

BAA

The OFT's reference to the Competition Commission

April 2007

OFT912

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1 EXECUTIVE SUMMARY

- 1.1 The Office of Fair Trading (OFT) has decided to make a reference to the Competition Commission (CC) under section 131 of the Enterprise Act 2002 (the Act) for an investigation into the supply of airport services by BAA within the UK.¹ This confirms the OFT's proposed decision which was published on 12 December 2006,² and on which the OFT publicly consulted.
- 1.2 The OFT has based its decision on evidence of features of the market that we suspect prevent, restrict or distort competition. In deciding to make a reference the OFT has taken account of the views expressed by respondents to the consultation, particularly in relation to the evidence and analysis set out in the proposed decision.³
- 1.3 One company, BAA,⁴ owns airports through which over 60 % of all UK air passengers travelled in 2005.⁵ It is a major company, with UK revenues⁶ of £2,275 m in 2005/06, and its activities impact on a large number of businesses and consumers. The OFT has concluded it has reasonable grounds to suspect 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

¹ The full terms of reference for the CC investigation are at Annexe A.

² OFT882, UK airports: Report on the market study and proposed decision to make a market investigation reference, December 2006.

³ Strictly speaking, the OFT published a document which was both a proposed decision on reference and a report on its market study.

⁴ Throughout this document we will use the name 'BAA' to mean the body which owns and operates Heathrow, Gatwick, Stansted, Southampton, Edinburgh, Glasgow and Aberdeen airports and various associated activities. More detail is given in Chapter 2.

⁵ Source: CAA Airport Statistics.

⁶ BAA Annual report 2005/06. BAA also has overseas revenues not included in this figure.

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).

- 1.4 There has been increasing competition between airlines in recent years, driven by the entry and rapid growth of low cost carriers (LCCs) whose activities were assisted by the EU's liberalisation of airspace. This competition and the development of new business models has reduced the average fare prices paid by consumers, particularly on domestic and short haul flights.
- 1.5 Airports have benefited from the rapid and ongoing expansion of the airlines, leading to greater economies of scale in certain operations, while posing challenges to expand capacity to meet demand.
- 1.6 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 competitive 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 prevents, restricts or distorts competition.
- 1.7 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 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 representations from airlines in relation to BAA's current investment plans in the South East of England.

- 1.8 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.
- 1.9 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'). While the CAA has a role in approving the inclusion of investments within the regulatory asset base, it is also under a duty to promote investment. The appropriate timing and specification of investments are extremely difficult for a regulator to assess.
- 1.10 There is evidence of poor quality of service at BAA airports, particularly those in the South East of England. This low quality appears to go hand in hand with relatively high yields. The combination of low quality and high yields was raised by several respondents during the market study and in the consultation on our proposed reference decision which raises a valid question as to the benefits to consumers of the current situation.
- 1.11 We believe that enhanced 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 the travelling public. It could also deliver lower prices and a higher quality of service.
- 1.12 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 may lead to higher charges, or higher yields, and ultimately higher costs than would be the case if these airports were owned by separate firms.
- 1.13 Finally, airport expansion and increased air traffic, give rise to both local and global environmental concerns. These are significant matters, but 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.

- 1.14 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.
- 1.15 We have found potential adverse effects relating to a combination of features: joint ownership (with very high regional market shares), regulation, development restrictions and capacity constraints. We have concluded that we have reasonable grounds to suspect that the above features prevent, restrict or distort competition with adverse consequences for customers and consumers using these UK airports. We recognise that our preliminary analysis has not reached firm conclusions on these matters, but consider the analysis appropriate for the first phase and look forward to the outcome of the CC's investigation of these significant issues.
- 1.16 Our report entitled *UK Airports: Report on the market study and proposed decision to make a market investigation reference* (OFT882) ('the proposed decision') can be found on the OFT web site at:

www.offt.gov.uk/advice_and_resources/resource_base/market-studies/airports

2 INTRODUCTION

- 2.1 On 12 December 2006, the OFT announced its proposal to refer BAA's supply of airport services within the United Kingdom to the CC for a market investigation.⁷ Its reasoning was set out in the OFT's *UK Airports: Report on the market study and proposed decision to make a market investigation reference* (OFT882) (the 'proposed decision').
- 2.2 The proposed decision followed a market study of certain aspects of UK airports. Market studies⁸ were introduced by the OFT following the 2001 White Paper *Productivity and Enterprise*. The OFT's powers to conduct market studies were strengthened in the Enterprise Act 2002, of which relevant provisions came into effect in June 2003. This Act also gave the OFT the power to make market investigation references to the Competition Commission.
- 2.3 The OFT had been considering a study of these markets during the early months of 2006. Prior to making a decision to do a market study, the OFT became aware of a possible bid for BAA. It made a public statement that it was considering a study in this area on 23 May 2006, before final decisions were made on the bid as it seemed likely that the competition issues might require examination regardless of who owned BAA. The OFT confirmed its decision to study the market, and announced its scope on 30 June 2006.
- 2.4 In the market study, the OFT reviewed competition issues involving airports in three UK regions namely the South East of England, the North of England, and within Scotland. The range of issues included the joint ownership of airports, the regulatory system, and the prospect for

⁷ Throughout this document we will use the name 'BAA' to mean the body which manages and performs operational functions at Heathrow, Gatwick, Stansted, Southampton, Edinburgh, Glasgow and Aberdeen airports. This includes BAA Lynton and the World Duty Free retail chain.

⁸ See Market Studies: guidance on the OFT approach (OFT519) paragraph 1.2.

adequate investment to meet the anticipated growth in passenger numbers in the future. In considering these matters we also looked at indicators of the level of charges to airlines and the quality of service received by passengers at airports.

- 2.5 Our study found that in the North of England competition for new business between independently owned Liverpool, Leeds Bradford, and Manchester airports had led Manchester to reduce its prices faster than regulatory requirements while increasing its responsiveness and quality of service, to the benefit of airlines and their passengers. In relation to the other two geographic areas, however, we felt there was scope for more competition, so we proposed a market investigation reference of BAA's airports in the UK, identifying features that we suspect prevent restrict or distort competition in those areas.
- 2.6 Under section 169 of the Act, where the OFT proposes to make a market investigation reference to the CC, it must first consult, so far as is practicable, any person on whose interests the reference is likely to have a substantial impact. The OFT invited comments on its proposed decision over an eight week period ending on 8 February 2007. In total we received 62 responses, consisting of 37 responses from individuals, 11 from airlines and airline associations, 2 from airport consultative committees, one from an airline consultative committee, one from an airport group (BAA) and 10 from other organisations. The OFT has considered all responses carefully in reaching its final decision.
- 2.7 This decision sets out the OFT's reasons for making a reference of BAA's UK airports and related activities to the CC. Significant views received during the consultation have been included, wherever possible, within the analysis presented in this decision. A few points made by individual consumers which did not fit within the framework have been summarised in Annexe B.
- 2.8 The structure of this document broadly follows that of the proposed decision except that certain introductory and background materials have been amalgamated and the market study material relating to the North of England has largely been omitted. The decision covers:

- Market structure and context (Chapter 3)
- Market definition (Chapter 4)
- Features of the market in the South East of England that raise competition concerns (Chapter 5)
- Features of the market in Lowland Scotland that raise competition concerns (Chapters 6)
- Other issues raised with us by respondents (Chapter 7)

2.9 The appropriateness of the reference decision, and the scope and terms of the reference are covered in Chapter 8.

3 MARKET STRUCTURE AND CONTEXT

Air transport industry background

- 3.1 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 year. The UK aviation industry generates over £13 billion of revenues per year.⁹ Most forecasters expect growing economic prosperity to bring greater demand for air travel in the years to come.
- 3.2 Aviation is of great importance to the UK economy. This is a large sector both in terms of monetary value¹⁰ and in terms of its effect on wider productivity.¹¹ BAA airports in the South East of England have a turnover of over £1.5 bn per annum.¹² 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 million¹³. Aviation is estimated to be worth £600 million to the Scottish economy,¹⁴ accounting for 1.2 per cent of Scottish GDP in 2000.
- 3.3 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

⁹ Mintel, Airlines Leisure Intelligence, June 2005.

¹⁰ UK airports' annual turnover was reported as £2.8 billion in 2005 by Keynote.

¹¹ For example see, BAA, Issues brief: Economic benefits of aviation, November 2004. Available through www.baa.com.

¹² BAA Annual Report 2005/06. Figures exclude revenue of £385m from World Duty Free.

¹³ As footnote 12.

¹⁴ Aviasolutions, The future development of air transport in the United Kingdom A National Consultation: A report on responses to the Government's consultation: Scotland.

Transport¹⁵ the Government noted that one third of our visible exports, by value, now goes by air.

- 3.4 Aviation facilitates tourism and leisure. Around 25 million foreign visitors per year contribute to a tourist industry that directly supports more than two million jobs. The DfT estimates that 80 % 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.
- 3.5 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.
- 3.6 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.
- 3.7 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 affects capacity constraints at airports.

¹⁵ Department for Transport, The Future of Air Transport, 16 December 2003.

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

UK airports

3.9 The UK has a large number of airports, which were originally owned by central or local government. During the second half of the twentieth century airports were increasingly developed in partnership with private companies and many were sold into private ownership. The British Airports Authority was established by legislation passed in 1965 as a public body which operated several major UK airports. There have been acquisitions and disposals from its airport portfolio since that time.¹⁶ BAA was privatised in 1987 following the Airports Act of 1986. BAA was acquired by the Ferrovial Group (in consortium with two financial investors) in 2006.

3.10 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 Table 3.1 below.

3.11 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.

¹⁶ See the BAA web site for further details of its history.

Table 3.1: UK airports by ownership and share of passenger trips, 2005

Owner	Airport	Million passengers per annum	%
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
Macquarie	Birmingham	9.3	4
	Bristol#	5.2	2
Peel Airports	Doncaster Sheffield	0.6	0
	Durham Tees Valley	0.9	0
	Liverpool	4.4	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. The four airports indicated with * are designated for price control (see paragraph 3.24).

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

The Table includes one change of ownership in 2006. Macquarie purchased Ferrovial's 50 % stake in Bristol airport to become the sole owner of Bristol airport.

How UK airports charge airlines

- 3.12 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.
- 3.13 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

- 3.14 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

- 3.15 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.
- 3.16 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.
- 3.17 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.¹⁷ This may change in the future as newer aircraft come into production which can fly long distances from comparatively shorter runways.¹⁸
- 3.18 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

- 3.19 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

¹⁷ This may not only apply to runway specification. For example, the new Airbus A380 requires larger aircraft stands.

¹⁸ 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 2020.¹⁹

3.20 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 % in nominal prices for economy class seats with moderate reductions in the real price of business class seats.²⁰ 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 3.2: 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

3.21 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

¹⁹ DfT, Passenger Forecasts: Additional Analysis, December 2003.

²⁰ 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.

book flights and accommodation separately and this possibly lies behind a loss of market share by traditional charter flights.²¹

- 3.22 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.
- 3.23 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

- 3.24 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,²² 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:²³

²¹ For example, see Mintel, Airlines, Leisure Intelligence, June 2005.

²² Airports at which annual turnover has exceeded £1 million in two of the last three financial years.

²³ Department of Transport, Review of the Framework for Economic Regulation of Airports, March 1995. The DfT published a proposal to revise the criteria in March 2007.

- the market position, including extent of competition from other airports and other modes of transport
- 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.

3.25 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.

3.26 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.'²⁴ In doing so, the CAA may have regard to the airports' past and forecast revenues, costs and investment programmes.

3.27 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.²⁵ A key issue in this process is the need to ensure future investment in appropriate infrastructure to meet anticipated demand from airlines.

²⁴ Section 40(1) and (3) AA86.

²⁵ Current caps are Heathrow: RPI + 6.5 per cent, Gatwick and Stansted: RPI, Manchester: RPI – 5 per cent.

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

- For airports, the CAA has no concurrent powers to enforce competition law under CA98 or EA02.²⁶ It does have a power under section 41 of the Airports Act to impose conditions²⁷ on regulated airports²⁸ that are found to be pursuing courses of conduct that are broadly anticompetitive.²⁹
- 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 remedies³⁰ 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.

²⁶ 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

²⁷ 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.

²⁸ That is all airports whose turnover exceeds the qualifying threshold, including designated airports.

²⁹ Civil Aviation Authority, 'The CAA's use of section 41 of the Airports Act 1986: A Consultation document', December 2005.

³⁰ Under section 46(2) AA86.

- 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 purpose of price cap regulation rests with the Secretary of State for Transport.
- 3.29 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.
- 3.30 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

- 3.31 The European Commission regulates a range of aviation activities. Areas covered include consumer rights, ground handling and slot allocation (see next paragraph). In addition aviation (as with all industry sectors) is subject to European competition law, including merger control, competition law and state aid controls.
- 3.32 Access to the airspace at certain busy airports is subject to EC regulation to ensure fair allocation of slots for take off and landing when there is greater demand than the available supply. Slot coordination must be performed by an independent body at such airports. Airport Coordination Limited (ACL) performs this function at all of the UK's major airports.³¹ Incumbents are able to retain the use of slots provided they make sufficiently regular use of them. When airports are full and unable, or unwilling, to expand capacity, the regulations can therefore

³¹ See www.acl-uk.org for further information on ACL's activities and ownership.

introduce some rigidity, but they have not prevented some switching in practice. In particular airport slots can be and have been traded between airlines.³²

International regulation

- 3.33 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 are increasingly being shared with the European Commission (see example below).
- 3.34 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.
- 3.35 These restrictions are increasingly being removed. One respondent to our consultation drew attention to the benefits which had followed

³² See, OFT/CAA (OFT832), The competition issues associated with the trading of airport slots, June 2005.

liberalisation of the UK-India air services.³³ The most important of these agreements to the UK is that with the US – the most significant long haul destination. The discussion on Open Skies between the European Commission and the USA has recently proposed liberalisation on this matter, among others.

- 3.36 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

- 3.37 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.

³³ The CAA has published a review of this liberalisation which is available at www.caa.co.uk/docs/589/ERG_EPIA_India_Liberalisation.pdf

4 MARKET DEFINITION

- 4.1 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'.³⁴
- 4.2 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.
- 4.3 During the consultation, BAA questioned whether the OFT's market analysis was a sufficiently robust foundation upon which to make a market investigation reference. BAA did not, however, provide an alternative analysis and it accepted that OFT is not required to undertake a conclusive analysis in order to make a reference. The OFT believes its analysis is appropriate for a first phase investigation. We do not consider we need to reach final conclusions on market definition issues because we believe the adverse effects are sufficiently clear to give reasonable grounds to suspect an adverse effect on competition from the analysis we have undertaken (see Chapters 5 and 6).
- 4.4 The focus of the market definition process is to examine the constraints operating on BAA's airports in the South East and Scotland in order to understand the extent to which they may already compete for airlines and passengers and, further, the extent to which passenger and airline choices suggest there is scope for further competition within the market absent joint ownership. Market definition is only part of this exercise but it provides a framework to understand the competition considerations.

³⁴ OFT511, *Market Investigation references: Guidance about the making of references under Part 4 of the Enterprise Act*, paragraph 4.8.

4.5 Our preliminary view is that the relevant product market for the purpose of this reference should be defined as the supply of airport services as a bundled product comprised (broadly) of airport infrastructure services to airlines, services delivered directly to air passengers, and services to other commercial operators at airports. In terms of relevant geographic markets, our preliminary view is that these comprise:

- the South East of England and East Anglia, including Heathrow, Gatwick, Stansted, Luton and City airports and potentially Southampton, and
- Lowland Scotland³⁵ including Glasgow, Edinburgh and Prestwick airports.

4.6 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 retail³⁶ which may be operated by third parties on their behalf, but effectively charge air travellers indirectly.

4.7 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.

4.8 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

³⁵ Lowland Scotland comprises the Scottish Parliamentary regions of Lothians, Mid-Scotland and Fife, Glasgow, Central Scotland, South of Scotland, and West of Scotland.

³⁶ For example at Heathrow airport, approximately 45 % of revenues are derived from these sources.

commercial services (such as retail or rental concessions).³⁷ We have taken account of these in our thinking about airport markets.

Product market

4.9 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:

'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 fire fighting. 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).'³⁸

4.10 We consider passenger and airline demand for these services.

Passenger demand

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

4.12 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

³⁷ For example the Anticipated acquisition by Macquarie Airports Ltd and Ferrovial Aeropuertos SA of Exeter and Devon Airport Ltd (www.offt.gov.uk)

³⁸ 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

depends in turn upon airlines deciding to operate services from the airport

- the convenience of the airport, which in turn 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
- the quality and price of services at the airport (including car parking and retailing), although evidence³⁹ suggests that these are of less importance in the passenger's decision to use the airport.

4.13 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,⁴⁰ and may be more flexible about the choice of destination. Inbound passengers⁴¹ are likely to be influenced by proximity of an airport to business or tourist centres according to the purpose of their journey.

³⁹ 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.

⁴⁰ 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.

⁴¹ 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 % 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 % of passengers are interconnecting via UK airports.

Airline demand

- 4.14 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.⁴² Economies of scale favour basing operations at a single airport in each region, but there can be marketing benefits from being present at many different airports.
- 4.15 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.⁴³ In addition, new airlines must choose an airport to operate from when entering the market.
- 4.16 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 4.11 to 4.13 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

⁴² We have been provided with examples of switching, growth, and new entry by airlines.

⁴³ 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.

- 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.

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

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

- very few airports specialise exclusively in one type of flight (see Table 4.1) 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 4.1: Proportion of passengers by category at relevant airports, 2005

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

*Includes all 23 airports surveyed by CAA.

4.19 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

4.20 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

- 4.21 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.
- 4.22 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.⁴⁴ 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).
- 4.23 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 to compete by making themselves more convenient, for example by investing in improved transport links, but their ability to do this may be limited.

⁴⁴ 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

- 4.24 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 is likely to affect both its investment decisions and its subsequent pricing decisions.

Geographic market

- 4.25 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 4.2 sets out the region of origin of passengers departing from the main airports in the South East and East Anglia,⁴⁵ and Scotland. A map of showing the location of major airports in Great Britain is shown below.

Table 4.2: The regions of origin of passengers using particular airports 2005

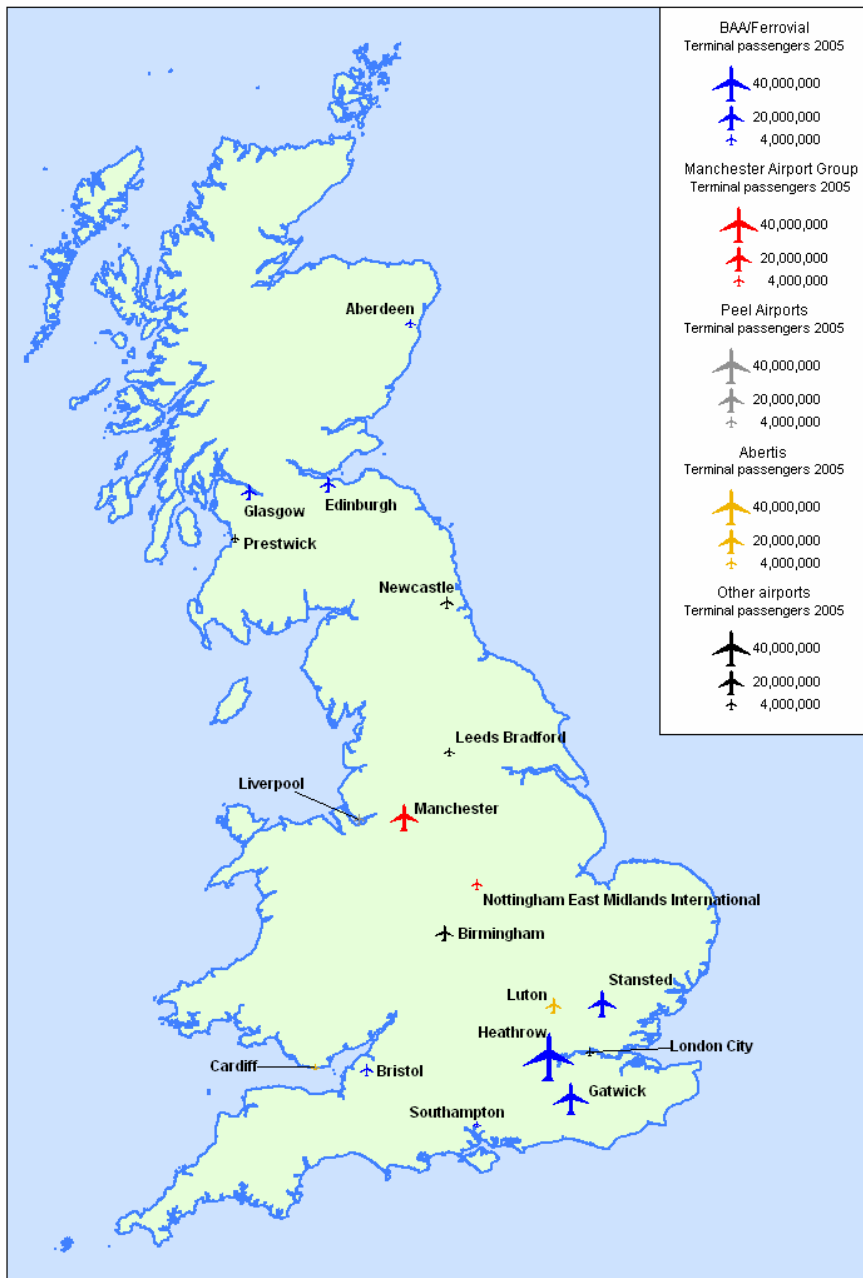
Region	LHR	LGW	STN	LTN	EDI	GLA	ABZ	PIK	All airports
South East and East Anglia	55 %	74 %	77 %	75 %	0 %	0 %	0 %	0 %	39 %
Scotland	0 %	0 %	0 %	0 %	97 %	97 %	90 %	99 %	11 %
North West	0 %	0 %	1 %	1 %	0 %	0 %	0 %	0 %	8 %
Yorkshire & Humberside	1 %	0 %	2 %	1 %	0 %	0 %	0 %	0 %	4 %
Others	9 %	10 %	9 %	16 %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

Source: CAA survey data

LHR – Heathrow, GTW – Gatwick, STN – Stansted, LTN – Luton, EDI – Edinburgh, GLA – Glasgow, PIK – Prestwick, ABZ – Aberdeen

⁴⁵ 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.

Figure 4.1: Map of major airports in Great Britain



- 4.26 Table 4.2 confirms the common sense expectation that airports attract the majority of passengers from the regions where they are located.
- 4.27 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.
- 4.28 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, other things being constant, 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).
- 4.29 Previous competition decisions have been based on a regional analysis, for example the European Commission has 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.⁴⁶

Airports in the South East of England

- 4.30 Our preliminary view is 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

⁴⁶ Case No COMP/M.4164 – Ferrovial / Quebec / GIC / BAA, paragraphs 18 and 21. BAA commented in a footnote to its consultation response that it could not see the relevance of these cases as 'precedents'. We do not rely on them as precedents for our market definition in this case, but note them as evidence that a regional approach to the analysis of airport markets is not unusual.

City airport or BAA's Southampton airport should be included because the relatively small scale of these airports mean that their inclusion or exclusion would not affect our later conclusions.⁴⁷ The South East also includes two major airports not owned by BAA: Luton and London City.

- 4.31 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.
- 4.32 Given the joint ownership of the largest airports within the South East of England, an analysis of 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.
- 4.33 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

⁴⁷ London City airport was given planning approval in 1998 for 73,000 Air Traffic Movements (see Annexe D) 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.

served by the airport. We analyse the extent of the overlap in the following sections.

Regional presence

4.34 Table 4.3 shows all airports with over 1 % 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 4.3: 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.⁴⁸ All other airports less than 1 %

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

4.35 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 districts⁴⁹ within the South East as an indicator of likely substitution between airports.

⁴⁸ 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.

⁴⁹ These are local authority districts, the smallest geographic areas available within the data before us.

4.36 In order to be within the same market, it is only necessary for there to be a sufficient number of marginal customers between two airports for them to act as a constraint on behaviour - not a majority of customers. To establish whether a significant proportion of air passengers within a single district used more than one airport in the South East, 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.

4.37 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.

4.38 The results are reported in the table below.

Table 4.4: 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 % 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 % 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

4.39 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.

4.40 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.

4.41 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 lower but still substantial.

4.42 Table 4.5 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 4.5 Share of airport passengers coming from 15 % 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

4.43 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.

4.44 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.

4.45 From the perspective of the air passenger, this suggests substantial choice between these airports is available for specific destinations.

4.46 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 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.⁵⁰ Airlines also provided some analysis. Previous experience of the OFT with isochrone analysis⁵¹ has found that results can vary according to the software and assumptions used.⁵² We consider that the margin of error is small in the context of our application of the technique.

- 4.47 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.
- 4.48 The CAA suggested that business passengers may have a lower propensity to travel to reach their chosen airport. 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 4.13).

⁵⁰ See, for example Paragraph 22 of the Macquarie decision (footnote 37). During our market study, 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.

⁵¹ Primarily within merger analysis, for example the analysis of supermarket mergers.

⁵² For example, the average speed and time of travel.

Figure 4.2: 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 4.3: 90 minute drive time analysis in the South East



Figure 4.4: 120 minute drive time analysis in the South East



4.49 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.

4.50 In its response to our consultation, BAA queried the validity of isochrone analysis, albeit specifically in relation to airports in Scotland. We are satisfied that isochrone analysis is an appropriate methodology in the South East of England and Scotland, as part of the evidentiary base for

reaching a view on market definition. The OFT recognises that the technique has limitations: it uses drive time as a means of assessing consumer preferences even though some consumers will use other modes of travel. Nevertheless travel time is one of the important criteria consumers use (see paragraph 4.12). As such, isochrones provide a useful adjunct to the other evidence available to us.

- 4.51 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 % of all air passenger trips across this wider geographical market. In terms of assessing the impact of joint ownership of BAA's airports in the South East, widening the market to include the Midlands would not have a material impact.
- 4.52 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

- 4.53 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, for a variety of reasons.
- It may well reflect that airports which are under joint ownership do not have an incentive to steal business from one another.
 - The existing 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.

- Actual switching may understate the potential to switch.

4.54 BAA felt that this analysis was not sufficiently developed. The OFT considers that these points are sufficient for a first phase analysis, when read in conjunction with airline comments below. The absence of switching does not inform us as to the extent to which the airports may or may not be substitutes given these points.

Views and other evidence on market definition

4.55 BAA told us during our study 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.

4.56 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 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.⁵³
- 4.57 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.⁵⁴ The OFT and EC did not reach final conclusions in 2002 as to whether Heathrow and Gatwick were in the same market.⁵⁵
- 4.58 Some airlines listed other European hubs (in Paris, Frankfurt and Amsterdam) as Heathrow's principal competitors.
- 4.59 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.
 - 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.
- 4.60 One airline provided evidence during our study of competition on domestic routes to support the inclusion of Southampton airport in the market. During the consultation it provided further evidence to support

⁵³ The treaty is generally known as Bermuda II.

⁵⁴ See www.usdoj.gov/atr/public/press_releases/2001/9705.htm and docket OST-2001-11029.

⁵⁵ 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.

this point. We still consider it unlikely that Southampton, even if independently owned, could exert a substantial competitive constraint on a hypothetical monopoly owner 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.

- 4.61 BAA said that even where catchment areas overlapped, passengers might 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.
- 4.62 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.
- 4.63 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.
- 4.64 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.
- 4.65 One charter airline provided analysis which indicated some overlap between Manchester airport and the South East of England.
- 4.66 In response to the OFT consultation document, several airlines were supportive of our approach to market definition and commented critically on the approach of the CAA in respect of the proposals for the next

price control period of BAA's London airports.⁵⁶ We have noted the CAA's analysis, which is not necessarily inconsistent with our approach as it has been prepared for a different purpose. We continue to believe our preliminary views on market definition are appropriate for the issues considered in this reference decision.

4.67 BAA said during our market study that an empirical assessment, which it had not undertaken, would be necessary to assess the relevant product and geographic markets. In response to our consultation document BAA reaffirmed this point. It also said that there are a large number of factors ranging from 'choice of destinations, frequency of flight times, surface access time and cost to ticket price which could limit the extent to which individual passengers perceive one or more airports as substitutes or not' – 'and which might limit the incentive of airlines to switch their operations from one airport to another'. While these factors are all potentially relevant to market definition, we believe our analysis is sufficient for the purposes of a market investigation reference, given this is a first stage investigation and we are not intended to carry out an in depth investigation. This approach has received some support in a recent CAT ruling.⁵⁷ Our market definition exercise has:

- Interrogated passenger survey data from the CAA to examine to what extent BAA airports custom overlaps with other airports (paragraphs 4.35 to 4.43).
- Considered overlaps in airline destinations served from these airports (paragraphs 4.44 to 4.45).

⁵⁶ See CAA, Airports price control review – Initial proposals for Heathrow, Gatwick and Stansted: Supporting paper II Competitive constraints faced by Stansted Airport, December 2006.

⁵⁷ [2005] CAT36, paragraph 7, '...There is, if we may say so, some risk that one may mistake the height of the hurdle which s.131(1) presents. It is a 'reasonable ground to suspect' test. The scheme of the Act is that a full investigation is carried out at the stage of the Competition Commission not at the stage of the OFT, although admittedly the OFT has to address the matter sufficiently to decide whether there are reasonable grounds 'to suspect'...'.

- Examined isochrones around the BAA airports (paragraphs 4.46 to 4.48).
- Considered evidence of switching by airlines (paragraph 4.53).
- Considered the views put to us by airlines and airports (paragraphs 4.55 to 4.66).
- Sought views from BAA, which declined to put forward its view on what market definition would be reasonable.

Conclusion on South East market

- 4.68 Our preliminary market definition suggests (1) that BAA's airports could compete with each other absent joint ownership and (2) that the constraint offered from airports outside of the South East is likely to be comparatively weak. We note that on the first point BAA appears to have expressed similar views to this analysis in a submission to the CAA.⁵⁸ BAA said that it believed substantial overlap occurred between Heathrow and Stansted and indeed, all the airports serving London for leisure passengers. Consequently, having considered the representations of BAA on this point we are content that our analysis suffices.
- 4.69 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).

⁵⁸ BAA/Q5/100, Response to CAA Policy Issue Consultation Paper, March 2006.

- 4.70 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.
- 4.71 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.
- 4.72 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 primary hub airport) or as competing with other hub airports in Europe in the context of a hypothetical complaint where the issue was limited to hub airports. In the present circumstances, however, we are concerned with competition for airlines and passengers within South East England where the evidence before us suggests Heathrow attracts a significant proportion of passengers who may also use Gatwick, Stansted or Luton. 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.
- 4.73 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

- 4.74 We consider that the relevant geographic market for BAA's airports at Edinburgh and Glasgow is Lowland Scotland.⁵⁹ 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.
- 4.75 The main evidence that has drawn us to this conclusion is our analysis of CAA survey data showing the origin 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

- 4.76 CAA statistics show that four airports, all located within Scotland, serve the vast majority of passengers originating in Scotland. These are Glasgow, Edinburgh and Aberdeen airports owned by BAA and Prestwick airport.
- 4.77 Edinburgh and Glasgow airports each account for just over 35 % 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

⁵⁹ Footnote 35 provides a definition of this area.

share of the Scottish passenger market above one per cent are shown below.

Table 4.6: 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

4.78 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 4.7.

Table 4.7: 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

4.79 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. 16 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).

4.80 Table 4.8 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 4.35 to 4.37).

Table 4.8: 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 % 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 % 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

4.81 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.

- 4.82 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.⁶⁰ 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 (Thomas Cook) offers flights from both airports.⁶¹
- 4.83 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.
- 4.84 The map below illustrates the area of Scotland that can be covered within a 90 minute drive⁶² from Glasgow airport. We selected this drivetime after considering isochrones for 60, 90 and 120 minutes. We found that 90 minutes most closely mirrored the CAA passenger survey

⁶⁰ These figures may be affected by alleged bundling whereby BAA links discounts to airlines to operating air routes at both Glasgow and Edinburgh.

⁶¹ Source: airport web sites, 26 March 2007.

⁶² When we refer to drive times, we are using an average drive time as calculated by MapInfo which uses average speeds for 36 different road types. An individual journey time may be shorter or longer depending on the day, time of day and other factors.

data in Scotland.⁶³ Not only are Edinburgh and Prestwick clearly within this area but so is the majority of Scotland's population.⁶⁴

Figure 4.5: 90 minute drive time around Glasgow airport (MapInfo)



4.85 A similar map generated for a 90 minute drive time⁶⁵ 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

⁶³ For example, we examined the isochrones for Edinburgh and Aberdeen on the basis of a 120 minute drivetime. These predicted a small overlap in their respective catchment areas around Dundee. However, as we previously noted, the overlap between Edinburgh and Aberdeen is not significant according the CAA survey data we have examined.

⁶⁴ 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.

⁶⁵ The inclusion of a portion of sea is a consequence of the software used.

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.

Figure 4.6: 90 minute drive time around Aberdeen airport (MapInfo)

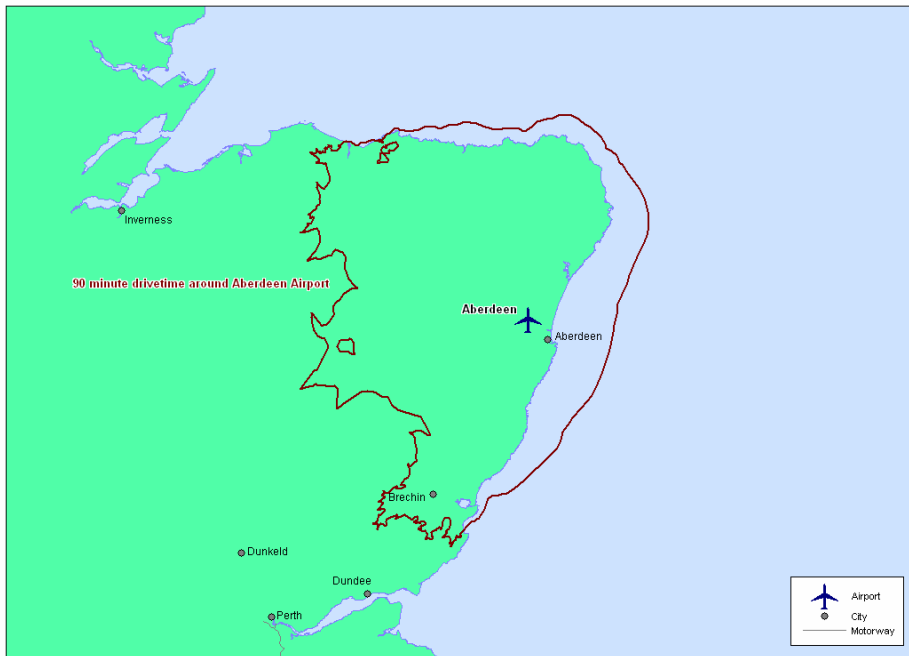


Figure 4.7: 90 minute drive time around Edinburgh airport (MapInfo)



Substitution by airlines

4.86 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. However, actual switching may understate the potential for switching, a key factor in considering market definition.

Views

4.87 During our market study, 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 are 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 analysis⁶⁶ 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).

4.88 In response to our consultation, BAA questioned whether there was sufficient evidence that Glasgow and Edinburgh are potential competitors. It stated that the examples on switching by airlines between Glasgow and Prestwick were not conclusive for Edinburgh and Glasgow. We agree. Nevertheless we consider our evidence of actual and potential substitution (by airlines and passengers) between Edinburgh and Glasgow is sufficient to give us reasonable grounds to suspect that there could be (greater) switching between Edinburgh and Glasgow in the event that they were no longer jointly-owned. BAA told us that passenger demand shows a marked demarcation between

⁶⁶ By a charter operator, based on passenger data.

Edinburgh and Glasgow which principally serve their respective cities. As noted above the survey data does show strong local demand for these airports. However, it also shows some significant overlaps. As we discuss in our guidelines,⁶⁷ in order to be within the same market, it is only necessary for there to be a sufficient number of marginal customers to act as a constraint on behaviour - not a majority of customers. At the 15 per cent level the extent of overlap shown in Table 4.8 is significant. At the 25 per cent level the extent of overlap is lower, and the effect is less clear cut. Nevertheless there are two points which lead us to conclude, for the purposes of this decision, that Glasgow and Edinburgh airports should be considered potential substitutes:

- As noted above, common ownership may affect the extent of destination overlap, which in turn may distort passenger behaviour compared to a situation where the airports were under separate ownership and there was a greater incentive for airlines and passengers to switch.
- We have not reached firm conclusions that either the 15 per cent or 25 per cent threshold is definitive given the range of other factors that influence consumer choice. Nevertheless we believe these represent an appropriate range within which the issue can be judged. It would be inappropriate to rule out potential competition based on the overlap at 25 per cent being marginal in a preliminary analysis, especially given the existence of other pointers, discussed above, which indicate they should be included within the market and the fact that we are a first stage investigator and as such do not have to reach definitive conclusions on this issue.

4.89 In addition to querying whether Glasgow and Edinburgh compete, BAA told us that the constraint offered by Newcastle Airport should also be taken into account. The nearest main Scottish airport to Newcastle is Edinburgh. There is some overlap in districts where these airports draw

⁶⁷ See paragraph 4.9 OFT, Market investigation references Guidance about the making of references under Part 4 of the Enterprise Act, 2002.

their passengers. Using the same analysis as used above, at the lower 15 per cent threshold this indicates that less than 1 per cent of either airport's passengers are drawn from such districts. We therefore remain of the view that Newcastle Airport does not act as a constraint on the Scottish airports.

- 4.90 BAA told us that the use of isochrones may not be appropriate, that passenger substitution should be analysed on the basis of population centres and it questioned the use of a 90 minute isochrone. We explain in paragraphs 4.46 to 4.50 our rationale for the use of isochrones and the assumptions we have chosen. While it is possible that a different drive time is appropriate in Scotland, we have seen no evidence to support this nor has BAA provided any. Centring isochrones on population centres is a valid exercise,⁶⁸ but we believe that the passenger origin data analysis effectively captures this concept in any event, since passenger origins will largely correlate with population density. BAA reported a drive time of 1 hour 24 minutes between Prestwick and Edinburgh airports, and suggested that, on the basis of this drive time, Prestwick might hypothetically constrain Edinburgh. We have already noted (paragraph 4.78) that the CAA passenger origination statistics show that overlap between Edinburgh and Prestwick is muted. We are not saying that Prestwick is in a different market to Edinburgh, rather, given the relative differences in airport size and in distance, the competitive constraint that Prestwick offers to Edinburgh is likely to be muted.
- 4.91 BAA also said we ought to have considered journey times by public transport. In a first stage investigation we do not believe this would have been appropriate. We therefore believe, for the purposes of our analysis, that the isochrone analysis is a useful indicator as part of our overall analysis of the relevant markets. We have, as already noted, examined CAA survey data on the origin of passengers using these airports. To the

⁶⁸ For example this methodology has been used to assess supermarket mergers.

extent that passengers used public transport, the overlap analysis will therefore have included it.

4.92 In response to our consultation, BAA told us that it was surprised there was no assessment of passenger demand substitutability on domestic routes. BAA told us that given the importance of domestic flights to their airports in Scotland, consideration should be given to how far passengers will switch airports for alternative domestic flights. We note our analysis of CAA survey data captures this as it contains information on passengers who are catching domestic flights.

4.93 BAA also told us in response to the consultation that given the importance of domestic flights to its Scottish airports, the potential substitution to rail services should be considered. The MMC⁶⁹ has previously considered that some high speed rail links may compete with certain flights.⁷⁰ Consequently, it appears plausible that **airlines**, on specific routes, face some competitive constraint from alternative rail services. But there are significant differences between the effects of rail on airlines, and the potential effect on **airports**.

4.94 We take the view that for the following reasons this consideration is insufficient to change our decision in respect of referring BAA's airports in Scotland for a market investigation:

- BAA has not provided any evidence on the effect of rail services in constraining prices or behaviour at their airports in Scotland.
- Even where rail services offer a constraint to some flights, that does not necessarily imply a constraint on airport charges for all flights.

⁶⁹ The Monopolies and Mergers Commission, the body that became the Competition Commission.

⁷⁰ Monopolies and Mergers Commission, 'British Airways plc and Cityflyer Express Limited, Cm 4346, July 1999.

- Airport charges represent a significant proportion of airline costs (estimates vary but the CAA recently concluded they represent 20 per cent to 30 per cent of costs⁷¹). But a 5 to 10 per cent rise in airport charges which was passed on in full by airlines (not something which would necessarily happen) would only result in a 1 per cent to 3 per cent rise in air fares. Hence there are reasons to believe rail services are a more distant constraint upon airports than on airlines.
- We have received no evidence or views from others to suggest the availability of rail travel constrains airport charges.
- We therefore conclude there is insufficient evidence to change our view as a first stage investigator, but this matter can be considered further by the CC.

Conclusion on market in Scotland

4.95 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.

⁷¹ See CAA, Supporting paper II: Competitive constraints faced by Stansted Airport, December 2006.

5 BAA AIRPORTS IN THE SOUTH EAST OF ENGLAND

5.1 Chapter 4 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.

5.2 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.

5.3 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

5.4 The planning system acts as a serious barrier both to new entry and to 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.

- 5.5 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.
- 5.6 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.
- 5.7 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.
- 5.8 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 2019.⁷² Investment decisions at airports involve very long timescales and consequently ignoring long term expansion at Gatwick would not be appropriate.
- 5.9 Other factors beyond the planning regime which can limit the ability to establish a new airport or expand a current airport include:

⁷² 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.

5.10 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.

5.11 In response to our consultation, several respondents agreed that planning and development restrictions were significant, and some respondents wanted environmental factors to be given even greater weight in the future. Whilst we recognise the importance of these issues to the respondents, they do not alter our final conclusions on competition issues.

Capacity constraints

5.12 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.

5.13 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.⁷³

5.14 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 Regulation⁷⁴ 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 (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.

⁷³ 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 % 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).

⁷⁴ Council Regulation (EEC) 95/93 as amended by Regulation 793/2004.

5.15 BAA told us during our study 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 500m².

Conclusion on development restrictions and capacity constraints

5.16 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

5.17 Heathrow, Gatwick and Stansted are subject to economic regulation which places upper limits on the prices these airports can charge airlines. We discuss the broad current framework of regulation in paragraphs 3.24 to 3.36. 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 was, until recently, unable to achieve the price ceilings allowed by the CAA.

5.18 In response to our consultation, we were told that prices at Stansted will rise to the cap from April 2007. The CAA has confirmed that it expects this to happen.

5.19 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. BAA also accepted that regulation could be improved to give better incentives to all parties:

- 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 more highly specified than they want. Similarly, the fact that all investments attract the same return can distort investment signals.
- 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.
- In response to our consultation BAA also referred to its earlier submission that the 'single till' mechanism, whereby commercial revenues are effectively taken into account in setting the price caps, disincentivises them from riskier long-term commercial developments. This raises the issue of whether regulation prevents, restricts or distorts competition. We do not need to come to a conclusion on this specific point.

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

Effect of regulation on investment incentives

- 5.21 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),⁷⁵ regardless of whether these investments are valued by airport users. Second, that there appears to be an assumption by BAA that future investment should be funded by higher charges⁷⁶ rather than greater volumes and efficiency improvements. We discuss these concerns in greater detail at paragraphs 5.29 to 5.36 below.
- 5.22 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.
- 5.23 We are not convinced by this line of logic in the form it has been presented to us for the following reasons:

⁷⁵ 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.

⁷⁶ 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'.

- 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 may be able to benefit from economies of scale and scope as they grow.⁷⁷ We have seen mixed evidence from developments at other airports. There are examples of high cost developments where charges have risen,⁷⁸ but there are also examples of low cost terminals,⁷⁹ and independently operated terminals⁸⁰ where charges have fallen. It follows, that new development need not always require an increase in airport charges.
- 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.

5.24 In its response to our consultation BAA questioned the evidential value of the above examples, noting that international comparisons can be difficult. OFT accepts that international comparisons need careful consideration and do have limitations. Nevertheless the examples establish that it is possible to expand airport facilities without increasing charges. BAA did not provide any evidence to us to explain why it felt the price reductions we had cited were not relevant to building of new terminals in the UK. The CC will be able to examine this issue in more depth.

⁷⁷ We also recognise that such economies of scale may not apply to large scale capacity expansion where land is scarce and significant local transport improvements are required to cope with additional traffic.

⁷⁸ For example, Toronto airport.

⁷⁹ Frankfurt Hahn, Singapore Changi, and Marseille.

⁸⁰ Terminal four at John F. Kennedy airport.

- 5.25 In response to our consultation, BAA told us that pre-funding of investment is not inherently objectionable and believes pre-funding mimics the behaviour of competition in a capacity constrained environment whereby prices increase until it becomes profitable to invest in more capacity. Furthermore it believes pre-funding reduces regulatory risk. BAA also told us that current prices are not necessarily efficient but equate to the historic average costs of providing the assets and may not represent the incremental costs of accommodating additional traffic or the economic value of the capacity that already exists.
- 5.26 To be clear, we are not saying pre-funding is never appropriate; but we question whether it should automatically be the route to fund investment and indeed whether charges should automatically increase. We also recognise it is perfectly possible that current prices are not economically efficient and we have already noted that regulation is unlikely to perfectly mimic competition. We believe these points reinforce the view that investment incentives are likely to be distorted.
- 5.27 The Civil Aviation Authority (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.⁸¹ 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.
- 5.28 We discuss these concerns in greater detail below.

⁸¹ In its latest proposals, CAA's initial price control proposals for Heathrow, Gatwick and Stansted airports, December 2006, the CAA has put forward a proposal for addressing the concern that the RAB incentive is distorting the investment proposed for Stansted Airport by disassociating the value of future investment from the price control formula.

RAB incentive

- 5.29 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 capacity and may even reduce capacity.⁸² 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.
- 5.30 In response to our consultation, BAA told us that concerns that investment had occurred in the wrong assets - terminals but not runways - were misplaced because runways do not increase capacity unless they have terminals to support them. We agree that the two may need to go together.
- 5.31 BAA told us that its investment record is good and highlighted that Terminal 5 is on time and to budget. BAA also told us that investment is not automatically added to the RAB. Rather it is subject to regulatory scrutiny. We have discussed the regulatory regime extensively with the CAA during our study. We understand that certain elements of BAA's capital investment programme are subject to extensive scrutiny, for example the CAA has commissioned consultants to assess the efficient cost of constructing certain facilities proposed by BAA. However, the

⁸² 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.

appropriate timing and specification of investments are extremely difficult for a regulator to assess, not least due to the difficulties associated with assessing passenger and airline demand for different facilities in a dynamic market place. One of the reasons for instituting Constructive Engagement was to address this issue. Whilst this process has met with some success at Heathrow and Gatwick, it appears to have failed at Stansted. We received mixed evidence on proposed future developments, with some favourable comments, and others critical of what they saw as excessive retail development. We are not well placed to assess the value of particular development proposals. Moreover, our concerns do not turn on this.

5.32 BAA also said that its investments were not risk free. BAA told us that the risky nature of new investment is evidenced by the fact that until recently BAA had not been able to price to the regulatory cap at Stansted. Whether or not it can price up to the price cap appears to be largely independent of the views of airlines towards its investment programme as evidenced by the situation at Stansted. Furthermore we do not believe the Stansted example provides the evidence that BAA suggests: the decision to build Stansted occurred prior to BAA privatisation.⁸³

5.33 BAA pointed to two reports as providing evidence on its investment performance:

- The Scott Wilson report⁸⁴ examined the efficiency and effectiveness of investment at Stansted. The report found that BAA's analysis of facility requirements was generally reasonable⁸⁵ but that BAA's

⁸³ BAA told us during our market study that the original terminal was designed more than 20 years ago by the former British Airports Authority.

⁸⁴ Scott Wilson, Advice to CAA on BAA's Capital Investment Plan at Stansted, December 2006.

⁸⁵ Para 4.1.8

capital costs could be reduced.⁸⁶ We believe that the report is of limited usefulness for the purpose of examining whether investment incentives are distorted. In particular the report highlights that it did not consider fundamentally alternative developments to those proposed by BAA. Nor did it address the development of Stansted's proposed second runway – the area about which we received most concerns in respect of Stansted.

- The Currie & Brown report⁸⁷ examined cost benchmarks for a range of airport infrastructure in order to assess value for money from BAA. The report noted improvement since 2004 including a greater degree of commercial rigour. Nevertheless the report also identified that, if its benchmarking exercise was implemented in the 2006 CIP there could be a 5 per cent saving against historical cost data.⁸⁸ Again the OFT considers the usefulness of this report to address distortions to investment incentives to be limited. It did not examine the decision of what to invest in, and when.

5.34 In response to the 'gold plating' criticism BAA also pointed to its annual publication at each airport of a Capital Investment Programme (CIP) in order to facilitate consultation with airlines on its investment plans, and said that the process of constructive engagement (CE) has provided airlines with a broader mechanism to become actively engaged in the capital investment programme. As mentioned above, whilst there have been some positive comments on this process in respect of Heathrow and Gatwick the process of constructive engagement appears to have failed at Stansted. This is the airport where the strongest criticisms of gold plating have been levelled. We therefore do not consider that the

⁸⁶ Para 4.1.11, largely reflecting the findings of the Currie & Brown report.

⁸⁷ Currie & Brown, Heathrow Airport Capital Investment Programme Capex Efficiency Workstream – Facility Benchmarking, February 2006.

⁸⁸ BAA told us it had incorporated this into its current capital expenditure plans.

CIP and CE processes are evidence that gold plating is not incentivised or that it cannot occur.

- 5.35 We do not believe the two reports are necessarily inconsistent with the views expressed to us by the airlines during our study.
- 5.36 In the course of our study 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'. During our consultation, BAA told us that there is a connection between service quality and levels of investment, and that its latest investments, Heathrow East and Terminal Five, are intended to enhance service quality. We summarise later in this document the evidence we have on the quality of service at BAA's airports in the South East. BAA has accepted that its record on quality of service could be improved. The investment programme BAA has highlighted may eventually address the apparent shortfall, at least at Heathrow. However, as we later note, this does not address other airports BAA owns within the South East, nor does it explain how the situation arose.
- 5.37 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

- 5.38 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 the 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 (BAA provided the example of Heathrow Terminal 4 being built in response to demands from two airlines which no longer exist – TWA and Pan Am).

- 5.39 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 Q5⁸⁹ price control'.
- 5.40 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.
- 5.41 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.
- 5.42 In response to our consultation BAA told us its corporate financing arrangements were irrelevant. It believed there was no reason to suppose that the ability to pay cash to shareholders meant that the company was earning excessive returns. We have not reached a conclusion on this specific issue as we do not believe it is necessary to do so.

⁸⁹ Q5 is an industry acronym for the fifth quinquennial price review.

Consumers and airlines

5.43 In response to our consultation, BAA expressed concern that our proposed decision was over reliant on the views of airlines without questioning whether these were aligned with the interests of consumers. In particular it had previously told us that the strong position of British Airways, Ryanair and easyJet meant that they had an incentive to prevent further expansion of airports in the South East (in particular Stansted) in order to prevent expansion of their rivals and hence competition in providing flights to consumers.

5.44 The OFT agrees that the views of airlines will not always be fully aligned with those of consumers. The OFT and the EC have taken action against airlines in respect of both consumer and competition legislation in the past. Nevertheless, for the following reasons we believe the evidence provided by the airlines can reasonably be taken into account:

- Airlines have been pressing for expansion at Heathrow, and have offered to build new facilities at Stansted.
- Airlines, including BA, Ryanair and easyJet, appear to be subject to significantly more competition than BAA's airports. Paragraph 3.20 summarised the evidence of increasing competition and falling air fares. Hence they should be more aligned with consumer interests due to their greater incentives to win the business of air travellers in competition with rival airlines.
- Airlines other than BA, Ryanair and easyJet expressed similar concerns to us. In particular the SACC represents all the airlines operating at Stansted and we explicitly asked for and received confirmation that no member of the SACC disagreed with the views expressed. 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.

- During our study many airlines told us they are concerned that capacity is not increasing or there are excessive delays in delivering capacity, especially at Heathrow. Such expansion is likely to increase downstream competition and, for airlines based at Heathrow, is likely to provide more intense competition than from rival airlines expanding at a neighbouring airport. This suggests that concerns of increasing competition are not the motivating factor behind their submissions.
- 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.'⁹⁰ BAA has informed us, both prior to and during our consultation, that this report contains both positive and negative feedback.

5.45 We agree there are some positive messages and the table below reproduces part of the survey summary. Nevertheless we do not believe this undermines the main point we make that airlines other than RyanAir and easyJet held concerns about Stansted. BAA's revised proposals in December 2006 do not seem to have satisfied the airlines. BAA also asked us to quote some material relating to the context of the survey. This is quoted verbatim from the report immediately below the table:

⁹⁰ BAA airline perception survey, 2005

Good News	Room for Improvement
<ul style="list-style-type: none"> • There is recognition that BAA is changing and becoming more customer focused • They think BAA has come some way but from a low base • In general the airlines consider facilities to be good • Project delivery for one respondent is 'the best it has been' • They believe the airports are well managed • Constructive Engagement is helping⁹¹ 	<ul style="list-style-type: none"> • Although moving in the right direction BAA is still uncommercial, monopolistic • There is a belief that the facilities are comparatively too costly • Too often there are teething problems which are avoidable and negatively impact airline operations • They feel that they don't have access to all the data and the information they want and this makes them assume the worst and be suspicious • The information/discussions are very technical and don't seem to focus on the business impact for them which is what they care about • Consultation is lengthy and resource intensive; it could be more efficient • They are frustrated when BAA does not put into action what is agreed at consultation meetings or when things disappear from the CIP without discussion • BAA is '<i>Effective. But not efficient</i>'

- 'They recognise the tensions created by the many conflicting demands
- They understand the constraints at Heathrow and the size of the challenge ahead
- They think it is OK for BAA to make a profit
- A fair proportion do not understand construction or the industry, nor do they wish to. It is because of the increased investment in the CIP that the question of value has come under the spotlight.

⁹¹ The survey related to all three London airports. We have seen other evidence suggesting that constructive engagement is helping at Heathrow and Gatwick, but is not working at Stansted (paragraph 5.31).

- And that is because it relates to charges'

5.46 In conclusion, we accept that regulatory gaming is something which airlines as well as BAA can engage in. Nevertheless the balance of the evidence we have seen gives us reasonable grounds to suspect that airlines' concerns have some validity.

Conclusions on features of economic regulation

5.47 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 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.

5.48 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.

5.49 We have balanced all the evidence before us including the points put to us by BAA and others during the consultation. We note BAA recognises that the current regulatory system prevents, restricts or distorts competition albeit for different reasons to those given by airlines. The requirement for detailed regulation instituted by government itself reflects a recognition that the commercial discipline competition can provide is insufficiently strong. However, price regulation can also impose costs on an industry as highlighted by BAA and airlines. This can involve 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.

5.50 To the extent competition can increase, reliance on regulation can be lessened. Competition can work alongside regulation as occurs in other regulated industries. The in depth investigation that the CC can

undertake within a market investigation will allow them to assess the framework of regulation and the extent to which it should be amended, relaxed or left unchanged, alongside the scope for greater competition.

Joint ownership

- 5.51 BAA owns the three largest airports in the UK: Heathrow, Gatwick and Stansted airports. These airports handle approximately 91 % of passenger trips and over 83 % of flights within the South East of England⁹² and East Anglia (see Table 4.3). Luton is the only significant airport in the region not owned by BAA. Chapter 4 describes the large extent to which these BAA airports could compete to serve the same airlines and passengers.
- 5.52 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 5.16 above.
- 5.53 Whilst we do not think it is appropriate to do so, if the market was widened, for example to include the Midlands,⁹³ this would also not affect our conclusions as BAA would still have a high and persistent market share in this wider market and we do not expect the additional airports that would be included in this wider area to place a significant constraint on BAA.
- 5.54 Given these considerations we conclude that BAA holds substantial and persistent market power in the South East of England.

⁹² BAA also owns Southampton airport which has a one % share of passengers in the South East.

⁹³ 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.

Does joint ownership prevent, restrict or distort competition?

- 5.55 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 in this market.
- 5.56 BAA told us that it considered the proposed decision did not adequately take into account the effect of the EC's slot regulations and airlines' grandfather rights to slots at capacity constrained airports. Nor did it take into account the existence of bilateral agreements. These were discussed at paragraphs 3.32 to 3.35. Both factors may affect the potential for competition between airports in the South East. We agree that these issues, which are outside the direct control of BAA, may have an impact. However, for the following reasons, we do not believe these are significant enough to change our view:
- The OFT has examined the EC's slot regulations jointly with the CAA and has given advice to the EC on reform of the regulations.⁹⁴ Our proposed decision recognised at footnote 69 that ownership of slots combined with grandfather rights restricts the ability of airlines to switch airports or to gain access to airports where there are capacity constraints. This is likely to lead to some inefficiency. However, this does not prevent benefits of increased competition between airports being passed on to consumers. Firstly some aspects of airport service are experienced directly by consumers.⁹⁵ Secondly, slot regulations do not prevent competition between airlines hence some benefits to airlines are likely to be passed on to consumers. We have already cited evidence of competition between airlines driving down air fares (see paragraph 3.20).

⁹⁴ OFT/CAA, Competition issues associated with the trading of airport slots, June 2005 (OFT832).

⁹⁵ For example consumers directly experience the quality and cleanliness of airport facilities and are subject to waiting times within airports.

- In respect of Air Service Agreements (ASAs), we accept these can, where present, limit the extent of downstream competition which can occur between airlines. But we have already noted above that evidence exists that the broad picture is that competition has driven down prices among airlines.
- Furthermore, the majority of routes are not affected by ASAs⁹⁶ and there is a trend for routes to be liberalised when ASAs are renegotiated, for example with India. The CAA allocates capacity for such expanded routes on a basis which takes into account the benefits of competition among airlines.⁹⁷
- Even where ASAs do limit competition, this does not mean there is no competition.
- In the case of both slots regulations and ASAs two further points can be made. The benefits from increased airport competition may be enhanced through further liberalisation, similarly benefits from liberalisation may increase due to competition between airports. Requiring one to happen before the other could lead to the situation where neither occurs.
- The CC will be free to examine each issue in more depth, to the extent that it impacts on the benefits to be accrued from airport competition.

5.57 BAA told us that significant capacity constraints also prevent any substantive competition emerging between airports in the South East, both now and in the future. BAA has also said that even if there is some limited spare capacity, the OFT does not provide an appraisal as to

⁹⁶ Looking at Heathrow, Gatwick, Stansted and Luton – over half of the traffic goes to EU countries which are already liberalised. The most significant traffic associated with ASAs is the US which represents over 13 per cent but this may also be liberalised - see paragraph 3.35.

⁹⁷ For example see CAA, Decisions on air transport licences and route licences 1/04.

whether this available capacity is of sufficient magnitude to facilitate material airport competition.

5.58 We agree that, taking the four main airports in the South East as a whole, spare capacity is currently scarce. The capacity that does exist tends to be of the lower value slots. Nevertheless for the following reasons we maintain that the potential benefits of significantly greater competition between Heathrow, Gatwick and Stansted airports in the **short run** should not be discounted:

- There is substantial overlap between both the passenger origins and the destinations served from these airports and hence potential for airlines and passengers to switch (see Table 4.5 and paragraph 4.41). Evidence submitted by BAA during our study demonstrates that passenger numbers and flights have shown a long term growth despite persistent capacity constraints.⁹⁸
- An airport business involves high fixed costs (those which are incurred whatever the volume of passengers) where 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. Furthermore, given the importance of commercial revenue to airports, there is also an incentive to maximise the passenger numbers. Clearly where airlines switch services significant numbers of passengers are likely to move with them. However, where destinations are already served from other airports, passengers can also switch (for example, in response to poor quality of service).

⁹⁸ Furthermore, from year to year the absolute level of growth has changed from airport to airport (see CAA passenger statistics). This demonstrates the potential for competition at the margins even before capacity expansion.

- 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.

5.59 In addition, in the **long run**:

- a separately owned Heathrow, Gatwick or Stansted could compete by increasing capacity, for example by building a new runway. 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 5.16.

5.60 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.

5.61 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 % 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.

5.62 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 discounts⁹⁹ 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 process of expiring. BAA had signalled that discounts at Stansted will cease in March 2007.¹⁰⁰ During our consultation we received confirmation that prices will rise accordingly. In contrast, Gatwick gave only £[] in rebates in 2004-05¹⁰¹ while receiving £144 million in airport charges. Heathrow does not give discounts. Its airport charges totalled £532 million in 2005-06.

5.63 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.

5.64 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.¹⁰² More recently the OFT referred the proposed merger of Bristol and Exeter airports to the Competition Commission due to its potential to

⁹⁹ Two discount figures have been excised from this paragraph for commercial confidentiality reasons.

¹⁰⁰ BAA Annual Report and Accounts 2005/06, page 39. The CAA has also confirmed with us that this is also their expectation.

¹⁰¹ The BAA Annual Report states that airlines operating at Gatwick and Heathrow were charged at the regulatory price cap in 2005/06.

¹⁰² 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.

substantially lessen competition.¹⁰³ 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 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,¹⁰⁴ the approach to market definition, and the analysis of competition issues are substantially similar.

- 5.65 BAA told us that the test used for analysing mergers was irrelevant to the considerations before us as it is a different legal test. We agree that it is a different legal test. However, we consider merger analysis to be a relevant indicator to our considerations of the effect of joint ownership on competition, especially since the substantive analysis implied by the test is largely the same.

Countervailing buyer power

- 5.66 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

¹⁰³ See footnote 37. The deal was abandoned following the referral.

¹⁰⁴ 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.

substantially reduces the market power that joint ownership of Heathrow, Gatwick and Stansted confers on BAA.

- 5.67 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.
- 5.68 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 5.62) demonstrates that competition is restricted. We suspect that this is due to a combination of the features of joint ownership and capacity constraints. We also note that pre-existing discounts negotiated at Stansted have now expired and BAA will henceforth price at the level of the cap.¹⁰⁵

Effect of joint ownership on investment incentives

- 5.69 Our biggest concerns about the effect of BAA's joint ownership of airports in the South East relate to potential distortions to investment incentives.
- 5.70 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.
- 5.71 In relation to investment, we have reasonable grounds for suspecting that both the system of regulation (described in paragraphs 5.21 to 5.42) and the joint ownership of airports act to distort incentives. The potential distortion may be large and may have long lasting impacts on

¹⁰⁵ See paragraph 5.18.

consumers (in terms of choice of where to fly from, and the cost -as we note later the evidence on service quality also seems consistent with this view). 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.

5.72 We have reasonable grounds to suspect that the current market structure could lead to investment decisions which do not maximise benefits to air passengers. In particular:

- joint ownership may discourage investment in capacity 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 5.79 to 5.81 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 5.23 we question the assumption that investment should, of itself, require higher charges. See paragraphs 5.82 to 5.88 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.

5.73 Responding to our consultation, BAA made a number of points, which we summarise and address below:

- Concerns that joint ownership restricts capacity are highly theoretical and do not reflect a serious and balanced interrogation of the planning regime. BAA intends to meet the White Paper which sets out the agenda for capacity expansion on a significant scale.

Paragraphs 5.4 to 5.11 set out our findings on the restrictions to airport expansion due to the planning regime. We accept that the planning regime can lead to significant restrictions on the ability for airports to expand. However evidence BAA submitted earlier in our study suggests there is still some room to manoeuvre.¹⁰⁶ The White Paper lays out a framework but does not bind airport expansion decisions. We also note that planning restrictions set upper limits. They do not prevent capacity expanding more slowly, or to lower than maximum levels.

We accept that some of our concerns are based on established economic principles in relation to expected behaviour absent a competitive constraint. The fact that a firm with a strong market position restricts output in order to increase profits is not a novel concept. It would be the rational approach of firms in such a position. The views expressed to us by airlines during our study appear to be consistent with that theory, taking into account the potential distortions introduced through the regulatory regime.

- Concerns expressed by airlines do not necessarily represent the views of consumers.

We address this issue in paragraphs 5.43 to 5.46.

- BAA's financial resources left it less likely to be constrained by the lumpiness of investment at individual airports than might be the case

¹⁰⁶ BAA/OFT/45 para 11, '...The £450 million Heathrow Express rail link was opened by the Prime Minister in 1998, connecting Heathrow to central London's Paddington station. This commitment to invest in public transport services for the airport has helped us gain further planning permissions to develop the airport.'

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 3.1. This does not necessitate ownership of adjacent airports.

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

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.

5.74 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 (paragraphs 5.79 to 5.81).

5.75 As we have outlined in paragraph 5.69, joint ownership, where it prevents, restricts or distorts competition, can be expected to distort investment incentives. The concerns relayed to us by airlines (the direct customers of BAA) during our study accord with this view and we believe it significant that all airlines who contacted us expressed

concerns. Some of these concerns were also expressed inside BAA's survey of customer perceptions which we discuss in paragraph 5.44.

- 5.76 We have carefully considered the points BAA has put to us concerning its investment programme in its response to our proposed decision. It is certainly true that distinguishing whether or not any single investment is inefficient, gold plated or deliberately delayed is not something the OFT is well placed to judge. We have also carefully considered its points about whether airlines have incentives in this regard which are not necessarily in the best interest of consumers.
- 5.77 In considering, in this Chapter, whether the section 131 test for a market investigation reference is met¹⁰⁷ – we have borne in mind that the threshold is a low one. We need only to establish 'reasonable grounds to suspect' that one or more features of the relevant market prevents restricts or distorts competition. We have balanced the evidence before us and we believe that we meet this test in respect of the joint ownership of airports, and that investment decisions are just one way in which this can manifest itself. An in depth investigation by the CC can examine this issue in detail in order to test the veracity of the concerns.
- 5.78 The sections below lay out the main concerns expressed to us by airlines.

Broad concerns on investment at airports in the South East

- 5.79 The majority of airlines expressed the view that separation of ownership would lead to more appropriate investment. The broad picture was of too much investment at Stansted and too little at Heathrow and Gatwick. 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

¹⁰⁷ Appropriateness of a reference is assessed in Chapter 8.

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.

- 5.80 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 between Heathrow and Luton airport where it claimed that Luton airport was actively promoting the building of a 'new' runway.
- 5.81 BAA told us that it had adequately resourced the Heathrow runway project, which was at an earlier stage. During the consultation, BAA also told us that priority was given to Stansted to reflect Government policy and that expansion is planned at both Stansted and Heathrow subject to environmental conditions being met. It is true that the White Paper envisages expansion to occur first at Stansted and thus it is not surprising that plans for expansion are more advanced at Stansted. However, this does not inform us as to whether the concerns that investment at Heathrow is being delayed are valid or not.

Stansted Generation 2

- 5.82 In 2005 BAA published a consultation document proposing a second runway at Stansted, which would increase capacity by 41 million passengers per annum. BAA has modified this proposal¹⁰⁸ since our proposed decision. The original proposal drew strong criticism from the SACC which represents the airlines that use Stansted, and from individual airlines at both Stansted and Heathrow. It is not unusual for detailed plans for large scale investment to change. We do not think the changes to this individual proposal affect our overall reasoning nor do they change our broad conclusions. We note that the revised proposals have also drawn public criticism from members of the SACC. Whilst the proposal has been revised, the broad concerns remain the same, that the

¹⁰⁸ BAA press release of 30 January 2007 entitled 'BAA update on second runway at Stansted Airport'.

incentives on this investment may be distorted by the joint ownership of BAA's airports.

5.83 The SACC's principal concerns in relation to the earlier proposal were that:

- the cost of the new facilities was excessive - four times the cost of one of their own proposals¹⁰⁹, and
- BAA's forecasts of demand at Stansted were excessive. The SACC envisaged significantly lower growth in demand if airport charges have to rise to fund increased capacity.

5.84 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.

5.85 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.

5.86 In its consultation response BAA referred to the criticism that its forecasts are excessive, and made the point that Government evidently believes that early build at Stansted is desirable. The OFT has not reached, nor attempted to reach a firm view on the robustness of BAA's forecasts for demand at Stansted. As noted this is an area of considerable contention between BAA and the airlines. We do however note that the differences between the airlines and BAA are not just limited to estimates of demand for Stansted.

¹⁰⁹ The revised proposal is less than three times the cost.

- 5.87 Another concern that was raised by airlines using Heathrow was that if BAA made a loss making investment at Stansted it might seek permission to recoup its losses through higher charges at Heathrow and Gatwick. During the consultation BAA confirmed (as indicated in our proposed decision) that such cross subsidy is not currently allowed by the Regulator. In its response to our consultation BAA also suggested that if the CAA were to change the model there may be sound economic reasons for allowing such a cross subsidy. Cross subsidy is not ruled out by legislation and could occur in future. The CAA told us that it could not fetter its discretion on this matter. We note that **if** investment is distorted **such that** BAA over invests in Stansted, the fact that such an overinvestment could potentially be derisked through cross subsidy from Heathrow and Gatwick would not appear beneficial for wider stakeholders. As such the concern appears to have merit on face value and we note BAA's briefings to investors in 2005 which suggested it considered cross subsidy as a goal.¹¹⁰
- 5.88 BAA told us that incumbent airlines at Stansted 'focused on pushing down costs, with the associated constraint on capacity growth. BAA said 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. We addressed the issue of airline incentives earlier in paragraphs 5.43 to 5.44.

¹¹⁰ BAA told potential investors in May 2005 that it thought a return to a system approach would be merited, and contained indicative costs to Heathrow and Gatwick passengers.

Communication between BAA and its customers on investment requirements

- 5.89 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.¹¹¹
- 5.90 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 part of this process at Stansted, its customers at Stansted clearly do not view the process as constructive.

Implementation

- 5.91 Respondents to BAA's airline perception survey (see paragraph 5.44) said that BAA provided facilities which were ultimately of high quality, but with too many initial snags. Concern was also expressed that BAA's tendering process for contractors was not always competitive or well managed.
- 5.92 In its response to our consultation, BAA said it thought we had been selective in our APS quotation above, 'publishing negative statements without the positive'. It did not accept the allegations about tendering processes. We have reviewed the APS document again prior to publication of this decision and consider the quotation used is broadly consistent with the general tone of that report. We acknowledge the report does contain some positives for BAA. We discussed this in more detail in paragraph 5.44.

¹¹¹ Civil Aviation Authority, Heathrow, Gatwick and Stansted airports: Review of existing public interest conditions, Consultation paper, October 2006.

- 5.93 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 % 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

- 5.94 During the study some airlines 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.
- 5.95 In its consultation response BAA told us that the idea that it had overstated environmental constraints at Heathrow was risible. The OFT agrees that environmental issues would have to be addressed in any expansion of Heathrow but this does not imply the concerns regarding distorted investment incentives do not occur.

Conclusion on features affecting competition in the South East of England

- 5.96 Taking into account the above analysis and in particular the overlap in catchment areas described in Chapter 4, 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.
- 5.97 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

5.98 According to paragraph 4.5 of the OFT's Market Investigation Reference guidance,¹¹² 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

5.99 The majority of comments we received on price were directed at the level of the price cap.

5.100 IATA¹¹³ 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 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.¹¹⁴ In IATA's view,

¹¹² Market investigation references Guidance about the making of references under Part 4 of the Enterprise Act, March 2003.

¹¹³ The International Air Transport Association (IATA) is a trade association representing airlines which together carry 94 per cent of all international scheduled air traffic.

¹¹⁴ IATA's submission to CAA's consultation on the airports price control review.

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.¹¹⁵

- 5.101 In response to our consultation, BAA contested the views of IATA and noted that just because other costs have fallen to airlines does not imply that airport costs should decrease. The OFT agrees that there is no automatic relationship. Our point was that the data may indicate that competition is effective in driving efficiencies in airlines leading to reduced costs and air fares. But BAA airports do not appear to be subject to as vigorous a competitive constraint and we believe it is legitimate to ask whether increased competition between airports could yield similar benefits.
- 5.102 To assess the evidence on pricing and yields 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.
- 5.103 The key results for Gatwick and Heathrow airports are shown in Table 5.1.¹¹⁶ Stansted was not part of the sample.
- 5.104 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.

¹¹⁵ 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.

¹¹⁶ Data from the TRL, Airport Performance Indicators, 2005.

5.105 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.

Table 5.1: 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)

5.106 The extent to which high commercial revenues indicate consumer detriment is unclear. In its response to our consultation BAA told us that 'the fact that commercial revenues are high simply reflects good performance on BAA's part in developing commercial activities that are highly valued by passengers'. It also felt that there should be a presumption that its prices were fair as a result of the single till regime. We note that many individual prices are unregulated, and would question the validity of such a presumption. 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) or could reflect high charges to retailers

- 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. We received some consumer complaints about the level of parking charges during our market study. This concern was confirmed in responses to our consultation.
- 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).

5.107 In its consultation response, BAA told us that the fact its charges were regulated by the CAA should enable a presumption that they were reasonable. This is to pose a different question. As discussed in paragraphs 5.38 to 5.40 the price cap is currently a result of a RAB based system of regulation. If investment is distorted such that gold plating occurs, then the regulated price will be set too high. We have already discussed why a regulator may be unable to control for this.

Furthermore as we note in paragraphs 5.47 to 5.50 regulation is not a perfect substitute for competition, which would ensure an appropriate level of charges.

5.108 In its consultation response, BAA said that 'the data does not provide any indication at all that Gatwick's charges are 'high'. On all of the indicators (save commercial revenues) Gatwick ranks in the middle of the sample. Secondly, Heathrow tends to rank higher, but Heathrow's ranking in respect of aeronautical charges - the key charge to airlines - is well below the top of the sample.'

5.109 The OFT has not said Gatwick's charges are too high. In our proposed decision we considered there was a question as to whether overall **yields** (revenue per passenger) are too high at BAA's airports in the South East. We examined the 2006 edition of TRL's report on Airport Charges cited by BAA in its consultation response. The Airport Charges report ranked Heathrow 19th out of fifty for the average charge for a hypothetical bundle of eight common types of aircraft. This figure is not inconsistent with the other figures prepared by TRL which are presented above. However this report is limited because it does not include an important income stream of airports, commercial revenue.¹¹⁷

5.110 We recognise that the issue of pricing is complex, BAA has put to us that the relevant benchmark may not be other airports but rather:

- market clearing prices, which may well be substantially above the current price at some capacity constrained airports such as Heathrow
- long run incremental cost, or cost of capital, both of which are well known concepts particularly within regulated industries.

¹¹⁷ We also checked the companion volume, the 2006 edition of Airport Performance Indicators, which does cover commercial revenue, since we had quoted from the 2005 edition of this work (Table 5.2). We found the 2006 performance figures were broadly consistent with 2005 results. BAA's rankings were slightly higher on most measures, but this might be due, in part, to a change in airports included in the sample.

5.111 We recognise this could be an important issue. For example, in principle high market clearing prices that increase price may lead to a more efficient utilisation of an airport. The OFT continues to suspect there are issues here which would benefit from detailed investigation by the CC.

Efficiency

5.112 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 5.2, 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 5.2: 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

- 5.113 During our market study 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.
- 5.114 Notwithstanding this, we considered that the evidence raised the question of whether overall yields at BAA airports in the South East were too high and whether this was consistent with our view that features of the market may prevent, restrict or distort competition.

Service quality

- 5.115 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.¹¹⁸ The 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.¹¹⁹ Views provided to the OFT on whether quality had improved in areas outside those specifically covered by the scheme have varied.

¹¹⁸ As in footnote 38.

¹¹⁹ www.caa.co.uk/docs/5/ergdocs/erg_ercp_servicequalitymods_feb05.pdf

5.116 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, travelers 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
- when lifts, baggage carriers and travelers 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.

5.117 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.

5.118 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 2006¹²⁰ 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.

¹²⁰ The most current survey available when the proposed decision was prepared.

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 5.3: 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

5.119 On this measure it appears that BAA airports, especially Heathrow, have performed relatively poorly in respect of service quality.

5.120 In its consultation response BAA said 'BAA is aware that its record on quality of service could be improved, especially in the South East, and is currently undertaking record investment to improve the passenger experience at its South East airports'. BAA felt, however, that the OFT had not sufficiently evidenced a link between quality of service and competition issues. In particular BAA noted that the top five performers in the ASQ 2006 survey were local monopolists.¹²¹ It also noted that Stansted had performed better than Manchester in this particular survey.

5.121 We consider there is a great deal of evidence from all sectors and over many years that healthy competition leads to innovation, reductions in price and improvements in quality. An individual firm may not be able to make progress in all of these areas at the same time, however. In the case of Manchester we found evidence of price reductions, and

¹²¹ BAA told us the top five airports by rank in the ASQ Q1 survey were Seoul - Incheon International, Hong Kong International, Singapore-Changi, Nagoya - Centrair International and Kuala Lumpur International.

improvements in customer responsiveness, leading to the IATA quality award. We found mixed evidence on quality itself.¹²²

5.122 We note BAA's comments about the top performers in the ASQ survey. We agree it is desirable to take account of relevant factors when it is possible to do so, but there are limits in what can reasonably be achieved in a first phase study. We believe that the following two facts, in combination raise a valid question as to the benefits to consumers of the current situation which the CC should investigate:

- The relatively high level of profitability per passenger of BAA's London airports in international surveys we note earlier (see Table 5.1).
- The relatively poor performance in providing quality of service to consumers at BAA's London airports in international surveys (see Table 5.3)

5.123 We recognise that the ASQ data is an imperfect indicator, especially given the different age, size and congestion of different airports, but BAA has accepted that its record on quality of service could be improved. It may be the case that planned investments will eventually address the apparent shortfall, at least at Heathrow. However, this does not address other airports, nor does it explain how the situation arose and why it has taken so long to address. We therefore consider that the evidence raises the question of whether the overall low quality at BAA airports in the South East is associated with a lack of competition in the market.

Security arrangements

5.124 We received several submissions from airlines during our market study concerning the effects of the security alert of the 10 August 2006¹²³

¹²² See paragraph 8.20 of the market study.

¹²³ On the 10 August 2006, the level of security at airports throughout the UK was raised.

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.

- 5.125 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 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.
- 5.126 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. We received a number of consumer complaints about security queues in responses to our consultation.
- 5.127 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 making the decision on reference.

6 BAA AIRPORTS IN LOWLAND SCOTLAND

- 6.1 Chapter 4 identified the possible relevant geographic market as Lowland Scotland, which gave a competitor set of Glasgow, Edinburgh and Prestwick airports.
- 6.2 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.
- 6.3 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

- 6.4 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.
- 6.5 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

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

Table 6.1: 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

6.7 BAA has a very high share of passengers in Lowland Scotland of 88 %. 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 3 indicates that Prestwick may only compete directly with Glasgow airport. Our main concerns here relate to pricing as set out below, we have also considered the impact of joint ownership on investment and quality.

6.8 Given the market definition analysis in Chapter 4, 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

6.9 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

6.10 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.

- 6.11 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.'¹²⁴

- 6.12 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.

¹²⁴ Department of Transport, 'Review of the Framework for Economic Regulation of Airports', March 1995

Table 6.2: 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.

6.13 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.

Table 6.3: 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 are 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.

6.14 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).

- 6.15 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.
- 6.16 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.
- 6.17 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.
- 6.18 BAA has made several representations to us on this analysis. These can be summarised as follows:
- The OFT has not obtained data on Prestwick's prices or yields, to support its assertion that yields are lower at Glasgow due to the impact of Prestwick. It cannot be assumed that BAA's lower average yields at Glasgow result from competition at Prestwick.

We agree that further information on Prestwick's prices would assist this analysis and that no conclusive assumption can be drawn that Prestwick has caused the lower average yields at Glasgow. Nevertheless the evidence before us is consistent with views put to us by airlines that competition with Prestwick has constrained prices at Glasgow. We believe it is sufficient to establish reasonable grounds to suspect and thus it is an indicator which we believe has been used appropriately. BAA has not presented us with evidence to the contrary.

- Competition between Prestwick and Glasgow does not imply that competition can occur between Glasgow and Edinburgh.

Competition between Prestwick and Glasgow indicates that competition between airports can occur. In combination with the other evidence within this decision, most notably our analysis of the market definition, we believe this does indicate that competition could also occur between Edinburgh and Glasgow although we accept this is a topic for more in depth investigation by the Competition Commission. We noted at paragraph 4.82 that a pattern of similar destinations and airlines at Glasgow and Edinburgh, but not Prestwick, may also have an influence on current levels of competition.

- If Prestwick constrains Glasgow its constraint on Edinburgh should also be considered.

As we noted at paragraph 5.70 of our proposed decision, overlaps between Edinburgh and Prestwick are muted. In particular Prestwick is physically much closer to Glasgow. Using the same analysis of the CAA survey data as we used in market definition, there are no overlap districts between Prestwick and Edinburgh whereas there are quite substantial overlaps between Prestwick and Glasgow. We believe that the constraint of Prestwick on Edinburgh is therefore likely to be significantly lower than the constraint it offers on Glasgow.

6.19 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 1992.¹²⁵ 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.

6.20 In conclusion, we consider that the evidence on pricing supports our conclusion that the joint ownership of airports in Lowland Scotland and

¹²⁵ It is currently owned by Infratil Ltd.

the development restrictions that restrict new entry and expansion may prevent restrict or distort competition.

Other issues raised in relation to Scottish airports

Investment

- 6.21 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.
- 6.22 We note that companies with large financial resources other than BAA can and do own and invest in airports (see Table 3.1). This does not necessitate ownership of adjacent airports.
- 6.23 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 affect prices and quality of service, or may delay or impede investment due to the lack of incentive for the airports to compete against each other because of business stealing effects. For example, a decision to expand at one of these airports would be expected to take into account the potential business stealing effect on the other.
- 6.24 During our consultation BAA asserted that there was no evidence of underinvestment in Scotland. We agree that there is little evidence before us to suggest this has occurred. This does not detract, however, from the evidence we present below on the potential impact of joint ownership on pricing at Scottish airports.

Service quality

- 6.25 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.¹²⁶
- 6.26 BAA told us that quality of service at its Scottish airports compared well to Manchester. It further felt that there is no evidence that there is any link between quality of service and competition between airports.
- 6.27 On the issue of the link between quality of service and competition, we agree we have no specific evidence linking quality of service at the Scottish airports and competition. We consider there is a great deal of evidence from all sectors and over many years that healthy competition can lead to improvements in quality. Nevertheless we are not relying on any evidence in relation to these aspects with respect to the reference in Scotland.

Other issues

- 6.28 Few specific issues were put to us in relation to the Scottish airports during our study. 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

¹²⁶ 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.

contingent on similar services being purchased at Glasgow airport (which is subject to more competition from Prestwick).¹²⁷

- 6.29 We have no other evidence that such bundling occurs, and during our consultation, BAA denied that it does. 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.¹²⁸ The evidence before us does not indicate this occurred. We reach no conclusions on this point, therefore, but it is an open question for the CC.
- 6.30 In its consultation response, BAA drew our attention to an article in the Scotsman newspaper¹²⁹ in which it was said that easyJet had recently obtained a good deal from BAA. We asked easyJet to comment. It told us that the deal received from BAA from Edinburgh was poorer than Glasgow and that the article was incorrect on certain key points.
- 6.31 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.

¹²⁷ 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.

¹²⁸ See OFT414a, Assessment of conduct: draft competition law guideline for consultation, April 2004, paragraphs 5.9 to 5.13.

¹²⁹ 19 December 2006.

7 OTHER ISSUES PUT TO US DURING THE STUDY

7.1 Various other issues were put to us during the course of the market study, some of which attracted further comment during the consultation. 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.

Transport facilities to and from airports

7.2 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. We note that such matters are normally best handled by commercial negotiation, although there is scope for a competition law investigation in the event that the OFT has reasonable grounds to suspect an abuse of dominance, and subject to meeting the OFT's prioritisation criteria. The CC considered similar issues on car rentals in its 2002 reports and concluded that no action was necessary at that time. 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.

7.3 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.

7.4 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. The party concerned told us it is preparing a dossier for the CC to consider.

- 7.5 The CC has likewise considered the extent to which unregulated charges at designated airports should be brought within the ambit of the CAA.
- 7.6 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. The CC will be able, if it wishes, to examine such conduct in the context of the market investigation reference. The OFT could reconsider whether further action (including the possibility of action at non BAA airports) was merited based on the CC's findings.

The system of economic regulation

- 7.7 The CAA has expressed concern to the OFT that the current system of regulation is not fit for purpose. As noted in paragraph 3.28 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, for example IATA echoed the CAA's phrase in its consultation response, and was also critical of certain CAA proposals, which are beyond the scope of this decision.
- 7.8 The OFT can see merit in the points that have been made to us. Within the scope of a short market study and consultation on reference, the OFT has reached no conclusion on detailed matters relating to the regulatory framework, although we made some high level recommendations in December, to which the Government has responded. We consider 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, and note that recommendations on regulatory change, if warranted, could be an outcome of the CC's investigation. Such recommendations as are made may need to be informed by the impact of any other remedies.

Access to London Heathrow by US Carriers

7.9 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 topic.¹³⁰
- 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

7.10 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.

7.11 We received a submission from a property investment and development company ('Company A') which was concerned how the scope of an 'operators' functions' would be interpreted in the event of a dispute. We note that BAA has, in the past, developed a range of commercial

¹³⁰ OFT 832, Competition issues associated with the trading of airport slots: A paper prepared for DG TREN by the OFT and Civil Aviation Authority, June 2005. Available at: www.of.gov.uk.

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.

- 7.12 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 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 asset¹³¹ 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.
- 7.13 During our consultation on the proposed decision we received a confidential submission from a second, unrelated, company which supported company A's broad arguments and gave a specific example where the potential for a CPO was an obstacle to commercial use of land outside the boundary of future airport expansion. We have not discussed these examples with BAA in detail for confidentiality reasons, but it did not comment on the points made in the proposed decision in its response to the consultation. We consider them to be sufficiently credible that the present regulatory framework for CPOs could result in a distortion of competition which should be investigated by the CC. Company A suggested this matter should be addressed in a modification to the AA86.

¹³¹ 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.

- 7.14 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.
- 7.15 BAA informed the OFT during its market study 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 State in approving CPOs, and relevant Government advice.¹³² BAA noted that land acquired would be at full market value and said that subsequent increases due to development were irrelevant.
- 7.16 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, 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 is internal or external.
- 7.17 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 note that the complaints only referred to BAA and the

¹³² 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.'

scope of our reference, which includes BAA Lynton, leaves it open to the CC to examine this issue in more depth.

Pricing of airline tickets, refunds and Air Passenger Duty

- 7.18 We received a small number of submissions in the market study from individual consumers who were concerned in particular about the overall price of airline tickets, refund policies and Air Passenger Duty (APD).
- 7.19 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 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.
- 7.20 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.
- 7.21 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.
- 7.22 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

- 7.23 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. We received some further complaints about quality during our consultation on the proposed reference, as described in Annexe B.
- 7.24 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.
- 7.25 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.
- 7.26 We received one complaint during the consultation period about the price of BAA's Heathrow Express service. We have not reached any view on this particular issue as our decision does not turn on this.

General aviation

7.27 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 review¹³³ 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 further.

Planning and environmental issues

7.28 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 appropriate for OFT to comment on individual decisions to grant or deny planning permission. Some respondents to our consultation stressed the importance of environmental issues to us. We do not disagree, but can only review issues that fall within our remit.

¹³³ CAA, Strategic review of general aviation in the UK, July 2006.

8 DECISION ON REFERENCE

- 8.1 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.
- 8.2 Reasonable grounds to suspect is a relatively low threshold, reflecting the OFT's role as a first phase investigator. Following publication of our proposed decision, BAA's response claimed that the OFT had not made a 'compelling case for reference founded on a robust analysis of the market'. We reject this to the extent that a 'compelling case' implies a higher standard of proof than the legal test requires.¹³⁴
- 8.3 BAA also stated that two of the features we identified, capacity constraints and regulation, were outside of its control. It is not necessary for features to be within the control of an individual party for them to be included within the terms of a reference made under section 131.
- 8.4 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 5 and 6 covers both together,

¹³⁴ The threshold for reference was discussed in [2005] CAT 36 in the context of an appeal against an OFT decision not to make a market investigation reference. OFT has also taken account of the CAT's view on 'reasonable grounds to suspect' in the CA98 context see www.catribunal.org.uk/documents/Tran1073Bran280406.pdf, page 19, lines 24-28 in case 1073/2/1/06.

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

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

- The existence of development restrictions and capacity constraints (paragraphs 5.4 to 5.16).

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 5.51 to 5.127).

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 in spite of current capacity constraints and development restrictions 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 and BAA's submissions about its investment programme. 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 5.17 to 5.50).

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.

- 8.6 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.
- 8.7 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 perhaps 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,¹³⁵ the approach to market definition, and the analysis of

¹³⁵ 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.

competition issues are substantially similar. We do not rely on this hypothetical, but we regard it as a useful cross-check that the feature of joint ownership may prevent, restrict or distort competition.

- 8.8 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 (see paragraph 3.33). 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

- 8.9 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.

- 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, we have reasonable grounds to suspect that competition from Prestwick has 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.

- 8.10 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.

Other issues raised with us

8.11 Chapter 7 describes a wide range of other issues that were raised with us either during the market study or in responses to the proposed decision. These were peripheral to our study, and we have accordingly not considered these matters in much detail. We highlight the issues raised in relation to Compulsory Purchase Orders as being potentially relevant to the enquiry into whether and how the regulatory framework may prevent, restrict or distort competition.

Appropriateness of a reference

8.12 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:¹³⁶

- 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.
- 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.

¹³⁶ OFT511, 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.1.

- Undertakings in lieu – it would not be more appropriate to address the problem identified by means of undertakings in lieu of reference.

8.13 These four factors are considered below.

Proportionality

8.14 BAA was concerned that a CC reference would be a significant burden on public resources and would have a major impact on BAA's (and others) management time. The OFT believes a reference would be proportionate given:

- **the scale of the problem.** This is a large market both in terms of monetary value¹³⁷ and in terms of its effect on wider UK productivity.¹³⁸ Chapter 3 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 % 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 features giving rise to the adverse effect on competition are likely to be persistent.** There is no indication that BAA currently intends to divest any of the airports that cause us concern. A market

¹³⁷ UK airports' annual turnover was reported as £2.8 billion in 2005 by Keynote.

¹³⁸ For example see, BAA, Issues brief: Economic benefits of aviation, November 2004. Available through www.baa.com

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. Regulation and development restrictions and capacity constraints similarly do not appear likely to be short lived issues.

- **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 provided an opportunity for BAA to make further representations but BAA did not address this specific point.

Furthermore, we note that if the CC finds an adverse effect on competition, and remedies it, or makes recommendations to government in respect of regulation, these might reasonably be expected to result in benefits to society which exceed the direct and indirect costs of the reference.

- 8.15 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 announcement¹³⁹ 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.

Availability of remedies

8.16 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 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 and BAA 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.¹⁴⁰ 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

¹³⁹ OFT press release of 25 May 2006

¹⁴⁰ Civil Aviation Authority, Competitive provision of infrastructure and services within airports, Consultation document, February 2001 (Responses available through www.caa.co.uk)

airport in New York where a terminal was built and operated by a private consortium in competition with other terminals at that airport

- **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.

- 8.17 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.
- 8.18 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.
- 8.19 The high barriers to new entry and barriers to expansion created by development restrictions (described in Chapter 5) are less amenable to remedy. The planning system balances conflicting interests. Following the reference, 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.
- 8.20 The OFT has not reached any conclusions on whether a break up of BAA would be an appropriate remedy to the competition issues we have identified. Following the reference, the CC will perform an independent investigation and reach its own conclusions on remedies if it finds they are needed.
- 8.21 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 in submissions to our study and during our consultation on a proposed reference. We are satisfied that potential remedies exist.

Alternative Powers

- 8.22 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 current 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 rules¹⁴¹
 - the OFT's powers to conduct a market study.
- 8.23 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. As part of this review the CC will consider whether BAA (as the airport

¹⁴¹ See paragraph 2.7 of the OFT's guidance on Market Investigation References

operator) has pursued any course of conduct¹⁴² 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 propose remedies to problems identified.¹⁴³ However we do not believe that this provides a substitute for a market investigation reference. The CAA/CC review takes place 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.¹⁴⁴ 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

¹⁴² 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).

¹⁴³ 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.

¹⁴⁴ 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.

something that the CC will consider following the 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: 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.¹⁴⁵ 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. We note that BAA itself had concerns about the regulatory framework.

8.24 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. Almost all

¹⁴⁵ OFT511, 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.8.

respondents to our consultation supported a reference, with only one body (BAA) clearly against.

Undertakings in lieu of a reference

- 8.25 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. BAA has not offered undertakings in lieu of a reference.

Conclusions on the case for a reference

- 8.26 Taking account of the relevant factors outlined in the OFT's guidance document on market investigation references, and the representations received, we have concluded 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.

Scope of Reference

- 8.27 BAA's consultation response opined that 'the OFT has a duty to protect consumers – in this case passengers. ...Therefore if a reference is made, it is incumbent on the OFT to set terms of reference which allows for the CC to consider and where possible address issues around airlines' market power...'.¹⁴⁶ BAA was also concerned that any remedies might impact at other levels of the value chain and stated that 'It would be an error to ignore the market position of airlines at Heathrow, which, unlike

¹⁴⁶ BAA/OFT/73, paragraph 9.

BAA, control slots at that airport, and the implication of this for potential competition between our South East Airports.'¹⁴⁷

- 8.28 Airlines were not the subject of the market study and proposed reference decision. The CC can take account of the effects of airline market power in examining airport competition issues without them being specifically included in the terms of reference. It will also consider wider impacts if it is proposing to remedy any adverse effects it finds. The OFT has recognised that ongoing control of slots is a consequence of EC regulation which can affect the scope for new entry at airports. As noted in the proposed decision (paragraph 11.9) the OFT and CAA have given advice to the EC on the rules governing slot allocation within the last year and we understand the scope for reform is being actively considered.¹⁴⁸ Nevertheless the CC could examine this issue insofar as it is pertinent to competition between airports.
- 8.29 The OFT does not have reasonable grounds to suspect airlines of preventing, restricting or distorting competition at BAA airports, nor has BAA provided any detailed evidence to this effect. We therefore disagree that it is 'incumbent on us' to include airlines within the scope of the reference.
- 8.30 BAA also asked us to exclude Southampton and Aberdeen airports from the geographic scope of the CC reference.
- 8.31 Section 133(1) of the Act requires the OFT to specify the terms of the reference. Section 133(2) gives the OFT the power (but not a duty) to frame a market investigation reference so as to limit the scope of a CC investigation by reference to the place where goods or services are supplied or acquired.

¹⁴⁷ BAA/OFT/73, paragraph 10.

¹⁴⁸ OFT832, Competition issues associated with the trading of airport slots: A paper prepared for DG TREN by the OFT and Civil Aviation Authority, June 2005. Available at: www.of.gov.uk.

8.32 We do not consider it appropriate to use this power in this case to confine the CC's investigation to the effects of features of the market for the supply of airport services by BAA at particular airports. As a first phase investigator the OFT reaches only preliminary conclusions on market definition, including geographic market definition. The CC conducts a completely fresh investigation, gathering fuller evidence, and has the scope to reach different conclusions. If we limited our terms of reference as BAA suggests and the CC reached a broader market definition, the only way to proceed would be for the OFT to vary the terms of reference. This would add to the cost and administrative burden of the reference for all involved. We are therefore making a reference of the supply of airport services by BAA in the United Kingdom. The terms of reference are given at Annexe A.

A TERMS OF REFERENCE

The OFT, in exercise of its powers under sections 131 and 133 of the Enterprise Act 2002 (the Act), hereby makes a reference to the Competition Commission for an investigation into the supply of airport services in the United Kingdom.

In accordance with section 133(2) and (3)(b) of the Act the Competition Commission shall confine its investigation to the effects of features of such market or markets for airport services in the United Kingdom as exist in connection with the supply of airport services by BAA.

The OFT has reasonable grounds for suspecting that a feature or a combination of features of the market or markets in which airport services are supplied by BAA prevents, restricts or distorts competition in connection with the supply of airport services in the United Kingdom.

For the purposes of this reference:

'airport services' means all airport services whether they are supplied to airlines, ground handlers, passengers or any other person and includes all or any of the following:

- (a) the provision of airport infrastructure services (including the development, maintenance, use and provision of access roads, runway facilities, fuelling facilities, taxiways, aprons, stands, loading bridges, piers and gaterooms, check-in and arrivals concourses, check-in desks, customs and immigration halls, baggage facilities, passenger care facilities, lifts, escalators, passenger conveyors, terminal offices, ramps, and other airport structures);
- (b) the co-ordination and control of the activities performed on or in airport infrastructure and the provision of associated services including security services; and
- (c) the provision (including the provision by persons other than BAA under arrangements made with BAA) of associated commercial services (including catering services, retail services, car rental services, the sale of

advertising space, the provision of car parking, and activities relating to commercial property).

'BAA' means the group of interconnected bodies corporate directly or indirectly owned or controlled (including by way of material influence) by Airport Development and Investment Limited which (from time to time) own and/or operate Heathrow, Gatwick, Stansted, Southampton, Edinburgh, Glasgow and Aberdeen airports, the World Duty Free business, and the BAA Lynton business, and which (from time to time) own and/or operate any other business providing airport services in the UK;

'control' and 'material influence' shall be construed in accordance with section 26 of the Act; and

'group of interconnected bodies corporate' shall be construed in accordance with section 129(2) of the Act.

Dated:

Signed:

B SUMMARY OF CONSULTATION RESPONSES

B.1 Following publication of the Proposed Decision, the OFT received 62 consultation responses.

Table B.1:

Type of Respondent	
Individuals	37
Airlines and airline associations	11
Airport and airline consultative committees	3
Airports	1
Other organizations	10
Total	62

B.2 Most of the responses from individuals were concerned about the quality of service and facilities at Heathrow airport, although some were also concerned about other BAA airports. For example, we received two complaints about Aberdeen airport. One from a consumer who was concerned with the price of car parking and the layout of the terminal and one concerned with the provision of taxi services.

B.3 Respondents were critical of a range of aspects of performance, particularly highlighting the time taken for coaching, security screening and baggage reclaim. They were also highly critical of facilities that were not working, or those perceived as dirty or below standard. Many respondents were regular travellers who felt that BAA airports gave a poor impression of the UK and compared unfavourably with airports overseas. Those who expressed a view favoured a reference and believed government, the OFT or the CAA should do something, such as setting tougher quality standards.

B.4 We cannot be certain if the comments received are representative of all passengers, as we are more likely to have heard from those with negative views. Security issues are discussed in Chapter 5. Baggage reclaim times initially depend on the efficiency of the airline's chosen

ground-handling companies in unloading aircraft and getting baggage to the reclaim area. Reclaim times are also affected by airport congestion, however. The capacity of baggage reclaim areas and their state of decoration are within BAA's control, subject to considerations of overall space allocation constraints. The OFT has not been able, in the time available, to assess the validity of these complaints, but notes they are not inconsistent with the findings of independent quality surveys (see Chapter 5). BAA told us¹⁴⁹ that 'it is aware that its record on quality of service could be improved, especially in the South East, and is currently undertaking record investment to improve the passenger experience at its South East airports.

- B.5 All other significant issues have been addressed in the relevant part of this decision.

¹⁴⁹ The BAA submission, BAA/OFT/73, was also published on its web site.

C SLOT DEMAND AT HEATHROW, GATWICK AND STANSTED

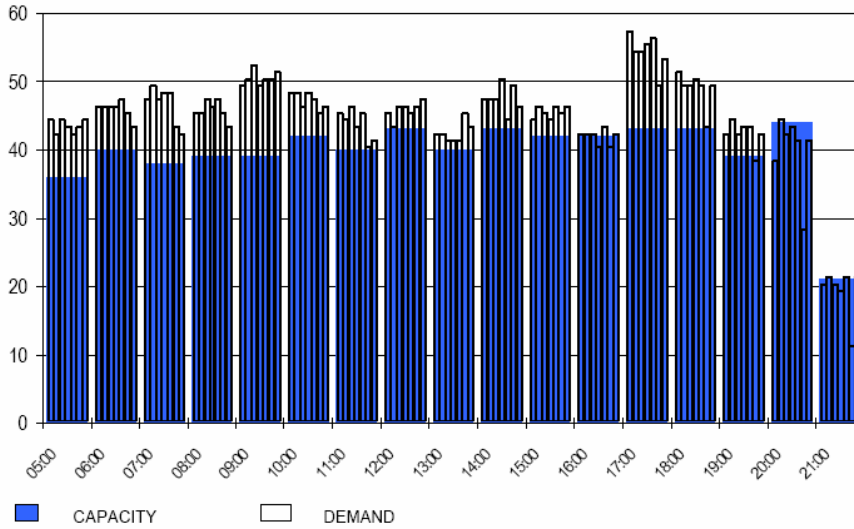
C.1 BAA provided us with the following five charts based on ACL data, all five refer to the Summer 2006 season:

- 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

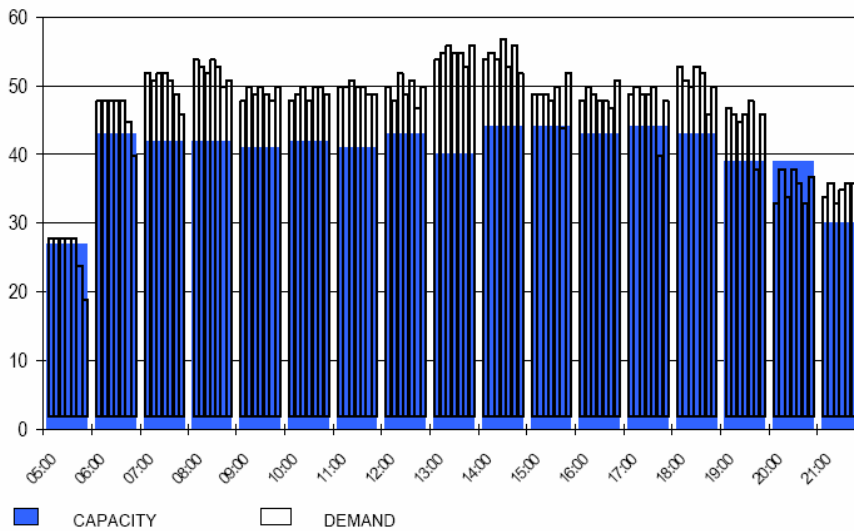
RUNWAY MOVEMENT DEMAND - ARRIVALS

Peak Week Movements per Hour - All times UTC



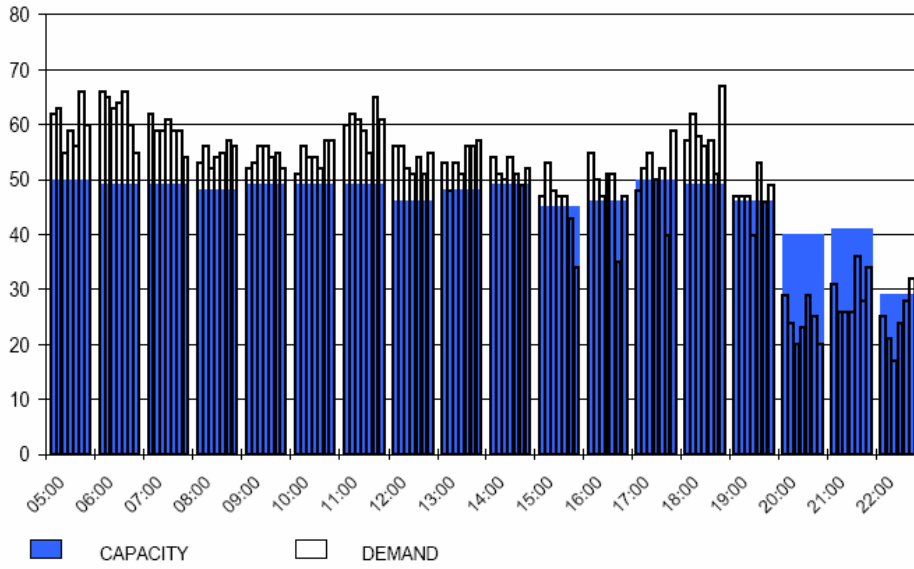
RUNWAY MOVEMENT DEMAND - DEPARTURES

Peak Week Movements per Hour - All times UTC



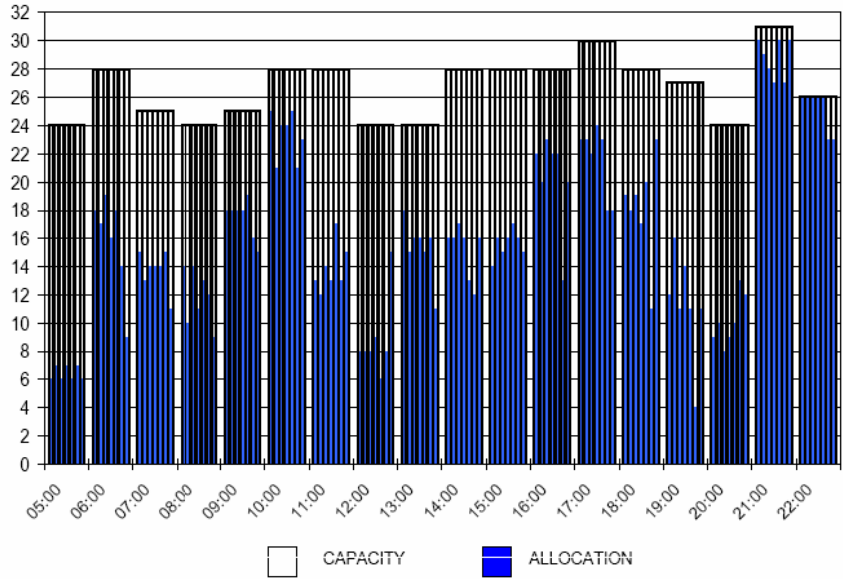
Gatwick

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

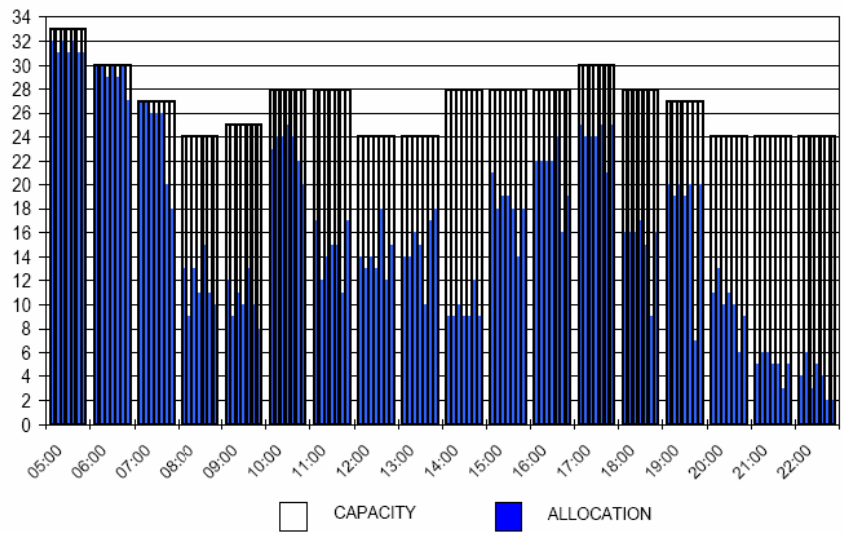


Stansted

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
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)
LGW	London Gatwick airport (BAA)
LHR	London Heathrow airport (BAA)
LTN	London Luton airport (owned by Luton council, but privately operated by Abertis – under a 30 year concession)
MIR	Market investigation reference to the CC under Part 4 of the EA02
mppa	Millions of passengers per annum. A standard 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
SACC	Stansted Airline Consultative Committee
STN	London Stansted airport (BAA)
Trips	This term is used throughout the decision to refer to individual passenger journeys by aircraft