Market Power Test Guidance (CAP1354, CAP1355)
Gatwick Airport Limited's
Response to Consultation

A. Introduction

1. Gatwick Airport Limited ("**GAL**") welcomes the opportunity to respond to the CAA's "Market Power Test Guidance – Draft for Consultation" (CAP1354 and CAP1355).

2. In sections B to E below, GAL responds to the four questions posed by the CAA in CAP1355.

3. In the remainder of this introductory section, GAL wishes to highlight two over-arching themes which it believes should be incorporated into the final version of the Guidance.

4. First, GAL believes that the final version should reflect the path to deregulation which is evident from both the Civil Aviation Act 2012 ("**the Act**") and the Competition Commission's ("**CC**")[1] report in BAA.

   (a) Taking the Act first, under s. 1(3), the CAA is required, in performing its duties under s. 1(2) and (3), to have regard to a list of considerations, one of which is that "*regulatory activities should be targeted only at cases in which action is needed*." This deregulatory intent – which was a central policy underlying the Act – is also reflected in s. 104 (which imposes a duty on the CAA not to impose or maintain unnecessary regulatory burdens) and the inclusion by Parliament in the Market Power Tests of Tests B and C.

   (b) The CC's report on BAA is crucial because it resulted directly in Gatwick, Heathrow and Stansted being in separate ownership and it

[1] Now the Competition and Markets Authority ("**CMA**").

underpins the Act. In its report, the CC stated: "*we strongly support the reduction and in due course the removal of regulation, as competition develops.*"[2] It expected regulation to continue only for a "*transitional period at Gatwick and Stansted*"[3] but said that it was "*difficult to predict precisely how and with what speed competition will develop*" and that, accordingly, there "*may*" need to be some form of regulation beyond Q5.[4] As it turned out, the CAA determined that GAL did need some form of regulation beyond Q5; but GAL believes that the final version of the Guidance should better reflect the deregulatory intent of Parliament in the Civil Aviation Act 2012 and the CC's intent that regulation should be removed as competition develops., . 5.We note that all CAA papers on market power prior to the enactment of the CAA 12 have been withdrawn. The CAA guidance published in 2011 usefully added to the general guidance referred to in s. 6(10) of CAA 12 and was the direct result of the large body of work that the CAA carried out prior to publication of the 2011 guidance, including liaising with industry working groups, passenger research, papers by leading experts and working papers on areas such as catchment overlap and empirical methods. GAL believes that the previous guidance had a good grounding in competition law and was underpinned by economic analysis and should be reflected in the new guidance. There is no good reason why such previous guidance should be dispensed with absent some fundamental change or development.

5. Specifically, when the CAA's draft Guidance discusses geographic market definition, it does so in three short paragraphs (paras. 4.19 to 4.21),[5] adding little, if anything, to the general guidance, even though geographic market definition is of central importance to market definition for airport services. It was central to the CC's decision to require divestments that the three BAA airports in London and the South East were significant actual or potential

2 Para. 10.344.
3 Para. 10.339.
4 Para. 10.338.
5 A significantly shorter section than that devoted to the much more theoretical account of the Hypothetical Monopolist Test at paras 4.23 to 4.26.

competitors to one another: if they were not, there would have been no need for the forced sales. Yet the CAA's Market Power Determinations took a narrower approach. Notwithstanding this significant divergence, the draft Guidance does not explain how the CAA will approach this issue in future.

6. The same analysis applies to the discussion of the product market, which now occupies just two brief paragraphs of the draft Guidance, and does not add in any respects to the general guidance.

7. This is not an issue that can simply be deferred until future Market Power Determinations because the methodology to be adopted will affect the question of whether there is a material change of circumstances. If (purely for illustration), the CAA will rely exclusively on factor X in determining the relevant geographic or product market, then changes affecting factors Y and Z will not give rise to a material change of circumstances; whereas if the CAA will rely principally on factors X, Y and Z, then changes affecting factors Y and Z, will, if sufficiently significant, give rise to a material change of circumstances. It is therefore important to identify at this stage those principal factors.

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

(i) Test A

8. Test A is that the relevant operator has, or is likely to acquire, substantial market power in a market, either alone or together with such other people as the CAA considers appropriate.[6]

9. In para. 4.5 of the draft Guidance, the CAA cites CAP1235, which notes that when assessing market power at an airport as a whole, the CAA will usually consider the overall bundle of AOS services and then determine the relevant market in which the airport offers those services. This approach (with which GAL agrees) is in contrast to paras. 4.18 and 4.22 of the draft Guidance,

[6] S. 6(3).

which indicate that the CAA might adopt narrower market definitions (by groups of customers and by time).

10. Paras 4.23 to 4.26 discuss the hypothetical monopolist test. As noted in para. 4.23, the test is applied using a SSNIP above the competitive price level. It would be useful to record at this point in the draft Guidance that the competitive price level in the supply of airport services is not necessarily the regulated price: the competitive price level may be higher than a price implied by an assessment of reasonably incurred costs and, specifically, may reflect the scarcity value of well-located airport assets. If the SSNIP test is applied to a price which is below the competitive price level, there is a risk of a "*reverse cellophane fallacy*" where the market is defined too narrowly because customers are unwilling to switch in response to a hypothetical price increase when they currently benefit from prices that are below the competitive level.

11. Paras 4.27 to 4.35 of the draft Guidance explain the CAA's approach to assessing market power. GAL believes it would be helpful to add a paragraph explaining that the assessment of market power will take account of the constraints *in aggregate*, with the consequence that a series of constraints may mean that an airport does not have market power even though none of the constraints taken individually would be sufficient to support such a conclusion.

12. In para. 4.36, the CAA raises the question of how it should assess an airport's behaviour and performance when the airport is subject to regulation. It would be useful at this point to distinguish between "traditional" regulation on the one hand, and regulation which is essentially supportive of contractual commitments agreed between an airport and its airline customers on the other. In the latter case (which covers the position of GAL), the operative cause of the airport performing in line with its contractual commitments is the contractual commitments themselves, not the supporting regulation. Similar points would apply to other non-traditional forms of regulation generally where the drivers to performance are other than the form of regulation chosen.

(ii) Test B

13. Test B is that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that substantial market power.[7]

14. In contrast to Test C, Test B does not include the words "*for users of air transport services*". If Parliament had intended Test B to be applied from the perspective of "*users of air transport services*" it could readily have included in Test B the words that it included in Test C. In the absence of such words, Test B is not to be applied from the perspective of users of an air transport service; rather, the words of Test B are to be applied as they are written. GAL therefore disagrees with paras 5.5 and 5.6 of the draft Guidance.

15. Test B is intended to reflect the de-regulatory intent identified in section A above. It must have a meaning independent of Test A, i.e. there must be realistic situations in which Test B is not satisfied even though Test A is satisfied; otherwise Parliament would not have enacted it. GAL believes that the draft Guidance should be amended to give Test B the independent significance that Parliament evidently intended. (As the draft Guidance stands, having identified excessive pricing and reduced service as the greatest likelihood of abuse and as the types of abuse with which competition law is least well equipped to deal, it is difficult to envisage circumstances in which Test A would be satisfied but Test B would not.)

16. Test B is concerned with the question of whether an airport operator with substantial market power might be able to <u>abuse</u> that market power without being constrained by competition law. It is not concerned with conduct that the CAA may regard as harmful to passengers and cargo owners but which is not an abuse within competition law. Two points follow from this.

17. First, the CAA cannot lawfully find that Test B is satisfied because of concerns that passengers and cargo owners may otherwise be harmed by conduct, if that conduct does not amount to an abuse of substantial market power. It is therefore an error to say in the draft Guidance at para. 5.21 (and similarly in

[7] S. 6(4).

para. 5.28) that "*there is likely to be a range of price (or service quality degradation) between what we may seek to regulate (as proxy for the competitive price) and what may be defined as 'excessive' or 'abusive' under competition law.*" As O'Donoghue & Padilla explain, in order to prove an excessive pricing abuse, it is necessary "*to show that prices are significantly above the 'competitive' benchmark*".[8] It follows that there is a range of prices that are above the "competitive" level, but are not abusive. Crucially, Parliament has not given the CAA powers to intervene to regulate such prices. Parliament was concerned only with the regulation of prices that would be abusive, i.e. *significantly* above the "competitive" benchmark.

18. Secondly, in enacting Test B, Parliament did not require or invite the CAA to assess the quality of the case law of the European and UK courts on abuses of a dominant position arising from excessive pricing or service quality degradation. Rather, Test B assumes that the law on the different categories of abuse is what it is, and requires the CAA to consider whether competition law provides sufficient protection against the risk of infringement. This calls for an analysis of the likelihood of detection and enforcement (by public authorities or private litigants) and the consequences for the airport operator (fines, damages payments, reputational issues) and, closely related, the deterrent effect on the airport operator: see, by analogy, Tetra Laval BV v. Commission.[9] GAL therefore disagrees with the CAA's approach in para. 5.21.

19. Relatedly, Test B is concerned with the real world question: does the CAA need to regulate, or does competition law adequately protect against the risk of abuse? It is not concerned with a hypothetical question: imagine that the ACRs and AGRs did not exist; would competition law then provide adequate protection? GAL disagrees with the CAA's proposal in para. 5.11 (and para. 2.32) to focus on the hypothetical, rather than the real-world, question. This is important, as the real-world question in respect of excessive pricing becomes:

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8 "The Law and Economics of Article 102 TFEU", 2nd ed., 2013, Hart Publishing, p. 755. Emphasis added.

9 Case T-5/02 [2002] ECR II-4381 at [159], considering whether competition law would adequately protect against a merged group pursuing a particular strategy.

given the existing prohibitions on discrimination, what scope is there for an airport operator to engage in excessive pricing and, if such an airport operator were to do so, would competition law provide adequate protection? Indeed, the draft Guidance itself rightly takes account of the ACRs under Test B in para. 5.20, i.e. para. 5.20 rightly asks itself the real world, not the hypothetical, question.

20. Finally, in para. 5.25, the draft Guidance states that the CAA will consider prior competition law action that the CAA has taken against airlines. GAL believes that this should be widened also to cover action taken by the CMA (as the heading to the paragraph states) and private actions (whether by airlines, other users or others) and to cover action under the former s. 41 of the Airports Act 1986. All forms of prior enforcement are capable of affecting airports' conduct in future and the guidance should make clear that all will be considered.

(iii) Test C

21. Test C is that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.[10]

22. The draft Guidance states that "*Test C focuses on whether an economic operating licence has more benefits than our non-licence powers*": para. 2.32, second bullet. GAL respectfully disagrees. Test C focuses on a comparison between the benefits of regulation and the adverse effects of regulation. GAL agrees that identifying the benefits of regulation requires a comparison with the position if the airport operator is not licensed; but this is not "*the focus*" of Test C. Parliament included Test C to ensure that there was not a tendency to over-regulate and it is important, therefore, that the test focuses on a comparison between the benefits of regulation and the adverse effects of regulation. (See also paras 6.24, 6.39 and 6.40 of the draft Guidance.)

[10] S. 6(5).

23. In para. 6.17, the draft Guidance states that "*We consider that a generic licence is the appropriate counterfactual as Test C considers the imposition of regulation, not its intensity*". GAL considers this approach appropriate when an airport is not licensed at the time of the market power assessment. However, if an airport *is* already licensed, the issue is whether it should cease to be licensed and the relevant real-world comparison must therefore be with the actual licence. It would be deeply strange in such a case for the CAA to find that Test C was satisfied when considering a generic licence as the counterfactual, if it would not have been satisfied had the actual licence held by the airport operator been considered as the counterfactual: the airport operator would continue to be subject to a licence even though the adverse effects *of that actual licence* outweigh the benefits *of that actual licence* because the CAA engaged in a "thought experiment" about a different generic licence not held by the airport operator.

24. In para. 6.18, the draft Guidance refers to the CAA considering the behaviour of a licensed airport operator under its current economic licence "*for example where it has developed extant agreements with third parties that are not linked to regulation through its current or any potential future economic licence*." GAL believes that this wording needs to be changed. GAL, of course, has an array of bilateral contracts and a set of commitments. These are "*linked to*" regulation in the sense that its licence refers to them. But the bilateral contracts and the commitments exist independently of the CAA licence: the licence is supportive of the contracts and commitments, but the operative cause of GAL complying with the contracts and commitments is those documents, not its licence with the CAA. Thus, a test of "*not linked to*" is too narrow. GAL suggests instead "*extant agreements with third parties that exist independently of regulation through its current or any potential future economic licence*".

25. In para. 6.20, the draft Guidance states that one of the benefits of economic regulation is that "*prices charged are cost-reflective*". This in itself makes a presumption as to the form of economic regulation and runs contrary to the statement in paragraph 6.9. that Test C is not to be applied to a specific set of

licence conditions. The Act empowers the CAA to regulate the prices of an airport operator with SMP to prevent an abuse (ss. 18(1)(a) and 19(2)). The CAA is therefore only authorised to prevent the charging of abusively excessive prices. In many industries, and certainly in airport operation, prices would not be abusive merely because they exceed costs: the legal question is whether the price bears no relation to the economic value of the product, as discussed in Port of Helsingborg.[11]

26. Para. 6.20 identifies (unqualified) benefits from economic regulation in terms of prices, efficiency, service quality and investment along with (more tentative) "other potential" benefits including operational resilience and financial resilience.[12] By contrast, when discussing adverse effects of regulation, the only (unqualified) adverse effect is time and expenditure on the regulatory process and the other factors are subject to the more tentative "other potential" wording. There should be specific references to cost rigidity, potential displacement of commercial relationships and interface costs.

27. Some of these adverse impacts of regulation were highlighted by in a speech given by CMA Chief Executive, Alex Chisholm, at the Bundesnetzagentur conference in Bonn 27th October 2015 where he stated

> "The potential costs of ex ante regulation should be carefully considered. For instance the cost of compliance with certain ex ante regulations can be substantial. Premature ex ante regulation can not only impose substantial direct compliance costs, but can also reduce potential competition. " and
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> "Ex post tools have the inherent advantage of being more targeted and proportionate by examining the extent to which actual harm may have occurred based on empirical evidence on a case-by-case basis."

28. If the issue is formulated as set out in paras 6.20 to 6.25 of the draft Guidance, it is difficult to envisage circumstances where Test C would not be satisfied. Yet Parliament clearly intended Test C to be of practical

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11 Case COMP/A.36.568/D3, Scandlines Sverige AB v. Port of Helsingborg, Commission Decision of 23 July 2004.

12 As to operational resilience and financial resilience, airport operators have huge incentives to remain operationally and financially resilient and in few, if any, instances could operational and financial resilience be described fairly as a benefit of economic regulation.

significance (not as a test that would always be satisfied if Test A were satisfied) and this was consistent with the deregulatory objectives evident from other provisions of the Act and reflecting the CC's report on BAA: see section A above. GAL suggests that the CAA's guidance on Test C needs to be rebalanced so that it does not reflect a preference for regulation over deregulation and gives greater weight to the undoubted adverse effects arising from regulation, taking account of the CAA's duty to promote competition and the potential for regulation to adversely affect the promotion of competition.

(iv) Standard of proof

29. The draft Guidance discusses the standard of proof in paras 2.33 to 2.35.

30. GAL agrees that the relevant standard is the balance of probabilities. However we question whether paragraph 2.34 and 2.35 have any relevance to guidance on how the CAA intends to apply the Market Power Test

31. There is no potential finding of "guilt" under the Market Power Test and citations referring to the "presumption of innocence" do not seem appropriate to GAL: para. 2.34.

32. Similarly, GAL questions the relevance of authorities on the duty of a public authority to make inquiries, or regarding challenges to its appraisal of conflicting evidence (fn. 23 to para. 2.34 and para. 2.35).

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

33. GAL believes that the Guidance should reflect the clear steer from the CC in BAA, namely that "*we strongly support the reduction and in due course the removal of regulation, as competition develops.*"[13] It expected regulation to continue only for a "*transitional period at Gatwick and Stansted*"[14] but said

[13] Para. 10.344.
[14] Para. 10.339.

that it was "*difficult to predict precisely how and with what speed competition will develop*" and that, accordingly, there "*may*" need to be some form of regulation beyond Q5.[15]

34. It follows that the development of competition to GAL would be a material change of circumstances, and that the CAA should not set an unduly high bar in applying the "material change of circumstances" test.

35. More generally, GAL agrees that it is neither possible nor desirable for the CAA to seek to set out an exhaustive statement of circumstances that would amount to a material change of circumstances. Rather, in addition to the points already mentioned, the approach adopted in para. 3.5 of the draft Guidance seems broadly correct ("*We consider that a change of circumstances needs to be material in areas that are likely to be relevant to Tests A to C*"). GAL's only other proposal is to change the words "*needs to be*" in this quote so that they read: "*would exist if the change is, or the changes together are*". This change would make clear that this is a sufficient, rather than a necessary, test.

36. Finally, the question of whether there has been a material change of circumstances is one of fact; it is not an issue of "*regulatory judgement*" as suggested in para. 3.6 of the draft Guidance.

D. <u>Question 3: Have you any comments on our proposed process for undertaking MPDs in the draft guidance?</u>

37. Para. 2.45 states that, in some cases, the CAA may decide to begin the process of developing a licence alongside the MPD. GAL believes that the two processes should be sequential to guard against the risk that the ongoing work on the licence conditions taints the MPD. A comparison might be drawn, in a criminal law context, with the inappropriateness of considering sentence alongside the assessment of guilt. Furthermore this would be inconsistent with the logical structure of the CAA 12 referred to in paragraph 6.9, namely the

[15] Para. 10.338.

decision of whether to impose a licence should be made before determination of the individual licence conditions.

38. As to the proposal in para. 3.14 that the CAA should have a non-binding target of 18 months to publish an MPD decision, GAL believes that 18 months should be the very outside limit.[16] One way to achieve this would be to apply informally an approach similar to that under the Enterprise Act 2002, under which the CAA would adopt a 12 month limit that could be extended if required by a maximum of six further months.

39. Para. 3.29 says, in respect of confidential information, that it will only be "*shared more widely, where to do so would, in our view, be appropriate in the circumstances*". This seems to GAL a rather vague and unconstrained approach, given that the confidential information held by the CAA might be very sensitive. GAL suggests that the guidance more closely reflects the provisions concerning confidential information in s. 59 and Sch. 6 of the Act.

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

40. As noted in the Introduction above, GAL believes that the final version of the Guidance should reflect the path to deregulation that is evident from both the Act and the CC's report in BAA and should provide practical guidance on how the principles set out in the general guidance published by the European Commission and the CMA will be applied under the Market Power Test.

[16] Any appeals might extend the time period.