

UK airports

Report on the market study and proposed decision to
make a market investigation reference

December 2006

OFT882

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1 EXECUTIVE SUMMARY

- 1.1 The OFT is proposing to refer the supply of airport services by BAA within the UK to the Competition Commission (CC) for a market investigation. This paper sets out our reasons and gives interested parties the opportunity to make representations.¹
- 1.2 We are also making recommendations to Government under section 7 of the Enterprise Act in relation to airports in the North of England. We recommend:
- Government publish criteria for de-designation of airports
 - CAA advises the DfT whether to de-designate Manchester airport before the statutory price control reference to the CC is due, and
 - Government consider transferring decisions on designation to the CAA.
- 1.3 Aviation is vital to the UK economy. UK airports had an annual turnover of £2.8 billion in 2005.² More significantly aviation carries large volumes of traded goods, is vital in linking business with the wider world and underpins the UK tourism and travel industries.
- 1.4 One company, BAA, owns airports through which over 60 per cent of UK air passengers travelled in 2005.³

¹ Under section 169 of the Enterprise Act 2002, when the OFT is proposing to make a decision on a reference to the CC it must first consult, so far as practicable, any person on whose interests the reference is likely to have a substantial impact.

² Keynote, Airports, 2006.

³ CAA Airport Statistics.

- 1.5 In publishing 'The Future of Air Transport' in 2003⁴ the UK Government laid out a framework for a major expansion in airport capacity over the next 30 years to meet a forecast doubling of passenger demand. It is therefore timely to ask the question whether a structure of ownership of airports that limits the potential for competition in key parts of the UK is the best way to serve the interests of air travellers.
- 1.6 The OFT believes that BAA's high regional market shares in the South East of England and Lowland Scotland, the system of economic regulation of airports, and capacity constraints combine to prevent, restrict or distort competition. This view is based on our analysis of the market but is also consistent with strong expressions of concern received from interested parties (especially airlines).
- 1.7 In Lowland Scotland, BAA's ownership of Edinburgh and Glasgow airports limits competition between these two airports. There are high barriers to entry and these airports are not subject to detailed price regulation. There is one independent competitor in this region, Prestwick airport, which seems to have had some positive effect on Glasgow airport. We believe there is room for competition to provide further benefits to air travellers. We consider that joint ownership of Glasgow and Edinburgh airports restricts, prevents or distorts competition.
- 1.8 In the South East of England, BAA's ownership of Heathrow, Gatwick and Stansted limits competition between airports to promote the delivery of extra capacity in a timely and cost effective manner. The overwhelming bulk of the planned expansion of capacity set out in the 'Future of Air Transport' would take place at BAA owned airports. BAA has made it clear that it will only deliver this capacity, subject to planning permission and continued Government support, if it is allowed an appropriate settlement at its price regulated airports (Heathrow, Gatwick and Stansted). We received a wide range of critical

⁴ Department for Transport, The Future of Air Transport, 16 December 2003.

representations from airlines in relation to BAA's current investment plans in the South East of England.

- 1.9 None of the major airlines operating out of BAA airports in the South East of England expressed confidence in BAA's current investment plans for the South East of England.
- 1.10 In contrast we did not receive airline complaints relating to investment at Manchester airport which appears to be subject to greater competition from separately owned airports. This competition appears to be driving down prices faster than regulatory requirements.
- 1.11 We also have concerns about the impact of the current regulatory framework. In particular, BAA has an incentive to make investments justifying higher charges to airlines, without necessarily expanding capacity ('gold plating').
- 1.12 Competition between airports would create better incentives to ensure that expansion takes place in a timely, cost effective manner focussed clearly on the needs of airlines and therefore ultimately the travelling public. It could also deliver lower prices and a higher quality of service.
- 1.13 In the short term, we consider that the lack of competition between BAA's airports in both the South East of England and Lowland Scotland leads to higher charges than would be the case if these airports were owned by separate firms. These raise costs to air travellers, with consequential effects on business and tourism.
- 1.14 Heathrow and Gatwick have performed poorly in international surveys of the quality of service at airports. Weak competition could be a contributory factor. During the same period Manchester airport won IATA awards for the quality of its service.
- 1.15 Some airlines have referred to BAA's management of the airport security crisis in August of this year as a symptom of 'poor management' caused by a lack of competition. However, given the unpredictability and complexity of this crisis, we do not have clear evidence of a causal link and have not reached a view on the extent to

which this criticism is relevant to our study. Consequently our conclusions do not rest on BAA's response to this issue.

- 1.16 Finally, airport expansion and increased air traffic, give rise to both local and global environmental concerns. It is not the OFT's statutory role to examine the validity of those concerns nor to develop policies to deal with possible adverse environmental effects arising from increased air travel. We see no inherent conflict between tackling environmental problems and developing more competition in airport services.
- 1.17 We consider that there is a reasonable prospect that appropriate remedies would be available if the CC were to find an adverse effect on competition. These may take the form of requiring BAA to divest some of its airports, or recommendations regarding the regulatory system, or both.
- 1.18 Given the concerns raised, we are consulting on whether a market investigation by the Competition Commission (CC) is the most appropriate way of examining and resolving the above issues. The consultation runs until **8 February 2007**.

2 INTRODUCTION AND CONSULTATION DETAILS

- 2.1 The focus of this market study⁵ is the scope for greater competition between airports or within airports in the South East of England, the North of England, and Scotland. The range of issues at stake includes the joint ownership of airports by BAA, the regulatory system, and the prospect for adequate investment to meet the anticipated growth in passenger numbers in the future. In considering these matters we also look at indicators of the level of charges to airlines and the quality of service received by passengers at airports.
- 2.2 BAA airports are used by the substantial majority of air travellers in the South East of England and in Scotland. Manchester airport has a relatively high market share in the North of England. Our aim was to assess the scope for achieving greater value for airlines and ultimately for the travelling public through enhanced competition both in the short term (through quality, service and price) and in the long term (through incentives to invest in capacity). We have also examined factors which may limit competition including short term capacity constraints, longer term planning restrictions, and price regulation.
- 2.3 Since our announcement of 30 June 2006, BAA has been purchased by a consortium, part of which (Ferrovial Infraestructuras S.A, through sister companies in the Grupo Ferrovial S.A) owns other airports within the UK. This merger was cleared by the European Commission on 23 May 2006 and we have taken into account the analysis of the European Commission in reaching its decision. We refer throughout this report to BAA, being that part of the merged corporate group which owns Southampton, Heathrow, Gatwick, Stansted, Glasgow, Edinburgh and Aberdeen airports as well as associated companies involved with activities at these airports such as BAA Lynton. None of

⁵ As set out in Office of Fair Trading, 'UK Airports', 30 June 2006.

our findings relate to the UK airports owned by sister companies in the Grupo Ferrovial S.A, namely Bristol airport⁶ and Belfast City airport.

- 2.4 The purpose of this report is to set out our findings and to explain the reasons for them, namely why we are minded to refer the supply of airport services by BAA within the UK to the CC for a market investigation and why we recommend (amongst other things) that the Government review the benefits of price regulation at Manchester airport.

The OFT's proposal to make a market investigation reference

- 2.5 Under section 131 of the Enterprise Act 2002 (EA02), the OFT may make a market investigation reference to the CC where it has reasonable grounds for suspecting that any feature, or combination of features, of a market in the United Kingdom for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK. Section 131(2) states that a feature of the market is to be construed as a reference to:

- (a) The structure of the market concerned or any aspect of that structure.
- (b) Any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned.
- (c) Any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

- 2.6 This does not mean the OFT is obliged to make a reference in relation to every market which it believes meets the threshold set out in

⁶ Bristol airport is jointly owned with Macquarie, which has an option to buy out Ferrovial's interest.

section 131. Rather, the OFT has a discretion whether to make a reference.

- 2.7 Section 133 of the EA02 requires the OFT to describe the goods or services to which a reference relates.⁷ The OFT may frame a market investigation reference so as to confine⁸ the scope of the CC's investigation. In this case we propose to refer the supply of airport services by BAA, within the United Kingdom.
- 2.8 In guidance published in March 2003⁹ the OFT said it would make references to the CC only when the reference test set out in section 131 of the EA02 and, in its view, each of the following criteria have been met:
- it would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT
 - it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference
 - the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it
 - there is a reasonable chance that appropriate remedies will be available.¹⁰

⁷ Section 133(1)(c)

⁸ Sections 133(2) and 133(3)

⁹ OFT 511, 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', 2003.

¹⁰ See footnote 9, paragraph 2.1.

- 2.9 Chapter 4 provides an overview of the UK aviation industry and includes a summary of the role of Government and regulators at UK, EU and international levels in relation to relevant activities.
- 2.10 Chapter 5 describes our approach to market definition, in which we make use of passenger survey data collected at UK airports and drive time maps. This chapter also includes some general observations relevant to all geographic areas.
- 2.11 Chapters 6 to 8 describes our detailed analysis of the features which we suspect prevent, restrict or distort competition.
- 2.12 Chapter 9 sets out the reasons why we consider the reference test to be satisfied, and why we are proposing to exercise our discretion to make a reference after considering the criteria in our guidance (see paragraph 2.8 above). Chapter 10 describes our findings in relation to Manchester airport and our recommendations to Government, which are not subject to consultation.
- 2.13 We received submissions covering several other issues in connection with UK airports. In all of these cases we do not propose any further action under this market study. These are listed and discussed in Chapter 11. We welcome submissions on our intended approach in respect of these issues.

Consultation on reference

- 2.14 Under section 169 of the EA02, when the OFT is proposing to make a decision on a reference to the CC it must first consult, so far as practicable, any person on whose interests the reference is likely to have a substantial impact.
- 2.15 Section 154 of the EA02 gives the OFT the power to accept binding undertakings instead of making a reference to the CC. When considering any undertakings the OFT must have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition identified (and any detrimental effects on customers resulting from the adverse effect on competition).

This consultation is therefore an opportunity for BAA to offer undertakings in lieu of a reference. Paragraphs 2.20 to 2.26 of our market investigation guidelines give further information about the criteria and process for accepting undertakings in lieu.

- 2.16 In conducting the study the OFT has been assisted by major airport operators in the UK, domestic and international airlines and regulatory bodies. We have also drawn on relevant published surveys and data.
- 2.17 This paper sets out our proposed decision and invites comments by **8 February 2007**. Comments should be sent to:

Office of Fair Trading
Airport Study
3S/12
Fleetbank House
2-6 Salisbury Square
London EC4Y 8JX

Airport.study@oft.gsi.gov.uk

3 BACKGROUND AND METHODOLOGY

- 3.1 This market study has been carried out under the OFT function contained in section 5 of the Enterprise Act 2002 (EA02).
- 3.2 The study was launched on 30 June 2006¹¹ as an own initiative investigation. Under the EA02 the OFT has the function of obtaining, compiling and keeping under review information about competition in markets. Our initial concern related to the high and persistent level of concentration of ownership of airports in the South East of England and in Scotland by BAA¹² and in the North of England by Manchester Airports Group plc. Submissions received during the course of this study did not concern competition between airports in other regions.
- 3.3 The focus of the study was to examine the scope for enhanced competition between airports (for example via divestment of airports) or within airports (via divestment or long term lease of terminals or runways) to drive better value for air travellers.
- 3.4 During the course of the study several related issues were drawn to our attention, in particular the implications that concentrated ownership may have for future investment in infrastructure in the South East. The most significant of these are addressed within Chapter 6 of this report.
- 3.5 We received no submissions concerning a lack of competition between airports other than those owned by BAA.

¹¹ See footnote 5.

¹² Where we refer to BAA we mean BAA, the company that owns Southampton, Heathrow, Gatwick, Stansted, Glasgow, Edinburgh and Aberdeen airports, as well as associated activities such as land development at these airports carried out by BAA Lynton and through joint ventures, rather than the wider consortium of companies (including Grupo Ferrovial S.A.) of which BAA plc is now part.

Methodology

- 3.6 In order to examine the validity of our concerns about the extent of competition within these markets we carried out a range of consultations and desk based research into the UK airport market.

Statistical information

- 3.7 We sent questionnaires to airports and airlines within the UK including BAA and Manchester Airport Group. These requested specific financial and statistical information to inform our view on the extent of existing and potential competition between airport operators. The Civil Aviation Authority (CAA) and the Department for Transport (DfT) have also provided statistical and technical information. We have also received a number of consumer and market research reports, some of them carried out on behalf of airports and airlines, and analysis by some airlines of their customer databases.

Stakeholder views

- 3.8 In addition to requesting detailed information we have sought the views of BAA, Manchester Airport Group, airlines, industry representative groups, Government departments and other interested parties in relation to the market study. Our document of 30 June 2006 also invited any other interested parties to submit their views to the OFT.¹³
- 3.9 Sixty three companies, individuals and other organisations sent submissions to the OFT. Over twenty follow up meetings were held with interested parties in order to better understand stakeholder views. Many interested parties invested significant resources in responding to the study for which we are thankful.

¹³ See footnote 5

Analysis

- 3.10 Recently the OFT has examined airport related markets in a variety of contexts.¹⁴ We have drawn upon this experience in the present study.

¹⁴ This includes assessments of complaints under competition law, merger control and consumer law as well as our recent joint work with the CAA on airport slots.

4 OVERVIEW OF THE AVIATION INDUSTRY

Air transport industry background

- 4.1 The UK air transport industry has grown rapidly in both passenger numbers and turnover. There has been a five fold increase in air travel over the last 30 years, and passenger growth continues at about 6 per cent per year. The UK aviation industry generates over £13 billion of revenues per year.¹⁵ Most forecasters expect growing economic prosperity to bring greater demand for air travel in the years to come.
- 4.2 Aviation is of great importance to the UK economy. This is a large market both in terms of monetary value¹⁶ and in terms of its effect on wider productivity.¹⁷ BAA airports in the South East of England have a turnover of over £1.5 bn per annum.¹⁸ Even considering Scotland on its own, the value of the market is significant. BAA's Glasgow and Edinburgh airports have a combined turnover of £152 million¹⁹ and aviation is estimated to be worth £600 million to the Scottish economy,²⁰ accounting for 1.2 per cent of Scottish GDP in 2000.
- 4.3 Airports are a key part of the UK's infrastructure, central to a large volume of international trade. In the White Paper 'The Future of Air

¹⁵ Mintel, Airlines Leisure Intelligence, June 2005.

¹⁶ UK airports' annual turnover was reported as £2.8 billion in 2005 by Keynote.

¹⁷ For example see, BAA, Issues brief: Economic benefits of aviation, November 2004. Available through <http://www.baa.com>

¹⁸ BAA Annual Report 2005/06.

¹⁹ As footnote 18

²⁰ Aviasolutions, The future development of air transport in the United Kingdom A National Consultation: A report on responses to the Government's consultation: Scotland.

Transport²¹ the Government notes that one third of our visible exports, by value, now go by air.

- 4.4 Aviation facilitates tourism and leisure. Around 25 million foreign visitors a year contribute to a tourist industry that directly supports more than two million jobs. The DfT estimates that 80 per cent of overseas visits by UK residents are by air. With the exception of the Channel Tunnel and ferry services to mainland Europe and Ireland, for the bulk of international business and holiday travellers to and from the UK there is no realistic alternative to air travel.
- 4.5 Airports provide a wide range of services drawing revenues from charging airlines for aircraft movements, passengers carried and associated services but also (and just as significantly at many airports) from direct and indirect charges to air travellers for example parking, catering and retail services. Airlines provide aircraft, carrying passengers between two airports. They receive most of their revenue from ticket sales.
- 4.6 Competition between airlines to attract air travellers has intensified in the UK, particularly in short haul services following liberalisation of the European market in the 1990s. To the extent that airlines are operating in a competitive market, their requirements for airport services will typically reflect underlying demand by air travellers.
- 4.7 The aviation industry in the UK is subject to significant regulation – not only economic but also in relation to planning, air safety, security and the environment. Competition between airports needs to be considered in the context of these existing regulations and also from the perspective of possible alternative systems of economic regulation. This study does not address the appropriate level of non-economic regulation though it does take into account non-economic regulation to the extent that it acts as a capacity constraint at airports.

²¹ See footnote 4.

- 4.8 The sections below draw out some key features of the air travel industry in the UK as a background to the study.

UK Airports

- 4.9 The UK has a large number of international airports in comparison to many other EU member states, with over 20 large airports which each serve over one million passenger journeys per year alongside a number of smaller airports. BAA owns airports through which over 60 per cent of all UK passenger trips occurred in 2005.
- 4.10 A network of regional airports in the UK has grown significantly in recent years. Apart from BAA, other significant airport groups in the UK are shown in the table below.

Table 4.1: UK airports by ownership, and share of passenger trips, 2005

Owner	Airport	Million passengers per annum	Per cent
BAA	Heathrow	67.7	30
	Gatwick	32.7	14
	Stansted	22.0	10
	Glasgow	8.8	4
	Edinburgh	8.4	4
	Aberdeen	2.9	1
	Southampton	1.8	1
Manchester Airport Group	Manchester	22.1	10
	Nottingham East Midlands	4.2	2
	Bournemouth	0.8	0
	Humberside	0.5	0
Abertis	Belfast International	4.8	2
	Cardiff Wales	1.8	1
	Luton*	9.1	4
Peel Airports	Doncaster Sheffield	0.6	0
	Durham Tees Valley	0.9	0
	Liverpool	4.4	2
Others	Birmingham	9.3	4
	Bristol	5.2	2
	Newcastle	5.2	2
	Leeds Bradford	2.6	1
	Prestwick	2.4	1
	Belfast City	2.2	1
	London City	2.0	1
	Others	5.7	2
	Grand Total	228.2	100

Source: CAA statistics

*Luton airport is operated under a concession from London Luton Airport Limited, a company wholly owned by Luton Borough Council.

- 4.11 As pointed out in the 'The Future of Air Transport' demand for passenger air travel is growing fastest outside the South East as airlines seek to offer direct services to a wider range of destinations.

How UK airports charge airlines

- 4.12 Airports charge airlines a fee for use of their services. Airports maintain airline price lists although negotiated prices are common and can be part of long term contracts. They typically charge airlines a fee per departing passenger for use of the terminal. They also charge landing fees, and charge for associated services and facilities. An airline's total payment to the airport will depend on both the number of flights it makes, and the number of passengers on its flights.
- 4.13 The revenue per passenger (or yield) to the airport from a given airline will therefore depend on the average number of passengers per flight, and varies from airline to airline at an airport.

Hub and spoke and point to point operations

- 4.14 Airports work in a commercial partnership with airlines. There is an industry distinction between 'hub and spoke' operations where airlines are flying passengers into their main airport base for connecting onward flights and 'point to point' operations where airlines are flying passengers direct from one airport to their ultimate destination. An airport that is serving as a hub base for an airline will normally offer enhanced baggage handling and other services to assist the transfer of passengers from one aircraft to another. Point to point services generally require a lower level of airport facilities. An area of recent development has been investment in airport facilities specifically designed to attract low cost airlines with a focus on simplicity and functional efficiency, for example at Frankfurt-Hahn airport in Germany.

Airlines

- 4.15 The airline industry is often segmented between:
- 'full service airlines' that seek to offer a traditional range of scheduled services including 'business' class premium seats and executive lounges in addition to standard services

- charter airlines that sell blocks of airline seats to package holiday operators, or who sell the package of accommodation and travel themselves, and
- low cost airlines that focus on delivering cheaper scheduled seats by stripping out bundled services and minimising costs.

4.16 The level of service and facilities required from airports appears to differ most significantly between low cost airlines and other types of airlines although the CAA told us the boundaries between the different types of airlines may be blurring.

4.17 A further distinction is between long haul and short haul services. Currently only certain airports in the UK can fully cater for long haul flights which operate larger aircraft and consequently require a higher specification of runway.²² This may change in the future as newer aircraft come into production which can fly long distances from comparatively shorter runways.²³

4.18 Different airline business models determine the services and standard of service required by airlines at airports. Airlines therefore have a strong interest in influencing the development of infrastructure at airports to better serve their future needs at least cost.

Overview of market trends

4.19 The airline industry has faced major challenges recently including terrorist attacks, the two Gulf Wars and the recent rapid rise in oil prices. However, the underlying long term trend in air passenger numbers is strongly upward. In 1970, 32 million passengers used UK airports. By 2002 the figure had risen to 189 million. The DfT currently

²² This may not only apply to runway specification. For example, the new Airbus A380 requires larger aircraft stands.

²³ For example, one respondent said the new Boeing 787, a mid-sized aircraft, would be able to fly long haul routes.

forecasts that between 350 and 460 million passengers will use UK airports by 2020.²⁴

- 4.20 Progressive liberalisation of European air routes by the European Commission in the 1990s (the third package of liberalisation 1993-97) facilitated the entry of new firms and removed international price setting. The effect of these changes was a reduction of approximately 66 per cent in nominal prices for economy class seats with moderate reductions in the real price of business class seats.²⁵ The establishment and growth of low cost airlines, particularly on routes to and from the UK, has had a major part to play in this by making air travel more affordable. This growth in low cost airlines is clear in the following table which shows estimated growth between 2000 and 2005.

Table 4.2: Estimated growth in UK airline passengers 2000 to 2005

Airline sector	Passengers (millions)		Passenger growth
	2000	2005	
Full service scheduled	125	119	-5 %
Low cost scheduled	19	77	305 %
Charter	38	35	-8 %

Source: submission to the OFT

- 4.21 Changes in consumer demand have assisted in these developments. An increased use of Internet booking of flights has made price comparisons by ultimate consumers easier while at the same time significantly lowering the distribution costs faced by airlines. Short city breaks have become increasingly popular. Consumers are also now more prepared to book flights and accommodation separately and this

²⁴ DfT, Passenger Forecasts: Additional Analysis, December 2003.

²⁵ See Department for Trade and Industry Economics Paper No.9 written by Centre for Competition Policy, University of East Anglia, The Benefits from Competition: some illustrative UK cases, July 2004. Page 53.

possibly lies behind a loss of market share by traditional charter flights.²⁶

- 4.22 It is clear that the increasingly competitive nature of the UK airline industry has led to significant benefits for consumers, both in terms of prices and the range of services on offer. One of the most important barriers to entry facing airlines is access to landing slots at airports which are operating at or near capacity. A key issue going forward is to ensure appropriate investment in additional airport capacity to underpin a competitive aviation industry in the future.

Economic regulation of airports and airlines

Domestic legislation

- 4.23 The main relevant regulation within the UK is the Airports Act 1986 (AA86) which lays out the duties and powers of the economic regulator, the CAA and the DfT. Under AA86, there are effectively two levels of regulation. The lower level applies to airports that satisfy the turnover qualification,²⁷ which need permission from the CAA to levy airport charges and must file annual statutory accounts and other information with the CAA. The upper level applies to airports that have been designated for price control by the Secretary of State, which are subject to price caps on their airport charges – fixed every five years by the CAA following a mandatory six month reference to the CC. In March 1995 the DfT laid out its criteria for designation:²⁸
- the market position, including extent of competition from other airports and other modes of transport

²⁶ For example, see Mintel, Airlines, Leisure Intelligence, June 2005.

²⁷ Airports at which annual turnover has exceeded £1 million in two of the last three financial years.

²⁸ Department of Transport, Review of the Framework for Economic Regulation of Airports, March 1995.

- prima facie evidence of excessive profitability or abuse of monopoly position
- the scale and timing of investment, and their implications for profitability, and
- efficiency and quality of service.

4.24 In recognition of the market power of a privatised BAA, its London airports (Heathrow, Gatwick and Stansted) were and continue to be designated and therefore subject to controls on the prices that can be charged. The other airport within the UK which has been designated for price regulation is Manchester airport, owned and operated by Manchester Airport Group (MAG).

4.25 For all designated airports the CAA establishes on a five year cycle 'such conditions as to ... airport charges... as the CAA considers appropriate for regulating the maximum amounts that may be levied by the airport... by way of airport charges at the airport during the [next] five year period.'²⁹ In doing so, the CAA may have regard to the airports' past and forecast revenues, costs and investment programmes.

4.26 In practice this has meant that these airports are subject to price controls that have pegged airport charges to inflation through an RPI +/– X formula.³⁰ A key issue in this process is the need to ensure future investment in appropriate infrastructure to meet anticipated demand from airlines.

4.27 The CAA's powers are more limited than those of other independent economic regulators in the UK. Most notably:

²⁹ Section 40(1) and (3) AA86.

³⁰ Current caps are Heathrow: RPI + 6.5 per cent, Gatwick and Stansted: RPI, Manchester: RPI – 5 per cent.

- for airports, the CAA has no concurrent powers to enforce competition law under CA98 or EA02.³¹ It does have a power under section 41 of the Airports Act to impose conditions³² on regulated airports³³ that are found to be pursuing courses of conduct that are broadly anticompetitive³⁴
- the periodic review of airport charges entails a mandatory reference to the Competition Commission (unlike some other regulated sectors where such an inquiry would only be initiated as an appeal procedure). The CC makes non binding recommendations on price controls to the CAA. The CC can also make adverse public interest findings in relation to airport conduct during the previous five years. These findings are binding on the CAA which will impose remedies³⁵ having regard to the CC's recommendations
- there is no up front licence for regulated or designated airports which can be modified and enforced by the CAA. Rather, as noted above, the CAA can only impose conditions on regulated airports in relation to past conduct under section 41 or (following a mandatory price control reference if the CC makes adverse public interest findings in relation to conduct) under section 46
- the CAA does not have the power to impose or remove price cap regulation. As set out earlier, the power to designate airports for the

³¹ The CAA's concurrent powers to apply CA98, and to make market investigation references under EA02, are only available in relation to the supply of air traffic services

³² If the airport operator opposes the conditions, the CAA is prevented from implementing them but can refer them to the CC for consideration under section 43(3) AA86.

³³ That is all airports whose turnover exceeds the qualifying threshold, including designated airports.

³⁴ Civil Aviation Authority, 'The CAA's use of section 41 of the Airports Act 1986: A Consultation document', December 2005.

³⁵ Under section 46(2) AA86.

purpose of price cap regulation rests with the Secretary of State for Transport.

- 4.28 The CAA is currently carrying out the periodic reviews of charges at Heathrow, Gatwick and Stansted airports. There will be a mandatory reference to the CC in 2007 for BAA's London airports and 2008 for Manchester airport.
- 4.29 The OFT has several powers which apply to all industries and hence cover aviation. These include the enforcement of competition laws, merger control, consumer legislation, market investigation references and market studies. The OFT has previously examined mergers between airports, has investigated airlines and airports for potential breaches of competition law, and has enforced consumer law within the aviation sector.

European regulation

- 4.30 The European Commission regulates a range of aviation activities. Areas covered include consumer rights, ground handling and slot allocation. In addition aviation (as with all industry sectors) is subject to European competition law, including merger control, competition law and state aid controls.

International regulation

- 4.31 Flights beyond the European Union are subject to Air Service Agreements (ASAs). These are agreements between countries which dictate the degree of access to each other's airspace. Most existing ASAs between the UK and other countries are negotiated by the UK Government, but competence for certain elements of such agreements is increasingly being shared with the European Commission.
- 4.32 These agreements can limit the number of 'traffic rights' between countries and can thus impede competition in air services to certain destinations from the UK. Typical restrictions include:

- limiting the number, size and destination points of flights that can take place between countries
 - restricting the type of direct connecting services or code sharing arrangements that airlines can offer
 - limiting airlines' freedom to set their own fares, often requiring fares to be approved by one or both of the contracting nations, and
 - requiring majority investor ownership and effective control to reside with nationals of the relevant country.
- 4.33 The most important of these agreements to the UK is that with the US – the most significant long haul destination.
- 4.34 Some aspects of international aviation are regulated by the International Civil Aviation Organisation (ICAO) which was established by the 1944 'Chicago Convention'. The Convention embeds the principle of non-discrimination on grounds of nationality of carrier in charging for services, and an intention that airport charges should be economically based.

Conclusion

- 4.35 Aviation is an important sector of the economy both nationally and regionally. The trend in passenger numbers is strongly upwards. New airlines have entered the market, increasing competition within the industry following deregulation of airlines within Europe, which has substantially reduced average fares. Airport ownership is still highly concentrated in the UK. The industry is subject to substantial regulation, including price regulation of the four largest airports, by a process which involves a mandatory CC reference every five years. The CAA lacks the powers of investigation and remedy under CA98 and EAO2 that are available to the OFT.

5 THE MARKET IN WHICH UK AIRPORTS OPERATE

- 5.1 In making a reference to the CC, the OFT's guidance says that the OFT must give 'some consideration to the definition of the relevant market'. It also observes that 'the effects on competition of some features may be clear enough that firm conclusions on the definition of the relevant market by the OFT are unnecessary'.³⁶
- 5.2 This requires some consideration of the relevant market but the effects on competition may be clear enough not to require a precise definition. We explain our market definition below. There are some areas where we have not reached firm conclusions, notably on the question of the precise product market and the width of the geographic market. We do not consider we need to reach final conclusions on these issues because the adverse effects are sufficiently clear from the analysis we have undertaken.
- 5.3 Our view is that the relevant product market for the purpose of this study should be defined as the supply of airport services as a bundled product comprised of airport infrastructure services to airlines, services delivered directly to air passengers, and services to other commercial operators at airports within:
- the South East of England and East Anglia, including Heathrow, Gatwick, Stansted, Luton and City airports and potentially Southampton
 - Lowland Scotland³⁷ including Glasgow, Edinburgh and Prestwick airports, and

³⁶ OFT 511, 'Market Investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 4.8.

³⁷ Lowland Scotland comprises the Scottish Parliamentary regions of Lothians, Mid-Scotland and Fife, Glasgow, Central Scotland, South of Scotland, and West of Scotland.

- the North of England (the North West and Yorkshire and Humberside³⁸) including Manchester, Liverpool and Leeds Bradford airports.
- 5.4 In arriving at this view we considered the extent to which airlines and air passengers view different airports as substitutes for one another. Airports are multi service firms which rely on revenues from charges to airlines, from services delivered directly to passengers, and from activities such as car parking and retail³⁹ which may be operated by third parties on their behalf, but effectively charge air travellers indirectly.
- 5.5 The range of services offered by airports (including those offered through concessionaires) are complementary. Demand by passengers for services at the airport (such as shops and car parks) depends on passenger demand for (and airlines supply of) flights. The airport receives income from passengers, airlines and other commercial operators.
- 5.6 Recent merger decisions have discussed subdividing the UK airports market into the provision of airport infrastructure services to airlines, provision of ground handling services, and the provision of associated commercial services (such as retail or rental concessions).⁴⁰

Product market

- 5.7 We take as our starting point the range of services provided by airport operators as summarised by the CC in its 2002 report on BAA:

³⁸ These are Government planning regions.

³⁹ For example at Heathrow airport, approximately 45% of revenues are derived from these sources.

⁴⁰ For example the Anticipated acquisition by Macquarie Airports Ltd and Ferrovial Aeropuertos SA of Exeter and Devon Airport Ltd (<http://www.oft.gov.uk>)

'Within the airport framework BAA is directly responsible for the provision and maintenance of airport infrastructure, such as runways, terminals and equipment, and the provision of essential services, including passenger and staff search, perimeter security, and firefighting. The airports contract out cleaning, catering, retailing, car parks management, electricity distribution and a large proportion of maintenance. BAA also allocates resources, both between airlines (for example, check-in desks) and between commercial concessionaires (such as car hire franchises).'⁴¹

5.8 We consider passenger and airline demand for these services.

Passenger demand

5.9 For airlines considering locating flights at an airport, potential demand from passengers for flights from that airport is a vital consideration.

5.10 Passenger demand for an airport will depend on:

- the range of destinations served by airlines operating at the airport, the frequency of service, the competitiveness of prices for flights from that airport, and the availability of seats. Each of these factors depends in turn upon airlines deciding to operate services from the airport
- the convenience of the airport depends on (a) the airport's distance from the passenger's location or (for passengers from abroad) its distance from business or tourist centres and (b) the quality of road and rail links to and from the airport, and

⁴¹ Competition Commission, BAA plc: a report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd), 2002, ISBN 0-11-515489-2 paragraphs 3.13 and 3.14

- the quality and price of services at the airport (including car parking and retailing), although evidence⁴² suggests that these are of less importance in the passenger's decision to use the airport.

5.11 Business and leisure passengers may differ as to the relative importance they attach to price, time of travel etc. Outbound leisure passengers may be less time sensitive and thus willing to travel longer distances to and from the airport,⁴³ and may be more flexible about the choice of destination. Inbound passengers⁴⁴ are likely to be influenced by proximity of an airport to business or tourist centres according to the purpose of their journey.

Airline demand

5.12 While passengers can switch between airports from one trip to the next, airlines make longer term decisions on whether to operate from an airport, and, more generally, on the scale of their operations across multiple airports.⁴⁵ Economies of scale favour basing operations at a

⁴² For example, a survey by Keynote of passenger priorities supports this view. Support also comes from a survey of passengers undertaken by an airport which specifically asked for reasons for choosing the airport. The most significant factors were location, cheaper flight, choice of destination. All of the highly rated factors reflected the airport's location or the service offered by airlines while airport quality factors rated low.

⁴³ Although one low cost airline provided us with detailed data about the location of its passengers, indicating a strong preference among passengers in the South East for their local airport. This preference varied with the quality of transport links.

⁴⁴ VisitBritain.com records that Britain had 30m overseas visitors in 2005. Since 228.2m passengers flew from UK airports in 2005, this suggests 'inbound' passengers (that is, those originating from outside the UK) account for around 10-15 per cent of flights (the precise figure will depend on the proportion of visitors travelling by air, and the number of passengers travelling one way to the UK (such as immigrants)). CAA survey data suggests a further 15 per cent of passengers are interconnecting via UK airports.

⁴⁵ We have been provided with examples of switching, growth, and new entry by airlines.

single airport in each region, but there can be marketing benefits from being present at many different airports.

5.13 Airlines very rarely switch their entire service from one airport to another but a substantial majority of UK traffic is accounted for by airlines present at several airports. This gives them scope, subject to capacity constraints, to concentrate on growing their business at one airport rather than another.⁴⁶ In addition, new airlines must choose an airport to operate from when entering the market.

5.14 Airline demand for an airport will depend on the expected profitability of operations, which depends on local passenger demand and operational costs incurred. Relevant considerations are:

- passenger demand (discussed in paragraphs 5.9 to 5.11 above)
- the presence of other airlines at the airport – from the airline's perspective this could be a negative (too much competition, congestion) or a positive (allowing passengers to make interconnecting flights), or both
- current and anticipated future airport charges and operational costs at the airport including any marketing support, and
- the quality of service from the airport – whether facilities allow airlines to operate a fast and reliable turnaround of flights while giving passengers an acceptable travelling experience. Poor quality of service from airports can affect their reputation and raise operating costs.

5.15 Some airports and airlines we spoke to argued that in analysing the industry we should distinguish between services to full service/low

⁴⁶ For example an airport informed us of services switched between Glasgow and Prestwick. An airline told us it had switched growth of services between Stansted, Luton and Gatwick and it had used the threat of such action in negotiating with airports in the South East of England and Scotland.

cost carrier/charter, peak versus off peak services, long/short haul/domestic services and hub and point to point services. They noted that any of these could possibly imply discrete markets.

5.16 We do not distinguish services on this basis for the following reasons.

- very few airports specialise exclusively in one type of flight (see Table 5.1) despite differences in emphasis. Indeed an individual aircraft will commonly carry business passengers, leisure passengers, interlining passengers, and point to point passengers on the same flight, and
- subject to some constraints (notably aircraft size) the same slot can often be used for domestic, short haul or long haul services. The exception may be long haul services which are largely restricted to certain airports.

Table 5.1: Proportion of passenger by category at relevant airports, 2005

	LHR	LGW	STN	LTN	EDI	GLA	ABZ	PIK	MAN	LPL	All Airports*
Domestic	5%	5%	4%	7%	37%	26%	36%	3%	8%	8%	9%
Short haul	17%	9%	14%	12%	6%	3%	15%	3%	10%	13%	13%
Long haul	13%	3%	0%	0%	0%	1%	0%	0%	1%	0%	5%
Total	35%	17%	18%	19%	43%	30%	51%	6%	19%	21%	26%
Domestic	5%	7%	8%	11%	36%	26%	30%	23%	7%	15%	10%
Short haul	26%	32%	69%	62%	16%	13%	10%	63%	22%	57%	34%
Long haul	34%	15%	0%	0%	1%	6%	0%	0%	11%	0%	15%
Total	65%	54%	77%	72%	53%	46%	40%	86%	40%	72%	60%
Short haul	0%	21%	4%	8%	4%	22%	3%	6%	33%	7%	13%
Long haul	0%	7%	0%	0%	0%	2%	0%	0%	7%	0%	2%
Total	0%	28%	4%	8%	4%	24%	3%	7%	40%	7%	15%
Domestic passengers	10%	12%	12%	18%	72%	52%	71%	26%	15%	23%	19%
Short haul passengers	44%	62%	87%	82%	26%	39%	28%	73%	66%	77%	59%
Long haul passengers	47%	26%	0%	0%	2%	9%	0%	0%	19%	0%	21%

Source: CAA survey data

Figures may not sum to 100 due to rounding.

LHR – Heathrow, GTW – Gatwick, STN – Stansted, LTN – Luton, EDI – Edinburgh, GLA – Glasgow, ABZ – Aberdeen, PIK - Prestwick, MAN – Manchester, LPL - Liverpool

*Includes all 23 airports surveyed by CAA.

- 5.17 On balance, we consider that the relevant product market is that of 'airport services' but we leave open the possibility it could be narrower. The most likely potential sub division would be long haul services which may require a higher specification of infrastructure. We take this into account in our competition analysis.

Timeframe of analysis

- 5.18 Competition between UK airports must be considered in the short term – 'how does or should the market constrain prices and promote quality of service for passengers?' But the prospects for competition in the long term are equally, and arguably more, important – 'what type of

market would best deliver the necessary investment to ensure that passenger needs are met in the future?' We discuss how we have approached these elements of competition between airports in the sections below.

Short term competition

- 5.19 In the short term, airport operators have an incentive to attract airlines to use their airport (whether an airline is entering the market or switching from a nearby airport). Airports also have an incentive to increase the number of routes served by airlines from the airport and to increase the frequency and capacity of existing airline routes. An airport can attract more airlines by offering discounts on its published charges. In many cases, this takes the form of 'marketing support' for a limited period. This may be particularly relevant for low cost carriers for whom (one such carrier told us) advertising is the largest set-up cost in establishing a new route.
- 5.20 While airports do not directly charge passengers to enter the airport, the costs borne by airlines in passenger and landing charges are, to some extent, passed on in higher airfares. Furthermore, there is a complex relationship between airfares, charges to airlines and charges to passengers for services at airports.⁴⁷ The higher the expected revenue to an airport from passengers using that airport, the greater the incentive to reduce airline charges (and hence encourage greater passenger numbers).
- 5.21 The willingness of passengers to travel to and from more distant airports shows that they make a trade off between convenience of location and cost. Airports may be able compete by making themselves more convenient, for example by investing in improved transport links, but their ability to do this may be limited.

⁴⁷ Taking BAA's London airports as an example, retail concessions as a proportion of airport revenue range from 18 per cent at Heathrow to 28 per cent at Gatwick, while car parking revenues range from 5 per cent at Heathrow to 21 per cent at Stansted.

Long term competition

- 5.22 In the longer term competition is primarily about investment to raise capacity. Airport operators can choose to expand in order to attract more airlines and air passengers. Capacity expansion creates an incentive for an airport to attract airline business (to fill up the new capacity and earn a return on the investment). Failure to invest, where a rival airport is expanding, can lead to a loss of business from airlines. Consequently competition faced by an airport will affect both its investment decisions and its subsequent pricing decisions.

Geographic market

- 5.23 Our initial statement on 30 June 2006 identified the geographical areas of interest in this study as the South East of England, Scotland and the North of England. In each of these areas a single airport operator has a large share of passengers. Geographic market definition is determined by the willingness of customers to switch between airports in different geographic areas. The point of origin of outbound UK passengers provides a guide. Table 5.2, based on CAA passenger survey data (2005 and earlier), sets out the region of origin of passengers departing from the main airports in the South East and East Anglia,⁴⁸ Scotland and the North of England. A map of showing the location of major airports in Great Britain is shown below.

⁴⁸ We will refer to the South East and East Anglia as the 'South East' in discussion sections for short, but will use the full wording in conclusions to avoid any possibility of misunderstanding.

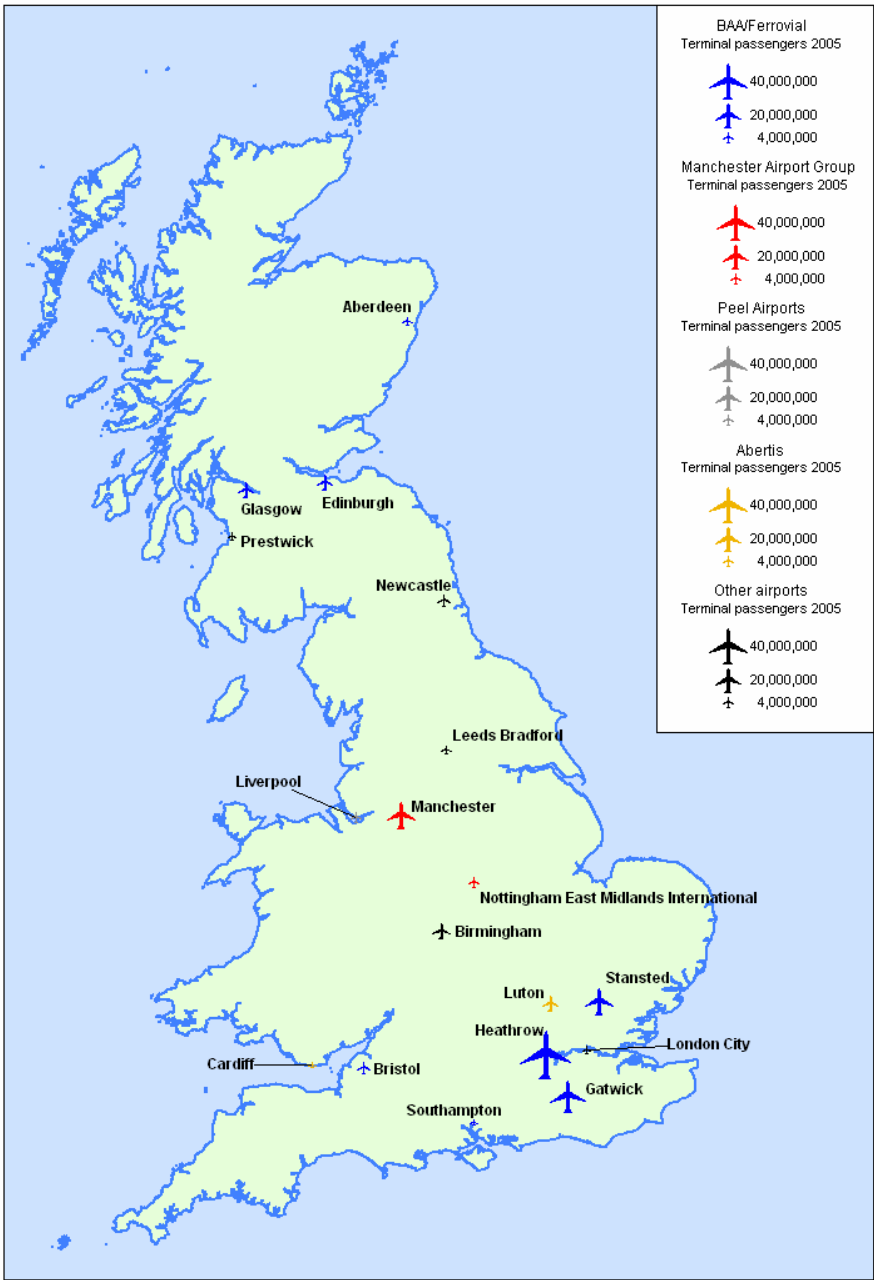
Table 5.2: The regions of origin of passengers using particular airports 2005

Region	LHR	LGW	STN	LTN	EDI	GLA	ABZ	PIK	MAN	LPL	All airports
South East and East Anglia	55%	74%	77%	75%	0%	0%	0%	0%	1%	0%	39%
Scotland	0%	0%	0%	0%	97%	97%	90%	99%	2%	1%	11%
North West	0%	0%	1%	1%	0%	0%	0%	0%	57%	75%	8%
Yorkshire & Humberside	1%	0%	2%	1%	0%	0%	0%	0%	20%	7%	4%
Others	9%	10%	9%	16%	0%	1%	0%	0%	18%	13%	19%
Interlining	35%	16%	11%	7%	2%	2%	10%	1%	3%	4%	16%

Source: CAA survey data

LHR – Heathrow, GTW – Gatwick, STN – Stansted, LTN – Luton, EDI – Edinburgh, GLA – Glasgow, PIK – Prestwick, ABZ – Aberdeen, MAN – Manchester, LPL - Liverpool

Figure 5.1: Map of airports relevant to the market study



- 5.24 Table 5.2 confirms the common sense expectation that airports attract the majority of passengers from the regions where they are located.
- 5.25 As a starting point we take a regional approach to market definition. We then consider whether this should be widened or narrowed based on substitution patterns by air passengers and airlines.
- 5.26 Some low cost airlines are willing to compare the costs and benefits of launching new flights at airports in different regions. In this sense, a UK airport may face a degree of competition from other comparable airports anywhere in the UK, and possibly outside of the UK. However, two airports which are physically closer to each other will be seen by airlines as closer substitutes than two airports which are further apart. As such, in defining a geographical market (for example, the South East of England) we recognise that every airport within that market is not an equal substitute for every other (even among airports of similar size and facilities), and that some airports outside the geographical market may offer a degree of competition (although we expect this to be small).
- 5.27 Previous competition decisions have been based on a regional analysis, for example the European Commission has recently concluded that Bristol airport is not within the same relevant market as the London airports and that Belfast City airport does not compete with Scottish airports.⁴⁹

Airports in the South East of England

- 5.28 We consider that the relevant geographic market for BAA's airports of Heathrow, Gatwick and Stansted is the South East of England for the purposes of our analysis. We do not address whether London City airport or BAA's Southampton airport should be included because the relatively small scale of these airports mean that their inclusion or

⁴⁹ Case No COMP/M.4164 – Ferrovial / Quebec / GIC / BAA, paragraphs 18 and 21.

exclusion would not affect our later conclusions.⁵⁰ The South East also includes two major airports not owned by BAA: Luton and London City.

- 5.29 In our view, the further the distance between airports, the less of a competitive constraint they offer to each other. The purpose of our market definition is to assess the boundaries within which meaningful competition could occur for the business of airlines and their passengers. We believe the South East of England is the appropriate area in which to assess this.
- 5.30 Given the joint ownership of the largest airports within the South East of England, the extent to which they compete cannot be based on the current behaviour of airports and airlines such as pricing decisions by the airports and switching by airlines. Our approach to market definition is therefore based on evidence from airlines, airports and CAA survey data showing where passengers using the relevant airports begin their journeys.
- 5.31 The CAA survey data provides us with details of which airports air passengers use by local authority district in the South East of England. If some passengers originating from a district use one airport and others use another airport, we interpret this as indicating the two airports are substitutes from the viewpoint of passengers in that district. We would expect that the more two airports overlap in the districts they serve the more likely an airline and air passengers are to see them as substitutes. Whether the airline sees the airports in question as close substitutes will depend on the extent of overlap, but also on other characteristics of the airport such as the overall size and demographics of the population served by the airport. We analyse the extent of the overlap in the following sections.

⁵⁰ London City airport was given planning approval in 1998 for 73,000 ATMs per year, which severely limits the scope for City airport to develop as a major competitor to Heathrow, Gatwick, Stansted and Luton. [BAA's Southampton airport, although larger than City, is a fair distance from the main London airports].

Regional presence

5.32 Table 5.3 shows all airports with over 1 per cent share of passengers in the South East, based on CAA survey data. Only five have a significant presence in the market: BAA's three airports, Luton and London City. We focus on the top four in our analysis.

Table 5.3: Shares of South East and East Anglia region passengers by airports, 2005

Airport	Share
Heathrow (BAA)	42%
Gatwick (BAA)	27%
Stansted (BAA)	19%
Luton	8%
London City	2%

Source: CAA survey data.⁵¹ All other airports less than 1 per cent

Figures do not sum to 100 per cent because of rounding, these figures do not fully reflect the relative traffic volumes of these airports as Heathrow attracts more passengers from outside the South East of England.

Substitution by passengers

5.33 We have examined the CAA's survey data for passengers using Luton, Stansted, Gatwick and Heathrow airports to determine the extent to which airports draw passengers from the same districts⁵² within the South East as an indicator of likely substitution between airports.

5.34 In order to establish whether a significant proportion of air passengers within a single district used more than one airport in the South East,

⁵¹ The survey did not cover BAA's Southampton airport. CAA traffic statistics indicate that Southampton has a 1 per cent share of passenger traffic in the South East.

⁵² These are local authority districts, the smallest geographic areas available within the data before us.

we had to make a judgement about the appropriate threshold. We carried out the analysis assuming that a district would be an 'overlap' for a specific airport if:

- 25 per cent of non-interlining passengers within a district used that airport and 25 per cent used an alternative airport, or alternatively
- 15 per cent of non-interlining passengers within a district used that airport and 15 per cent used an alternative airport.

5.35 We calculated the share held by each airport of the total air passenger numbers from each local authority district. We then identified those districts in which both the airport itself and an alternative airport accounted for at least 15 per cent or alternatively 25 per cent of passengers. For each of the airports we then calculated the proportion of their passengers being drawn:

- from districts in which the 25 per cent threshold was reached that is where both that airport and another airport served 25 per cent of passengers from that district
- from districts in which the 15 per cent threshold was reached that is where both that airport and another airport served 15 per cent of passengers from that district.

5.36 The results are reported in the table below.

Table 5.4: Passenger origin overlap between South East Airports, 2005

Proportion of each airport's passengers who originate in local authority districts of the South East of England where:					
25 per cent threshold		Heathrow	Gatwick	Stansted	Luton
Strong presence, no overlap	(Airport) has > 25% share of passengers and all others have < 25%	57%	24%	22%	16%
Strong presence, overlap	(Airport) has > 25% share of passengers and another has > 25%	33%	38%	25%	22%
Weak presence	(Airport) has < 25% share of passengers	10%	37%	53%	63%
15 per cent threshold		Heathrow	Gatwick	Stansted	Luton
Strong presence, no overlap	(Airport) has > 15% share of passengers and all others have < 15%	12%	4%	8%	0%
Strong presence, overlap	(Airport) has > 15% share of passengers and another has > 15%	86%	87%	70%	47%
Weak presence	(Airport) has < 15% share of passengers	3%	9%	22%	53%

Source: CAA survey statistics

5.37 To illustrate how the data is being analysed using Gatwick airport and the 25 per cent threshold as an example (in the second column):

- 24 per cent of Gatwick's passengers come from districts in which **only** Gatwick has a strong presence that is it accounts for more than 25 per cent of passengers from that district

- 38 per cent of Gatwick's passengers come from districts in which it has a strong presence (over 25 per cent share in each district) but **at least one other airport** in each district also has a strong presence
- 37 per cent of Gatwick's passengers come from districts in which Gatwick **does not have a strong presence** that is, its share is less than 25 per cent.

5.38 In considering these results it needs to be noted:

- the four airports differ significantly in size. Heathrow is a much bigger airport than Luton or Stansted
- Luton and Stansted do not serve the long haul market to any significant extent. An analysis of the extent of overlaps between airports at a local level purely for short haul flights would produce a different result.

5.39 The table shows that all the BAA airports draw most of their customers from districts in which passengers use at least one alternative airport based on a 15 per cent threshold. At the 25 per cent level, overlap is much lower but still substantial.

5.40 Table 5.5 below breaks down our analysis to airport pairs using the 15 per cent threshold. Thus for example 95 per cent of Luton airport's passengers originate in a district in which at least 15 per cent of passengers also use Heathrow airport.

Table 5.5 Share of airport passengers coming from 15 per cent overlap districts, 2005

Share of passengers at:	From districts in which 15% of passengers use:			
	Heathrow	Gatwick	Stansted	Luton
Heathrow	-	75%	44%	8%
Gatwick	89%	-	41%	6%
Stansted	80%	71%	-	11%
Luton	95%	62%	58%	-

Source: CAA survey statistics

- 5.41 All the BAA airports are drawing customers from districts in which a significant number of passengers are also using alternative airports in the region, but the overlaps are greatest between BAA owned airports: Heathrow and Gatwick and between Heathrow and Stansted.
- 5.42 We found that there is considerable overlap in the destinations served from the four major London airports. In 2005:
- Heathrow ran daily flights to 180 destinations, Gatwick to 210. Of these, 86 destinations were served from both airports
 - of these 180 destinations served daily by Heathrow, over 40 were also served daily from Stansted
 - Stansted and Gatwick had flights to around 80 common destinations on a daily basis.
- 5.43 From the perspective of the air passenger, this suggests substantial choice between airports is available for specific destinations.
- 5.44 We have also examined isochrone maps of the South East provided to us by the CAA, which provide an alternative approach to determining catchment areas, and therefore overlaps between airports. Isochrone maps are ones which show the furthest distance which can be travelled by car from a certain point within a specific time. The OFT has used isochrone analysis in some previous cases on the basis of a one to two hour drive time.⁵³ Airlines also provided some analysis. Previous experience of the OFT with isochrone analysis⁵⁴ has found that results can vary according to the software and assumptions⁵⁵

⁵³ For example Paragraph 22 of the document at footnote 40. One airport also provided isochrone analysis conducted internally for their business which primarily based analysis on a 60 minute drive time but also examined drive times up to 120 minutes.

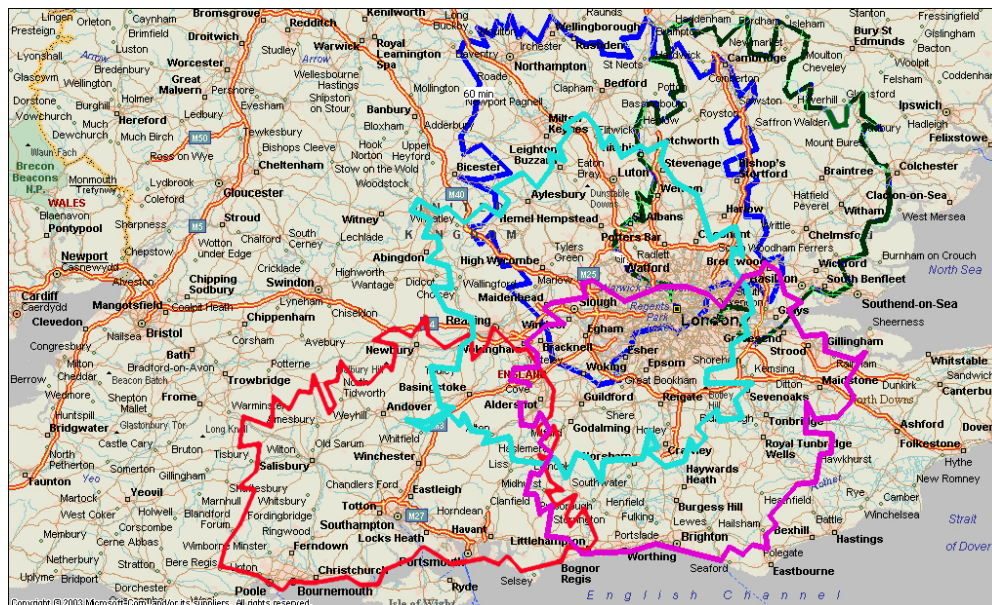
⁵⁴ Primarily within merger analysis, for example analysis of supermarket mergers.

⁵⁵ For example, the average speed of travel.

used. We consider that the margin of error is small in the context of our application of the technique.

- 5.45 The isochrone figures show that the catchment areas of these airports overlap to a large extent for air passengers. Long haul passengers may be willing to travel longer distances (in some cases flying to the 'starting' airport), while business passengers typically prefer their closest airports.
- 5.46 The CAA suggested that business passengers have a lower propensity to travel to reach their chosen airport and therefore a one hour isochrone is appropriate. The degree of overlap on this basis is predictably less. It is still high however, particularly between Heathrow and both Gatwick and Luton and between Stansted and Luton. Overlap within Central London is likely to be particularly important (given it is an important destination for inbound and the origin for many outbound business travellers). For leisure passengers a longer drive time may be appropriate reflecting their greater propensity to travel to an airport (see paragraph 5.11).

Figure 5.2: 60 minute drive time analysis in the South East



Colour coding (for this and following maps) Heathrow: light blue, Luton: dark blue, Stansted: green, Gatwick: pink, Southampton: red.

Figure 5.3: 90 minute drive time analysis in the South East

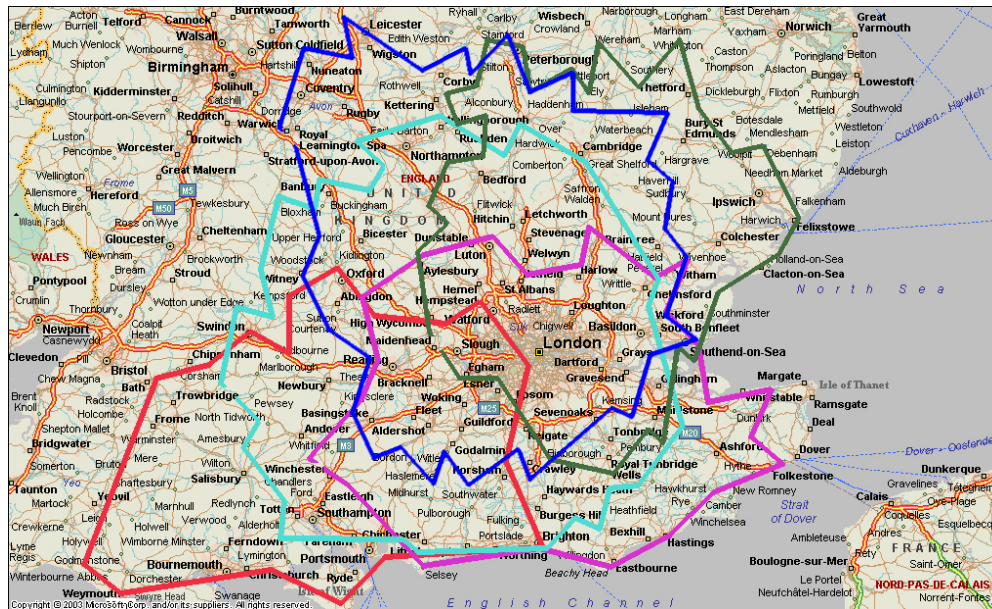


Figure 5.4: 120 minute drive time analysis in the South East



- 5.47 The isochrone maps cover an area wider than the South East of England. In considering whether the relevant geographic market should be extended beyond the South East of England, it is important to bear in mind:
- the extent of competition between airports is a matter of degree: the greater the distance between two airports, the less they will be seen as substitutes by passengers or airlines, and this is not captured by an either/or market analysis
 - ultimately, whether two airports act as a competitive constraint on each other depends on whether sufficient numbers of airlines and air passengers see the two as substitutes not simply on whether their catchment areas overlap.
- 5.48 On balance we do not believe we should narrow, nor should we widen the relevant geographic market beyond the South East of England and East Anglia. We believe this is sufficient for examining potential competition issues as it is likely to capture the main competitive constraints. But even if the geographic market were extended to include the whole of the Midlands, BAA airports would still account for 80 per cent of all air passenger trips across this wider geographical market.
- 5.49 In summary, there is significant overlap between BAA airports in the South East in the origin and destination of airport users. This indicates that there is clear potential for competition between these airports for airline business, at least in the longer term, as discussed below.

Substitution by airlines

- 5.50 In recent years, very few airlines have switched between airports in the South East of England.
- This does not necessarily imply that airlines do not see these airports as substitutes. It is more likely to reflect that airports which are under joint ownership do not have an incentive to steal business

from one another. Capacity constraints may also have hindered switching to Heathrow and Gatwick.

- Substitution need not take the form of airlines switching their business wholesale between airports. An airline may have a presence at several airports and vary the number of its flights between them. In addition, an airline entering the market (new to the region or a wholly new airline) may weigh up competing offers from different airports which it views as substitutes.

Views and other evidence on market definition

- 5.51 BAA said that an empirical assessment, which it had not undertaken, would be necessary to assess the relevant product and geographic markets. It said that Heathrow was likely to be unattractive to low cost airlines because it could not accommodate their quick turnaround requirements, while Stansted might be less attractive than Heathrow for long haul services with high volumes of interlining traffic. In a recent submission to the CAA,⁵⁶ BAA noted that it believed substantial overlap occurred between Heathrow and Stansted and indeed, all the airports serving London for leisure passengers. We believe the analysis we have undertaken is sufficient for our purposes.
- 5.52 Carriers offering extensive long haul services, particularly those serving the US market, saw limited scope for substitution away from Heathrow. Reasons included:
- when using an airport as a base, the airline was tied by long term investments such as branded business lounges and dedicated maintenance facilities. There could also be costs if long term agreements were broken
 - airlines in alliances, which schedule their flights to allow interconnection with other airlines in the alliance, could not

⁵⁶ BAA/Q5/100, Response to CAA Policy Issue Consultation Paper, March 2006.

realistically switch airports independently of other alliance members: 21 of the top 30 airlines (by airport revenue) at Heathrow are members of Star Alliance, Oneworld Alliance or SkyTeam Alliance

- only Heathrow has the infrastructure to support hub activities
- Heathrow is close to the large, wealthy population living along the M4 corridor, in north west London and in Buckinghamshire
- in some circumstances (most notably flights between the US and London) switching airports is restricted by international treaty.⁵⁷

5.53 One airline pointed to previous analysis by the US Department of Justice (2001) and OFT suggesting, in the context of a proposed alliance between British Airways and American Airlines, that for 'premium' or business passengers Gatwick services do not compete with Heathrow.⁵⁸ The OFT and EC did not reach final conclusions in 2002 as to whether Heathrow and Gatwick were in the same market.⁵⁹

5.54 Some airlines listed other European hubs (in Paris, Frankfurt and Amsterdam) as Heathrow's principal competitors.

5.55 Airlines acknowledged some scope for competition within the South East with individual airlines saying that:

- separate ownership of Gatwick and Heathrow could improve competition as national carriers fly from both airports
- London City, Luton, Gatwick, Southampton and Stansted were potential substitutes for Heathrow

⁵⁷ The treaty is generally known as Bermuda II.

⁵⁸ See http://www.usdoj.gov/atr/public/press_releases/2001/9705.htm and docket OST-2001-11029.

⁵⁹ EC Competition Policy Newsletter, June 2002, 38 and 39. See also the DGFT's decision of 1 November 2002 on a notification by British Midland and United Airlines.

- for business passengers, Gatwick was not a significant competitor for Heathrow, but Heathrow could be a competitor for Gatwick. For leisure passengers, there was a degree of competition between these two airports.
- 5.56 One airline provided evidence of competition on domestic routes to support the inclusion of Southampton airport in the market. We consider it unlikely that Southampton, even if independently owned, could exert much competitive constraint on the combination of Heathrow, Gatwick, Stansted, Luton and City airports. As such including or excluding Southampton from the market would not materially affect our conclusions. We therefore leave this question open.
- 5.57 BAA argued that even where catchment areas overlapped, passengers may not necessarily see two airports as substitutes. For example, passengers who would consider Gatwick when going on holiday might not do so when travelling on business and a passenger might consider only the nearest airport when travelling short haul, but consider both for long haul flights.
- 5.58 Whilst this may be true in some cases, it is insufficient to imply there are distinct geographic markets, given that all BAA airports in the South East attract both business and leisure passengers, for domestic, short haul flights, (and Gatwick and Heathrow both offer business and leisure long haul flights) and that the destinations served by these airports overlap to such a considerable degree.
- 5.59 The large majority of submissions we received considered that the relevant geographic market was the South East of England, with some arguing that individual airports, particularly Heathrow, may be in a market by itself. Luton airport told us that its emphasis on short haul low cost and charter segment of the market put it in competition with Stansted, Gatwick and airports in the Midlands.
- 5.60 One charter airline provided analysis which indicated some overlap between Manchester airport and the South East of England.

Conclusion on South East market

- 5.61 A number of major airlines in the South East of England see Heathrow, Gatwick, Stansted and Luton as the main potential substitutes for one another. Although the actual level of switching by airlines between these airports is low at present, this is to be expected given the current lack of spare capacity and BAA's joint ownership of three of the four major airports. The view that these airports could be substitutes is supported by the extensive overlap between their catchment areas (suggesting that air passengers can switch between them and thus an airline could reach some of the same passengers by locating at one airport or another).
- 5.62 We conclude that the evidence indicates a market for the supply of airport services in the South East of England and East Anglia. For the purposes of our analysis, we did not consider it necessary to determine whether the market is limited to major airports, or should also include smaller airports in the region (notably Southampton). These airports taken together carry only 4 per cent of the number of passengers carried by the major airports and would need to expand their capacity very substantially to seriously challenge the other airports in the region. Their inclusion or exclusion would not affect our conclusions.
- 5.63 We have seen evidence suggesting that the market may be wider than the South East of England and East Anglia. We do not rule out the possibility of a wider market. However, we have not seen convincing evidence to support the widening of the market at this stage.
- 5.64 The relevant market can depend on the specific competition concerns being analysed. Depending on the context, the market could be wider than the South East or, narrower. Heathrow could be seen as a market in itself (especially in view of its status as the UK's only hub airport) or as competing with other hub airports in Europe. The purpose of market definition is to help clarify the analysis of competition, and we consider the market as we have defined it to be suitable for our analysis.

- 5.65 In the event of a reference, the CC could gather further evidence to refine and extend this analysis. Questions about geographic markets might include:
- should Heathrow be treated as a separate market?
 - should Southampton be included within the market?
 - are the weaker constraints offered by airports outside the South East of England nevertheless significant enough to be considered part of the market?
 - are other partitions of the product market, such as short haul and long haul flights, relevant to the assessment of geographic market?

Airports in Scotland

- 5.66 We consider that the relevant geographic market for BAA's airports at Edinburgh and Glasgow is Lowland Scotland.⁶⁰ This area also includes one other major airport not owned by BAA: Prestwick airport. The evidence suggests that BAA's Aberdeen airport operates in a separate relevant geographic market.
- 5.67 The main evidence that has drawn us to this conclusion is our analysis of CAA survey data showing the origination of passengers using airports within these regions. This evidence and other views presented to the OFT are laid out below. We also include diagrams illustrating drive times around Edinburgh, Glasgow and Prestwick airports and separately Aberdeen airport.

Regional presence

- 5.68 CAA statistics show that four airports, all located within Scotland, serve the vast majority of passengers originating in Scotland. These are

⁶⁰ Footnote 37 provides a definition of this area.

Glasgow, Edinburgh and Aberdeen airports owned by BAA and Prestwick airport.

- 5.69 Edinburgh and Glasgow airports each account for just over 35 per cent of passenger flights in Scotland, while Prestwick and Aberdeen account for about 10 per cent each. English airports attract a small number of passengers from Scotland. Our analysis therefore considers only the four airports of Edinburgh, Glasgow, Aberdeen and Prestwick. Others with a share of the Scottish passenger market above one per cent are shown below.

Table 5.6: Passenger share of airports serving Scotland, 2005

Airport	Share
Glasgow	37%
Edinburgh	36%
Prestwick	10%
Aberdeen	10%
Inverness	3%
Manchester	2%
Newcastle	1%

Source: CAA survey data.

Substitution by passengers

- 5.70 Edinburgh airport draws its passengers disproportionately from within Lothian, Central, Fife and Tayside regions while Glasgow is strongest in Strathclyde and Dumfries and Galloway. The two overlap in several districts in Central, Fife and Tayside. Prestwick overlaps with Glasgow in several districts. The overlap between Aberdeen and Glasgow and between Edinburgh and Prestwick is far more muted. It appears likely that Aberdeen is located within a separate relevant geographic market. Regional market shares are shown in Table 5.7.

Table 5.7: Airports' share of passengers within regions of Scotland, 2005

Region	Edinburgh	Glasgow	Prestwick	Aberdeen	Region's share of total passenger trips in Scotland
Borders	63%	8%	1%	0%	1%
Central	57%	35%	5%	0%	4%
Dumfries and Galloway	10%	50%	10%	0%	1%
Fife	77%	17%	3%	0%	5%
Grampian	5%	8%	1%	80%	11%
Highland and Islands	10%	19%	4%	7%	4%
Lothian	82%	7%	6%	0%	27%
Strathclyde	5%	73%	19%	0%	40%
Tayside	62%	25%	2%	7%	6%
Total Scotland	36%	37%	10%	10%	22.6m

Source: CAA survey data

5.71 At the district level, not shown in the table, Edinburgh and Glasgow airports overlap significantly (each have a 25 per cent plus presence) in 7 districts. On the same basis Glasgow airport overlaps with Prestwick airport in 3 districts, all located within Strathclyde. Sixteen per cent of Glasgow's passengers are in districts where it overlaps with other airports (8 per cent with Prestwick and 8 per cent with Edinburgh).

5.72 Table 5.8 looks at airport pairs in more detail and is based on the same methodology as applied to airports in the South East of England (see paragraph 5.33 to 5.35).

Table 5.8: Overlaps in the origin of passengers using Scottish airports, 2005

Proportion of each airport's passengers who originate in local authority districts of Lowland Scotland where:				
25 per cent threshold level		Edinburgh	Glasgow	Aberdeen
Strong presence, no overlap	(Airport) has > 25% share of passengers and all others have < 25%	78%	71%	86%
Strong presence, overlap	(Airport) has > 25% share of passengers and another has > 25%	14%	17%	9%
Weak presence	(Airport) has < 25% share of passengers	8%	12%	6%
15 per cent threshold level		Edinburgh	Glasgow	Aberdeen
Strong presence, no overlap	(Airport) has > 15% share of passengers and all others have < 15%	63%	31%	79%
Strong presence, overlap	(Airport) has > 15% share of passengers and another has > 15%	31%	62%	15%
Weak presence	(Airport) has < 15% share of passengers	6%	7%	6%

Source: CAA statistics

5.73 The tables show a more local pattern of airport use in Scotland than we found for South East England. We also found that three out of every four destinations served by airlines at Edinburgh are also served by airlines at Glasgow. In addition, four of the top five airlines at Glasgow (by number of flights) are also in the top five at Edinburgh. As

such, passengers may not have much incentive other than to go to the closest airport. One airline told us that BAA tends to offer better deals to airlines which use both airports, suggesting that current passenger usage patterns may to some extent reflect joint ownership.

- 5.74 Of the top 20 airlines (by number of flights) at Edinburgh in 2005, 13 also had a substantial presence at Glasgow (at least 10 flights per day), while of the top 20 in Glasgow, 12 had a substantial presence at Edinburgh.⁶¹ There is very little overlap between airlines at Glasgow and Prestwick, the majority of traffic from Prestwick comes from one airline, Ryanair. Only one airline (MyTravel) offers flights from both airports.⁶²
- 5.75 Further evidence supporting the exclusion of Aberdeen airport from that in which Glasgow, Edinburgh and Prestwick could compete is provided by a consideration of the distances between these three airports in comparison to the relative remoteness of Aberdeen airport.
- 5.76 The map below illustrates the area of Scotland that can be covered within a 90 minute drive from Glasgow airport. Not only are Edinburgh and Prestwick clearly within this area but so is the majority of Scotland's population.⁶³

⁶¹ These figures may be affected by alleged bundling whereby BAA links discounts to airlines to operating air routes at both Glasgow and Edinburgh.

⁶² Source: airport web sites, 17 November 2006.

⁶³ We estimate that approximately 60 per cent of the Scottish population falls within a 90 minute drive time of Glasgow airport, 70 per cent within a 90 minute drive time of Edinburgh airport, and 12 per cent within a 90 minute drive time of Aberdeen airport.

Figure 5.5: 90 minute drive time around Glasgow airport (MapInfo)



5.77 A similar map generated for a 90 minute drive time⁶⁴ around Aberdeen airport shows no overlap with the area that can be covered within a 90 minute drive of Glasgow airport. Nor is there any overlap between the catchment areas of Edinburgh and Aberdeen airports for a 90 minute drive time. Taken together with the evidence of limited overlaps in passenger catchment areas this indicates that Aberdeen airport is not in the same geographic market as Glasgow, Edinburgh and Prestwick.

⁶⁴ The inclusion of a portion of sea is a consequence of the software used.

Figure 5.6: 90 minute drive time around Aberdeen airport (MapInfo)

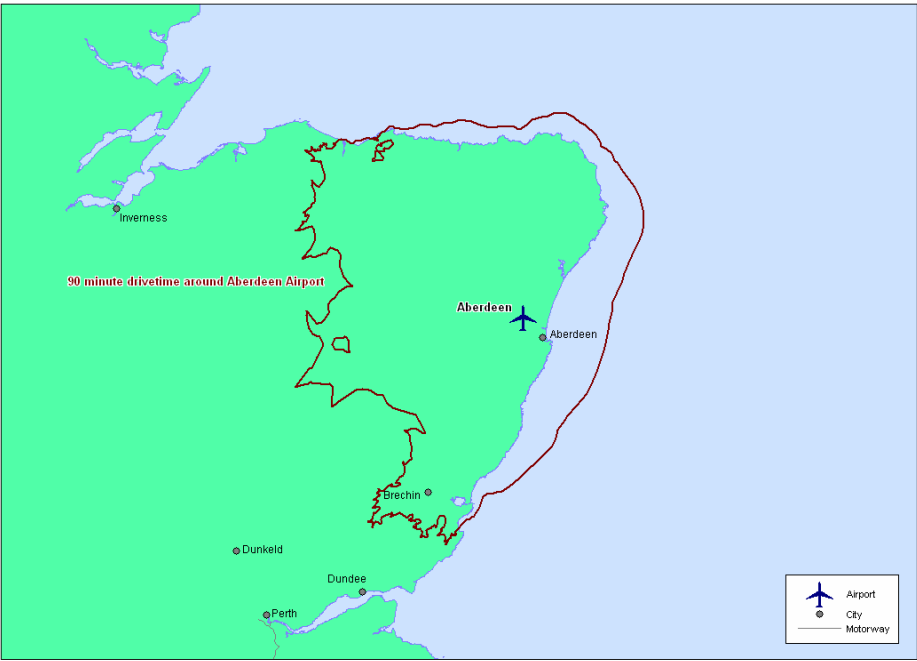
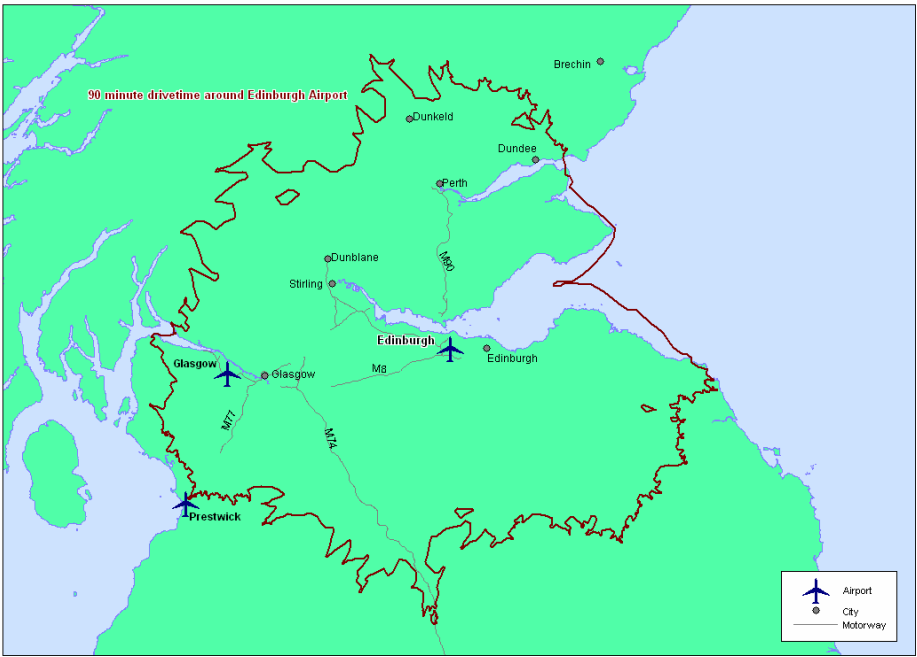


Figure 5.7: 90 minute drive time around Edinburgh airport (MapInfo)



Substitution by airlines

- 5.78 Bmibaby switched its Cardiff service from Glasgow to Prestwick in 2003 and reverted to Glasgow in 2006, while Globespan switched route from Prestwick to Glasgow in 2003. No other switching occurred during the period from BAA airports in Scotland.

Views

- 5.79 BAA provided information to the OFT concerning Scotland but did not provide its own assessment of the relevant market. Several airlines told us that Edinburgh and Glasgow serve essentially overlapping markets and were mutual potential substitutes. One noted that BAA's willingness to give financial incentives at Glasgow but not at Edinburgh reflected competition from Prestwick, and that separate ownership of Edinburgh and Glasgow would 'bring a similar competitive tension'. Catchment analysis⁶⁵ provided to the OFT showed that Edinburgh's catchment area for charter flights was within that of Glasgow (charter passengers account for 24 per cent of traffic at Glasgow and 4 per cent at Edinburgh).

Conclusion on market in Scotland

- 5.80 The evidence regarding BAA's airports in Scotland is consistent with Edinburgh, Glasgow and Prestwick belonging to the same market within Lowland Scotland, and Aberdeen to a separate market in the north of Scotland.

Airports in the North of England

- 5.81 We consider that the relevant geographic market within which Manchester airport competes is the North West and Yorkshire and Humberside. This area also includes two other major airports not owned by Manchester Airport Group: Liverpool and Leeds Bradford.

⁶⁵ By a charter operator, based on passenger data.

The relevant market may be wider than this but we leave this question open as it would not affect our conclusions.

- 5.82 The main evidence that has drawn us to this conclusion is our analysis of survey data showing the origin of passengers using airports within these regions. This evidence and some of the views presented to the OFT are laid out below.

Regional presence

- 5.83 A previous Competition Commission investigation of Manchester airport in 2002 defined Manchester's catchment area as being primarily comprised of the North of England and part of the Midlands.⁶⁶ Seventy seven per cent of all passengers who use Manchester airport come from two regions (North West and Yorkshire and Humberside).⁶⁷ The airports drawing passengers from these regions are therefore more likely to be substitutes to Manchester airport.
- 5.84 We focussed on the North West and Yorkshire and Humberside in our analysis below.

⁶⁶ Competition Commission, 'Manchester Airport PLC: A report on the economic regulation of Manchester Airport PLC', October 2002. Paragraph 2.14

⁶⁷ These are Government planning regions.

Table 5.9: Share of passenger trips in the North West and Yorkshire & Humberside, 2005

Airport	North West	Yorkshire & Humberside	Combined
Manchester*	76%	45%	64%
Liverpool	20%	3%	14%
Leeds Bradford	< 1%	25%	9%
Nottingham East Midlands*	1%	7%	3%
Heathrow	1%	5%	2%
Stansted	1%	4%	2%
Humberside*	1%	4%	1%
Other	< 1%	8%	4%

Source: CAA survey data

* These airports are owned by MAG

Substitution by passengers

5.85 Examining the customer survey data of these airports provided by the CAA we found that:

- in the North West region (where 57 per cent of Manchester's passengers originate) over 75 per cent of passengers used Manchester airport and 20 per cent used Liverpool airport. No other airport handled more than 1.5 per cent of passengers originating in the North West
- in Yorkshire and Humberside, (where 20 per cent of Manchester airport's passengers originate), 45 per cent of passengers used Manchester airport, over 25 per cent used Leeds Bradford and almost 7 per cent used Nottingham East Midlands
- Manchester and Liverpool are the largest districts in terms of passenger numbers. Manchester airport has 85 per cent of passengers originating in Manchester. Liverpool airport unsurprisingly

has its highest share in Liverpool (51 per cent, against Manchester airport's 45 per cent)

- approximately 20 per cent of Manchester airport's current passengers originate in local authority districts where either Liverpool or Leeds Bradford airport is used by over 25 per cent of passengers originating in those districts.

5.86 The destinations offered by airlines from Liverpool and Leeds Bradford airports were also generally on offer at Manchester. The destination overlap was in UK domestic and European routes (including North Africa and Red Sea resorts), but not long haul. Over 60 per cent of Liverpool's 67 destinations were offered from both Liverpool and Manchester airports. This overlap represents about 20 per cent of more than 200 destinations served by Manchester (reflecting its larger size and range of destinations).

5.87 There is therefore strong evidence that the set of potential substitutes to Manchester airport includes Liverpool and Leeds Bradford airports but could potentially include others. This accords with the views expressed to the OFT.

Substitution by airlines

5.88 There appears to be competition for the location of new airline flights as opposed to switching of existing airline flights (which is rare), especially between Manchester and Liverpool airport.

5.89 Liverpool airport has been particularly successful in capturing growth in low cost carriers. This is the area in which most airline growth has occurred in recent years (we describe this further in Chapter 9).

Views

5.90 Manchester airport said it competes within several markets with distinctions by type of airline service (for example long haul and short haul, domestic and international). It also believes it competes with a wide set of airports including the London airports, and some European

Hubs for long haul traffic; with rail for domestic traffic; and also faces some competition from airports whose catchment areas overlap with the catchment areas of more directly competing airports. We do not discount these possibilities but clearly the majority of Manchester's passengers come from two regions and each of these regions has only one other airport which is used to any significant extent by air travellers. Consequently we limit the set of potential substitutes to Liverpool and Leeds Bradford airports but recognise it could be wider.

- 5.91 Several airlines said that they had considered both Liverpool and Manchester when initially setting up services in the region. Their choice had been driven by commercial terms and efficiency of operation. Overall many airlines had mentioned Liverpool, and several mentioned Leeds Bradford, as offering competition with Manchester. Customer postcode analysis was presented to support this.
- 5.92 One airline believed Manchester's catchment area was a 90 minute drive, which covers a wider area than the North West and Yorkshire & Humberside. This would include Liverpool, Birmingham, Nottingham East Midlands and Leeds Bradford airports. It believed only Birmingham was a potential substitute for long haul flights.

Conclusions on market around Manchester

- 5.93 On the evidence before us, there appears to be a strong case that Manchester competes within an area which overlaps with Liverpool and Leeds Bradford airports. The extent to which other airports are substitutes is less clear cut but we cannot rule out the possibility that it may be wider and include airports such as Birmingham.

6 BAA AIRPORTS IN THE SOUTH EAST OF ENGLAND

- 6.1 Chapter 5 covered the geographic market relevant to the South East of England which gave a competitor set of Heathrow, Gatwick, Stansted, Luton, London City airport and possibly Southampton.
- 6.2 There are three interlinked features of the market for the supply of airport services in the South East of England that we suspect prevent, restrict or distort competition. These are:
- the joint ownership of Heathrow, Gatwick and Stansted airports by BAA
 - the existence of development restrictions and capacity constraints, and
 - the regulatory regime applied to BAA's airports.
- 6.3 We believe joint ownership of Heathrow, Gatwick and Stansted airports restricts competition. This may interrelate with the other features we have identified: development restrictions, capacity constraints and the regulatory regime. Furthermore, the scale and scope of BAA's operation may have resulted in the creation of a regulatory regime which distorts competition. In the following analysis we seek to make these connections where they are relevant. We consider the effects of joint ownership last, as the other features provide an important context within which the effects need to be assessed. We then consider whether data on pricing and profitability supports our analysis that competition is prevented restricted or distorted by these features. Finally, we consider other complaints made to us about service quality and security issues.

Development restrictions and capacity constraints

Development restrictions

- 6.4 The planning system acts as a serious barrier both to new entry and expansion by existing airports. The planning system, as it currently

works, does not allow us to foresee any possibility of new entry on a significant scale.

- 6.5 New airports or airport expansion projects may be ruled out because of their impact on noise levels, air quality and traffic in the surrounding area. Even where a project is possible, it will invariably be subject to a lengthy consultation process. For example the planning inquiry into the development of Heathrow Terminal 5 began in May 1995 but was not completed until 1999. Terminal 5 is due to open in 2008.
- 6.6 The White Paper, 'The Future of Air Transport' (2003) sets out Government policy towards the development of airport capacity in the next 30 years for the whole of the UK. While it does not authorise or preclude any particular developments, it sets out which developments the Government will support, and under what conditions.
- 6.7 The White Paper takes a region wide approach to capacity expansion in the South East. It concludes that provision should be made for two new runways in the South East by 2030: the first new runway should be at Stansted as soon as possible; the second at Heathrow between 2015 and 2020, conditional on compliance with air quality limits and other constraints.
- 6.8 The White Paper sees Gatwick as the alternative to Heathrow, if development is not possible there. Gatwick is subject to an undertaking that no development will take place before 2019.⁶⁸ Investment decisions at airports involve very long timescales and consequently ignoring long term expansion at Gatwick would not be appropriate.
- 6.9 Other factors beyond the planning regime which can limit the ability to establish a new airport or expand a current airport include:

⁶⁸ In the White Paper, the Department for Transport concluded it should not take action to overturn the 1979 agreement between West Sussex County Council and BAA which contains this undertaking. The DfT believed land should be safeguarded for a second runway at Gatwick in case expansion at Heathrow proves unattainable.

- congestion and emissions: airports can generate significant levels of road traffic and thus nitrogen oxides and other emissions. The associated congestion and air quality issues can impact on the degree and rate at which an airport can grow. The Government expects airports to pay the cost for upgrading road, rail or other transport networks needed to cope with additional passengers
- green belt and planning conditions: certain airports including Heathrow, Manchester and Edinburgh are subject to more onerous planning requirements due to the existence of green belt.

6.10 The significant environmental, traffic and noise impact of airports necessitates some restrictions on their establishment and growth. These restrictions add considerably to the length of time and cost involved in building and expanding airports. It therefore appears that considerable barriers to entry and expansion exist.

Capacity constraints

6.11 All of BAA's South East airports are operating at capacity at peak times of the day. Heathrow is operating at capacity at most times of the day most days of the year. Stansted is operating close to capacity at peak hours of the day.

6.12 Airports operating at capacity have little incentive to attempt to attract business from other airports for example by lowering prices or improving quality. Furthermore if airlines were to leave Heathrow or Gatwick there is little doubt that other airlines would be quick to fill any capacity which was freed up.⁶⁹

6.13 BAA told us it viewed Heathrow, Gatwick and Stansted as airports where capacity limits had an impact on the operation because they are operating at or near capacity. They are designated as 'coordinated' airports under the EU Slot Regulation⁷⁰ due to these constraints. BAA provided us with charts based on data from Airport Coordination Limited (ACL), the independent coordinator of slot allocation at Heathrow, Gatwick and Stansted (see Annexe C). These show that:

- applications for slots at Heathrow are significantly higher than available capacity across the whole day and year
- applications for slots at Gatwick are significantly higher than available capacity at peak times, and on many days of the week, though not in winter, and
- Stansted's slots are currently only constrained in the key peak period for early morning, but these slots are crucial to low cost airlines aiming for high aircraft utilisation.

⁶⁹ BAA cannot directly allocate capacity at Heathrow, Gatwick and Stansted to airlines. Rather, slots are allocated by an independent coordinator Airport Coordination Limited (ACL) under EU legislation. Airlines request slots for each season, and ACL allocates them according to certain rules, notably that of 'grandfather rights'. This means that an airline is entitled to the same slot in the next winter or summer season as long as it operated the service at least 80 per cent of the time in the last winter or summer season. BAA may be able to indirectly influence this in the longer term by structuring charges so as to discourage specific types of air traffic (for example by making smaller aircraft relatively more expensive to operate from Heathrow).

⁷⁰ Council Regulation (EEC) 95/93 as amended by Regulation 793/2004.

- 6.14 BAA told us that at Heathrow it faced two key capacity constraints: a longstanding agreement that runways should be used in segregated mode (one for arrivals, one for departures) to alleviate local noise impact (greater throughput could be achieved in the alternative 'mixed mode'), and a planning condition limiting air traffic movements to 480,000 per year (473,000 were handled in 2005-06 – 98.5 per cent of the limit). If a third runway does go ahead at Heathrow, the first constraint would be alleviated whilst the planning process would need to address the second constraint. We understand from the airport Master Plans that BAA's airports in the South East are subject to tighter planning constraints than the other BAA airports, in that they must get separate consent for construction or extension of any passenger terminal with a floor space greater than 500m.²

Conclusion on development restrictions and capacity constraints

- 6.15 In the long term there is scope for expansion of existing airports in the South East but no real scope to build a major new airport serving key population centres. Expansion is subject to a range of hurdles, which can cause delays and may hinder the development of sufficient capacity to facilitate competition. Therefore we consider that development restrictions and capacity constraints are a feature of the market that restricts, prevents or distorts competition.

Economic regulation

- 6.16 As noted in Chapter 4, Heathrow, Gatwick and Stansted are subject to economic regulation which places upper limits on the prices these airports can charge airlines. The fact that Heathrow and Gatwick price up to their price caps suggests that price controls hold prices lower than would otherwise be the case. However at Stansted BAA is not currently able to achieve the price ceilings allowed by the CAA.
- 6.17 We have received a great deal of evidence, primarily from airlines but also from airports, in relation to how regulation may be restricting, preventing or distorting competition. The most significant points are:

- the 'guaranteed return' from investment under the current regulatory regime may lead designated airports to over invest in facilities which from the viewpoint of airlines and/or passengers are higher quality than they want
- there is a potential mismatch between the five year timeframe of the regulatory process and the longer lifetime of investments, which may be amortised over fifty years. This creates a regulatory risk, that even if acceptable returns are available when a project commences, they may be changed to unacceptable levels in a later review period. Likewise, if the price cap is set below what the operator regards as an acceptable level, the operator of a designated airport may decide to delay investment, or not invest at all
- the current framework may encourage BAA or airlines to engage in 'regulatory gaming'. Several airlines have claimed that BAA has overestimated the costs and under delivered on operational activities to inflate the price cap. They believed that BAA would always devote significant resources to achieving a favourable regulatory outcome, while for airlines, airport charges are just one of many costs. Airlines are therefore unable to commit the same level of resources to balance the regulatory process.

6.18 In our view, the most important of these points relate to the potential effect on investment incentives.

Effect of regulation on investment incentives

6.19 Airlines expressed two principal concerns about the interaction between economic regulation and investment. First, that the regulatory framework rewards a regulated airport for investments which increase its regulatory asset base (RAB),⁷¹ regardless of whether these

⁷¹ RAB: The Regulatory Asset Base, a regulatory valuation of the company assets on which the regulator calculates the appropriate returns to the company for the purposes of price regulation. Investment by a regulated company will typically increase the value of assets which will increase the revenue it is allowed to recoup and hence increase charges.

investments are valued by airport users. Second, that there appears to be an assumption by BAA that future investment should be funded by higher charges⁷² rather than greater volumes and efficiency improvements. We discuss these concerns in greater detail at paragraphs 6.23 to 6.29 below.

6.20 Several commentators have mentioned a trade off between short term price competition and long term investment decisions. The argument is that airports should be allowed to earn significant profits now in order to fund future investment.

6.21 We are not convinced by this line of logic in the form it has been presented to us for the following reasons:

- investment at airports should take place if the present value of future revenue streams generated by the project exceeds the present value of the costs of the investments, including a risk based return on capital. Airports should be able to benefit from economies of scale and scope as they grow. We have seen mixed evidence from developments at other airports. There are examples of high cost developments where charges have risen,⁷³ but there are also

⁷² BAA's response to the Government consultation 'The Future Development of Air Transport in the United Kingdom: South East (SERAS)' (May 2003) - which preceded the White Paper - notes at para 3.27 that Government should 'aim to provide as much clarity as possible to investors and allow airports to continue to attract private sector funds for investment in airport infrastructure. Investors must have the prospect of being able to make an appropriate return from their investment in BAA. Increases in airport charges will be required if BAA is to invest profitably in high-quality airport facilities, including runways and additional airport-related environmental mitigation measures. Recognition of this point would help to achieve the Government's stated objective'.

⁷³ For example, Toronto airport

examples of low cost terminals,⁷⁴ and independently operated terminals⁷⁵ where charges have fallen

- we therefore question the view that any investment funding should be generated by higher charges to current users before the investment takes place. Investment projects are usually selected on their ability to generate new revenues, not in view of the scope to raise current prices to fund them.

6.22 The CAA is, and the CC will be, conducting a quinquennial review of BAA's London airports in 2007 which would, in principle, be capable of addressing the concerns of airlines. However, price regulation only exists where competition is not effective. To the extent greater competition could occur, this could deliver benefits to air travellers which exceed, or extend those that price regulation can deliver. For example, strong competition can remove the need for price regulation altogether. We discuss these concerns in greater detail below.

RAB incentive

6.23 Airlines expressed the view that the current regulatory structure creates the incentive for airport owners to maximise the cost of planned investment ('gold plating'). They believe it enables BAA to achieve a guaranteed return on RAB rather than focusing primarily on meeting the needs of its customers for timely, efficient, and cost effective investment in airport capacity. One airline put this in terms of BAA having an incentive to invest in the RAB but not necessarily in runway capacity, reducing congestion, or at the best time/place to meet market needs. It was concerned about the high cost of the Heathrow East terminal development, which would not increase

⁷⁴ Frankfurt Hahn, Singapore Changi and Marseille

⁷⁵ Terminal four at John F. Kennedy airport

capacity and may even reduce capacity.⁷⁶ It was also concerned that BAA had an incentive to invest in retail space, rather than aeronautical facilities, and that too much retail activity tended to delay passengers in getting to the boarding gate, to the detriment of airlines.

- 6.24 BAA told us that due to scarce runway capacity at Heathrow and Gatwick, investment was more likely to be aimed at improving service quality and reducing congestion, particularly in the case of Terminal 5, which would have a marginal effect on capacity. BAA also described Heathrow East, as intended 'simply to replace outdated buildings and deliver great service'.
- 6.25 The Stansted Airline Consultative Committee (SACC) argued that the Stansted capital investment options put forward by BAA are excessively expensive, are inefficient, and can only be explained by BAA's 'guaranteed 7.75 per cent return on capital investment'.

Price cap

- 6.26 BAA said that the price control formula should be seen as a five year framework contract, in which prices are set on condition that investment is made broadly in accordance with a published programme. It said there was a disjoint between the five year time period of the pricing formula and the life of investment (typically 50 years for a new terminal). It said that in its view CAA and CC had a responsibility to ensure a clear and consistent policy incorporating regulatory risk – the risk relating to their own future regulatory decisions - into the price. BAA noted that while users may demand long term investment, there is no guarantee that they will pay for it (they provided the example of Heathrow Terminal 4 being built in

⁷⁶ In a community consultation paper issued Summer 2006 'inform Heathrow', BAA stated that Terminal East would not add to airport capacity, providing space for 30m passengers, compared with 35m passenger capacity of Terminals 1 and 2 which it will replace. It also stated there would be no increase in flights.

response to demands from two airlines which no longer exist – TWA and Pan Am).

- 6.27 On the other hand one airline said that BAA could hold the CAA hostage by refusing to invest unless it was offered a good settlement. BAA told us that 'the status of Heathrow East depends on a satisfactory Q5⁷⁷ price control'.
- 6.28 Some airlines argued that price rises should not be a precondition for airport development: investment could be funded from efficiency gains and the revenue growth generated by new capacity. One commented that if an airport chooses to grow its capacity 'more of the same should not be more expensive'. Airlines also pointed out that they had been able to significantly expand capacity at a time when air fares were falling in real terms. Airport investment is arguably significantly more lumpy than airline investment. However it is a challenge for regulators operating within a system based on ensuring adequate returns on a regulated asset base to avoid the delivery of excessive investment in assets to achieve low risk 'guaranteed' returns.
- 6.29 Several airlines told us that the returns on capital allowed in the 2002 price cap review were excessive. Some claimed that this was borne out by BAA's ability to offer £750 million to shareholders in defence of the Ferrovial takeover.

Conclusions on features of economic regulation

- 6.30 The issues raised by airlines in relation to the current regulatory system and the method for setting the price cap could arguably be dealt with in the next quinquennial review. Nevertheless, in our view, price regulation is a second best solution to competition problems. Opportunities for increasing competition can be identified even in a regulated industry and these could deliver benefits to air travellers which exceed, or extend those delivered by economic regulation.

⁷⁷ Q5 is an industry acronym for the fifth quinquennial price review.

- 6.31 Airlines have been quite clear that they support price regulation and would want continued regulation of prices at the designated airports in the South East. Airlines have also argued that there is scope for greater competition between airports. This corresponds with OFT's view.
- 6.32 Price regulation can also impose costs on an industry, both direct costs from operating a regime to enforce price regulation and, more importantly, indirect costs caused by the distortions in market signals and regulatory gaming that may occur.

Joint ownership

- 6.33 BAA owns the three largest airports in the UK: Heathrow, Gatwick and Stansted airports. These airports handle approximately 91 per cent of passenger trips and over 83 per cent of flights within the South East of England⁷⁸ and East Anglia (see Table 5.3). Luton is the only significant airport in the region not owned by BAA. Chapter 5 describes the large extent to which these BAA airports could compete to serve the same airlines and passengers.
- 6.34 These high market shares have existed since privatisation in 1987 and are likely to persist, given capacity constraints in the South East, and the very high barriers to new entry and barriers to expansion summarised at paragraph 6.15 above.
- 6.35 If the market was widened, for example to include the Midlands⁷⁹ this would also not affect our conclusions as BAA would still have a high and persistent market share.

⁷⁸ BAA also owns Southampton airport which has a one per cent share of passengers in the South East.

⁷⁹ According to CAA airport statistics, BAA's share of passenger trips in 2005 is 89 per cent in the South East of England and East Anglia and is still 80 per cent if this is widened further to include both East and West Midlands. We note even if we considered this over the whole of the UK, BAA's share remains over 60 per cent, a level at which significant market power would normally occur.

- 6.36 Given these considerations we conclude that BAA holds substantial and persistent market power in the South East of England.

Does joint ownership prevent, restrict or distort competition?

- 6.37 BAA's joint ownership of airports in the South East is only capable of preventing, restricting or distorting competition if some competition between BAA's airports would be possible absent joint ownership, given price regulation and given the capacity constraints operating in this market.
- 6.38 There are a number of reasons why we believe that there could be significantly greater competition between Heathrow, Gatwick and Stansted airports. In the **short run**:
- there is substantial overlap between the passengers these airports attract hence potential for airlines to switch between them (see Table 5.5 and paragraph 5.41)
 - operating airports involves high fixed costs (those which are incurred whatever the volume of passengers) whilst a substantial proportion of revenue is directly related to the volume of passengers using the airport. This means that even airports with only a small amount of spare capacity will have an incentive to compete to fill this capacity. Both Gatwick and Stansted have some spare capacity outside peak periods
 - a short term fall in demand for air travel (for example following the introduction of a tax, or an economic downturn) could free up capacity, creating a greater incentive to compete
 - capacity constraints are not absolute. Heathrow airport has seen a growth in passenger numbers despite an overall limit on air traffic movements (ATMs) as airlines and the airport make more efficient use of their facilities

- 6.39 In the **long run**:

- a separately owned Heathrow, Gatwick or Stansted could increase capacity, for example by building a new runway, and then compete with the other two to fill this capacity. Greater competition might alter the incentives to invest in airport expansion in the South East. We consider this point in our discussion of investment below. This is particularly important given the very high barriers to new entry summarised in paragraph 6.15.

6.40 Of these the last is, in our view, the most important consideration. Investment in additional capacity creates potential for more competition to emerge. Competing airports would be expected to seek advantage over one another by building new capacity to attract airlines from their rivals and making best use of existing capacity. Such competition between airports may result in spare capacity which will in itself generate stronger short run competition.

6.41 Considering individual BAA airports, Heathrow is widely seen by airlines as having a unique status, due largely to its location and the fact that it is a hub airport with 35 per cent of its customers interlining. We believe that Heathrow would retain market power due to its hub status (and possibly other factors including its size, reputation and good surface access from central London). However, the majority of its customers still come from the South East of England. Thus Heathrow is also a potential competitor with other airports within this region.

6.42 Stansted's market power appears to be less than Heathrow and Gatwick. It is close to Luton, and serves a similar profile of airlines, Ryanair and easyJet together having a majority presence at both. In addition, it has, in the past, had substantial spare capacity to fill. This is reflected in the fact that it gave airlines discounts⁸⁰ of almost £[] million in 2005-06, leaving it £72 million in airport charges. These discounts are associated with long term contracts which are in the

⁸⁰ Two discount figures have been excised from this paragraph for commercial confidentiality reasons.

process of expiring. BAA has signalled that discounts at Stansted will cease in March 2007.⁸¹ In contrast, Gatwick gave only £[] in rebates in 2004-05⁸² while receiving £144 million in airport charges. Heathrow does not give discounts. Its airport charges totalled £532 million in 2005-06.

6.43 Given these considerations, we suspect that the joint ownership of Heathrow, Gatwick and Stansted prevents competition which would erode some, but not all, of the market power at the individual airports.

6.44 This view is consistent with merger analysis undertaken by both the OFT and other competition authorities, in which adverse findings have been made in cases involving adjacent airports. In 1996 the proposed merger of Belfast City and Belfast International airports was prohibited following an MMC report which detailed concerns about a loss of competition.⁸³ More recently the OFT referred the proposed merger of Bristol and Exeter airports to the Competition Commission due to its potential to substantially lessen competition.⁸⁴ Given that BAA's joint ownership of airports in the South East is a situation which has existed for over two decades, assessing what would occur in its absence is a difficult question and one more suited to the more in depth investigation offered by the CC. We have, however, reviewed, as a hypothetical, whether a merger or series of mergers of these airports

⁸¹ BAA Annual Report and Accounts 2005/06, page 39.

⁸² The BAA Annual Report states that airlines operating at Gatwick and Heathrow were charged at the regulatory price cap in 2005/06.

⁸³ Monopolies and Mergers Commission, Belfast International Airport Limited and Belfast City Airport Limited: A report on the merger in contemplation, 1996. The MMC concluded that the two Belfast airports had sought to compete vigorously under separate ownership, and considered that this encouraged competition between airlines. They did not expect such competition to continue under joint ownership, and expected the loss of competition between airports to result in higher airport charges than would apply in the absence of a merger. The merger was prohibited by the Secretary of State for Trade and Industry.

⁸⁴ See footnote 40. The deal was abandoned following the referral.

would be likely to trigger the OFT's duty make a reference to the Competition Commission under the merger provisions of the EA02. We have concluded that the OFT's duty would be likely to be triggered. Whilst the legal test for referring a merger to the Competition Commission is different to the s131 test for a market investigation reference,⁸⁵ the approach to market definition, and the analysis of competition issues are substantially similar.

Countervailing buyer power

- 6.45 We have also given consideration to whether countervailing buyer power of airlines may reduce the market power of BAA, a point put to us by BAA. Some airlines – notably BA at Heathrow and Gatwick, Ryanair at Stansted – account for a substantial share of the airport's business. We are not convinced that countervailing buyer power of airlines substantially reduces the market power that joint ownership of Heathrow, Gatwick and Stansted confers on BAA.
- 6.46 In principle, it may be possible for some airlines to exert some buyer power against airports – for example by threatening to concentrate growth at other airports if BAA does not offer them sufficiently attractive terms. But there are also reasons to doubt whether the individual buyer power of two or three airlines could offset the substantial position of BAA due to its joint ownership of the large majority of airport capacity in the South East of England.
- 6.47 Given that we would expect airlines with buyer power to be able to negotiate discounts off BAA's charges, the fact that they are unable to do so at Heathrow and Gatwick (see paragraph 6.42) demonstrates

⁸⁵ The OFT must make a merger reference if it believes that it is or may be the case that a relevant merger situation may be expected to result in a substantial lessening of competition (sections 22 and 33 Enterprise Act 2002). The OFT has the power to make a market investigation reference under section 131 if it has reasonable grounds for suspecting that any feature or combination of features of a market in the UK prevents restricts or distorts competition.

that competition is restricted. We suspect that this is due to a combination of the features of joint ownership and capacity constraints.

Effect of joint ownership on investment incentives

- 6.48 Our biggest concerns about the effect of BAA's joint ownership of airports in the South East relate to potential distortions to investment incentives.
- 6.49 In relation to airport services in the South East of England, many airlines and other commentators saw investment in capacity as the most important issue for this study. Investment generated the most complaints to the OFT from airlines.
- 6.50 In relation to investment, we have reasonable grounds for suspecting that both the system of regulation (described in paragraphs 6.19 to 6.29) and the joint ownership of airports act to distort incentives. The potential distortion may be large and may have long lasting impacts on consumers (in terms of choice of where to fly from and at what cost). The question of how best to regulate so as to avoid perverse incentives on investment has no obvious clear cut answer. We believe that the question of whether it is possible to increase competition is an important one here. Increased competitive pressure would not only deliver benefits to air travellers, it would also reduce reliance on regulation and could provide valuable information for regulatory benchmarking purposes.
- 6.51 We have reasonable grounds to suspect that the current market structure could lead to investment decisions which do not maximise benefits to air passengers. For example:
- joint ownership may discourage investment if BAA is concerned that expanding one airport will 'steal' passengers from another of its airports in the region. A similar concern expressed to us is that by constraining expansion at one airport (Heathrow) the 'spill over'

demand benefits an adjacent airport (Stansted). See paragraphs 6.56 to 6.58 where such concerns were expressed to us

- inappropriate investment at regulated airports, to the extent that it is funded by higher charges, will be a cause of consumer detriment – raising airlines' costs and hence fares without providing value to passengers. As discussed in paragraph 6.21 we question the assumption that investment should, of itself, require higher charges. See paragraphs 6.59 to 6.67 where such concerns were expressed to us
- under investment (or delays in investment) in capacity at airports can dampen downstream competition between airlines (through lack of capacity to offer competing services) resulting in less choice and higher fares.

6.52 BAA told us that:

- Its financial resources left it less likely to be constrained by the lumpiness of investment at individual airports than might be the case under separate ownership. It said that 'while in theory financing should not be a constraint if prospective returns were above the cost of capital, in practice separately owned airports, especially Stansted, might be put off investing if this required major equity subscriptions, rather than simply pricing up existing capacity'.

We note that companies with large financial resources other than BAA can and do own and invest in airports (see Table 4.1 on page 19). This does not necessitate ownership of adjacent airports.

- The scope for future higher profits acts as a stimulus to current investment.

While such a stimulus can be pro competitive in innovative markets, where firms compete to win short term market power, in the case of BAA any such profits could in principle be sustained indefinitely, long after the investment has been remunerated. Economic regulation may

address this issue in part but may not be as well placed to address it as competition given the high barriers to entry that exist.

- Alternatively, BAA said that joint ownership of airports enables better coordination, and therefore more appropriate investment on a region wide basis.

We are not swayed by this line of argument. We have seen no evidence that coordination would enhance investment.

6.53 BAA told us it plans to expand airport capacity along the lines of the White Paper, subject to planning permission, continued regulatory support and an appropriate regulatory settlement. Some airlines have commented on this, as discussed later (para 6.72).

6.54 We are concerned about inappropriate investment incentives. We believe it is significant that all the major airlines operating out of airports in the South East of England expressed to us concern with BAA's proposed long term capital investment programme. The following sections summarise the main concerns put to us by airlines. We are not however drawing judgments on individual investment decisions or their cost. Our analysis of the evidence we have collected and the views put to us (in particular the widespread concern of airlines as the main customers of airports) gives us reasonable grounds to suspect, that joint ownership of airports by BAA, acting alone or in combination with the other structural features we have identified, prevents restricts or distorts competition, in particular by distorting long term investment incentives.

6.55 The sections below layout the main concerns expressed to us.

Broad concerns on investment at airports in the South East

6.56 The majority of airlines expressed the view that separation of ownership would benefit investment. For example, one airline commented that 'Separate ownership [of Heathrow and Stansted] would ensure that the development of each airport reflects the market opportunities available, and that the expansion at one airport is not

held back to suit the commercial needs of a monopoly owner.' It said that in its view BAA had an incentive to delay Heathrow investment while upgrading Stansted, as this would reduce the investment risk at Stansted.

- 6.57 One airline claimed that whilst the severest capacity constraints occur at Heathrow, BAA had given greater priority and resource to developing Stansted airport. The same airline drew a contrast with Luton airport where it claimed that the airport was actively promoting the building of a new runway. BAA told us that it had adequately resourced the Heathrow runway project, which was at an earlier stage.
- 6.58 Other airlines also believed that separate ownership of BAA's airports in the South East would lead to more appropriate investment. The broad picture was of too much investment at Stansted and too little at Heathrow and Gatwick.

Stansted Generation 2

- 6.59 In 2005 BAA published a consultation document proposing a second runway at Stansted, which would increase capacity by 41 million passengers per annum. The proposal has drawn strong criticism from the SACC which represents the airlines that use Stansted, and from individual airlines at both Stansted and Heathrow.
- 6.60 The SACC's principal concerns are that:
- the cost of the new facilities is excessive - four times the cost of one of their own proposals, and
 - BAA's forecasts of demand at Stansted are excessive. The SACC envisages significantly lower growth in demand if airport charges have to rise to fund increased capacity.
- 6.61 Airlines operating out of Stansted believe that increased airport charges at Stansted to fund development could not simply be passed through to air travellers. If a low cost airline's costs rose to the point at which a particular service no longer achieved the required rate of return, then

the service would simply be withdrawn. They claimed an increase in airport charges would imply a lower than forecast growth and not higher fares.

- 6.62 Another concern that was raised by airlines using Heathrow was that if BAA made a loss making investment at Stansted it might seek to recoup its losses through higher charges at Heathrow and Gatwick.
- 6.63 We believe that increased airport charges would lead to increases in air fares, lower margins for airlines and a decrease (or slower growth) in overall air travel.
- 6.64 BAA told us that incumbent airlines at Stansted 'focused on pushing down costs, with the associated constraint on capacity growth. This would be a rational approach for near monopolist buyers of capacity from a supplier with capped prices. It effectively offers the prospect of their maximising monopoly rents by buying scarce capacity at cost, and using capacity shortages to exclude competition and raise prices'. BAA argued that providing capacity to Ryanair's competitors would put it (BAA) in a stronger bargaining position at Stansted. A counterargument could be that introducing a large amount of spare capacity which it needed to fill would weaken its bargaining position, at least in the short term.
- 6.65 Concerns about BAA's investment plans at Stansted were not limited to Ryanair: the SACC represents airlines at Stansted generally, while easyJet (a member of the SACC) has also publicly criticised the proposals. The SACC told us that it circulated its minutes to all airlines using Stansted and none had objected to the approach adopted by the SACC to BAA's investment proposals. Ryanair told us it had offered to part finance the provision of a low cost, efficient second runway. EasyJet told us that its business model relied on growing volume within the market and that it would therefore not be in its interest to artificially restrict airport capacity.
- 6.66 BAA commissioned a survey which was conducted on its behalf in 2005 among airlines using its South East England airports. The report

notes that 'At first we thought the issues highlighted by Ryanair and easyJet were specific to them, however other airlines interviewed also had concerns about the consultation process at Stansted. The budget airlines using Stansted seem to have different views because of their perception that their business model is incompatible with that of BAA.'⁸⁶

- 6.67 Some airlines at Heathrow also expressed concerns about the cost of the proposed development at Stansted. Their concern was that at some point in the future CAA would allow BAA to revert to a 'system approach' to calculating price caps, in which BAA would be able to cross-subsidise development at Stansted by raising charges at Heathrow (and/or Gatwick).⁸⁷

Communication between BAA and its customers on investment requirements

- 6.68 The CAA introduced a Constructive Engagement (CE) process in 2005 to facilitate agreement between airports and airlines on investment projects. This process was introduced at a time that consideration was being given to the CC holding a Public Interest Inquiry into capital investment programmes at BAA airports.⁸⁸
- 6.69 The process appears to have had some success at Heathrow and Gatwick. Airlines have commented positively about the new process. However it appears to have broken down at Stansted. We have received extensive evidence from airlines on this issue. Whilst BAA has provided us with a large volume of documents related to or provided to airlines as

⁸⁶ BAA airline perception survey, 2005

⁸⁷ We have seen confidential information from May 2005 in which BAA told potential investors that it thought a return to a system approach would be merited, and contained indicative costs to Heathrow and Gatwick passengers.

⁸⁸ Civil Aviation Authority, Heathrow, Gatwick and Stansted airports: Review of existing public interest conditions, Consultation paper, October 2006.

part of this process at Stansted, its customers at Stansted clearly do not view the process as constructive.

Implementation

- 6.70 Respondents to BAA's airline perception survey (see paragraph 6.66) said that BAA provided facilities which were ultimately of high quality, but with too many initial snags. A concern was also expressed that BAA's tendering process for contractors was not always competitive or well managed.
- 6.71 An airline told us that delays were costly to airlines and passengers but not to BAA. It said BAA postponed investment until the airport was operating to capacity. This made it more costly to expand (for example because work could only be carried out at night). It claimed that 30 per cent of capital expenditure at Heathrow was wasted because contractors were operating in a constrained environment, when work could have been performed at a much earlier stage.

BAA influence on airport strategy

- 6.72 Some airlines have expressed the view that BAA has more knowledge and expertise than other interested parties, in providing the information DfT needs to formulate transport policy including the White Paper itself. They have argued for example that the environmental constraints on building a third runway at Heathrow may have been overstated in the White Paper and could be overcome. Their concern is that on commercial grounds, and to meet the demands of air travellers, expansion of capacity at Heathrow should take precedence over expansion at Stansted.

Conclusion on features affecting competition in the South East of England

- 6.73 Taking into account the above analysis and in particular the overlap in catchment areas described in Chapter 5, we have reasonable grounds to suspect that the joint ownership of Heathrow, Gatwick and Stansted

airports prevents, restricts or distorts competition in the South East of England.

- 6.74 We suspect that development restrictions and capacity constraints, the regulatory regime, and joint ownership of Heathrow, Gatwick and Stansted airports, acting alone and in combination, are features of this market that prevent, restrict or distort competition, in particular by distorting investment incentives. This is to the detriment of airlines and ultimately of air passengers.

Other issues relating to the South East: pricing, efficiency, quality and security

- 6.75 According to paragraph 4.5 of the OFT's Market Investigation Reference guidance,⁸⁹ information on prices and profitability can sometimes be a useful supplement to the OFT's evidence on structural features of a market or on firms' market conduct. We therefore set out in this section the evidence on pricing and efficiency that we have considered in the course of this study, and our conclusions as to whether this evidence supports our analysis of the features that we suspect may prevent restrict or distort competition between airports in the South East.

Aeronautical charges and prices at airports

- 6.76 The majority of comments we received on price were directed at the level of the price cap.
- 6.77 IATA⁹⁰ commented on the disparity between prices and costs in the airline industry and those of UK airports. It said that airline competition had driven down average airline non fuel unit costs by 14 per cent since

⁸⁹ Market investigation references Guidance about the making of references under Part 4 of the Enterprise Act, March 2003.

⁹⁰ The International Air Transport Association is a trade association representing airlines which together carry 94 per cent of all international scheduled air traffic.

2001 while its members' labour productivity had improved by 34 per cent. In contrast the headline price cap of RPI + 6.5 per cent at Heathrow had resulted in an 8.7 per cent increase in 2006-07 airport charges following an 11.7 per cent increase the previous year.⁹¹ In IATA's view, current price caps are unbalanced, unfair and unsustainable. Other airlines made similar comments and believed that prices paid at Heathrow were high in comparison to those they paid at other European airports.⁹²

- 6.78 To assess the evidence on pricing we examined data from TRL, a transport consultancy on airport performance in 2005. The TRL survey covered a sample of 50 major airports and airport groups worldwide. TRL analysed key performance indicators drawn from airports' annual Reports and Accounts supplemented by some information drawn directly from airports.
- 6.79 The key results for Gatwick and Heathrow airports are shown in Table 6.1.⁹³ Stansted was not part of the sample.
- 6.80 Heathrow's revenue per passenger is among the highest of the airports in the survey. This is driven by its high commercial revenues per passenger. Heathrow achieved the twelfth highest operating profit as a percentage of turnover of the sample and the sixth highest return on capital employed.
- 6.81 Gatwick Airport's commercial revenues are ranked fifth in the sample, but its total revenues are ranked nineteenth. Its operating profit as a percentage of turnover is ranked twentieth.

⁹¹ International Air Transport Association's submission to CAA's consultation on the airports price control review.

⁹² As an illustration one said that the highest airport charges it paid (across over 75 European airports) were at seven airports in Ireland and the UK (including, ranked descending by charge) Manchester, Gatwick, Edinburgh and Stansted.

⁹³ From TRL, Airport Performance Indicators, 2005.

Table 6.1: TRL survey of airport performance indicators 2005

	Heathrow		Gatwick	
	Rank (out of 50*)	Index	Rank	Index
Commercial revenue per passenger	2	190.4	5	160.1
Aeronautical revenue per passenger	14	114.7	32	76.7
Total Revenue per passenger	5	143.2	19	105.4
Operating profit per passenger	2	227.2	17	119.7
Return on Capital Employed	6	187.1	20	94.6

Source: TRL, separate information on Stansted was not available.

Index – mean value for the sample of 50 airports is 100

*The 50 airports/groups surveyed were not a random sample, and included some duplication

(for example, separate entries appear for Heathrow, Gatwick and BAA Group)

6.82 The extent to which high commercial revenues indicate consumer detriment is unclear. Commercial revenue has a number of components, of which the most important are:

- retail concessions (20 per cent of total revenue at BAA London airports in 2005): High retail revenues may reflect a greater volume of sales (perhaps due to better retailing facilities, more delays or a combination of such factors) rather than high prices
- specified activities (11 per cent of revenue at BAA London airports): these are facilities for which BAA currently charges airlines separately. These charges are not subject to the price cap (although, like other commercial revenues, they are included in the single till and hence these revenues are netted off aeronautical revenues when

calculating the price cap). Several airlines had complaints about BAA's charges for such activities, including: requiring the use of BAA facilities which could be provided by airlines; excessive increases in prices and changes to pricing structures which greatly increase costs

- car parking (8 per cent of revenue at BAA's London airports): unlike retail revenues, the use of car parking facilities may in some cases be essential to the journey. We have seen no evidence of airports seeking to attract passengers directly to their airports by offering more competitive car parking. Passengers may also have the choice of alternative modes of transport, and at Heathrow and Stansted BAA's average car parking revenue per passenger has declined in recent years
- the remainder of BAA London airports' commercial revenue is derived from: property income (6 per cent of revenue); Heathrow Express (4 per cent); advertising (2 per cent); car rental (1 per cent); and other items (4 per cent).

Efficiency

- 6.83 While IATA referred to inefficiency at BAA's operations, most of those who believed BAA was too costly seemed to think that this reflected excessive profits, rather than inefficiency. Further results from TRL, shown in Table 6.2, indicate that BAA's total costs and operating costs per passenger are not out of line with other airports, and are low relative to several non UK European airports and groups. It is not clear how good a competitive benchmark these airports represent. There may also be effects associated with how close to capacity Heathrow and Gatwick are operating.

Table 6.2: Comparison of costs across European airports, 2005

Airport	Total costs per passenger (£)	Operating costs per passenger (£)
Heathrow	12.8	6.3
Gatwick	11.1	5.4
BAA Group	11.3	4.3
Manchester	12.6	6.7
Birmingham	10.6	4.7
AENA (Spanish airports)	5.5	2.1
Aeroporti di Roma	10.9	4.8
Aeroports de Paris	16.6	6.9
Amsterdam Group	14.1	7.9
Fraport	13.7	1.3
Munich	17.3	8.0

Source: TRL, separate information on Stansted was not available

Conclusions on price and efficiency

- 6.84 We received complaints about pricing, and efficiency in respect of BAA's London airports from a range of airlines. London's airports are among the busiest in the world, which provides substantial economies of scale and scope, but poses challenges from congestion and the evidence needs to be judged in that light. Further we are cautious in the use of international comparisons given the difficulties in controlling for factors outside of an airport operator's control.
- 6.85 Notwithstanding this, we consider that the evidence raises the question of whether overall yields at BAA airports in the South East are too high and is consistent with our view that features of the market may prevent, restrict or distort competition. At this stage we have not seen strong evidence of inefficiency although we note this is particularly difficult to

measure. These are issues that the CC may wish to consider further in the event of a reference.

Service quality

- 6.86 In 2003, the CAA introduced a scheme of standards and rebates under which Heathrow and Gatwick airports were obliged to pay rebates when certain specified elements of quality fell short of defined standards. This scheme was the remedy to a public interest finding by the CC made as part of its five yearly review of the BAA London airports.⁹⁴ CAA revised the scheme in 2005, noting that it has been widely acknowledged in response to the consultations that there had been a greater focus by airport management on service quality and general improvement in the specific areas covered by the scheme at Heathrow.⁹⁵ Views provided to the OFT on whether quality had improved in areas outside those specifically covered by the scheme have varied.
- 6.87 One airline told us that the scheme at Heathrow was limited but had led to some improvements. Several airlines expressed dissatisfaction with service and the price paid for the level of service at BAA airports:
- service quality and standard of facilities were generally poor at Heathrow. For example heating/cooling problems, travelators out of service, insufficient seating, roof leaks and poor segregation system
 - facilities in Gatwick South Terminal were of poor quality but were charged at the same price as the superior North Terminal
 - security staff levels were consistently inadequate to meet the volume of traffic. We examine this in more detail later

⁹⁴ As in footnote 41.

⁹⁵ http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_servicequalitymods_feb05.pdf

- when lifts, baggage carriers and travelators break down the cost is largely borne by the airlines in terms of disruption. The penalties for breaches of service level agreements were felt to provide an insufficient incentive to BAA to ensure reliability.

- 6.88 BAA provided us with reports from its Quality of Service Monitor survey from 2001 to 2005. Ratings ranged from 1 (extremely poor) to 5 (excellent). Heathrow, Gatwick and Stansted generally scored around 4 (good) overall and between 3.5 and 4 on specific measures. The other BAA airports (Scotland and Southampton) scored between 4 and 4.5 on most measures.
- 6.89 Evidence based on a large sample of international travellers benchmarking the level of customer satisfaction at BAA airports against other international airports is provided by surveys conducted by the Airports Council International (the trade association for airports). This is based on a random sample of passengers on a quarterly basis. Fifty eight airports were involved in the survey in 2006. In Q1 2006⁹⁶ on the measure of overall satisfaction among travellers Stansted was ranked 43rd out of 58, Gatwick 49th out of 58, and Heathrow 56th out of 58. BAA told us that airport age was a significant determinant of the relevant ranking, and subsequently indicated that it also considered congestion was also a key factor.

Table 6.3: Airports Council International survey of passenger satisfaction (Q1 2006)

Airport	Ranking out of 58
Edinburgh	38
Stansted	43
Glasgow	44
Gatwick	49
Heathrow	56

Source: Airports Council International/ BAA

⁹⁶ The most current survey available.

- 6.90 On this measure it appears that BAA airports, especially Heathrow, have performed relatively poorly in respect of service quality.
- 6.91 We recognise the limits of comparators, especially given the different age, size and congestion of different airports. We consider, nevertheless, that the evidence raises the question of whether overall quality at BAA airports in the South East are too low and is consistent with our view that features of the market may prevent, restrict or distort competition. The CC may wish to consider these points further in the event of a reference.

Security arrangements

- 6.92 We received several submissions from airlines concerning the effects of the security alert of the 10 August 2006⁹⁷ and BAA's response to this event. We were provided with copy correspondence with BAA both prior and subsequent to the events of the 10 August. Complaints largely concerned insufficient manning of security gates at BAA's London airports and the time taken to increase staffing levels since the 10 August. We were also informed that other airports in the UK suffered less disruption due to a more cooperative and efficient handling of the situation as it arose. Manchester airport was used as a comparison in this respect. We also received complaints from individual consumers relating to experience both before and after the escalation.
- 6.93 On its own initiative, BAA provided to the OFT its assessment of the events of 10 August 2006 and the reasons behind the increased delays these events caused. BAA provided examples where airlines had heightened the operational difficulties it faced, for example, through allowing passengers to arrive at central security with excessive hand luggage and inappropriate items. It also provided evidence concerning the delays caused by checking in passenger luggage, which is the direct responsibility of airlines. BAA also noted that on previous occasions of such threats, airports have been closed down rather than operated with

⁹⁷ On the 10 August 2006, the level of security at airports throughout the UK was raised.

additional security procedures and as such it was an unprecedented event. In the light of previous experience it was reasonable to assume that it would not be efficient to staff up to cope with these types of rare events. BAA did however accept that the 10 August represents a change of environment and it would be assessing staffing requirements in light of this.

- 6.94 The security alert of the 10 August 2006 was an exceptional event. The additional security measures implemented in response to Government directives had major operational implications in the context of BAA operating some of the busiest airports in the world.
- 6.95 We are not in a position to draw conclusions from the evidence we have been presented by both sides as to whether BAA is culpable for the extent of delays to passengers which developed as a result of these measures or, indeed, whether any culpability would be relevant to assessment. We understand the CAA is actively looking at this area in the light of recent developments. Hence we are not relying on evidence relating to the handling of enhanced levels of security at UK airports since August 2006 in considering the case for making a market investigation reference.

7 BAA AIRPORTS IN LOWLAND SCOTLAND

- 7.1 Chapter 5 identified the possible relevant geographic market as Lowland Scotland, which gave a competitor set of Glasgow, Edinburgh and Prestwick airports.
- 7.2 There are two features of the market for the supply of airport services in Lowland Scotland that we suspect prevent, restrict or distort competition. These are:
- the existence of development restrictions, and
 - the joint ownership of Glasgow and Edinburgh airports by BAA.
- 7.3 The case in Lowland Scotland is simpler than that in the South East because airports here are not price regulated and are not significantly capacity constrained. While development restrictions nevertheless constrain new development and expansion, our key concern is with the increment in market power caused by BAA owning adjacent airports in Scotland at Glasgow and Edinburgh.

Development restrictions

- 7.4 In relation to constraints on new entry and expansion of existing airports, many of the planning and other development restrictions affecting the South East also apply in Lowland Scotland. The White Paper did not support a new airport in central Scotland.
- 7.5 Capacity expansion is expected at Prestwick (development of terminal facilities), Glasgow (increased terminal capacity) and Edinburgh (the construction of a new runway around 2020).

Effect of joint ownership on potential competition between airports in Lowland Scotland

- 7.6 BAA has a large market share in the whole of Scotland with over 80 per cent of passenger trips. The two largest BAA airports, Glasgow and Edinburgh, account for over 71 per cent.

Table 7.1: Passenger shares of BAA's Scottish Airports, 2005

Airport	Share of Scotland	Share of Lowland Scotland
Glasgow	38%	45%
Edinburgh	36%	43%
Aberdeen	10%	-
Prestwick	11%	12%

Source: CAA statistics

- 7.7 BAA has a very high share of passengers in Lowland Scotland of 88 per cent. There is only one competitor and its share is well below the combined share of BAA's airports: Edinburgh and Glasgow. Furthermore the overlap analysis described in Chapter 5 indicates that Prestwick may only compete directly with Glasgow airport.
- 7.8 In relation to the effect of joint ownership in Lowland Scotland, BAA told us that its large balance sheet and financial resources left it less likely to be financially constrained by the lumpiness of investment at an individual airport than might be the case under separate ownership. The Scottish Council for Development and Industry (SCDI) stressed the need to balance divestment against the potential negative economic impact of new owners which might be unwilling to make the same long term investment commitments.
- 7.9 We note that companies with large financial resources other than BAA can and do own and invest in airports (see Table 4.1 on page 19). This does not necessitate ownership of adjacent airports.
- 7.10 We found no convincing argument as to benefits derived from BAA's joint ownership of Edinburgh and Glasgow airports. On the other hand, joint ownership may delay or impede investment due to the lack of competition between the two airports. For example, a decision to expand at these airports would be expected to take into account the potential business stealing effect on the other.
- 7.11 Given the market definition analysis in Chapter 5, and the analysis above, we suspect that the joint ownership of Edinburgh and Glasgow airports enhances BAA's market power in the provision of airport

services in Lowland Scotland and prevents, restricts or distorts competition there.

Conclusions on features restricting competition in Scotland

- 7.12 The issues laid out above are simpler than those in relation to the regulated and relatively capacity constrained airports in South East England. Our main concern relates to the restrictive effect on competition of joint ownership of Glasgow and Edinburgh airports, which is exacerbated by very high barriers to entry operating in this market.

Evidence on pricing

- 7.13 As noted in our analysis on the South East, information on prices and profitability can be a useful supplement to the OFT's evidence on structural features of a market or firms' market conduct. Here we consider the pricing evidence we collected in relation to Lowland Scotland, and whether that evidence supports our analysis of the features that we suspect may prevent, restrict or distort competition in that region.
- 7.14 Several respondents mentioned voluntary undertakings by BAA Scotland. BAA has told us that these voluntary constraints are RPI-1 at Aberdeen and RPI-3 at Edinburgh and Glasgow which is the result of a commercial decision to provide airlines with some continuity in pricing so as to better enable them to grow their business. Other commentators believe this to be the result of the threat of price regulation. The Department of Transport reviewed the situation in Scotland in 1995 and noted:

'Glasgow in particular has a strong degree of local market power, though less so than the currently designated airports... There is no evidence of abuse of monopoly position, in that airport charges compare favourably with those at similar sized airports, or inefficiency. BAA has undertaken voluntarily to cap airport charges, including coverage of security costs, at Glasgow and Edinburgh with a formula of at least RPI -3 over the next 3 years... believes that the threat of designation itself provides a strong incentive to BAA to

continue to control charges at these airports. The Government therefore does not propose to designate Glasgow or Edinburgh, at the present time.⁹⁸

7.15 The table below shows recent changes in yields we calculated from information provided by BAA. It appears, at least since 2000-01, that yields have come down faster than RPI-3. It is also apparent that the airport most likely to be subject to some competition, Glasgow, which is closest to Prestwick (an airport not owned by BAA), has the largest decreases in yields.

Table 7.2: Change in yields at BAA's Scottish Airports

	2001/02	2002/03	2003/04	2004/05	2005/06
Edinburgh	-2%	-6%	-2%	0%	0%
Glasgow	-4%	-6%	-5%	-3%	-2%
Aberdeen	2%	-1%	1%	0%	0%
RPI-3	-2%	0%	0%	0%	-1%

Source: OFT analysis of BAA data. We did not have access to data on prices at Prestwick.

7.16 However these decreases are from a high base and the yields from aeronautical charges at these airports are greater than those from Gatwick and Stansted. A comparison is shown in the table below. Again it appears that Glasgow has the lowest yields which may reflect competition from Prestwick.

⁹⁸ Department of Transport, 'Review of the Framework for Economic Regulation of Airports', March 1995

Table 7.3: Aeronautical yield per passenger at BAA's Airports

	2000/01	2005/06
Edinburgh	£6.05	£5.49
Glasgow	£6.22	£5.09
Aberdeen	£6.39	£6.55
Heathrow	£5.23	£7.89
Gatwick	£4.06	£4.67
Stansted*	£3.28	£3.25

Source: calculated from information provided by BAA. Figures shown in nominal terms.

* From 2002/03, airport charges at Stansted were recorded net of marketing expenses in the statutory accounts. The 2000-01 figure above (£3.28) has been adjusted for marketing expenses to allow comparison with the 2005-06 figure.

- 7.17 In this case it appears that competition with Prestwick has constrained the prices at Glasgow airport to some extent but not Edinburgh (as would be expected given the relative distances between these airports). However, Prestwick is still relatively small in comparison to Glasgow: air traffic movements at Glasgow and Edinburgh in 2005 were around 95,000 and 115,000 respectively (just over 10 per cent higher than the levels in 2002). In contrast air traffic movements at Prestwick were just over 20,000 (35 per cent higher in 2005 than in 2002).
- 7.18 One airline provided pricing data which in its view demonstrated how increased competition from Prestwick had kept prices down at Glasgow whilst at Edinburgh airport prices had risen and led to lower relative growth in air services at that airport. Several airlines also noted the comparatively high level of charges at Edinburgh airport. These views accord with our price analysis above.
- 7.19 Our analysis of BAA data found that Glasgow provided greater discounts than Edinburgh. Aberdeen's discounts to airlines were smaller than Edinburgh's, taking their respective aeronautical revenues into account. This pattern tends to support the view that an airport with a nearby competitor, and with spare capacity, will compete harder to win business from airlines than one which does not face such a competitor.

- 7.20 In respect of Edinburgh we believe that greater competition could deliver direct benefits in terms of prices to airlines and thus ultimately to air passengers.
- 7.21 From the evidence before us it appears that Prestwick has introduced competition which appears to be benefiting air passengers. This is a situation that would not have occurred if BAA had not sold Prestwick in 1992.⁹⁹ However, the smaller scale of Prestwick may limit these benefits. We believe that the CC should examine to what extent further competition benefits can be realised within Lowland Scotland. In particular it should consider what further benefits might arise if Edinburgh and Glasgow competed for airline customers under independent ownership.
- 7.22 In conclusion, we consider that the evidence on pricing supports our conclusion that the joint ownership of airports in Lowland Scotland and the development restrictions that restrict new entry and expansion may prevent restrict or distort competition.

Other issues raised in relation to Scottish airports

- 7.23 We had access to survey data relating to customer satisfaction, benchmarking BAA airports against international comparators, referred to in relation to the South East of England, above. Edinburgh comes out 38th out of 58 airports and Glasgow 44th. This may reflect the relative mix of passengers at the two airports. Edinburgh is a more business orientated airport and consequently there may be a stronger incentive to raise quality of service there in comparison to Glasgow.¹⁰⁰ Quality of service issues may warrant further investigation by the CC in the event of a market investigation reference.

⁹⁹ It is currently owned by Infratil Ltd.

¹⁰⁰ According to CAA survey evidence, 30 per cent of Glasgow passengers were business passengers, comparable figures for Edinburgh were 43 per cent and for Prestwick 6 per cent.

- 7.24 Few specific issues were put to us in relation to the Scottish airports. One that was mentioned was the bundling of services at Edinburgh and Glasgow airports to airlines. It has been alleged that achieving discounts in the headline prices at Edinburgh airport is made contingent on similar services being purchased at Glasgow airport (which is subject to more competition from Prestwick).¹⁰¹
- 7.25 We have no other evidence that such bundling occurs. Even where bundling occurs it need not be harmful to customers or rivals. Where concerns about bundling exist they usually relate to the exclusion of rivals.¹⁰² The evidence before us does not indicate this occurred. We can, however, leave this as an open question for the CC.
- 7.26 A concern was expressed that joint ownership of the London and Scottish airports by BAA ensured access to capacity constrained airports within the South East for regional flights to and from Scotland. BAA does not allocate slots at Heathrow, Gatwick or Stansted. This is the responsibility of the independent slot coordinator (ACL). Consequently we do not believe this concern to be valid.

¹⁰¹ The OFT has previously investigated a similar allegation following a complaint in 2003 under CA98. The OFT found insufficient evidence to support a finding of a breach of the Act at that time.

¹⁰² See OFT414a, Assessment of conduct: draft competition law guideline for consultation, April 2004, paragraphs 5.9 to 5.13.

8 MANCHESTER AIRPORT IN THE NORTH WEST AND YORKSHIRE AND HUMBERSIDE

- 8.1 In contrast to the position of BAA airports, the views of airlines and the evidence before us indicate that Manchester airport faces growing competition from other airports in its region.
- 8.2 This raises the issue of whether price regulation at Manchester airport is still necessary and proportionate. We do not have the evidence before us to conclude on this issue and we recognise, given Manchester airport's still significant share of passengers in this region, its potential to retain significant market power.
- 8.3 Nevertheless it is an open question and one which we think deserves further exploration.

Potential competitive constraints on Manchester Airport

- 8.4 Chapter 5 identified the possible relevant geographic market as the North West of England and Yorkshire and Humberside.
- 8.5 Manchester airport is the only airport outside the BAA group which is designated for price control. This reflects its historical importance in serving air passengers in the North of England.
- 8.6 The table below shows Manchester airport's share of passengers in the North West and Yorkshire and Humberside regions, its prime catchment area. It has been put to us that competition in the long haul flight market segment is significantly different and in particular that Manchester competes in this segment with more distant airports. Consequently we calculated shares by type of flight.

Table 8.1: Shares of passengers in the North West and Yorkshire & Humberside, 2005

Airport	Domestic	Short Haul	Long Haul	Total
Manchester*	64%	61%	83%	64%
Liverpool	19%	15%	-	14%
Leeds Bradford	13%	10%	< 1%	9%
Nottingham East Midlands*	1%	4%	-	3%
Heathrow	< 1%	1%	13%	2%
Stansted	-	3%	1%	2%
Humberside*	< 1%	2%	-	1%
Gatwick	< 1%	1%	3%	1%
Other	2%	4%	1%	3%

Source: CAA survey

* Part of the Manchester Airport Group

8.7 Manchester airport's main competitors appear to be Liverpool and Leeds Bradford airports. The exception may be long haul¹⁰³ where 34 per cent of long haul passengers currently using Manchester originate outside the North West and Yorkshire and Humberside. Here Heathrow and Birmingham may be the main alternative airports: neither Liverpool nor Leeds Bradford airports have any significant long haul business.

8.8 Manchester's share of the region's passengers is very significant and may indicate significant market power being held by Manchester airport.

Constraints on market power

8.9 Manchester airport sees itself as operating in a very competitive market environment. Most of Manchester's market demand is for outward travel

¹⁰³ Long haul represents 19 per cent of passengers at Manchester airport in comparison to 47 per cent of passengers at Heathrow and 6 per cent of passengers at Birmingham airport.

and this contrasts with the main London airports which generate a more even mix of demand. Manchester airport considers that it competes for, but does not dominate, the locally generated business travel and long haul markets, competing across wider catchment area and with airports outside the northern regions.

8.10 Airlines and representative bodies submitted evidence and views to the OFT which highlighted:

- Liverpool as the main competitor to Manchester airport. Liverpool airport has enjoyed significant expansion since 1997 when it changed ownership. This growth has been largely the result of the expansion of the low cost airline market. EasyJet and Ryanair have chosen Liverpool as a base
- long haul and charter operators having few if any alternative airports to Manchester in the North of England
- that Manchester, after initially not being interested in attracting low cost carriers has reversed this policy – the majority of growth in the region has come from low cost airlines. Liverpool airport has been much more successful in capturing these than Manchester. The success of low cost airlines has, somewhat been at the expense of charter operators, a significant part of Manchester airport's custom¹⁰⁴
- one example of an airline which considered starting a base at Manchester but chose to locate at another airport due to more competitive terms being offered
- customer analysis by airlines showed some overlap between Manchester and Liverpool airports and Manchester and Leeds

¹⁰⁴ Charter passengers currently represent 40 per cent of Manchester airport's customers whereas the proportion at Liverpool is 7 per cent and at Leeds Bradford 17 per cent. At the biggest charter base in the UK, Gatwick airport, charter represents 29 per cent of passengers.

Bradford airports. Some catchment area analysis also caught airports further afield.

- 8.11 It appears that the broad picture in relation to Manchester airport is that competing airports, particularly Liverpool airport, have been very successful in capturing growth in air passengers through attracting low cost airlines. This has acted as a particular constraint on Manchester airport due to its traditional reliance on charter carriers who appear to be in slow decline.

Capacity

- 8.12 Airports which compete with Manchester have some spare terminal and runway capacity at current levels of demand.

Table 8.2: Terminal capacity in the North of England

Airport	Terminal Capacity (millions per annum) ¹	Terminal Passengers 2005 (millions per annum) ²
Manchester	23	22.1
Leeds Bradford	3.0	2.6
Liverpool	5.0 - 6.0	4.4
Birmingham	12.0	9.3

Source:

1: Regional Air Services Co-ordination Study – DfT 2002

2: CAA Airport Statistics – 2006

- 8.13 The scale of current excess capacity at the three competing airports in Table 8.2 is limited when compared with the size of Manchester airport. The combined excess capacity at Liverpool and Leeds Bradford is between 4 and 9 per cent of the throughput at Manchester airport. That said, Liverpool has been incrementally expanding to meet demand and thus this comparison may not tell the full story.

- 8.14 On future levels of capacity the 2003 White Paper concluded that Manchester airport should not face any future capacity constraints before 2030 but that this situation should be kept under review. Terminal capacity could reach 30 million passengers per annum (mppa) and further proposals might allow 40-45 mppa. Other airports in the region are also identified for planned expansion, including Liverpool to 12 mppa and Leeds Bradford to 7 mppa.
- 8.15 In conclusion, capacity constraints do not appear to be an important factor affecting competition between Manchester, Liverpool and Leeds Bradford airports.

Pricing behaviour

- 8.16 Manchester airport is subject to price controls set on a five yearly basis. In 2002 the CAA imposed a cap of RPI-5 per cent until the next review in 2007. In its review the CC had recommended¹⁰⁵ a significantly tighter price cap of RPI-8.9 per cent.
- 8.17 Manchester airport's charges to airlines have been below the price cap in recent years. It told us that its charges were determined by competitive pressure from other airports, not by the regulatory price cap. The more stringent price cap proposed by the CC would have brought down prices below current levels. However we accept that Manchester airport faces growing competition and that the CAA price cap is the relevant benchmark.
- 8.18 Overall the pricing evidence indicates that there are constraints operating on Manchester airport which are more significant than statutory price caps. There are two factors here which draw us to a different position than Stansted – where prices are also below the regulated price cap and indeed are substantially lower than charges at Manchester airport in absolute terms. These are:

¹⁰⁵ Manchester Airport plc: A report on the economic regulation of Manchester Airport plc, Competition Commission 2002.

- the fact that Stansted is adjacent to two other airports owned by the same company. It thus may act as an increment to existing joint market power of the airports in the South East of England
- at Manchester airport the trend in pricing appears to be downwards and this is supported by views of airlines operating out of Manchester. At Stansted, the evidence is less clear. Prices are currently constrained by long term contracts which are drawing to a close. Airlines have said that they expect prices to increase substantially from their current low levels. BAA has signalled its intention to end discounts at Stansted in early 2007 in advance of the next regulatory review of price caps.¹⁰⁶ When considered in conjunction with the first bullet point, the situation at Stansted raises more questions than Manchester.

Service quality

8.19 Several airlines compared Manchester airport favourably to BAA airports in terms of quality of service and responsiveness to customer requirements. In addition we note that Manchester airport has recently won several airport awards including twice winning the IATA Eagle Award for value for money and high quality of service to customers.¹⁰⁷

¹⁰⁶ 'Discount arrangements with airlines operating at Stansted airport continue to unwind and will cease in March 2007. Airlines operating at Stansted will be charged at the regulatory price cap from 1 April 2007', BAA annual report 2005-06, page 39.

¹⁰⁷ The IATA website describes the awards as: 'The IATA Eagle Awards are presented annually to recognise airport and air navigation service infrastructure providers who provide value for money and quality service to their airline customers. The Waterford Crystal trophy presented at the IATA Annual General Meeting acknowledges the positive steps being taken by airports and air navigation services to control infrastructure costs and related charges. Award winners are selected by a neutral and independent panel of experienced individuals drawn from aviation industry backgrounds.'

8.20 There is some mixed evidence here. Regular AETRA¹⁰⁸ surveys on the views of airline passengers using Manchester suggest:

- Manchester airport is broadly just below average across all services compared with other comparable European airports
- in some areas Manchester airport is significantly below the average compared with other European airports for value for money for parking and catering services
- areas where Manchester scores higher than other European airports tend to be most closely related to the physical infrastructure or related directly to flight processing services rather than pricing or consumer facilities.

Investment

8.21 Manchester airport has made major investments in terminal capacity (1989 and 1993) and opened a second runway in 2001. Manchester airport submits that there is no link flowing from investment to charges or bargaining power and it has used investment to provide capacity and better service. It claims its investment decisions take account of forecasts of market demand and the views of airlines.

8.22 Some airlines were concerned with over investment at Manchester and felt that regulation encouraged this. On the other hand, substantial investment at Manchester may be intended to meet anticipated future demand, and airport charges have fallen in real terms, albeit from a high base.

8.23 One airline said that Manchester had invested in adequate runway capacity but had failed to match this with investment in related infrastructure. However another said Manchester was prepared to invest in infrastructure, and that consultation with Manchester was excellent.

¹⁰⁸ Surveys provided to the OFT by Manchester Airport Group.

- 8.24 On a balanced assessment of the evidence, it appears that investment has not been a significant cause for concern in respect of Manchester airport among its customers. This contrasts with the evidence provided to us in relation to BAA's investment plans in the South East of England.

Conclusions in relation to Manchester airport

- 8.25 The balance of evidence before us points to increasing competition, primarily from Liverpool and Leeds Bradford airports, acting to constrain Manchester airport's conduct. The evidence would suggest prices are falling and service quality is relatively high with little evidence of problems in relation to investment.
- 8.26 Given the findings above, there is little evidence of any adverse effect on competition, nor significant scope for savings to air travellers in the North West and Yorkshire and Humberside through including Manchester airport in any market investigation reference.
- 8.27 One open question is whether continued price regulation is necessary in the conditions described above. Deregulation could reduce the burden on Manchester airport's management which we understand is significant during the time of the periodic review of airport charges. We consider this further in Chapter 10.

9 PROPOSED DECISION ON REFERENCE

- 9.1 In order to make a market investigation reference, the OFT must have reasonable grounds for suspecting that any feature or combination of features of a market in the UK for goods or services, prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or part of the UK (the 'section 131 test'). Where this threshold is met, the OFT has a discretion as to whether to make a reference. This section sets out the two stages of our decision making process.
- 9.2 Section 131 of the Enterprise Act 2002 sets out the three types of market feature that could have an adverse effect on competition: structural features, conduct of firms, and conduct of customers. Our guidance says that there will often not be clear separation between structural features and those relating to conduct, and the evidence supporting a reference set out in Chapters 6 to 8 covers both together, but here we summarise the features which in our view form the basis for a reference and meet the s131 test. We do this separately for the South East of England and for Lowland Scotland.

The section 131 test for the South East of England

- 9.3 The structural features we suspect adversely affect competition in the South East of England are:

- The existence of development restrictions and capacity constraints (paragraphs 6.4 to 6.15).

Development restrictions create serious barriers to entry and expansion. When taken together with the current capacity constraints in the South East the overall effect is to restrict the amount of competition that is possible between airports in the short term. In the longer term investment in capacity could allow for airport expansion and increased competition.

- The joint ownership of Heathrow airport, Gatwick airport and Stansted airport by BAA (paragraphs 6.33 to 6.95).

This distorts short run competition between these airports as BAA has no incentive to compete with itself. We have discussed how such competition could occur under separate ownership and have considered the claims that some airlines may have buyer power.

In the long run we suspect that common ownership distorts decisions on investment at these airports because the airports can be managed as a group, rather than competing for business. We have considered the representations we received which were critical about proposed major investments at Stansted and elsewhere. We have reasonable grounds to suspect that common ownership distorts investment from that which would occur under separate ownership, and therefore restricts competition between airports.

- The regulatory regime applied to BAA's airports (paragraphs 6.16 to 6.32).

We suspect that the price regulation of BAA's airports may distort investment incentives by providing a guaranteed return on investment, and encouraging regulatory gaming. We recognise that some airports – in particular Heathrow - might have individual market power and require a degree of price regulation even if Gatwick and/or Stansted were under different ownership. Nevertheless we have reasonable grounds to suspect that the regulatory regime, in combination with the other features, prevents, restricts or distorts competition.

- 9.4 The evidence we have seen on pricing, conduct and proposed investment decisions all tends to support these conclusions, albeit we recognise the limits of comparators, especially given the different age, size and degree of congestion at airports. We also note the high level of concern expressed by airlines in relation to BAA in the South East.
- 9.5 Given that BAA's joint ownership of airports in the South East is a situation which has existed for over two decades, assessing what would occur in its absence is a difficult question and one more suited to the

more in depth investigation offered by the CC. We have, however, reviewed, as a hypothetical, whether a merger or series of mergers of these airports would be likely to trigger the OFT's duty to make a reference to the Competition Commission under the merger provisions of the EA02. We have concluded that the OFT's duty would be likely to be triggered. Whilst the legal test for referring a merger to the Competition Commission is different to the s131 test for a market investigation reference,¹⁰⁹ the approach to market definition, and the analysis of competition issues are substantially similar.

- 9.6 We recognise that there are other features which may also prevent, restrict or distort competition, for example international treaties limiting the ability of airlines to switch between airports. We do not consider that these are addressable by the CC under its statutory powers, although it could make recommendations to Government if appropriate. Since we believe we have met the s131 threshold, we do not consider these further in this section.

The section 131 test for Lowland Scotland

- 9.7 The structural features we suspect adversely affect competition in Lowland Scotland are:

- The existence of development restrictions

We suspect that the effect of these constraints is to raise high barriers to new entry.

¹⁰⁹ The OFT must make a merger reference if it believes that it is or may be the case that a relevant merger situation may be expected to result in a substantial lessening of competition (sections 22 and 33 Enterprise Act 2002). The OFT has the power to make a market investigation reference under section 131 if it has reasonable grounds for suspecting that any feature or combination of features of a market in the UK prevents restricts or distorts competition.

- The joint ownership of Edinburgh airport and Glasgow airport by BAA

We suspect that this distorts pricing incentives at the airports. The evidence we have on price tends to support this conclusion. In particular, competition from Prestwick appears to have driven down prices at Glasgow faster than at Edinburgh. This is a situation which would not have occurred had not BAA sold Prestwick airport in 1992.

- 9.8 Given that this is a situation which has existed over a long period of time, assessing what would occur in its absence is a difficult question and one more suited to the more in depth investigation which the CC can carry out.

Appropriateness of a reference

- 9.9 It is our view that the section 131 test for making a reference is met and hence the decision on whether to make a reference rests on the exercise of the OFT's discretion. Given that within the South East and Lowland Scotland, the proposed market investigation refers to a single firm, and that a key feature in each area is the issue of joint ownership, we have considered our discretion over the two areas. The OFT's guidance on market investigation references sets out four criteria that must, in our view, be met before we decide to make a reference:¹¹⁰

- Proportionality – the scale of the suspected problem, in terms of its adverse affect on competition, is such that a reference would be an appropriate response to it.
- Availability of remedies – there is a reasonable chance that appropriate remedies will be available.

¹¹⁰ OFT 511, 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.1.

- Alternative powers – it would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT or, where appropriate, to sectoral regulators.
- Undertakings in lieu – it would not be more appropriate to address the problem identified by means of undertakings in lieu of reference.

9.10 These four factors are considered below.

Proportionality

9.11 The OFT believes a reference would be proportionate given:

- **the scale of the problem.** This is a large market both in terms of monetary value¹¹¹ and in terms of its effect on wider UK productivity.¹¹² Chapter 4 provides details of the importance of airports and aviation to the UK. Furthermore the large number of customers who support a reference and the wide range of complaints brought before the OFT has indicated the importance of these issues to airlines and ultimately their air passengers within the UK
- **the proportion of the market affected by the feature giving rise to this adverse affect.** The airports involved in this reference carry over 60 per cent of UK air passengers. This represents a very significant proportion of total air traffic and suggests that any potential remedies available from a CC investigation would have a major impact
- **that the feature giving rise to the adverse effect on competition is likely to be persistent.** There is no indication that BAA currently

¹¹¹ UK airports' annual turnover was reported as £2.8 billion in 2005 by Keynote.

¹¹² For example see, BAA, Issues brief: Economic benefits of aviation, November 2004. Available through <http://www.baa.com>

intends to divest any of the airports that cause us concern. A market investigation reference is the only way that joint ownership can be considered and, if necessary to address any adverse effects on competition, divestment can be required

- **that the adverse effects of the market features are not offset by consumer benefits.** BAA has submitted to the OFT that benefits accrue from joint ownership of airports in the South East. It has cited its track record of delivering investment and claimed there are economies of scale from joint ownership. We explain above our concerns in relation to investment within the current structure of ownership and regulation and note that investment would also have occurred under different ownership, although it is impossible to quantify this. As to economies of scale, we have seen no quantification of any benefits and therefore cannot assess if they might outweigh the adverse effects on competition we have identified. The consultation provides an opportunity for BAA to make further representations on this point.

9.12 The OFT has also borne in mind that any reference can bring uncertainty to an industry which could affect investment and incur significant costs. We have also noted the significant expenditure to date on the Stansted G2 proposal. Nevertheless given the scale of the proposed investment involved in Stansted G2 and in any later runway development projects at BAA airports in the South East, we believe the costs are small in relation to the long term potential benefits. We also note that many airlines have referred to the timeliness of the study and support a reference despite this. The previous OFT announcement¹¹³ laying out the potential for a market investigation reference did not prevent the successful takeover of BAA plc and the purchaser was fully aware of the potential for this to occur.

¹¹³ OFT press release of 25 May

Availability of remedies

9.13 We have given careful thought to the possibility of remedies and have also benefited from submissions in relation to the potential for remedies in both the South East of England and Scotland. We have concluded that divestment of runways, while theoretically possible, would be likely to pose practical difficulties. We note that this remedy was not supported by those respondents who expressed views. We are satisfied that the CC will have a range of other potential remedies to the features we have identified. These include:

- **the divestment of one or more airports.** This would directly address the potential issue of joint ownership of airports. Several airlines advocated this as part of a solution to the issues they had put before us
- **the divestment or long term lease of existing terminal facilities.** This could potentially introduce competition not only between airports but within airports. For example, to the extent Heathrow retains significant market power resulting in some of the detriments outlined above, potentially divestment or long term lease of terminal facilities could dilute such market power. Some respondents thought that this was an issue worth investigating but many airlines believed this would not be practical given the tight capacity constraints in the South East and the attendant importance of coordinating facilities within an airport. We have also noted the results of a previous CAA examination of this issue.¹¹⁴ Where capacity is less constrained so that 'spare' terminals can be built, benefits may be greater. Several respondents pointed to the positive experience at John F Kennedy airport in New York where a terminal was built and operated by a private consortium in competition with other terminals at that airport

¹¹⁴ Civil Aviation Authority, Competitive provision of infrastructure and services within airports, Consultation document, February 2001 (Responses available through <http://www.caa.co.uk>)

- **The tendering out of specific airport activities (potentially including the construction and operation of new terminal facilities).** There may be a more subdued version of splitting up existing terminal facilities. This was a suggestion that was put to us that may address questions of cost efficiency and service quality.
- 9.14 Within the South East of England, where the BAA airports are subject to economic regulation, each of these remedies could also entail some change or withdrawal of regulation to reflect greater competition. We consider that the CC could, if appropriate, make recommendations to the Government or to the CAA to address these issues.
- 9.15 The high barriers to new entry and barriers to expansion created by development restrictions (described in Chapter 6) are less amenable to remedy. The planning system balances conflicting interests. If a reference is made, the CC will be able to consider the extent to which any adverse effects that it finds from this feature, or from this feature in combination with other features, are capable of remedy. It will also be able to consider whether recommendations to Government could remedy any adverse effects on competition it finds.
- 9.16 The OFT has not reached any conclusions at this stage on whether a break up of BAA would be an appropriate remedy to the competition issues we have identified. If a reference is made, the CC would perform an independent investigation and reach its own conclusions on remedies if it finds they are needed.
- 9.17 At this stage it is not for the OFT to determine whether the remedies are appropriate - only that possible remedies exist. In this respect we have taken on board views of airlines, several of which advocated the break up of BAA. We are satisfied that potential remedies exist.

Alternative Powers

- 9.18 The OFT has also considered whether a market investigation of BAA is appropriate, in light of:

- the fact that CAA is already regulating prices for the most significant of BAA's airports
- the imminent statutory quinquennial review of BAA's airport price caps in the South East by the CC
- the principle that single firm conduct will, where necessary and possible, generally be dealt with under the Competition Act 1998 or by applying sectoral legislation or rules¹¹⁵
- the OFT's powers to conduct a market study.

9.19 The following factors have led to the conclusion that a reference is merited despite these factors:

- **Economic regulation.** The Airports Act 1986 (AA86) sets out the framework of economic regulation for UK airports. We have received widespread concerns from airlines about the ability of price regulation to address problems relating to BAA's current investment programme.
- **The forthcoming mandatory reference of BAA's London airports to the CC.** It is anticipated that BAA's operations at its London airports will be referred for a CC investigation under the AA86 early next year. As part of this review the CC will consider whether BAA (as the airport operator) has pursued any course of conduct¹¹⁶ at these airports over the previous five years that has operated or might be expected to operate against the public interest and it has powers to

¹¹⁵ See paragraph 2.7 of the OFT's guidance on Market Investigation References

¹¹⁶ In relation to any airport charges levied at the airport, any operational activities carried on relating to the airport or the granting of rights to carry out operational activities relating to the airport to any other person (section 43(2)(a) AA86).

propose remedies to problems identified.¹¹⁷ However we do not believe that this provides a substitute for a market investigation reference. The CAA/CC review will occur under the AA86, restricting its remit. We believe that the key benefit of any market investigation reference is that it would enable the CC, if it finds any adverse effect on competition resulting from any features, to consider whether divestment of one or more airports or parts of airports would be an appropriate remedy. Under the provisions of the AA86, it is very unlikely that the CC would be able to recommend, or the CAA to implement, a divestment of any airport as a means of remedying conduct. The requirement to demonstrate detriment in line with the duties under the AA86 makes this a remedy which could only be applied in extreme circumstances.¹¹⁸ We also note that the AA86 review would not cover BAA's Scottish airports. In noting this we are not prejudging the question of appropriate remedies. This is something that the CC would consider following any market investigation reference.

- **Competition enforcement powers.** Single firm conduct may be dealt with under CA98, which prohibits anticompetitive agreements and the abuse of a dominant position. In this case, we are not primarily concerned with issues of conduct but rather with structural issues:

¹¹⁷ If it finds any such courses of conduct the CC can make recommendations as to how these could be remedied by the imposition of conditions in relation to the airport (section 43(2)(b) AA86). The CAA will be bound by the CC's public interest findings, but not by the CC's recommendations.

¹¹⁸ This is because the remedies applied under the AA86 must relate to the adverse effects of one or more courses of conduct relating to airport charges or operational activities **at an individual airport**. Only in the most extreme circumstances could conduct at an individual airport ever justify divestment of that airport under the provisions of the AA86. By contrast this proposed market investigation reference relates not to specific conduct issues relating to operational activities or airport charges, but to the effects of joint ownership of groups of airports on individual airports' incentives to compete. Such effects could more easily merit divestment and these could not be considered or addressed by the CC or the CAA under the AA86.

how the current structure of ownership of airports in the South East of England and Lowland Scotland affects incentives to compete. The CA98 is not an effective means of addressing these issues.¹¹⁹ The same principle applies to the CAA's power under section 41 AA86 to put in place conditions to remedy specific issues related to conduct by an airport operator at a regulated airport. Our underlying concerns are not to do with any conduct that may or may not abuse a dominant position or that may or may not fall within section 41 AA86.

- **The OFT's powers to conduct a market study.** We have considered whether a longer OFT market study would be more appropriate at this point. We have concluded that it would not. As noted already, we see the key benefit of a CC reference as allowing for consideration of the competition issues in the context of a wider range of possible remedies, including divestment. The OFT could not do this in a market study. The CC could also make recommendations for regulatory change, as appropriate, taking into account of any other remedies it might require.

9.20 It is noticeable, notwithstanding the current ongoing periodic review of BAA's London airports and the attendant CC reference under the AA86 that many airlines see the benefit of a wider market investigation reference which can examine the regulatory framework, the structure of the industry and a wider range of airports than the AA86.

Undertakings in lieu of a reference

9.21 We will take account of any undertakings in lieu of a reference that are offered by BAA before making our final decision on whether to make a market investigation reference.

¹¹⁹ OFT 511, 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.8.

- 9.22 Section 154 of the Act gives the OFT the power to accept undertakings instead of making a reference to the CC. In considering accepting undertakings in lieu, the OFT must have regard to the need to achieve as comprehensive a solution, as is reasonable and practicable, to any adverse effects on competition identified and will take into account customer benefits. Paragraphs 2.20 to 2.26 of our market investigation guidance lay out our criteria and process for undertakings in lieu. In particular, if the OFT is proposing to accept undertakings it will publish the proposed undertakings, consult affected parties, and consider their representations prior to making its decision.

Conclusions on the case for a reference

- 9.23 Taking account of the relevant factors outlined in the OFT's guidance document on market investigation references, we believe that the statutory test for a reference is met and the balance of arguments points in favour of exercising our discretion to make a reference to the CC of the supply of airport services in the UK by BAA.
- 9.24 Our present view is that in order to give the CC scope to reach its own conclusions on the relevant geographic markets in this case, we should not seek to restrict the terms of reference to particular geographic areas within the UK. Nevertheless the CC will note that our concerns relate to BAA airports in the South East of England and East Anglia, and Lowland Scotland. We invite comment on this approach.

10 RECOMMENDATIONS IN RELATION TO MANCHESTER AIRPORT

10.1 The OFT does not believe there is a case for including Manchester airport in any market investigation reference. In contrast to the other areas considered we have found evidence of increasing competition from independently owned airports leading to lower prices and improved service at Manchester airport. Whether or not the situation in the North of England would technically meet the s.131 test we consider the following factors would lead us to exercise our discretion not to make a market investigation reference.

- **The scale of any problem.** There is very limited evidence of any adverse effects from Manchester airport's market power. Whilst Manchester airport is regulated by the CAA it is currently pricing below what is required under regulation. In contrast to the situation at Stansted airport (which is also pricing below its price cap), we received no evidence this pattern is likely to reverse, and significant evidence that prices are constrained by competition from other airports in the area rather than by regulation. Comments of customers on service and customer responsiveness supported this view. The balance of arguments from customers at Manchester airport contrasted significantly with those who commented on BAA. Manchester airport was seen as increasingly customer focused and we also noted the recent quality awards won by Manchester airport.
- **Availability of remedies:** The situation at Manchester airport also differs in that the market share does not relate to joint ownership of airports.¹²⁰ Remedies are thus somewhat limited in comparison to the situation with BAA. Responses we received which addressed this issue specifically in relation to Manchester were not supportive of the potential divestment or long term lease of individual terminal

¹²⁰ We recognise that the Manchester Airport Group also controls Nottingham East Midlands airport which draws some passengers from Manchester airport's core catchment areas. Its presence here, however, is marginal and is unlikely to represent a substantive constraint.

facilities. This was due to potential detriments to airlines due to the lack of coordination between terminals such a remedy might engender.

- 10.2 Taking these factors as a whole suggests the potential scope for benefits to customers from a market investigation reference of Manchester airport are far more limited than at BAA. As such we consider even if the situation might meet the s.131 test (on which we have reached no conclusion), we would exercise our discretion not to refer on the grounds that to do so would be disproportionate given the lack of evidence of any competition problem.

Deregulation

- 10.3 The evidence of growing competition which constrains Manchester airport more significantly than the statutory price cap raises the question as to whether regulation remains necessary. It is unclear to the OFT that the costs of regulation at Manchester airport, both direct and in terms of diverted management time, are justified by any identifiable benefits to the consumer. We note there is also a risk that detailed economic regulation introduces distortions into the decisions made by Manchester airport, by airports that compete with it, and by airlines that use it.
- 10.4 The OFT recognises that several airlines were not in favour of deregulation and felt that some more time should be allowed to pass before this question is judged. Within the scope of a short market study it is not possible for the OFT to provide a firm recommendation on the outcome. Instead, we are making recommendations to Government using our powers under section 7 of the Enterprise Act. **We recommend that:**
- in the short term the Department for Transport should determine clear criteria for dedesignation¹²¹ of airports. These criteria should be

¹²¹ Airports subject to detailed price regulation are designated by the Secretary of State for Transport under s.40 of the Airports Act 1986. Whilst criteria for designation were published in 1995, these appear to require updating.

based on an appraisal of the economic costs and benefits generated by regulation, and

- in parallel to its upcoming price review of Manchester airport, the CAA should advise the Secretary of State for Transport of on whether Manchester airport should be dedesignated on competition grounds. If the weight of evidence does support this, it would be beneficial to do so before the costs of the mandatory price control reference of Manchester airport to the CC are incurred.

10.5 We believe the decision to price regulate an airport is fundamentally dependent on the extent that an airport faces competition from other airports. The principles embodied in the Competition White Paper and the Enterprise Act 2002 provide an appropriate framework to assess such issues for sectors other than airports. In line with this policy, **we recommend that:**

- consideration should be given to as to whether it remains necessary for Government Ministers to have the central role in making decisions on airport designation or whether this function might be transferred to the CAA.

11 OTHER ISSUES PUT TO US DURING THE STUDY

11.1 A range of other issues have been put to us during the course of this study. We summarise below those that we have considered and the approach we are proposing to take. We have attempted to be exhaustive in picking up all other issues that relate to competition. Insofar as commentators feel we have missed key points, disagree with the position we intend to take or wish to submit further evidence to support contentions, this consultation provides the opportunity to do so.

Transport facilities to and from airports

- 11.2 The OFT received confidential submissions relating to car rentals at various UK airports, and the prices paid to airports for such concessions as well as operational considerations. The CC considered similar issues on car rentals in its 2002 reports and concluded that no action was necessary. The CC considered that airlines and passengers benefit, in the form of lower airport charges, from any surplus arising from unregulated charges within a single till regime. It also noted that the airport's conditions were transparent at the tender stage, and companies could take account of these in their bids.
- 11.3 The OFT also received a submission concerning charges for access to dropping off facilities, which may be necessary to compete in providing off airport car parking. This related to a variety of UK airports and, in principle, there may be very local markets for car parking around each UK airport.
- 11.4 This effectively alleges a refusal to supply in order to eliminate or dampen competition from rival off airport car parks. We have noted that most of the specific examples cited had been resolved in commercial negotiations and therefore our current view is that, on OFT administrative priority grounds, they do not merit investigation under CA98.
- 11.5 The CC has likewise considered the extent to which unregulated charges at designated airports should be brought within the ambit of the CAA.

- 11.6 Several complaints specifically referred to actions by BAA at airports in both Scotland and the South East of England. This included the enforcement of trademarks, the acquisition of off airport car parks around Gatwick as well as excessive charging for pick up and drop off facilities at Edinburgh. If the proposed market investigation reference goes ahead, the CC would be able to examine such conduct. The OFT could reconsider whether further action (at non BAA airports) was merited based on the findings of the market investigation.

The system of economic regulation

- 11.7 The CAA has expressed concern to the OFT that the current system of regulation is not fit for purpose. As discussed in paragraph 4.27 the Airports Act 1986 sets up a system which is quite different to the other economic regulators of utilities. Some third parties have expressed similar concerns to the OFT
- 11.8 The OFT can see merit in the points that have been made to us. Within the scope of a short market study, the OFT has reached no conclusion on detailed matters relating to the regulatory framework, although we have made some high level recommendations. It appears that the CAA and CC are well placed to bring to the attention of the DfT any deficiencies in the current regulatory framework in order to enact appropriate legislative change. It would be premature of the OFT to make recommendations to Government, especially as this is a remedy that would be available to the CC in the event of a market investigation reference and such recommendations as are made may need to be informed by the impact of any other remedies.

Access to London Heathrow by US Carriers

- 11.9 One US airline raised concerns about access to Heathrow to new entrant transatlantic carriers. In particular of obtaining suitable slots at Heathrow such as for evening flights from the US which arrive at Heathrow in the morning. It urged the OFT to study this situation. Other carriers also mentioned the current rules governing the allocation of slots at capacity constrained airports. The OFT does not propose to take any action in

relation to this complaint and the situation in relation to slots generally at this time for the following reasons:

- the rules governing slot allocation are subject to EC legislation. If a reference is made, the CC could make recommendations to the EC but the OFT and CAA have already made representations to the EC on this very topic¹²²
- the Bermuda II agreement is the main barrier to entry on transatlantic routes - this is currently part of ongoing negotiations on 'Open Skies' between the EC, US, UK and other nations.

Compulsory Purchase Powers

11.10 Under the Airports Act 1986 BAA is allowed to make an application to the Secretary of State to make a compulsory purchase order (CPO) for any purpose connected with the performance of BAA's functions as an airport operator.

11.11 We received a submission from a property investment and development company ('Company A') which was concerned how the scope of 'operators functions' would be interpreted in the event of a dispute. We note that BAA has, in the past, developed a range of commercial facilities, including hotels, office space, car parks and retail developments which might, or might not be regarded as necessary for the performance of its functions as airport operator.

11.12 Company A has submitted that CPOs are being used by BAA to acquire land below its development value. If there is any subsequent commercial development on that land, this value is captured by BAA and is not necessarily passed back to users of an airport through a reduction in

¹²² OFT 832, Competition issues associated with the trading of airport slots: A paper prepared for DG TREN by the OFT and Civil Aviation Authority, March 2006. Available at: www.offt.gov.uk.

regulated charges. Company A noted that increases in land value may be partially passed back through planning permission requirements, for example in terms of road access improvements. In the case of BAA, Company A submitted, that all such requirements are funded through regulated charges whereas the increase of land value which can be realised through the sale of the asset,¹²³ was not fed back into a reduction in regulated charges. Company A noted that BAA Lynton's assets were not included in the definition of regulatory capital value, but revenues arising could be taken into account by the CAA and CC under the single till principle.

- 11.13 If these allegations were substantiated, this could amount to a distortion of competition which should be investigated if a CC reference is made. Company A suggested this matter should be addressed in a modification to the AA86.
- 11.14 The OFT notes that any surplus arising from BAA's commercial development at a designated airport is currently used to subsidise airport charges, but the position is less clear in relation to BAA Lynton and its partnerships. We note, however, that BAA has asked the CAA to give consideration to allowing BAA to benefit from surplus to book value during the next Review. BAA considers that this would provide an appropriate incentive to derive greater value from its RAB in such a way that both BAA and airlines benefited. We also note that CPOs can be sought by all airports, not just designated ones.
- 11.15 BAA has informed the OFT that the Government granted airports CPO powers in order to promote infrastructure development in the national interest. BAA has also drawn attention to the role of the Secretary of

¹²³ Several examples of sales of on airport assets were provided to us including joint ventures such as a 50:50 property joint venture between BAA Lynton and Morley Fund Management. The assets included within this joint venture included cargo warehouses and offices at BAA's airports with a net book value of £628 million.

State in approving CPOs, and relevant Government advice.¹²⁴ BAA notes that land acquired would be at full market value and said that subsequent increases due to development were irrelevant.

- 11.16 The OFT recognises that CPOs may be required and may facilitate investment in certain circumstances. If it is the case, however, that CPOs could be used to facilitate the development of land in a way which bypasses regulation and allows additional profits to be made outside of regulatory control, then there could be a competition issue to consider. The regulatory system might incentivise BAA to develop land itself even where more efficient outside companies could do so. Without such an incentive, BAA would be likely to seek the most cost effective method of development whether that be internal or external.
- 11.17 It is not clear whether competition in the market that is the subject of this study is prevented, restricted or distorted to a material extent by the use of CPOs. We therefore leave this issue open. We note that the complaint only referred to BAA and the scope of our proposed reference, which would include BAA Lynton, leaves it open to the CC to examine this issue in more depth, if they feel this is warranted.

Pricing of airline tickets, refunds and Air Passenger Duty

- 11.18 We received a small number of submissions from individual consumers who were concerned in particular about the overall price of airline tickets, refund policies and Air Passenger Duty (APD).
- 11.19 As discussed elsewhere there are a variety of factors which determine air fares, including demand, which is often not the same at both ends of an air route. The need to attract business at both ends of the route to fill the aircraft drives airlines to adopt flexible pricing models, whereby

¹²⁴ ODPM circular 02/2003, 'A Compulsory Purchase Order should only be made where there is a compelling case in the public interest. An acquiring authority should be sure that the purposes for which it is making a Compulsory Purchase Order sufficiently justify interfering with the human rights of those with an interest in the land affected.'

prices usually differ according to the point of origin of the passenger, and may vary according to the forecast of demand at the time of booking. The success of these models has resulted in higher utilisation factors and lower overall fares, thus the OFT would not see grounds for intervention.

- 11.20 The OFT is aware of certain issues relating to refunds and the charging of APD when journeys are not made. Consumers often have a choice between purchasing flexible tickets and purchasing cheaper tickets for which refunds are not available. We would urge consumers to think carefully before making that choice. Consumers should also consider taking out insurance if they are concerned about particular risks, albeit they should make sure that any policy covers the risks that are of concern to them. There is a wide range of providers of travel insurance, and annual policies can be particularly cost effective for regular travellers.
- 11.21 We recognise that airlines incur administrative costs in processing refunds and we do not object to the relevant costs being passed on, provided they are a reasonable estimate of the costs to the airline of processing refunds.
- 11.22 APD is levied on chargeable passengers who are carried on chargeable aircraft and HM Revenue and Customs is responsible for its collection. In respect of refunds of APD, we understand that there is no law that specifically requires airlines to give such refunds however many airlines will, if asked, refund APD provided a ticket has not been used.

Other Consumer issues

- 11.23 We also received a small number of submissions from individual consumers who were concerned about pricing or quality issues concerning food and beverage outlets, car parking and taxi services.
- 11.24 We consider that competition is the best means of ensuring low prices and consumer choice, but also recognise that airports have space constraints, which can limit the ability to franchise competitors. It is

worth remembering that a consequence of the single till arrangement at designated airports is that revenues from commercial activities are used to subsidise airport charges. Thus all travelling passengers at these airports will benefit indirectly in the form of lower air fares. Where such regulations do not exist, but competitive pressure remains, we would expect a similar effect as airports balance the additional commercial revenues they would gain through reducing prices to airlines and thereby generating additional air passengers.

- 11.25 We considered one consumer complaint that use of the term 'tax-free' in connection with certain air side retailing might be misleading consumers. We found that discounts equivalent to the VAT were given in the shops which used this term. As a consequence we do not consider that there is sufficient evidence of consumer detriment to justify further investigation under the Control of Misleading Advertisements Regulations 1988.

General aviation

- 11.26 The Aircraft Owners and Pilots Association asked the OFT to consider issues relating to General Aviation. They were concerned with reduced and more expensive access to some airfields in the UK by general aviation. The OFT notes that the CAA published a strategic review¹²⁵ of General Aviation in July 2006 which recognised this issue and made a recommendation to Government. The OFT considers the DfT is better placed to take this forward than the OFT, and does not intend to consider these issues in the present study.

Planning and environmental issues

- 11.27 Several respondents brought to our attention refusals to allow or permissions to allow the building or expansion of airports. These matters are the responsibility of the relevant planning authorities and it is not

¹²⁵ CAA, Strategic review of general aviation in the UK, July 2006.

appropriate for OFT to comment on individual decisions to grant or deny planning permission.

A HISTORY OF BAA

Pre-Privatisation

- 1960's Ministry of Civil Aviation controlled all commercial aviation
- 1965 Labour Minister for Aviation, Roy Jenkins, promoted the Airports Authority Bill. His key argument was the nation's airports could be more flexible and better able to generate profits, remaining responsible to Parliament. The Bill was passed and the British Airports Authority established
- April 1966, British Airports Authority assumed ownership and responsibility for Heathrow, Gatwick and Stansted airports and Prestwick airport in Scotland
- 1971, Acquired Edinburgh airport from the Government
- 1975, Acquired Aberdeen airport from the CAA and Glasgow from Glasgow Corporation
- 1986 Airports Act was passed, calling for dissolution of the authority and the transfer of its property, rights and liabilities to a new company, BAA plc
- July 1987: BAA plc was privatised with a capitalisation of £1,225 million.

Post-privatisation

- 1990, Acquired Southampton airport
- 1992, Sold Prestwick airport
- 1999, competition review of BAA's ownership of London airports announced in the Budget

- 2000, following competition review by the Deputy Prime Minister, BAA allowed to retain ownership of its London airports
- 2003, Government gave up its 'golden share' in BAA following ECJ judgement declaring this illegal
- 2006, a consortium including Grupo Ferrovial purchases BAA.

Source: BAA website

B AIR TRAFFIC FORECASTS

B.1 Stansted ACC commissioned York Aviation to assess the forecasts of BAA and DfT. York produced a range of forecasts all of which were significantly below those of BAA and DfT. Alternative forecasts are set out in Table B.1.

Table B.1: Air Traffic forecasts for Stansted airport, millions of passengers per annum

Forecast Year	BAA	DfT	York (1)	York (2)
2015	41	57.1	22.9	42.1
2030	76	73.2	33.4	61.5

(1) 'realistic projection' with high elasticity to airport charges

(2) 'optimistic projection' unconstrained

B.2 Clearly, BAA/DfT forecasts are well above those of York Aviation. DfT made a number of comments about the approach used by York:

- DfT said that York's approach might only be justified if Heathrow and Gatwick had been at capacity over the past 10 years: it could not allow for overall future South East demand or recognise the pool of unsatisfied demand which would grow significantly now that Heathrow and Gatwick had reached runway capacity. We note that Heathrow was at capacity for much of the past 10 years¹²⁶ and that growth at Gatwick was modest over this period.¹²⁷

¹²⁶ The Competition Commission, commenting on 2001 figures, noted that 'growth at Heathrow has been significantly constrained by lack of capacity'.

¹²⁷ The number of ATMs at Gatwick grew strongly until 98/99, was just over 1 per cent per annum for the next two years, fell for the next three years, and did not recover its 2000-2001 peak until 2005-2006. Passenger growth was stronger though following a broadly similar pattern.

- DfT's interpretation of its approach was that 'York Aviation believe that the no-frills carrier market is supply rather than demand driven. We are not aware of a theoretical framework nor empirical evidence to justify this'. DfT cited the counter-examples of Cardiff and Teesside, which had low growth in no-frills carriers. We note that the two most successful no-frills carriers, Ryanair and easyJet, have no presence at Cardiff and little presence at Teesside (Ryanair serves one route, to Dublin). In practice, both demand and supply factors are likely to be important to market growth.
- DfT noted that York Aviation's assumption of price elasticity (-1.3) was well above that suggested by CAA research. CAA¹²⁸ estimated an elasticity of -0.7 to -0.8 for leisure air travel, demand tending to be more inelastic at low fare levels.¹²⁹ Stansted ACC representatives argued that their experience was of highly price-elastic customers. We note that customers may be highly responsive to an increase in the prices of one airline (if they can use another, cheaper, airline instead) without necessarily responding to a price increase across all airlines (where the only alternative to paying the higher price is not to travel from that airport), such as may occur following an increase in airport charges at Stansted.

B.3 We have not reached a view as to the merits of the different cases put forward regarding expansion at Stansted.

¹²⁸ Demand for Outbound Leisure Air Travel and its Key Drivers, December 2005.

¹²⁹ With an elasticity of -1.3, a 10 per cent increase in the price would lead to a 13 per cent decrease in tickets sold; with one of -0.7, a 10 per cent price increase would lead to a 7 per cent decrease in ticket sales.

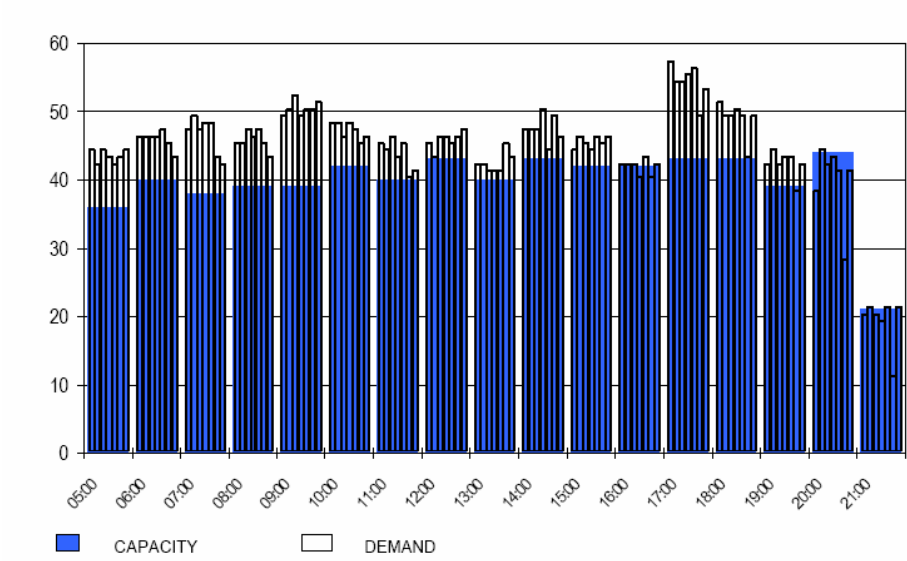
C SLOT DEMAND AT HEATHROW, GATWICK AND STANSTED

C.1 BAA provided us with the following five charts based on ACL data, all five refer to the Summer 2006 season:

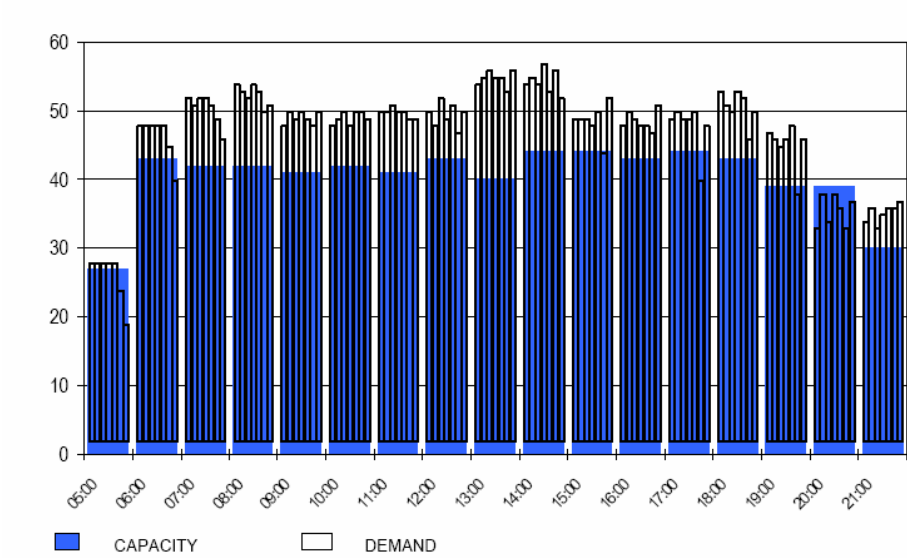
- the first two show the initial demand for runway slots for the Summer 2006 scheduling season compared with the available runway capacity at Heathrow
- the third does the same for Gatwick, combining arrivals and departures, and
- the fourth and fifth show the allocation of slots and the level of slot use at Stansted. BAA noted that Stansted's runway slots were currently only constrained in the key peak period, which was for early morning departures, but that these slots were of very high importance for Stansted-based no-frills operations as without them they could not achieve the high aircraft utilisation that their business model required.

Heathrow

RUNWAY MOVEMENT DEMAND - ARRIVALS
Peak Week Movements per Hour - All times UTC

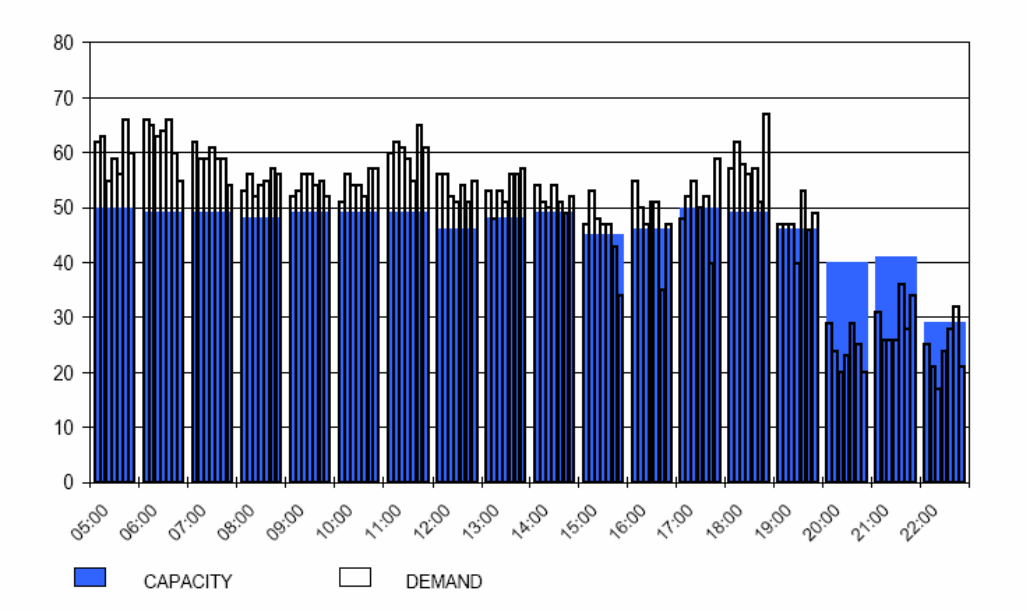


RUNWAY MOVEMENT DEMAND - DEPARTURES
Peak Week Movements per Hour - All times UTC



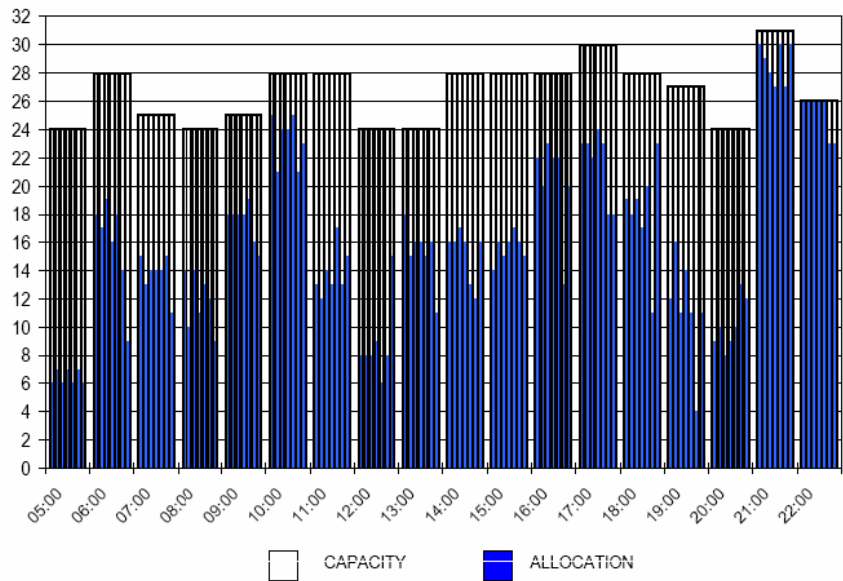
Gatwick

RUNWAY DEMAND - TOTAL MOVEMENTS
Peak Week Movements per Hour - All times UTC

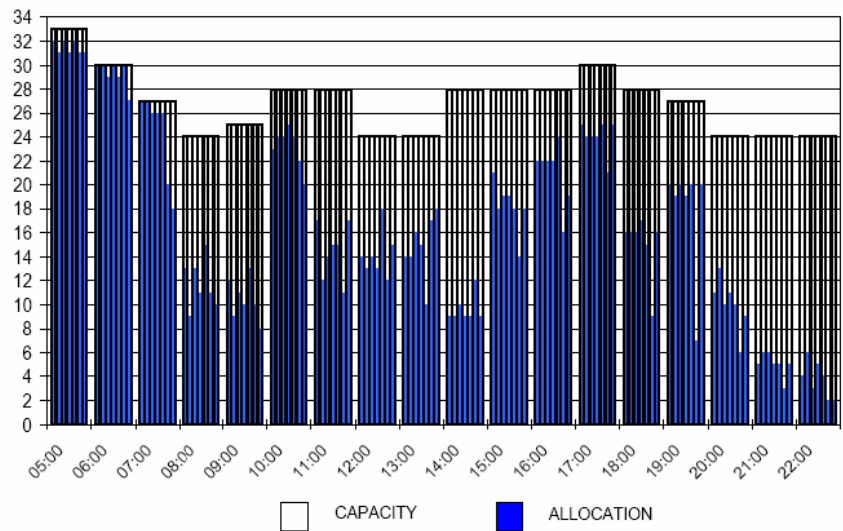


Stansted

RUNWAY ALLOCATION - ARRIVAL MOVEMENTS
Peak Week Movements per Hour - All times UTC



RUNWAY ALLOCATION - DEPARTURE MOVEMENTS
Movements per Hour - All times UTC



D GLOSSARY

AA86	The Airports Act 1986
ABZ	Aberdeen airport (BAA)
ACC	Airline Consultative Committee
ACL	Airports Coordination Limited, the independent coordinator of slot allocation at Heathrow, Gatwick and Stansted airports
APS	Airline Perception Survey
ASA	Airline Service Agreements – normally bilateral agreement between two Governments in relation to flights into each others airspace (and thus airports)
ATM	Air Traffic Movements (for example a landing or a take-off)
BAA	The owner of seven UK airports, formed by privatisation of British Airports Authority. It is now controlled by the Ferrovial Consortium
BHX	Birmingham international airport
CA98	The Competition Act 1998, which prohibits anticompetitive agreements between undertakings and the abuse of a dominant position by one or more undertakings
CAA	Civil Aviation Authority
CC	Competition Commission
DfT	Department of Transport
EA02	The Enterprise Act 2002, which includes the OFT's powers and duties in relation to market studies, mergers and market investigation references
EDI	Edinburgh airport (BAA)
IATA	The International Airline Trade Association represents airlines which together carry 94% of all international scheduled air traffic

GLA	Glasgow airport (BAA)
LCC	Low Cost Carriers (also known as budget airlines)
LCY	London City airport
LGW	London Gatwick airport (BAA)
LHR	London Heathrow airport (BAA)
LPL	Liverpool John Lennon airport (owned by Peel airports)
LTN	London Luton airport (owned by Luton council, but privately operated by Abertis – under a 30 year concession)
MAG	Manchester Airport Group (own and operator of MAN and three other UK airports – owned by a consortium of local councils)
MAN	Manchester airport (owned by MAG)
MIR	Marketing investigation reference to the CC under Part 4 of the EA02
mppa	Millions of passengers per annum. A standards measure of airport outturn and capacity
OFT	The Office of Fair Trading
PIK	Glasgow Prestwick airport
RAB	Regulated Asset Base. The definition used by the CAA as the starting point for determining regulated charges
SOU	Southampton airport (BAA)
STN	London Stansted airport (BAA)
Trips	This term is used throughout the report to refer to individual passenger journeys by aircraft