

NOTICE OF DETERMINATION UNDER SECTION 8 OF THE CIVIL AVIATION ACT 2012: HEATHROW AIRPORT

The Civil Aviation Authority has made the following determination under section 7 of the Civil Aviation Act 2012 (the CA Act).

The market power test set out in section 6 of the CA Act is met in relation to the following airport areas located at London Heathrow Airport:

- 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.

Tests A to C of section 6 of the CA Act have been met by the relevant operator, namely Heathrow Airport Limited.

The airport area does not include any area in respect of which the CAA has made an operator determination under section 10 of the CA Act determining that Heathrow Airport Limited does not have overall responsibility for the management of that area.

The reasons for this determination are set out in the document “Market power determination in relation to Heathrow Airport –statement of reasons, CAP 1133.”

Any word or expression defined for the purposes of any provision of Part 1 of the CA Act shall have the same meaning when used in this notice.

Market power determination in relation to Heathrow Airport – statement of reasons



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CHAPTER 1

Introduction

- 1.1 This document sets out the reasons for the CAA's market power determination that the market power test is met in relation to the core area of the airport area (as defined in section 5(4) of the Civil Aviation Act 2012 (CA Act) comprising London Heathrow Airport (Heathrow)).¹
- 1.2 Section 3 of the CA Act prohibits the operator of a dominant area at a dominant airport from requiring payment of relevant charges without a licence. The CA Act only permits economic regulation of an airport operator and the granting of a licence by the CAA if all three components of the market power test set out in section 6 of the CA Act are satisfied. Those components are:
- Test A, which requires the CAA to establish whether the relevant operator has, or is likely to acquire, substantial market power (SMP) in a market for one or more types of airport operation service provided within all or part of the airport area.²
 - Test B, which requires the CAA to establish 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.³
 - Test C, which requires the CAA to establish that, for current and future users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh are likely to outweigh the adverse effects.⁴
- 1.3 In carrying out its assessment, the CAA is acting under its general duty to carry out its functions in a manner which it considers will further the interests of passengers and cargo owners regarding the range, availability, continuity, cost and quality of airport operation services. The

¹ The CAA considers that HAL has overall responsibility for the management of the airport area, consisting of the facilities at Heathrow, with the exception of the fuel facilities, pursuant to the CAA's operator determination under section 10 of the CA Act. See CAP 1136 available on the CAA's website.

² Section 6(3) read together with sections 6(6) and 6(7) of the CA Act.

³ Section 6(4) read together with sections 6(8) and 6(9) of the CA Act.

⁴ Section 6(5) of the CA Act.

CAA is also carrying out this function in a manner that it considers will promote competition in the provision of airport operation services (and, where appropriate takes into account the regulatory needs and principles in the CA Act).⁵

- 1.4 This is the non-confidential version of this document and excisions from the text in the chapters and associated appendices are marked with [§<].

Structure of this document

- 1.5 Given the complexity and volume of evidence and economic analysis forming part of this statement of reasons, it has been necessary to distil the CAA's principal findings and conclusions into the main body of this document.

- 1.6 The main chapters of this statement of reasons document set out the CAA's principal findings of fact and reasons as well as its final decision on each of the three Tests A, B and C. The supporting evidence, inferences, reasons and detailed economic analysis are to be found in the accompanying appendices and are an integral part of the CAA's reasoning. The main body of the document and the appendices should be read as a whole and the fact that the discussion of a particular issue is reserved to the appendices does not undermine its relevance or importance.

- 1.7 The remaining chapters and appendices of this document are:

- Chapter 2: Main findings and conclusions
- Chapter 3: Consultation history
- Chapter 4: Market definition – final decision
- Chapter 5: Test A: Market power – final decision
- Chapter 6: Tests B and C
- Chapter 7: Conclusion
- Appendix A: List of representations and evidence received
- Appendix B: Glossary
- Appendix C: The business of Heathrow Airport Limited
- Appendix D: Evidence and analysis on market definition

⁵ Section 1(1) of the CA Act, read together with sections 1(2), 1(3) and 1(4).

- Appendix E: Evidence and analysis on competitive constraints
- Appendix F: Evidence and analysis on indicators of market power
- Appendix G: Evidence and analysis on Test B
- Appendix H: Evidence and analysis on Test C.

CHAPTER 2

Main findings and conclusions

- 2.1 The CAA has defined the relevant product market as the provision of airport operation services to full service carriers (FSC) and associated feeder traffic airlines. The CAA has also defined the relevant geographic market to the area that is limited to Heathrow. This market definition is unchanged from that outlined in the CAA's Consultation on Heathrow market power assessment CAP 1051 (the Consultation).
- 2.2 In coming to this decision, the CAA has had regard to its general duties under the CA Act and the relevant notices and guidance issued by the European Commission (EC) and the Office of Fair Trading (OFT) regarding the application and enforcement of the Chapter I and II prohibitions and Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU), here-in referred to as the competition law notices and guidance.
- 2.3 Having analysed the above market, and taken due account of the competition law notices and guidance as well as the responses to the CAA's Heathrow: Market Power Assessment, the CAA's Initial Views - February 2012 (the Initial Views) and the Consultation, the CAA has decided that HAL has SMP in this market, which is expected to persist over the period April 2014 – December 2018 (Q6). This decision is unchanged from that proposed in the Consultation.
- 2.4 The CAA has come to this conclusion as it considers the evidence suggests that:
- The most likely source of any SMP that HAL has stems from its position as the operator of the UK's only hub airport and the combined package that Heathrow offers of strong demand, including premium passengers, cargo and connecting passengers. This makes Heathrow attractive for both based and inbound airlines.
 - The airline network effects⁶ available at Heathrow means that very few airlines would be able and willing to switch sufficient capacity to constrain an increase in HAL's charges.

⁶ Airline network effects result where an airline's services benefits from demand from passengers who connect at the airport using its own or other airlines' services.

- Heathrow's good surface access options, the inherent attractiveness of the London market, and its strategic importance to airlines combined with the capacity constraints in the London system act to reduce the available alternatives to airlines.
- The strength of airline demand to operate from Heathrow means that HAL would be effectively insulated from the effects of any switching away as a result of higher airport charges.

2.5 The Government has also put on hold the expansion of the main London airports and that the Airports Commission, which is examining how additional UK airport capacity needs can be met in the short, medium and long term, is not expected to issue its final report until summer 2015. The CAA considers that any change in Government policy after the release of the Airport Commission's final report may take some time to be implemented and that any significant capacity expansion would not be expected until at least 2025. Over the Q6 period, due to improving economic conditions and the lack of significant capacity expansion, the CAA considers that HAL's SMP will endure.

2.6 Two of three respondents to the Consultation supported the CAA's minded to view that HAL has SMP. Only HAL did not agree with this finding. HAL, in its response to the Consultation, perceived inconsistencies between the CAA's market definition and previous precedents established by the CAA, the Competition Commission (CC) and other regulators.

2.7 The CAA, having carefully considered the issues that HAL has raised on the market definition outlined in the Consultation, including perceived inconsistencies with the CAA's previous statements and precedents established by other regulators, notes that:

- The CAA does not consider that it is bound by its previous statements where the evidence or subsequent analysis suggests that its previous position should be changed.
- Much of the material that HAL refers to was undertaken a significant time ago under different legislation and a different regulatory regime.

- It would be negligent for the CAA not to take into account the approach and findings of the CC and the Competition Appeal Tribunal (CAT) in developing its thinking and assessment of the current market position of HAL. As such, the de-designation assessment of Stansted in 2007 and the comments made by the CAA in its initial considerations of the CC's investigation into BAA airports need to be considered in the appropriate context.
- It is widely accepted that market definition is a flexible tool that may alter depending on the question being asked. The CC's BAA airports investigation considered a wide question on the potential of the development of competition between the three BAA airports and sought to remove structural impediments to development of potential competition. The CC was not considering the narrower question that the CAA must consider under Test A, which is the particular market in which an individual airport operator operates.
- The divestment remedy imposed by the CC as a consequence of its airports investigation did not bring an immediate and effectively competitive market into existence. The CC's expectation was for competition to develop over time.
- Merger case law highlighted by HAL is concerned with whether a merger will weaken current competition observed within a market. Similar to the fourth bullet point outlined above. This material is not considering the narrower question that the CAA must consider under Test A.
- Market definition is a time sensitive and context specific exercise. It is based on an analysis of the structure of the market and competition prevailing at a particular point in time.⁷ Hence, an assessment will change over time as market circumstances evolve. A prior finding of dominance by the EC or a National Competition Authority (or even a national court) is therefore not binding.⁸

⁷ Bellamy & Child, EU law of competition, paragraph 10.018.

⁸ For example, the EC has to start new analysis on the condition of competition in course of making new decisions: '*in the course of any decision applying Article 86 of the Treaty the Commission must define the relevant market again and market a fresh analysis of the conditions of competition which will not necessarily be based on the same considerations as those underlying the previous finding of a dominant position.*' Source: Case T-125/97 Coca-Cola v Commission [2000] ECR ii-1733, paragraph 82.

- Since the publication of the Initial Views, the CAA has developed a substantial evidence base on which it has refined its thinking.⁹
- 2.8 In relation to Test B, the CAA concludes that competition law will not provide sufficient protection against the risk of HAL abusing its SMP. In reaching this conclusion the CAA has had regard to the competition law notice and guidance as well as the regulatory principles in the CA Act.
- 2.9 The risk associated with finding that HAL has SMP is that higher prices, reduced choice and/or poorer service quality levels could result if HAL is not subject to economic regulation. The CAA cannot assume that these risks will have no negative effect on end users, even if price rises might be absorbed, in whole or in part, by the airlines. The CAA also considers it is likely that HAL will continue to face investor pressure to keep prices as high as possible.
- 2.10 Ex post competition law, whether under the Competition Act 1998 or the Enterprise Act 2002, is not well adapted to pre-empting conduct which amounts to abuse of SMP in the form of excessive pricing or reduced service.
- 2.11 There are also considerable challenges for the users of air transport services, particularly passengers, who are affected by this kind of abuse in bringing challenges or seeking damages based on competition law. This limits the likely deterrent effect of competition law.
- 2.12 The CAA has a duty to apply Test B in a way that will further the interests of such users under section 1(1) of the CA Act. The CAA cannot be confident that competition law would be sufficient to protect passengers against the abuse of SMP by HAL and/or would adequately further their interests in the range, availability, continuity, cost and quality of airport operation services. In addition, the CAA cannot be confident that leaving passengers to have recourse to competition law alone, particularly when airlines may not challenge any abuse by HAL on their behalf, would be consistent with that primary duty.
- 2.13 When the market is impaired by the existence of SMP which brings with it the risk of abuse by the holder of that SMP, there is a need to open markets and construct remedies that are detailed, timely and able to be flexed over time. The CAA has concluded that in relation to HAL, competition law will not readily present such incentives or offer effective

⁹ Details of the CAA's response to HAL's concerns with the Consultation are available in the appendices that form part of this document.

and/or timely remedies. In such circumstances, it is appropriate and proportionate to look at regulatory controls.

- 2.14 The CAA's decision on Test B is unchanged from that proposed in the Consultation.
- 2.15 In relation to Test C, the CAA considers that, taking account of the interests of current and future users of air transport services, particularly their demands in terms of stable supply of high quality airport services at reasonable cost, the benefits of licence regulation outweigh any adverse effects.
- 2.16 The CAA considers that its decision on Test C (together with its decisions on the other components of the market power test (Tests A and B) and the Q6 Final Proposals) will enable HAL to deliver high standards of service quality at a reasonable cost and will promote the efficiency and long-term investment in airport services under a stable regulatory framework.
- 2.17 The CAA's decision on Test C is based on the following considerations:
- If a licence were not in place, HAL would be subject to market forces, sectoral legislation (Airport Charges Regulations (ACRs) and Airport Groundhandling Regulations (AGRs)) and competition law. As set out in its findings under Tests A and B, the CAA considers that HAL has SMP and that competition law is not sufficient to protect users against the risk that HAL may abuse that SMP. While the ACRs and AGRs offer some scope to challenge airport charging structures, their focus is broadly on ensuring airport operators are transparent, objective and non-discriminatory in their treatment of air carriers and suppliers of groundhandling. As such, the ACRs and the AGRs are unlikely to provide sufficient protection to users.
 - Having considered the impact of regulation through price, efficiency, service quality and investment, the CAA is of the view that, despite possible distortions that regulation may cause in theory, in practice minimal distortions are actually occurring at Heathrow. Given the market position of HAL, even when such distortions do arise, it is likely that the negative effects are outweighed by the benefits of regulation.
 - The CAA observes that HAL has undertaken significant investment under the current regulatory regime. Also, it appears the operators of the other airports in the region, which have also been subject to regulation, have not been deterred from taking forward significant investment programmes.

- Analysis shows that Heathrow, under HAL, has a lower level of efficiency when compared to similar airports. Given the lack of competition that HAL is exposed to, it will face limited pressure to tackle these inefficiencies absent licence regulation.
 - Evidence shows that HAL has a good service quality record, although it is difficult to isolate the motivations for its current performance.
 - There are benefits to users by having good operational resilience plans for times of disruption. Similarly, benefits are likely to accrue to users from a financially resilient airport. A licence condition targeting resilience could, therefore, bring substantial benefits to users.
 - While licence regulation may displace, to some extent, a more commercial approach by airport operators, licence regulation would not preclude the ability of the airport operator to negotiate bi-lateral arrangements with its airline customers.
 - Licence regulation can be tailored to minimise the level of management distraction.
 - The direct costs of licence regulation for HAL are likely to be in the region of £12 million per annum. However, the CAA estimates that its proposed price control for HAL is, on average, some £282 million per annum lower than HAL's proposed pricing.
- 2.18 The CAA has also had regard to the regulatory principles in the CA Act and, in particular, that regulatory activities are targeted only at cases where action is needed and are carried out in a way which is transparent, accountable, proportionate and consistent. The CAA considers that a well designed licence based regulatory regime that imposes transparent, proportionate and consistent regulatory obligations on HAL, having a position of SMP in the relevant market, and backed up by effective remedies in the event of a breach, is consistent with UK and European experience that the most effective way to promote competition, economy, efficiency and quality of service.
- 2.19 The CAA's decision on Test C is unchanged from that proposed in the Consultation.
- 2.20 Given Tests A, B and C are met by HAL the CAA has determined that the market power test in section 6 of the CA Act is met in relation to Heathrow Airport.

- 2.21 The effect of this positive determination is that HAL is to be regarded as the operator of a dominant airport operator at a dominant airport for the purposes of section 5 of the CA Act and, pursuant to section 3, HAL is required to have a licence before it can lawfully require its users to pay any relevant charges in respect of airport operation services.
- 2.22 The CAA is consulting separately on the proposed terms and conditions of the licence to be imposed on HAL and they are expected to come into force by 1 April 2014.

CHAPTER 3

Consultation history

- 3.1 Since 1987, the operator of Heathrow has been economically regulated by the CAA in accordance with the Airports Act 1986 (AA86). Under AA86, an airport operator with an annual turnover of at least £1 million requires a 'permission' to levy airport charges at the airport.
- 3.2 When the Secretary of State issued the initial permission to levy airport charges, this included conditions that set maximum airport charges and required HAL's financial accounts to disclose additional information on costs and revenues.
- 3.3 It then fell to the CAA to re-set the price cap at subsequent five yearly intervals in accordance with the AA86, which also obliged the CAA to make a prior reference to the CC.
- 3.4 In the first two price control periods a separate price cap was set for HAL. In the third price control, a single cap covering both HAL and GAL was set, although there was a proviso that charges at Heathrow should rise by at least 1 per cent per annum more than at Gatwick. From the fourth price control period onwards there has been a separate price cap on HAL.
- 3.5 While the CAA currently sets an average maximum yield per passenger that the airport operator is able to recover, the airport operator is able to set the level of individual charges as it considers appropriate to recover up to this maximum in line with its commercial interests. The effect of this is that where an airport operator has entered into bilateral arrangements with airlines at charges below the published tariff the airport operator is not then free to recover the revenue shortfall through increasing the charges paid by other airlines.
- 3.6 Because the price cap is expressed in terms of charges per passenger, the price cap distinguishes between charges paid for passenger flights and those paid for flights not carrying passengers, in particular all-freighter aircraft. Revenues from all-freighter aircraft are not taken into account in the price cap although the airport may not charge more for such aircraft than it would for an equivalent passenger aircraft
- 3.7 In 2011, the CAA commenced a project to understand the extent and nature of market power held by the operators of the airports that were designated under the AA86 and that are subject to price regulation, i.e. Heathrow, Gatwick, and Stansted.

- 3.8 In February 2012, the CAA published the Initial Views¹⁰ and indicated that:
- HAL enjoyed a very strong market position amounting to SMP with regard to its overall operation. It noted that this outcome was primarily guided by:
 - Heathrow's strong market position as a hub airport with airline network operations.
 - A lack of viable substitutes for a considerable proportion of the airlines and passengers at Heathrow.
 - Heathrow's strong position for long-haul services and passengers.
 - The nature of airline economics at Heathrow meant that HAL's SMP extended to both surface and connecting passengers, short-haul services, and to the airport operator's operations overall.
 - HAL's SMP is unlikely to weaken considerably over the medium term due to the hub and network airline effects.
- 3.9 The CAA also invited stakeholders' comments on its proposals for market definition, indicators of market power and the presence or absence of SMP in the markets identified.
- 3.10 In response to the Initial Views, the CAA received three written submissions, and the non-confidential versions of these submissions were published on its website.¹¹
- 3.11 On 30 April 2013, the CAA published for consultation its initial proposals for the economic regulation of Heathrow, Gatwick and Stansted (the Initial Proposals).¹²
- 3.12 On 31 May 2013, the CAA published the Consultation.¹³

¹⁰ In January 2012, the CAA also published the Initial Views Summary. The Initial Views and the Initial Views Summary are available at:

<http://www.caa.co.uk/docs/5/MarketAssessmentsJan12.pdf> and

<http://www.caa.co.uk/docs/5/HeathrowMarketPowerAssessment.pdf>.

¹¹ See: <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=12275>.

¹² These documents are available from the CAA's website:

<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=67#All>.

¹³ This document is available on the CAA's website:

<http://www.caa.co.uk/application.aspx?catid=33&pagetype=65&appid=11&mode=detail&id=5576>.

- 3.13 In the period between the release of the Initial Views and the Consultation, the CAA:
- Undertook extensive evidence gathering and assessment, including through stakeholder engagement, empirical analysis and expert opinion.
 - Refined its thinking on a number of issues, including market definition, competitive constraints and indicators of market power.
- 3.14 In the Consultation, the CAA indicated that it was minded to conclude that:
- Test A was satisfied on the basis that HAL has, and is likely to continue to have, SMP in the market consisting of the provision of aeronautical services to full service carriers and associated feeder traffic airlines at Heathrow.
 - Under Test B, competition law would not provide sufficient protection against the abuse of that market power and some form of regulation might provide a more effective safeguard than competition law alone.
 - Test C was met as the benefits, for users of air transport services, of regulating HAL by means of a licence would outweigh the adverse effects.
- 3.15 As the three components of the market power test were met in relation to an airport area, the CAA was minded to make a market power determination under section 7 of the CA Act. As a result of the airport area and airport being dominant, it would be necessary¹⁴ for HAL to have a licence to charge for services provided in this area and any other area at the airport in respect of which HAL is the operator.
- 3.16 In addition, as part of the Consultation, the CAA welcomed representations, within a period of three months, on its provisional views of the relevant markets, competitive constraints and its assessment of the evidence.
- 3.17 On 3 October 2013, the CAA published for consultation its final proposals for the economic regulation of Heathrow, Gatwick and Stansted (the Final Proposals).¹⁵

¹⁴ Pursuant to section 3 of the CA Act.

¹⁵ These documents are available from the CAA's website:
<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=67#All>.

- 3.18 The CAA received three responses to the Consultation on HAL, these were from:¹⁶
- HAL;
 - Virgin Atlantic Airways (VAA); and
 - London Airline Consultative Committee (LACC) & Heathrow Airline Operators Committee (AOC).
- 3.19 Further detail on the responses to the Consultation and the CAA's responses to the issues raised in those responses can be found in the chapters and appendices of this document.
- 3.20 In January 2014, the CAA also released a document outlining the CAA's reasons for making an operator determination for the purposes of section 10 of the CA Act. As part of that operator determination, the CAA determines who has overall responsibility for management of the airport area comprising Heathrow Airport.¹⁷
- 3.21 A full list of stakeholders that responded to the Initial Views and the Consultation can be found at appendix A to this document and a summary of their key arguments can be found in appendices D – H.

¹⁶ Non-confidential versions of these submissions were published on the CAA's website:
<http://www.caa.co.uk/default.aspx?catid=1350&pagetype=90&pageid=14785>.

¹⁷ This document is available on the CAA's website.

CHAPTER 4

Market definition – final decision

Legal framework

- 4.1 Market definition is a key component of the market power test and is relevant for assessing:
- Whether HAL, as the operator of Heathrow, has SMP in the relevant market for the purposes of Test A.
 - Under Test B, whether there is a risk of abuse of such a position.
- 4.2 Both these 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.
- 4.3 In reaching its assessment, the CAA has had regard to:
- Its own guidance for the assessment of market power of airports (the Guidelines).¹⁸
 - The applicable OFT and EC competition law notices and guidance, to which it must have regard under section 6(10) of the CA Act.¹⁹
- 4.4 Market definition is a useful tool for identifying, in a systematic way, the competitive constraints which the relevant operator faces and whether those constraints prevent it from operating independently of effective competitive pressure.²⁰
- 4.5 However, there may 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

¹⁸ The CAA's April 2011, Guidance on the assessment of airport market power (the Guidelines), are available on the CAA's website:

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

¹⁹ See OFT's Competition Law Guideline on Market Definition, December 2004 (OFT 403) and the EC'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).

²⁰ EC Market Definition Notice, paragraph 2.

constraints faced by HAL in the round, regardless of whether they arise from within or outside the relevant market or markets.²¹

- 4.6 Market definition is also not an end in itself. Rather, it is an economic framework within which to analyse the competitive effects of market definition to support and inform the CAA's regulatory policy.²² 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.²³
- 4.7 The Guidelines state that, wherever feasible, the hypothetical monopolist test should be adopted as a useful starting point for defining the relevant market.²⁴ This test 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 significant non-transitory increase in price (SSNIP) above the competitive level, generally considered as being 5 to 10 per cent. If the price increase is unprofitable, due to customers switching away to substitute products and areas (or other suppliers entering the presumed market), the test is repeated by widening the set of products and geographic area to include additional substitutes until the price increase is profitable. What is then left is the narrowest set of products and geographic area over which a hypothetical monopolist could profitably sustain prices 5 to 10 per cent above competitive levels.
- 4.8 Although the SSNIP test is a useful starting point, it is a framework for approaching market definition rather than a prescriptive methodology. It is intended to be carried out by reference to the competitive price level with the result that it is more difficult to apply where the prevailing price levels observed are not reasonably close to the competitive price. 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 and that all players are profit maximising. In addition, there may be other external

²¹ The 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), paragraph 2.48 to 2.49.

²² The Guidelines, paragraph 1.4, 3.3 and 3.4. See also OFT 403, paragraph 2.1 and 2.6 and the EC Market Definition Notice, paragraph 2.

²³ EC Market Definition Notice, paragraphs 7 to 9 and 13 and the Guidelines, paragraphs 3.6 to 3.9.

²⁴ The Guidelines, paragraph 3.10 to 3.12; OFT 403, paragraph 2.5 to 2.13 and EC Market Definition Notice, paragraph 15 to 19.

considerations that might affect the uniformity and/or the profitability of the price increase.²⁵

- 4.9 As a result, and as noted in the Guidelines, it is therefore rarely possible to apply the SSNIP test in a precise manner due its limitations as well as data and evidential restrictions.²⁶
- 4.10 Given the particular circumstances relating to the historical common ownership and regulation of HAL, GAL and STAL, 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, so far as possible, within the hypothetical monopolist framework.

Product market

- 4.11 As defined in both EC²⁷ and OFT²⁸ 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.

Geographic market

- 4.12 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.*'²⁹
- 4.13 The geographic market area can be distinguished from neighbouring areas because the conditions of competition are appreciably different. It is also important to recognise that, as airports serve a number of different users, there may be different relevant geographic markets for different groups of users.³⁰

²⁵ OFT 403, paragraph 2.10 to 2.11 and 5.4 to 5.6. See also Guidelines, paragraph 3.15 to 3.16 and 3.24 to 3.25.

²⁶ The Guidelines, paragraph 3.13. See also the CC's 2009 BAA Report, paragraph 2.1.

²⁷ EC Market Definition Notice, paragraph 7.

²⁸ OFT 403, paragraph 2.5.

²⁹ The Guidelines, paragraph 3.8 and EC Market Definition Notice, paragraph 8.

³⁰ The Guidelines, paragraph 3.59.

- 4.14 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.

Temporal markets

- 4.15 It is also possible to segment a market across time periods. In the case of airports, it may be relevant to differentiate across seasons or between different times of day and, in particular, between peak and off-peak periods. These temporal differences may be relevant where airlines and/or passengers do not regard different time slots as substitutes.³¹

Market definition – the Consultation

- 4.16 Taking account of the statutory framework and the analysis in the Consultation, the CAA was minded to conclude that the focal product market was one or more airport operation services supplied by HAL in the core area at Heathrow, which was likely to consist of at least:³²
- the use of the runway and taxiways;
 - aerodrome Air Traffic Control (ATC³³);
 - aircraft parking;
 - ramp handling services;
 - fuel and oil handling;
 - the provision of facilities for aircraft maintenance; and

³¹ The Guidelines, paragraph 3.54.

³² The Consultation, p. 70.

³³ Aircraft landing at Heathrow will only face charges from the airport operator for the aerodrome element of ATC. The approach service is provided by NATS (En Route) 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 ability to land and manoeuvre aircraft at and around an airport is also 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 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.

- the provision of infrastructure needed for the provision of other airside and landside groundhandling services.³⁴

4.17 In addition, the CAA was minded to consider that aeronautical services will include:³⁵

- 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 (airline staff processing facilities);
- 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).
- access to additional airport infrastructure to allow for facilities such as lounges and priority security lanes for premium passengers (Premium passenger facilities); and
- 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).

4.18 The CAA also considered 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 that the product market should be aeronautical services supplied to full service long-haul carriers and associated feeder airlines.³⁶

³⁴ 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.

³⁵ The Consultation, pp. 70 to 71.

³⁶ The Consultation, pp. 61 to 116.

- 4.19 On the balance of the evidence of stakeholder views, airline switching, route overlap, passenger catchment areas and passenger switching and the CAA's analysis of such evidence, the CAA was minded to consider that there was one distinct market, that being the provision of aeronautical services for FSCs and associated feeder traffic airlines that was limited to Heathrow.³⁷
- 4.20 The CAA was minded to consider that there was no relevant segregation of the market to reflect differing temporal markets for Heathrow.³⁸

Stakeholders' views

- 4.21 HAL had numerous concerns with the CAA's approach to market definition. In particular, HAL considered that the CAA's approach was:
- Inconsistent with extensive precedent in the analysis of the airport sector (including in the London area) by competition authorities.
 - Inconsistent with its own views as expressed in earlier market power assessment documents and in other contexts.
 - Not supported by robust evidence.
 - Inconsistent with the evidence it has received on the variation in competitive conditions in different market segments.
 - Inconsistent with the legal framework within the CA Act.³⁹
- 4.22 The LACC & AOC (in a joint submission) and VAA both supported the CAA's conclusions on Test A.⁴⁰

CAA views

- 4.23 With respect to HAL's concerns on market definition:
- The CAA does not consider that it is bound by its previous statements where the evidence or subsequent analysis suggests that its previous position should be changed.

³⁷ The Consultation, pp. 61 to 116.

³⁸ The Consultation, p. 114.

³⁹ HAL's response to the Consultation is available on the CAA's website: <http://www.caa.co.uk/default.aspx?catid=1350&pagetype=90&pageid=14785>.

⁴⁰ VAA and the LACC & AOC's responses to the Consultation are also available on the CAA's website: <http://www.caa.co.uk/default.aspx?catid=1350&pagetype=90&pageid=14785>.

- Much of the material that HAL refers to was undertaken a significant time ago under different legislation and a different regulatory regime.
- It would be negligent for the CAA not to take into account the approach and findings of the CC and the CAT in developing its thinking and assessment of the current market position of HAL. As such, the de-designation assessment of Stansted in 2007 and the comments made by the CAA in its initial considerations of the CC's investigation into BAA airports need to be considered in the appropriate context.
- It is widely accepted that market definition is a flexible tool that may alter depending on the question being asked. The CC's BAA airports investigation considered a wide question on the potential of the development of competition between the three BAA airports and sought to remove structural impediments to development of potential competition. The CC was not considering the narrower question that the CAA must consider under Test A, which is the particular market in which an individual airport operator operates.
- The divestment remedy imposed by the CC as a consequence of its airports investigation did not bring an immediate and effectively competitive market into existence. The CC's expectation was for competition to develop over time.
- Merger case law highlighted by HAL is concerned with whether a merger will weaken current competition observed within a market. Similar to the fourth bullet point outlined above. This material is not considering the narrower question that the CAA must consider under Test A.
- Market definition is a time sensitive and context specific exercise. It is based on an analysis of the structure of the market and competition prevailing at a particular point in time.⁴¹ Hence, an assessment will change over time as market circumstances evolve. A prior finding of dominance by the EC or a National Competition Authority (or even a national court) is therefore not binding.⁴²

⁴¹ Bellamy & Child, EU law of competition, paragraph 10.018.

⁴² For example, the EC has to start new analysis on the condition of competition in course of making new decisions: *'in the course of any decision applying Article 86 of the Treaty the Commission must define the relevant market again and market a fresh analysis of the conditions of competition which will not necessarily be based on the same considerations as those underlying the previous finding of a dominant position.'* Source: Case T-125/97 Coca-Cola v Commission [2000] ECR ii-1733, paragraph 82.

- Since the publication of the Initial Views, the CAA has developed a substantial evidence base on which it has refined its thinking.⁴³

4.24 The CAA notes the LACC & AOC's and VAA's support for the conclusions on Test A that it outlined in the Consultation.

Market definition – final decision

4.25 As noted earlier, although the SSNIP test is a useful starting point for defining the market, it is intended to be carried out by reference to the competitive price level. It is also rarely possible to apply the SSNIP test in a precise manner due its inherent limitations as well as data and evidential restrictions.⁴⁴

4.26 Given the historical common ownership and regulation of HAL, GAL and STAL, the CAA has been unable to carry out a formal SSNIP test. However, the CAA has gathered evidence, including catchment area analysis, passenger surveys, documentary evidence and the views of airlines and relevant airport operators on substitutability to inform its analysis and this has been interpreted within the hypothetical monopolist framework.

4.27 The CAA has also carefully considered what price level it should use as a starting point for its analysis and has concluded that the current regulated prices are an appropriate benchmark (or proxy) for the following reasons:

- They are cost-based on the basis of an acceptable cost standard and are designed to allow the airport operator to earn a return consistent with the risk of its investment.
- They are the prices faced by airlines, groundhandlers and passengers. Its use therefore limits the risks involved in gathering evidence around or hypothesising about an abstract pricing level.
- Regulated prices have been used in several cases of market definition in regulated telecommunications across Europe. In particular, the EC has taken the view that regulated prices should be taken as the starting point for conducting a SSNIP test.

⁴³ Details of the CAA's response to HAL's concerns with the Consultation are available in the appendices that form part of this document.

⁴⁴ The Guidelines, paragraph 3.13. See also the CC's 2009 BAA Report, paragraph 2.1.

- 4.28 Taking account of the statutory framework, the analysis outlined in the Consultation, responses to the Consultation and a starting point for the SSNIP that is the current regulated price, the CAA concludes that the relevant market for HAL is the provision of airport operation services for FSCs and associated feeder traffic market that is limited to Heathrow.
- 4.29 The particular service provided at Heathrow consists of a single product that consists of the following airport operation services:
- the use of the runway and taxiways;
 - aerodrome ATC;
 - aircraft parking;
 - the provision of access and infrastructure needed for the provision of other airside and landside groundhandling services;
 - the provision of facilities for check-in;
 - baggage handling;
 - security screening;
 - holding passenger facilities;
 - airline staff processing facilities;
 - passenger transit facilities;
 - cargo processing facilities;
 - premium passenger facilities; and
 - integrated transfer facilities.
- 4.30 The key rationale for the CAA's decision that the relevant market for HAL is the provision of airport operation services for FSCs and associated feeder traffic market that is limited to Heathrow is summarised below.

Product bundle

- 4.31 The key rationale for the CAA's decision with respect to the product bundle is that:
- The CA Act provides a useful starting point in identifying the key product bundle. The CAA considers that the focal product is likely to consist of one or more of the airport operations services defined in section 68 of the CA Act.

- Given the complexity of Heathrow and the various products and services that HAL provides to users of the infrastructure at Heathrow, it is appropriate to determine a service bundle rather than individual products or services as:
 - 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.⁴⁵
 - 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).
- The market power test is applied to the operator of an airport area, which is defined in section 9(1) of the CA Act as the person having overall responsibility for the management of all of the area. In determining overall responsibility, the CAA is directed to have regard to the extent that the person controls the matters listed in section 9(4) of the CA Act, which include the type, price and quality of services provided in the area as well as access to the area. Accordingly, while recognising that HAL may not directly supply each individual service at Heathrow, HAL has some degree of control or influence on pricing of the services as the infrastructure operator. In addition, the CAA's approach is consistent with the approach adopted by the CC in its consideration of product market definition for the BAA airports market reference.⁴⁶

⁴⁵ 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.

⁴⁶ 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. The CAA does not, at this time, consider it is analytically necessary to define primary and secondary products, as the CC did. For clarity, the CAA considers them as a whole.

*Retail, property and car parks*⁴⁷

4.32 The key rationale for the CAA's decision with respect to retail, property and car parks is that:

- Retail, property and car parks are not part of the focal product market. The CAA considers that it is more appropriate to define a separate and distinct market for the provision of facilities for retail activities and car parks. This approach is consistent with the approach adopted by the CC with respect to these activities.
- While it is encouraging to see HAL actively targeting passengers and providing relevant services for passengers, it is ultimately the decision by airlines to provide services from Heathrow that drives passenger numbers at the airport. The CAA also considers that airlines take account of the needs of their passengers while they are at Heathrow and would therefore demand a certain level of facilities and services from HAL to accommodate these.
- Commercial revenues are complementary to aeronautical revenues rather than exhibiting the demand feedback that would be required in a multi-sided market. While the pricing of the aeronautical service bundle affects the overall passenger numbers at Heathrow, which in turn affects HAL's commercial revenue, HAL's pricing of commercial services at Heathrow does not affect the overall demand of either passengers or airlines for the aeronautical bundle.
- In practice, the price for retail activities is unlikely to affect passengers' choice of an airline or airport in a significant way. Therefore, the CAA considers that: (1) concessionaires' decisions are likely to be independent from decisions made by airlines in relation to aeronautical services; and (2) airlines' decision making and profitability is independent of that of the retail, property and car parks concessionaires'.

⁴⁷ In outlining this, the CAA recognises that some services, for example, some long stay car parks, will be outside the airport area as defined in this determination.

Other segmentations

4.33 The key rationale for the CAA's decision with respect to other segmentation is that:

- While recognising that connecting passengers may be more price sensitive and may face a different set of airports to choose from, the CAA does not consider it necessary to segregate the product market by introducing a separate segment for connecting passengers as they consume a similar bundle of airport operation services to origin and destination (O&D) passengers. The CAA considers this position is consistent with the relevant case law (which has not segregated the market by connecting and O&D passengers). In cases where segregation has been considered, it has been left open.
- The airport operation services for cargo and passenger transport markets are likely to differ, not least in the additional handling that cargo requires when at the airport. However, given that at Heathrow the focus of cargo operations is on the provision of bellyhold space by passenger airlines, the CAA does not consider it necessary to define an independent product market for cargo at the airport in its conclusion on market definition.

Supply side product substitution

4.34 The key rationale for the CAA's decision with respect to supply side product substitution is that:

- The 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. The CAA also considers that planning restrictions and other constraints mean that entry or expansion of other airports is unlikely to occur within a reasonable time period.
- It would not be rational to consider that airlines would alter their fleets as a response to a change in airport charges due to the sunk costs present in their current fleets and the costs involved in acquiring and equipping new aircraft.
- Supply side substitution would only occur based on currently available infrastructure.

Geographic market – demand side analysis

4.35 The key rationale for the CAA's decision with respect to demand side analysis as it relates to the geographic market is that:

- Despite the apparent choices available to connecting passengers, based on the available evidence, the level of competition from other hub airports is insufficient to suggest a geographical market that is wider than Heathrow. The evidence the CAA has obtained indicates that, at the airline level, there is likely to be a number of discrete markets for particular route pairs. These may involve connections over a number of hubs (and/or direct routes). While each of these hubs may compete with the other hubs providing such services to some degree, the level of competition falls short of the level of constraint necessary to suggest that such hubs constrain each other's pricing. The CAA does not therefore consider that there would be sufficient substitution to non-UK airports to make a SSNIP by HAL unprofitable.
- Evidence from based and inbound carriers suggests that Heathrow is a market in its own right, differentiated by brand and its hub status. This evidence also suggests that Heathrow is a preferred product to that offered at other UK airports. The switching that the CAA has observed also supports the view that Heathrow is a preferred product to Gatwick.
- Airport operator evidence suggests that the geographic market for Heathrow may be wider than that indicated by the airline evidence. However, it also shows that Heathrow provides airlines with significant additional benefits over other airports. This is likely to increase the barriers of switching away from Heathrow for airlines currently operating from that airport.
- While both catchment area analysis and passenger preference analysis have limitations, they suggest choice for surface passengers. However, the CAA does not consider that this evidence is conclusive for the purposes of geographic market definition. While it has not been able to carry out an appropriate price elasticity of demand analysis for passengers at Heathrow, the CAA has considered, on objective criteria, a critical loss analysis at the airline level which suggests that there would be insufficient switching from Heathrow as a result of a SSNIP.

Geographic market – supply side analysis

4.36 The key rationale for the CAA's decision with respect to supply side analysis as it relates to the geographic market is that:

- While both the supply side and passenger analysis suggests that all the London airports are potential substitutes, (especially those with sufficient infrastructure to compete over the aircraft in the 75 to 100 tonne maximum take off weight), and there is ample capacity at Stansted such that sufficient capacity could be switched from Heathrow, demand side analysis shows the service that HAL offers at Heathrow is highly differentiated from other services available at the other London airports which suggests a market that is limited to Heathrow.

Temporal markets

4.37 The key rationale for the CAA's decision with respect to supply side analysis as it relates to temporal markets is that:

- While recognising that the declared capacity at Heathrow varies with both the time of day and the season⁴⁸, the CAA does not consider that this affects the inherent competitive structure of the market between the seasons to the extent that the analysis would benefit from segmenting the market in this way. The CAA has also not seen evidence to suggest that passengers become more price sensitive between seasons. The CAA therefore considers that it is not appropriate to segment the market by time of day or season for its conclusions on market definition.

4.38 The CAA's identification of the relevant services and analysis of the key characteristics of demand and supply substitutability, airline and passenger substitutability and other market features which form the basis for this decision are set out in more detail in appendix D.

⁴⁸ Source: HAL [3<].

CHAPTER 5

Test A: Market power – final decision

Legal framework

- 5.1 Market power is the ability to profitably 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.⁴⁹ Market power is not an absolute term but a matter of degree which varies according to the individual circumstances of the case.
- 5.2 As part of its assessment of market power, the CAA needs to identify the existence and the potential strength of the competitive constraints⁵⁰ within the relevant markets. The CAA needs to do this to determine whether the relevant markets are subject to effective competition or not.
- 5.3 The Guidelines indicate that evidence on the market structure and market shares is commonly used in competition assessments. Market power is more likely to exist if an operator has a persistently high market share over time compared to its nearest rivals.⁵¹
- 5.4 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 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 share as an indicator of market power. It may be necessary to take account of constraints from outside the relevant market.

⁴⁹ OFT's Competition Law Guideline on Assessment of Market Power December 2004 (OFT 415), paragraph 3.1 to 3.3.

⁵⁰ 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.

⁵¹ The Guidelines, paragraph 4.2 and OFT 415, paragraph 4.2 to 4.3.

- There are aspects of airport markets that may reduce the reliability of market share 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 share as an indicator of market power.⁵²

5.5 In the case of the London airports, there are additional reasons why market share may not be a reliable measure of the level of market power of airport operators, including:

- Long-term capacity constraints at Heathrow and, to a lesser extent, at Gatwick. 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'*.⁵³
- 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 but, instead, it may have marketed its airports as complementary to one another to prevent growth at one airport cannibalising growth at another.
- The level of substitutability of airports for different airlines can be influenced by (among other issues) infrastructure requirements, capacity constraints, strategic reasons and costs.

5.6 Notwithstanding these concerns, the CAA has calculated market shares for HAL by reference to the market definition that the CAA has adopted (based on the available evidence). In addition, the CAA has had regard to other market features, including buyer power, barriers to entry and the extent of potential competition through new entry and/or expansion.⁵⁴ In so doing, the CAA has analysed the likely reactions, from within and outside the relevant market, to any attempt by HAL to restrict output, increase prices above the competitive level and/or reduce quality at Heathrow below the levels that would be seen in a competitive market.⁵⁵

⁵² The Guidelines, paragraphs 4.5 to 4.9.

⁵³ OFT, Assessment of market power, Understanding competition law, paragraph 4.4.

⁵⁴ See the Guidelines and chapters 5 to 7 and OFT 415, chapter 5.

⁵⁵ A discussion on HAL's pricing behaviour is outlined in appendix F.

- 5.7 The CAA has supplemented this analysis with analysis of other indicators of market power relating to HAL's behaviour and performance, including with respect to profitability measures, quality of service, efficiency and engagement with airlines and the effect of regulation to date.⁵⁶

Market power – the Consultation

- 5.8 Taking account of the analysis in chapters 4 to 6 of the Consultation, the CAA was minded to conclude that HAL had SMP for the provision of airport operation services to FSCs and associated feeder traffic airlines that were limited to Heathrow.
- 5.9 As part of this, the CAA noted that the most likely source of any SMP that HAL has would appear to stem from its position as the operator of the UK's only hub airport and the combined package that it offers of strong demand, including premium passengers, cargo and connecting passengers. This makes it attractive for both based and inbound airlines. The CAA considered that the importance of network effects meant that very few airlines would be able and willing to switch sufficient capacity to constrain an increase in HAL's charges.
- 5.10 The CAA also noted that Heathrow's good surface access options, the inherent attractiveness of the London market, and its strategic importance to airlines in general combined with constraints in the London system that act to reduce the number and size of available alternatives are also important.
- 5.11 In addition (as noted in chapter 2), the Government has put on hold the expansion of the main London airports and that the Airports Commission is not expected to issue its final report until summer 2015. As such, over the Q6 period, due to improving economic conditions and the lack of significant capacity expansion, the CAA considered that HAL's SMP was likely to endure.

Stakeholders' views

- 5.12 As outlined in chapter 3, the CAA received three submissions to the Consultation.
- 5.13 HAL considered that the CAA had based its conclusions on flawed analysis. In particular, it considered that:

⁵⁶ See the Guidelines, paragraphs 7.4 to 7.10 and OFT 415, paragraphs 6.5 to 6.7.

- The proposed market definition was inconsistent with extensive precedent from other competition authorities and inconsistent with the CAA's own previously expressed views. It was not supported by robust evidence, and it was therefore inconsistent with evidence on the different competitive conditions facing different market segments. Finally, it considered that the market definition appeared to be inconsistent with the legal framework established within the CA Act.
- The analysis of competitive constraints understated the cumulative effect of potential switching options available to airlines and passengers and overstated airlines' potential switching costs. It also considered that the CAA had failed to consider the wider dimensions of competition such as service quality.
- The CAA's critical loss analysis was subject to significant limitations, particularly the lack of direct price elasticity evidence to estimate 'actual' loss, the arbitrary alternative approach to estimating likely lost passengers, and the use of potentially skewed commercial income and cost elasticity assumptions with no sensitivity analysis.
- The CAA's review of market power indicators added little to the analysis.

5.14 VAA and the LACC & AOC (in a joint submission) agreed with the CAA and consider HAL has SMP.

- VAA, as a UK-based long-haul airline, disagreed with HAL's view that implied competition with European hub airports. It noted that bi-lateral air service agreements negotiated between governments coupled with the significant sunk cost invested in Heathrow meant that it was unable to relocate its services to a European hub. It also noted that HAL's dominant position was evidenced by HAL's ability to:
 - Reduce its proposed capital plan for Heathrow over Q6 without consultation (following the release of the Initial Proposals).
 - Increase prices above an efficient level.
- LACC & AOC considered that HAL was using its market power to sustain prices above an efficient level. It considered that behavioural evidence demonstrated this. For example, it noted HAL imposes the Conditions of Use each year and that delays and increased costs associated with delivering infrastructure was reflective of an infrastructure supplier that was not operating in a competitive environment.

CAA views

- 5.15 The CAA welcomes the responses and has considered all of these (and other submissions) as part of its decision making process.
- 5.16 With respect to HAL's concerns on market definition, the CAA, having considered the responses to the Consultation, continues to consider that the relevant market is the provision of airport operation services for FSCs and associated feeder traffic market that is limited to Heathrow. The CAA notes the concerns raised by HAL but, for the reasons outlined in chapter 4 (and appendix D), considers that its definition is appropriate.
- 5.17 On HAL's concerns that the CAA has not considered the cumulative effect of competitive constraints, the CAA disagrees. While the reasoning on each issue was set out separately in the Consultation, the CAA considered the cumulative effect of the constraints in reaching its conclusion. This approach of looking at different competitive constraints individually and as a whole is in line with the Guidelines and has been continued in the attached appendices.
- 5.18 On HAL's concerns on service quality, HAL appears to be responding to the regulatory incentives of service quality at Heathrow and this is a credit to it. However, HAL's observed service quality cannot on its own be interpreted as a sign of competitive pressures faced by HAL (although it is possible that it has improved due to these pressures). This is consistent with HAL's comment that *'Heathrow's continuing performance in service quality cannot be solely explained by regulatory incentives, but we agree that it may be difficult for the CAA to isolate the various incentive effects'*.
- 5.19 On HAL's concerns with the CAA's critical loss analysis, the CAA derived an estimate of the likelihood of marginal switching by airlines to compare to the critical loss. In the Consultation, the CAA acknowledged that the absence of a means of estimating direct 'actual loss' numbers and elasticities for Heathrow was a limitation to its analysis. The CAA decided not to commission a passenger demand forecasting run from the Department of Transport (as it has done in the case of Gatwick and Stansted), due to difficulties in using NAPALM – a passenger allocation model – to estimate airport charge increases for Heathrow. The CAA did this as:

- The airport is forecast to be 100 per cent full by 2014 and therefore any passenger switching estimated would, in effect, represent modelled adjustments around the binding capacity constraint. This means that the estimates would not be particularly informative of the response of passenger demand to an increase in airport charges.⁵⁷
- At Heathrow, where over a third of passengers are connecting (not surface passengers), the modelling approach of increasing surface access costs as a proxy for airport charge increases that was used for Gatwick and Stansted would not be suitable. This means that it would be difficult to model an airport charge increase for all passenger categories at Heathrow and the results of the modelling would be hard to interpret.

5.20 However, HM Revenue and Customs (HMRC) produced a report⁵⁸ that uses NAPALM to model the effect of potential increases of Air Passenger Duty (APD) at Heathrow. While the level of switching of APD paying passengers that would result from an increase in APD would be small in comparison with the cost increase at Heathrow⁵⁹, the CAA considers that some relevant information can be drawn from this. The report found that if the APD was increased Heathrow would lose some APD paying passengers (point-to-point) to neighbouring airports but gain connecting passengers (who would backfill the small loss of APD paying passengers).

5.21 The findings outlined in the HMRC report gives further confidence in that the actual losses at Heathrow as a result of a 5 to 10 per cent increase in airport charges is likely to be below the critical loss.

5.22 In addition, while there are limitations to performing a precise critical loss analysis, there can still be benefits to obtaining a partial indication to be assessed as part of a broader evidence base.

5.23 With respect to HAL's concern that the indicators of market power added little to the CAA's analysis, the CAA considers that the indicators can provide useful information to inform its assessment, particularly when a number of them are pointing to the same conclusion. In addition, HAL's pricing behaviour – an important indicator that was, in the Consultation,

⁵⁷ Estimates were, however, made for GAL and STAL in the respective consultation documents.

⁵⁸ HMRC, Modelling the Effects of Price Differentials at UK Airports, 2012, available at: <http://www.hmrc.gov.uk/research/report188.pdf>.

⁵⁹ The HMRC report estimates that if APD at Heathrow went up by 10 per cent APD paying passengers would fall by 1.6 per cent; non-APD paying passenger numbers would increase.

examined in the chapter on market definition – is, in this document, examined with the other indicators of market power.

Final decision

- 5.24 Taking account of the analysis outlined in this document (including the appendices), the CAA has concluded that HAL has SMP in the provision of airport operation services to FSC and associated feeder traffic airlines that are limited to Heathrow.
- 5.25 The basis for the CAA's finding of SMP in the market for the provision of airport operation services to FSC and associated feeder traffic airlines that are limited to Heathrow is that:
- HAL has 100 per cent of the market (irrespective of whether it is measured by passenger numbers or Air Transport Movements) and that this market share establishes a rebuttable presumption of a position of SMP in the relevant market. However, market share alone may not be sufficient to establish a position of SMP.
 - Switching costs for BA (the home hub carrier) and its partner airlines, can be particularly high due to network benefits derived from connecting passenger feed and the presence of strategic partner airlines which cannot be found at other London or UK airports.
 - Airlines in other alliances or unaligned carriers also face significant switching costs from the loss of network benefits (albeit slightly lower than those faced by partner airlines of BA). That said, a small number of airlines with little connecting traffic and few partner airlines might be more able to switch away.
 - The potential loss of cargo revenue may be an incremental switching cost for certain airlines, as the feed of cargo at Heathrow is the largest in the UK, due to the concentration of the air cargo community around Heathrow.
 - Airlines are likely to have sunk costs from marketing and other related costs from promoting its services, which to the extent that they need to be replicated at alternative airports, can be considered switching costs.
 - The effect on these airlines' profitability from switching away from Heathrow would be likely to considerably outweigh any longer term benefits of constraining a price increase at the airport (that is, Heathrow is of strategic importance to airlines at Heathrow).

- A comparison of an estimate of the size of marginal airline traffic at Heathrow against the critical loss estimates suggests that the scale of actual switching is likely to be insufficient to constrain even a 5 per cent increase in charges by HAL.
- While recognising that some airlines could have buyer power, the considerable strategic importance of operating from London and Heathrow, as well as the significant network effects at the airport, mean that airlines are unlikely to have significant choice to switch away. In addition, any buyer power that an airline may have needs to be considered within the context that:
 - There is excess demand for slots at Heathrow, which means that any released slots by an airline's marginal switching are likely to be backfilled by airlines waiting to enter or expand operations.
 - HAL does not appear to offer discounts on airport charges. This, coupled with the statements by the airlines that they need to absorb (or in some cases pass on) any cost increases, also suggests that airlines are highly unlikely to have countervailing buyer power to be able to constrain HAL by credibly threatening to switch away from the airport.
- Heathrow is effectively operating at capacity and there is currently a moratorium on airport expansion for the London airports. As capacity constraints at Heathrow are likely to increase up to at least 2020, and probably beyond, HAL will benefit from this. As the only hub airport in the UK, the competitive constraints faced by HAL from London or other UK airports is unlikely to strengthen in the short to medium term. This is likely to weaken further HAL's incentives to attract new airline business.
- In the event that competitive constraints faced by HAL weaken, HAL would have even greater pricing power towards airlines seeking to operate from a hub airport to serve London and the UK. In addition, it is unclear, after the excess demand is accommodated following any capacity expansion, whether there would remain sufficient spare capacity at Heathrow to significantly affect the airport operator's market position.

- Department for Transport forecasts suggest that capacity constraints will increase at Heathrow over the short to medium term. In addition, with the Airports Commission only reporting final proposals in 2015, it is highly unlikely that any new capacity will be available before 2025 at the earliest. In addition, it is unclear, after the excess demand is accommodated, whether there would remain sufficient new capacity at Heathrow to significantly affect the airport operator's market position.
- While new airports can sometimes enter the market, the investment and lead times involved in new entry are likely to significantly limit the impact of this form of competitive constraint. In addition, while the expansion and/or entry by existing aerodromes, and/or the threat thereof, may represent a source of competitive constraint, the cost and timescales involved in expanding to accommodate sufficient switching may still be too great to constrain HAL's prices in the short to medium term.
- Heathrow is a relatively expensive airport, HAL does not offer any discounts to its prices and there have been some significant price increases over the last ten years.
- As HAL is pricing to the cap, and slot pairs are traded for considerable sums, there is a reasonable expectation that, if the price cap was removed, HAL would seek to increase prices.
- Leigh Fisher's (LF) analysis shows that HAL's aeronautical charges are above those of comparator airport operators. In particular, LF's analysis shows that HAL's aeronautical revenue per passenger has, since 2008, been significantly above the average secured by comparable airport operators – at 2010, around £5 higher.
- The indicators of market power, particularly HAL's approach to price and to engagement and commercial negotiations, suggest (among other things) that HAL:
 - Does not pursue genuine engagement with its customers and that instead it acts to an appreciable extent unilaterally.
 - Does not enter into commercial negotiations with the airlines, instead it largely sets the terms that an airline will receive for using the infrastructure at Heathrow, and that the scope for negotiation is limited.

5.26 The CAA's analysis of the key characteristics of demand and supply substitutability and other market features which form the basis for this decision are set out in more detail in the appendices of this document.

Conclusion on Test A

- 5.27 In light of the CAA's findings on market definition, competitive constraints and indicators of market power, the CAA concludes that HAL currently has SMP in the relevant market and that its market power is unlikely to be eroded over the Q6 period.

CHAPTER 6

Tests B and C

Background

- 6.1 As outlined in chapter 1, section 3 of CA Act prohibits the operator of a dominant area at a dominant airport from requiring payment of charges without a licence. The CA Act only permits economic regulation of an airport operator and the granting of a licence by the CAA if all three components of the market power test set out in section 6 of the CA Act are satisfied.
- 6.2 Having determined that Test A of the market power test has been met, this chapter briefly outlines the CAA's views on whether or not Tests B and C are also met.

Test B conclusion

- 6.3 In the Consultation, the CAA considered that given the potential detriment to users of air transport services and the difficulties in pursuing potential exploitative vertical abuses, in light of the case law, that for HAL, competition law was unlikely to be sufficient to curtail abusive behaviour.
- 6.4 The CAA has carefully considered the representations from stakeholders to the Consultation. Its final conclusion is that competition law does not provide sufficient protection against the risk that HAL may abuse the substantial market power identified in the CAA's consideration of Test A.
- 6.5 The detailed reasoning and evidence supporting its conclusion on Test B are set out in appendix H on an issue by issue basis.

Test C conclusion

- 6.6 In the Consultation, the CAA considered that the benefits of licence regulation outweighed the costs to users.
- 6.7 The CAA has carefully considered the representations from stakeholders. Its final conclusion is that for HAL, the benefits of licence regulation outweigh the adverse effects.
- 6.8 The detailed reasoning and evidence supporting its conclusion on Test C are set out in appendix I on an issue by issue basis.

CHAPTER 7

Conclusion

7.1 The CA Act prohibits the operator of a dominant area at a dominant airport from requiring payment of charges without a licence. The CA Act only permits economic regulation of an airport operator and the granting of a licence by the CAA if all three components of the market power test set out in section 6 of the CA Act are met.

7.2 Pursuant to its duties specified under the CA Act and having regard to the relevant:

- notices and guidance published by the EC about the application and enforcement of the prohibitions in Articles 101 and 102 of the TFEU;
- advice and information published under section 52 of the Competition Act 1998 (advice and information about the application and enforcement of the prohibitions in Part 1 of that Act and Articles 101 and 102 of the TFEU); and
- the advice and information published under section 171 of the Enterprise Act 2002 (advice and information about the operation of Part 4 of that Act);

and after having taken due account of the competition law notices and guidance as well as the responses to the Initial Views and the Consultation, the CAA has defined the relevant market as the provision of airport operation services to FSCs and associated feeder traffic airlines that are limited to Heathrow.

7.3 This market comprises the following airport operation services provided at Heathrow:

- the use of the runway and taxiways;
- aerodrome ATC;
- aircraft parking;
- the provision of access and infrastructure needed for the provision of other airside and landside groundhandling services;
- the provision of facilities for check-in;

- baggage handling;
- security screening;
- holding passenger facilities;
- airline staff processing facilities;
- passenger transit facilities;
- cargo processing facilities;
- premium passenger facilities; and
- integrated transfer facilities.

7.4 The CAA, having regard to its general duties under the CA Act and the relevant notices and guidance issued by the EC and the OFT regarding the competition law notices and guidance, has determined that HAL has SMP in a market for one or more types of airport operation services to FSCs and associated feeder traffic airlines that are limited to Heathrow and that this is expected to persist over the Q6 period. Consequently, the CAA determines that Test A of the CA Act is met in relation to HAL

7.5 The CAA has also determined that competition law alone is unlikely to provide sufficient protection against the risk that HAL may abuse the substantial market power identified in the CAA's consideration of Test A. That is, the CAA has determined that Test B has been met.

7.6 In addition, the CAA has determined that the benefits to current and future air transport users of licence regulation outweigh any adverse affects. That is, the CAA has determined that Test C of the CA Act is met.

7.7 Given that Tests A, B and C are met in relation to HAL, being the operator of the airport area of Heathrow, the CAA has determined that the market power test in section 6 of the CA Act is met.