test C is met.

## CHAPTER 13

# The market power test and market power determination

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## Conclusion

- 13.1 This chapter concludes the CAA's 'minded to' consideration of the market power test (MPT) in relation to the Gatwick airport area, having regard to the markets that are relevant for the purposes of test A.
- 13.2 The Act specifies that the MPT is met in relation to an airport area if the three tests that it includes are met by the relevant airport operator.
- 13.3 The CAA has considered the market for airport operation services that are delivered from the core area of Gatwick, defined in section 5(4) of the Act as:
- the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft at the airport,
  - the passenger terminals, and
  - the cargo processing areas.
- 13.4 Under test A, the CAA is minded to find that GAL has SMP in the market for airport operation services in two markets:
- Airport operation services for low cost carriers (LCCs) and charter airlines covering a geographic market that is limited to Gatwick but may include Luton and Stansted.
  - Airport operation services for full service carriers (FSCs) and associated feeder traffic. The CAA's current view is that this market includes Heathrow.<sup>1025</sup>

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<sup>1025</sup> This market definition does not take account of capacity constraints at Heathrow, which were considered separately in the market power assessment.

- 13.5 Under test B, the CAA's current view is that competition law would not provide sufficient protection against the abuse of that market power. The CAA is minded to find that, for users of air transport services, the benefits of regulating GAL by means of a licence would outweigh the adverse effects, thereby satisfying test C.
- 13.6 As the CAA considers that the MPT is passed for the core area of Gatwick, the CAA's current view is that the market power test is met in relation to this area.
- 13.7 The CAA is therefore minded to make a market power determination (MPD) under section 7 of the Act in relation to this area. The CAA considers that, under section 5 of the Act, this area is a dominant area and, as it consists of all or part of the core area (as defined in section 5(4)), the airport is considered to be a dominant airport. Therefore, under s3, GAL must have a licence in order to be able to charge for services provided in this area and any other area at the airport in respect of which GAL is the operator.
- 13.8 The CAA is consulting separately on the proposed licence, including:
- the airport area to be covered;
  - the form of price control required;
  - any conditions that it thinks necessary or expedient to protect against the abuse of the market power found in the MPD; and
  - any other conditions that it thinks necessary or expedient having regards to its section 1 duties.