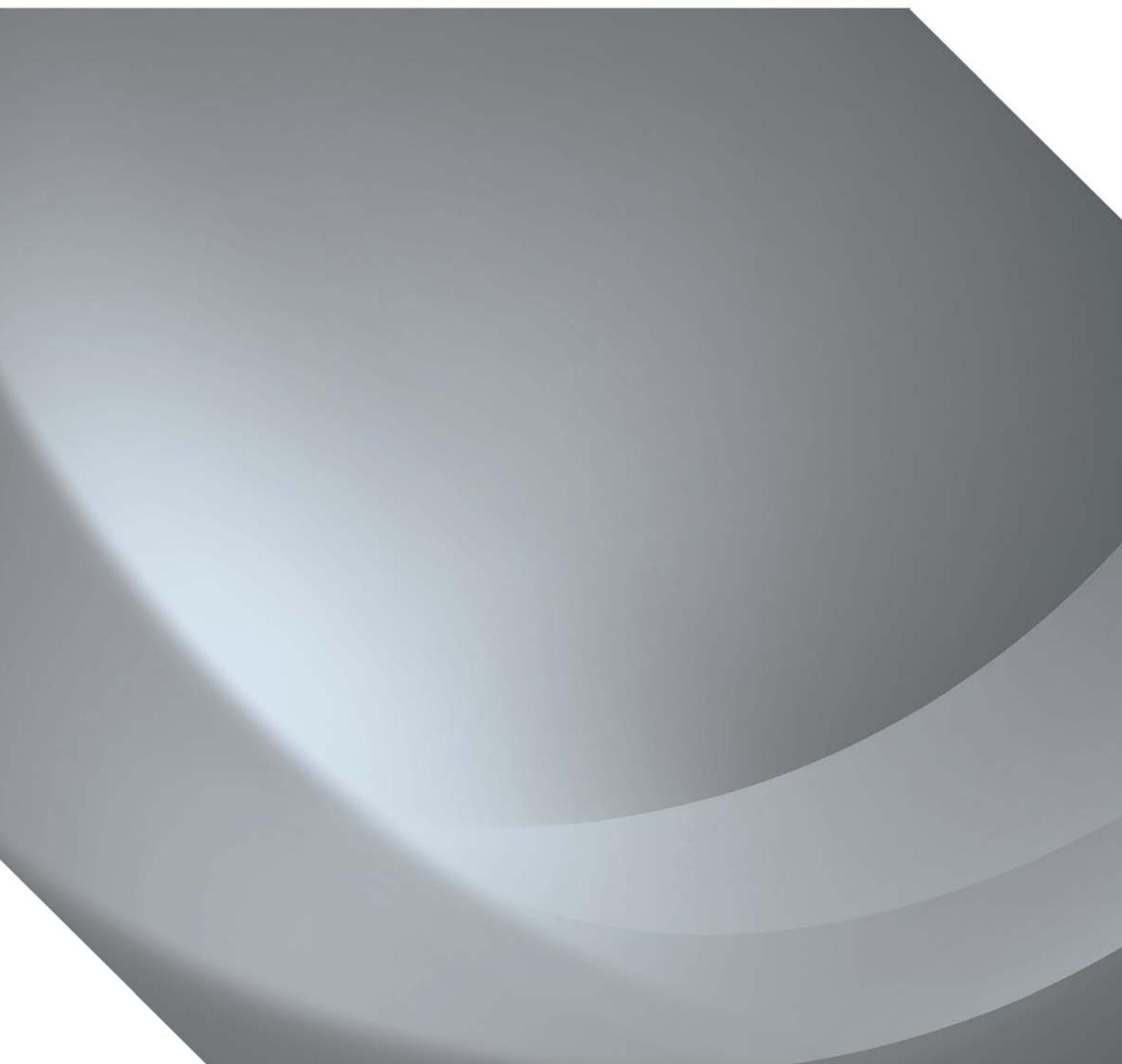


Draft guidance on the application of the Market Power Test under the Civil Aviation Act 2012: Consultation

CAP 1355



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Executive Summary

1. The Civil Aviation Act 2012 (CAA12) requires that we, the CAA, regulate certain airport operators directly by means of a licence if they, following a Market Power Determination (MPD), meet the requirements of the Market Power Test.
2. The Market Power Test consists of three parts:
 - Test A - whether an airport operator has substantial market power (SMP), which was the focus of our previous guidance.
 - Test B - whether competition law does not provide sufficient protection against the risk of abuse of the SMP.
 - Test C - whether the benefits of regulating the airport operator by means of a licence outweigh the adverse effects.
3. In April 2011, before CAA12 was enacted, we published 'CAA guidance on the assessment of airport market power'. This document was prepared in anticipation of CAA12 coming into force and did not cover all elements of the Market Power Test as set out in CAA12. The draft guidance in this consultation is intended to replace this 2011 document.
4. During 2013 and 2014 we conducted MPDs covering the three largest London airports.¹ The draft revised guidance largely reflects the framework we used for these MPDs. Some elements of the previous 2011 guidance have been removed where they were found to be overly detailed and did not have generic application. As well as these changes to guidance on Test A, we have also added sections to cover Tests B and C.
5. The revised guidance also contains more detail on the process we will follow. This aims to improve the way MPDs are delivered. In particular we propose:
 - a clear distinction between stages when we will be gathering information and when we will be consulting on our assessment;

¹ The 2014 MPDs are available at <http://www.caa.co.uk/default.aspx?catid=78&pageid=12275>.

- to set out an indicative timetable in advance for each MPD we commit to undertake. We aim to complete future MPDs within 18 months.
6. We are, therefore, now consulting on draft guidance. The document is on our website at www.caa.co.uk/CAP1354
 7. This remainder of this paper summarises the draft guidance and raises some questions stakeholders may particularly want to consider in any response. You are not, however, restricted to commenting on these issues and we would welcome views on any aspect of this draft guidance. Please can you send any responses to economicregulation@caa.co.uk no later than 12 February 2016.
 8. We will publish responses on our website after the end of the consultation period. If there are parts of your response that you consider to be commercially confidential, please can you clearly mark them as such and send us a non-confidential version that we can publish.
 9. If you would like to discuss any aspect of the draft guidance please can you contact Pedro Lino Pinto at pedro.pinto@caa.co.uk.
 10. We will take all responses received into account when producing our final guidance.

Test A - Substantial Market Power

11. Test A requires that we establish whether the relevant operator has, or is likely to acquire, substantial market power (SMP).² The assessment of market power was the main focus of the 2011 guidance. As explained above, we have updated our approach from this earlier document.
12. Compared to the 2011 document, our draft guidance places more emphasis on existing frameworks provided by the relevant notices and guidance issued by the European Commission (EC)³ and the Competition and Markets Authority (CMA)⁴. These provide a generic framework for market power assessment which goes into less detail than our 2011 document on methodologies we would use in particular circumstances. Nevertheless, we do cover some of the same ground in terms of:
 - consideration of how we define the focal product and the geographic market;
 - establishing a relevant market definition including use of the hypothetical monopolist framework and assessing market shares;
 - identifying the existence and the potential strength of competitive constraints⁵ from within and from outside the relevant market;
 - considering the specific barriers to airline and passenger switching, both within and outside the relevant market;

² Section 6(3) read together with sections 6(6) and 6(7) of CAA12.

³ [http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31997Y1209\(01\)&from=EN](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31997Y1209(01)&from=EN)

⁴ Available at:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284423/oft403.pdf and

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284400/oft415.pdf

⁵ CMA's Competition Law Guidance on Assessment of Market Power, December 2004 (OFT 415) 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.

- supplementing this with analysis on other available indicators of market power, including the airport operator's behaviour and performance, profitability measures, quality of service, efficiency and engagement with airlines; and
 - assessing countervailing buyer power where relevant.
13. Our 2011 document discussed in more detail how we could apply some of these topics in practice. However, on the basis of our experience in conducting the MPDs, we now consider that the guidance itself should be more generic so as to be able to consider all types of evidence submitted to us by stakeholders, as well as to be able to adapt the analytical effort to particular circumstances.
14. However, we recognise that we may need to perform a more detailed analysis on individual issues with respect to any particular airport. In this event, we would, where appropriate, expect to consult separately on a particular methodological approach we were intending to take as part of the MPD process. We may, for example, issue working papers for discussion or consultation as part of the MPD process or in preparation for an MPD.

Test B – Insufficiency of Competition Law

15. Test B requires that we establish whether competition law provides sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of its SMP.⁶ We carried out this test as part of the MPDs for the main London airports but have never previously issued guidance on our approach.
16. Although Test B is a separate test, it cannot be divorced from our assessment of Test A. If the airport does not have SMP, it cannot, by definition, abuse it.
17. Competition law prohibits dominant companies from abusing their market power: it is not the position of dominance or SMP that is, in itself, prohibited. Rather, using that position to prevent or distort effective competition in the market is prohibited. A dominant company has a special responsibility not to allow its conduct to impair or distort competition in the relevant market.⁷
18. The way we have dealt with Test B in our guidance is to assess the extent to which there has been scope for dealing with particular types of abuse on the basis of previous case law.
19. Our guidance notes that competition law, including in aviation, has been successfully applied and is likely to provide sufficient precedent in:
 - vertical exclusion cases; a situation where the business is dominant in the upstream market (i.e. airport facilities) and abuses its position by, for example, favouring its own or particular companies operating in the downstream market for other services; and
 - discrimination cases, where the airport operator would favour one user (e.g. an airline) or other customer group at the expense of others.⁸

⁶ Section 6(4) read together with sections 6(8) and 6(9) of CAA12.

⁷ Case 322/81 *Michelin v Commission* [1983] ECR 3461, paragraph 57.

⁸ Although not directly related to the question, we note that the Airport Charges Regulations also provide a specific framework for dealing with potential discrimination at airports.

20. However, we consider that there is less scope for competition law to deal with potential abuses of an airport operator's SMP in the form of exploitation through generally excessive prices or reduced service quality. This may affect users directly (e.g. through passenger related fees) or indirectly (e.g. through the airfare). The guidance notes that there are few successful or consistent cases against generally excessive prices or reduced service in aviation or, indeed, in other sectors. Therefore we conclude that we would be likely to focus our attention on these types of exploitative abuses relating to potentially excessive prices or poor service provision in our assessment of Test B.

Test C – Benefits and Adverse Effects of Economic Regulation

21. Test C requires that we establish whether, for current and future users, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.⁹ Again, this is an aspect of the market power test where we have not previously issued any guidance. In the guidance, we present Test C as a cost-benefit analysis.
22. In terms of benefits, economic regulation via a licence requires us to assess, for example, the impact on price, efficiency, service quality, and investment, and other potential benefits of licence regulation. It also requires us to assess the extent to which these could also be addressed by the existing sectoral regulatory powers, or competition law powers beyond those relating to an abuse of dominance.
23. On the other hand, the guidance notes the adverse effects of regulation via a licence which may include the following.
- Direct costs, including, among other things, the time and expenditure of management and regulation staff at the CAA, the regulated airport operator and their airlines.
 - Other adverse effects, including the crowding out of more commercial approaches; management distraction; distortions to incentives; and inefficiencies in the risk allocation between shareholders and customers of the airport operator.
24. We are not required to consider a specific set of licence conditions (regulatory obligations) in applying Test C. Such a requirement would reverse the logical structure of CAA12, and would require the determination of individual licence conditions before the decision of whether to impose a licence is made. We will, however, consider whether it would help the assessment to consider the specific issues that might be addressed by economic regulation.

⁹ Section 6(5) of CAA12.

25. The extent to which we develop these in the assessment phase will depend on what is necessary and expedient. The comparison will, therefore, be assessed as follows.
- If we are making an MPD of an airport whose operator does not currently hold a licence, we would make a comparison between the status quo (no economic licence) and a generic licence¹⁰ (the counterfactual).
 - Alternatively, if we were making an MPD of an airport whose operator currently holds a licence, we would make a comparison between the likely behaviour of the airport operator without an economic licence and a generic economic licence (the counterfactual). We consider that a generic licence, rather than the actual licence in force, is the appropriate counterfactual as Test C considers the imposition of regulation, not its intensity.

Question 1: Do you have any comments on our proposed approach in the draft guidance to apply Tests A, B and C of the Market Power Test?

¹⁰ We would not specify the precise form of licence regulation. CAA12 states that the licence may include:

- conditions that we consider are necessary or expedient having regard to the risk that the airport operator may engage in conduct that amounts to an abuse of SMP;
- price control conditions as we consider necessary;
- payment to us on the grant of the licence and/or while it continues in force; and
- other conditions that we consider are necessary or expedient having regard to our CAA12 duties.

When to launch the process for MPDs

26. Once an MPD has been made, there is no requirement on us to complete these at regular intervals (unlike the EU telecoms framework, for example). Likewise, we do not need to undertake MPDs as part of the preparation for every price review period. However, we can initiate a determination whenever we consider it is appropriate to do so.
27. For the London airports, where we have already made MPDs (i.e. Heathrow, Gatwick and Stansted), we could be asked to undertake a new one by any interested party. However we would only be obliged to do so if there had been a material change of circumstances (MCC) since the previous MPD.
28. It is for us to assess if an MCC has occurred. While MCCs have been assessed by other UK competition and regulatory authorities, there is no guidance on how to assess an MCC and we are not proposing to do this in our document. In part, this is because what constitutes an MCC is specific to the facts of each request. However, in making an assessment we may refer to judgements and decisions made by other UK competition and regulatory authorities where they have assessed whether an MCC has occurred.
29. We could be asked to complete an MPD for other airports over 5 million passengers per annum, where we have not previously done so. In this event, we would be obliged to complete an MPD. In the guidance, we state that we would seek to apply our prioritisation principles in deciding when to commence this work.

Question 2: Do you have any comments on our proposed approach in the draft guidance to decide when to launch the process for undertaking MPDs?

Process for undertaking MPDs

30. CAA12 does not specify how long we may take to complete an MPD. However, an MPD can mean that an airport is (or continues to be) regulated or is not (or ceases to be) regulated by means of a licence. This is likely to be a market sensitive decision so being as clear as possible on the process and minimising the time it takes can reduce uncertainty.
31. Overall, the four MPDs we published in 2014 took about three years to complete. Reflecting on the improvements we can make to the MPD process, we consider that an MPD for a single airport could be completed within 18 months.¹¹ As such, the guidance proposes that we will:
- have a clear process for each stage involved including a clear distinction between when we will be gathering information and when we will be consulting on our assessment;
 - set out an indicative timetable in advance for each MPD we commit to undertake.

Question 3: Have you any comments on our proposed process for undertaking MPDs in the draft guidance?

¹¹ This is the same length of time specified by the CMA for a market investigation.

Conclusion

32. The MPD process is a key element of the UK regulatory regime for airports. We consider it is appropriate to provide a clear framework for how we will take these decisions in future.
33. In conducting MPDs, we are required to take into account previous decisions of the UK and European competition authorities in arriving at our MPD decisions. We have modified our approach to Test A to make the guidance more generic and reflect the approach of the CMA and EU with respect to market power assessments. If particular methodological issues arise with respect to any individual airport in the context of an MPD we would engage with the relevant stakeholders on that matter.
34. For Test B and C, where no previous guidance exists, we will continue to use the approach we took in the recent MPD decisions. The revised guidance therefore formalises our existing approach.
35. For those airports where we already have made recent decisions, Heathrow, Gatwick and Stansted, we will not carry out an MPD unless there has been an MCC. We have previously stated that we would not consider the prospect of new runway capacity to represent an MCC until it was close to being operational.
36. We would normally expect to take 18 months to complete an MPD and would set out pre-defined phases for the project in terms of methodological discussion, information submission and consultation.

Question 4: Is there anything that we have not covered in our guidance that you think should be included?