APPENDIX G

Evidence and analysis on indicators of market power

Introduction

G1 The examination of indicators of market power can provide insight into whether or not an airport operator has substantial market power (SMP). While individual indicators of market power on their own may not be determinative of market power (as each may suggest slightly different assessments), when considered as a whole, they help to determine whether or not an airport operator has SMP.

G2 In this appendix, the CAA assesses the evidence on indicators of market power and considers whether it suggests that Stansted Airport Limited (STAL) has or does not have SMP in the relevant market comprising airport operation services to passengers.[1]

G3 Since the release of the Stansted market power assessment: Developing our 'minded to' position (the minded to Consultation), the CAA has reconsidered how it has defined the relevant market (see appendix D).

- The CAA now considers that it is unlikely that separate markets by airline business model are appropriate. However, in reaching this conclusion the CAA is mindful that there are significant operational differences between low cost carriers (LCCs) and full service carriers (FSCs) that affect their substitution opportunities.
- The CAA has also reached its final conclusion with respect to the definition of the relevant geographic market for STAL and now considers that the relevant geographic market area comprises Stansted, Luton and Southend airports.

G4 Since the release of the minded to Consultation, Manchester Airports Group plc (MAG) acquired STAL, with the approval of the Competition Commission (CC) in February 2013. MAG has also indicated its intention to compete vigorously with Gatwick Airport Limited (GAL) and Heathrow Airport Limited (HAL) to grow traffic and attract long-haul carriers.[2]

1 STAL's airport operations to cargo airlines are the subject of a separate determination.

2 MAG, Civil Aviation Authority Stansted Market Power Assessment, Interim response of MAG to the

G5 There are a number of indicators of market power that the CAA has considered as part of its market power assessment, including:

- market shares;
- efficiency;
- pricing;
- engagement with airlines and commercial negotiations;
- profitability; and
- service quality.

G6 In interpreting the evidence on the indicators of market power, the CAA recognises that STAL is subject to economic regulation and that its behaviour is likely to be influenced significantly by the regulatory requirements.

G7 As noted earlier, STAL has recently changed ownership. This development, which took place after the release of the minded to Consultation, has added a level of complexity to the analysis of the indicators of market power as:

- Much of the data that was considered in coming to the view on the indicators of market power that was outlined in the minded to Consultation reflected STAL's performance and behaviour under its previous owner (BAA).
- The evidence on MAG's performance and behaviour, especially with respect to efficiency, pricing, and the engagement and commercial negotiations with airlines is fairly recent and as such is more limited in scope due to the relatively short period of time that has elapsed since MAG took ownership of STAL.

Minded to consultation

G8 In the minded to Consultation, based on evidence of STAL's operation under BAA, the CAA examined a number of indicators of market power and concluded that:

- While the individual indicators may each suggest slightly different outcomes, when considered as a whole, on the balance of probability, they suggest that STAL may have SMP.

CAA's 'minded to document', p. 13.

- STAL is likely to acquire SMP in the future, not least due to improving economic conditions and tightening capacity across the London airports.

G9 In coming to this view, the CAA indicated that relatively more weight could be given to some indicators than others. Specifically, the CAA considered that indicators which may carry relatively more weight included price and STAL's approach to its negotiations.

- With respect to price, notwithstanding some heavily discounted prices being offered in negotiations with certain airlines, the CAA considered that the evidence suggested that prices at Stansted may be above the prices charged by other comparator airports and may be above that which would occur in a competitive environment.
- With respect to negotiations, the CAA considered that STAL's approach appeared, in general, to be relatively one sided, with its strategic aims underpinning many of its discussions.

G10 The CAA also outlined that likely future developments in the market, including the imminent divestment of Stansted, and their potential implications would form a key part of its assessment. The CAA acknowledged that one potential implication would be if the new owners of Stansted established different behaviours and relationships with the airlines.

G11 The CAA received seven responses to the minded to Consultation, six of which were relevant to the STAL passenger airline market:[3]

- easyJet;
- GAL;
- MAG (two submissions);
- Ryanair; and
- London Southend Airport Company Limited (LSACL).

G12 Stakeholders raised a number of concerns in response to the CAA's assessment on indicators of market power, including:

- The relevant markets were not correctly defined and therefore the market share analysis that was presented in the minded to Consultation was not appropriate.

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3 These submissions are available on the CAA's website: http://www.caa.co.uk/default.aspx?catid=1350&pagetype=90&pageid=14395.

- The CAA's analysis on profitability measures was flawed. Particular concerns raised included the CAA having inappropriately relied on some data and not considering other relevant data. However, other stakeholders highlighted that STAL's financial performance suggested that it had market power.
- The change in ownership at Stansted had not been fully factored into the minded to Consultation.

G13 To better understand the implications of the change in ownership and other potential material changes on the outcome of the market power test, the CAA released the Stansted Market Power Assessment: consultation on relevant market developments (the additional Consultation).[4]

G14 The CAA received seven responses to the additional Consultation, five of which were relevant to the STAL passenger airline market:[5]

- London First;
- GAL;
- MAG;
- Ryanair; and
- Stansted Airport Consultative Committee (SACC).

G15 The relevant stakeholders' responses to the additional Consultation can be summarised as follows:

- MAG and easyJet considered that the signing of long-term growth deals indicated that STAL does not have SMP and should not be subject to economic regulation.
- Ryanair and SACC considered that the signing of the long-term deals were achieved with regulation in place and that the deals should not be interpreted as the best outcome. They also considered that the CAA's minded to Consultation position that STAL is likely to acquire SMP should be maintained, given there was no structural change in the market.

4 The CAA consulted to give stakeholders the opportunity to make representations on the implications of these changes, or to present new evidence relating to those changes that it would not have been possible for them to present previously. This document is available at: http://www.caa.co.uk/application.aspx?catid=33&pagetype=65&appid=11&mode=detail&id=5807.

5 Non-confidential versions of all these submissions are available on the CAA's website.

CAA analysis

G16 In light of the representations from stakeholders as part of the minded to Consultation and the additional Consultation, the CAA has re-evaluated the evidence on the indicators of market power. The CAA concludes that when taken together, the analysis presented in this appendix, suggests that the rebuttable presumption of SMP established by the market share analysis cannot be maintained. This is particularly true given the signed long-term growth deals that STAL has agreed with its airlines – these deals cover over 90 per cent of the airport's passengers. The CAA's responses to the various issues raised to its consultation are examined below.

G17 The CAA received many responses to the minded to Consultation and the additional Consultation. It has carefully read and considered all the points made in each response. This final decision contains summaries of, and answers to, the key points raised.

G18 The CAA has analysed the issues raised in the additional Consultation, in the light of stakeholders' responses. This analysis is presented in the discussion on STAL's approach to engagement with airlines and commercial negotiations.

Market shares

G19 Evidence on market shares is commonly used in competition assessments as the starting point in the analysis of market power as it provides information about the competitive constraints from within the relevant market. However, market share analysis provides only an initial indication about the potential existence of SMP in the relevant market, which is not sufficient by itself to establish whether SMP actually exists.

G20 According to established European case law:

- A firm with a market share of less than 25 per cent is unlikely to have an SMP position in the relevant market.[6]

[6] Recital 15 of Council Regulation (EEC) No. 404/89 on the control of concentrations between undertakings, OJ 1989 L395-1 states that: '*[W]hereas concentrations which, by reason of the limited market share of the undertakings concerned, are not liable to impede effective competition may be presumed to be compatible with the common market; whereas, without prejudice to Articles 81 and 82 of the Treaty, an indication to this effect exists, in particular, where the market share of the undertakings concerned does not exceed 25 per cent either in the common market or in a substantial part of it*'.

- A firm with a market share of over 40 per cent generally raises SMP concerns in the administrative practice of the European Commission (EC).
- Large market shares (over 50 per cent) raise by themselves a rebuttable presumption of SMP.[7]

G21 The above is consistent with the view of the Office of Fair Trading (OFT) that:

The European Court has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50 per cent. The OFT considers it unlikely that an undertaking will be individually dominant if its share of the relevant market is below 40 per cent, although dominance could be established below that figure if other relevant factors (such as the weak position of competitors in that market and high entry barriers) provided strong evidence of dominance. [8]

G22 According to European competition law, an undertaking with a large market share may be presumed to have SMP if its market share has remained stable over time.[9] This is also consistent with the OFT's view that '*in general, market power is more likely to exist if an undertaking (or group of undertakings) has a persistently high market share.*'[10]

G23 The above is also consistent with the OFT's view that '*in general, market power is more likely to exist if an undertaking (or group of undertakings) has a persistently high market share.*'[11]

G24 However, as noted above, it is also true that high and stable market shares do not always indicate that a firm has SMP. Where high and stable market shares are present they will need to be interpreted differently depending on the particular commercial and regulatory history by which the market shares came about and other features of the relevant market, such as competitive constraints, barriers to entry and countervailing buyer power.

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7 Case C-62/86, AKZO Chemie BV v. Commission, [1991] ECR I-3359. A market share in excess of 50 per cent is said to create a rebuttable presumption of SMP.

8 OFT, Assessment of market power guideline (OFT 415), paragraph 2.12.

9 Case 85/76 Hoffman-La-Roche v Commission [1979] ECR 461, paragraph 41.

See also, by analogy, Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services, (2002/C 165/03), paragraph. 75.

10 OFT, Assessment of market power guideline (OFT 415), paragraph 4.2.

11 OFT, Assessment of market power guideline (OFT 415), paragraph 4.2.

Minded to Consultation

G25 In the minded to Consultation, market shares for two different markets for short-haul travel were examined, with short-haul being defined as travel to Europe.[12] The first market (Market 1) comprised Stansted, Luton and Southend; the second market (Market 2) comprised Market 1 plus Gatwick.

G26 As mentioned in the introduction, the CAA has re-considered its position on the definition of the relevant market for STAL (see appendix D). On the basis of this new market definition, STAL's market shares are shown in Figure G.1 (below).[13]

G27 As Figure G.1 shows, STAL's market share has varied over time but it has remained well above 50 per cent of the relevant market, irrespective of whether it is measured by the number of passengers or by air transport movements (ATMs).

[12] There are different types of carriers – based and in-bound – and although these carriers may face different switching costs, due to the adoption of different business models, it does not necessarily affect the way in which the relevant market for passenger airlines is defined (see chapter 4).

[13] The market shares outlined in Figure G.1 include short-haul, full service carrier connecting flights. The CAA has also considered the situation where these flights are excluded from the market. Under that scenario, Stansted's overall market shares are slightly larger. However, in 2011, the outcomes are broadly similar to those seen where these flights have not been excluded from the analysis.

Figure G.1: Market shares (2000–2012)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Passenger													
Stansted (%)	66	68	71	73	74	71	71	70	69	69	68	65	63
Luton (%)	34	32	29	27	26	29	28	29	31	31	32	34	35
Southend (%)	0	0	0	0	0	0	0	0	0	0	0	0	2
ATMS													
Stansted (%)	72	72	73	74	73	69	70	69	67	67	67	64	61
Luton (%)	28	28	27	26	27	30	30	31	33	33	33	35	35
Southend (%)	0	0	0	0	0	0	0	0	0	0	0	1	4

Source: CAA

Note: Columns may not add up to 100 per cent due to rounding.

G28 STAL's consistently high market share (see Figure G.1) under the new market definition therefore supports a rebuttable presumption of dominance in the relevant market for the provision of airport operation services to passenger airlines at Stansted comprising Stansted, Luton and Southend airports.

Stakeholders' views

G29 MAG was concerned with the analysis that the CAA had undertaken in the minded to Consultation. In particular, MAG considered that the CAA's position had changed from that outlined in the Stansted – Market Power Assessment, the Initial Views – February 2012 (the Initial Views)[14] and that it had failed to:

- Consider what STAL's market share would be on a London wide, a UK wide or a European wide market.

[14] Paragraph 22.

- Explain the decline in market shares seen since 2004, and connected with that, it had failed to consider all the variables that had contributed to the decline in ATMs seen across Gatwick, Stansted, Luton, Southend and London City since 2007.[15]

G30 MAG also considered that the declining market share at Stansted was evidence of a lack of market power due to the ability of the airlines to switch away from Stansted. In relation to this, MAG noted that '*despite strong evidence to the contrary, this seems to be Ryanair's assertion – it admits that it has switched away from Stansted in recent years but it says it cannot remove any further aircraft (although it does not provide any factual basis for this assertion).*[16]

G31 GAL highlighted a number of concerns with the CAA's analysis, including that:

- The conclusion that Stansted has a high market share is reached on the basis of an incorrectly defined market scope.[17]
- The CAA had not concluded firmly on the scope of the market (whether Gatwick was in or out of the relevant market.[18]
- The CAA had stated, not demonstrated, that STAL did not currently compete successfully in the market for full service long haul carriers and associated feeder traffic (and that this may change with the new owners at Stansted).[19]

G32 BA and easyJet also expressed concern with how the CAA had defined the relevant market(s).

CAA views and conclusion

G33 As outlined above, the CAA has re-considered its views on the definition of the relevant market for Stansted and now considers that:

- It is unlikely that separate markets by airline business model are appropriate. In reaching this conclusion the CAA is mindful that there are still significant operational differences between LCCs and FSCs that impact on their substitution opportunities.

[15] MAG, Interim response of MAG to the CAA's minded to document, pp. 42 to 43.

[16] MAG, Interim response of MAG to the CAA's minded to document, p. 42.

[17] GAL, CAA Stansted Market Power Assessment – Response from Gatwick Airport, p. 2.

[18] GAL, CAA Stansted Market Power Assessment – Response from Gatwick Airport, p. 6.

[19] GAL, CAA Stansted Market Power Assessment – Response from Gatwick Airport, p. 6.

- Gatwick should not be included in the relevant market; a possibility which was raised within the minded to Consultation.
- There is a single market for the provision of airport operation services to passenger airlines; this market extends to the services provided to airlines at Stansted, Luton and Southend. The CAA has formally excluded Gatwick from the market definition but recognises there is a degree of judgement in this decision and will recognise this uncertainty in the market power assessment.[20]

G34 On this basis, STAL's market share of the relevant market is outlined in Figure G.1 (above). Figure G.1 shows that while STAL's market share has varied over the period 2000 to 2012, it has remained well above 50 per cent of the relevant market, irrespective of whether it is measured by the number of passengers or by ATM's. As a result, STAL's market share analysis supports a rebuttable presumption of dominance. However, it is noted that there is a degree of uncertainty with respect to the inclusion of Gatwick in the relevant geographic market. If Gatwick is included in the relevant market, STAL's market share would be significantly lower[21] and would not support a rebuttable presumption of dominance.

G35 However, as discussed in appendix D, the use of regulated price is robust. If the CAA used a long run average incremental cost (LRAIC) or the Leigh Fischer (LF) benchmark based price for undertaking the SSNIP analysis it would have had to have conducted it using a price that was lower than the current regulated price. As a result, there would have been a risk of defining a narrower geographical market than it currently has – possibly a market that would exclude Luton and/or Southend from the geographic market. In this narrower market, STAL's market share would be higher, thereby further strengthening a rebuttable presumption of dominance for STAL.

G36 On MAG's concern with the market definition outlined in the minded to Consultation, given the updated market definition many of these concerns no longer hold. That said, where there are issues, the CAA has outlined its views in the discussion in appendix D. Similarly, on MAG's concerns

20 On MAG's concern with the market definition outlined in the minded to Consultation, given the updated market definition many of these concerns no longer hold. That said, where there are issues, the CAA has outlined its views in the discussion in appendix D. Similarly, on MAG's concerns on switching evidence and competitive constraints, the CAA has considered these issues in appendix E.

21 In this case the average market share for Stansted over the period 2000 - 2012 would be 35 per cent or 36 per cent in terms of ATMs and passengers respectively.

on switching evidence and competitive constraints, the CAA has considered these issues in appendix E.

G37 In relation to MAG's comment that STAL's market share has declined by around 8 percentage points since 2004 (across each market definition) the CAA considers that while STAL's market share has varied since 2000, it has also remained throughout the period both each year and on average at persistently high levels, and well above the level of 50 per cent that supports a rebuttable presumption of dominance.

G38 Going forward, under MAG's new ownership and management and STAL's stated intention to strengthen Stansted's competitive position, the CAA considers that STAL's market share will remain at high levels over the Q6 period, most likely continuing to support a rebuttable presumption of dominance.

G39 The above assessment is further supported by the evidence submitted by MAG, which noted, in its response to the minded to Consultation, that:

- *through a combination of service improvements, operating efficiency, value for money and an increased focus on commercial revenues, we will make Stansted more competitive and return the airport to the levels of traffic it had in 2007 as quickly as possible, and then grow from there.*[22]
- *We are looking to agree long term deals with airlines to drive growth at Stansted. Our ability to offer value to airlines will depend crucially on our success in growing other sources of revenue and making efficiency savings across the Stansted business.*[23]

G40 MAG has also indicted that it intends to compete vigorously with GAL and HAL to attract long-haul carriers.[24] For example, MAG noted that by:

...attracting new airlines, including long-haul carriers, full service carriers and LCCs, and in bringing growth back to our existing carriers, we aim to attract a greater share of passengers from central London (with the help of rail improvements), from key marginal areas around London, and from Stansted's own catchment area where its service offer has not been strong enough in recent years.

[22] MAG, Civil Aviation Authority Stansted Market Power Assessment, Interim response of M.A.G to the CAA's 'minded to document', p. 22.

[23] MAG, Civil Aviation Authority Stansted Market Power Assessment, Interim response of M.A.G to the CAA's 'minded to document', p. 22.

[24] MAG, Civil Aviation Authority Stansted Market Power Assessment, Interim response of MAG to the CAA's 'minded to document', pp. 12 to 13.

G41 More recent evidence suggests that STAL (under MAG ownership) has had some success in attracting new airlines to Stansted, namely:

- In April 2013, Air Moldova switched its limited three times a week service from London to the Moldovan capital Chisinau from Gatwick to Stansted.[25]
- In July 2013, it was announced that Aegean Airlines would be operating both economy and business class cabins on a thrice weekly service between Stansted and Athens in time for the busy summer season.[26]

G42 With respect to GAL's concern that the CAA had stated, not demonstrated, that STAL did not currently compete successfully in the market for full service long-haul carriers and associated feeder traffic (and that this may change with the new owners at Stansted), there were no full service long-haul carriers operating at Stansted at the time of writing the minded to Consultation.

G43 However, as outlined above, there have been some developments in this area. That said:

- The switching of air transport services to and from Stansted that have occurred (albeit under BAA ownership) have tended to be from Stansted to Gatwick. Only the most recent move by Air Moldova has been from Gatwick to Stansted and Air Moldova is an FSC operating two weekly services into Stansted on an Embraer 190.[27] This is issue is examined in more detail in appendices D and E.
- The evidence suggests that to operate long-haul services, FSCs tend to require an extensive short-haul network from which to feed their long-haul services, to ensure sufficient load factors on these flights (see appendix D).

G44 More broadly, while there is a mix of airline business models present at Stansted, the vast majority of passengers at the airport are carried on two LCCs.[28]

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25 Reported in the press and on STAL's website, the CAA has not been able to discuss the motivations for this move with the airline, see: http://www.stanstedairport.com/about-us/media-centre/press-releases/new-airline-for-new-stansted-owners (accessed 29 April 2013).

26 See: http://www.stanstedairport.com/about-us/media-centre/press-releases/new-athens-connection-at-stansted-for-summer-2013 (accessed 21 August 2013).

27 The Embraer 190 is a relatively small aircraft up circa 100 seats. Furthermore, GAL’s stated policy of incentivising the use of larger aircraft on its runway, which was a key issue in the Flybe S41 complaint against GAL. See: http://www.caa.co.uk/docs/5/S41GatwickFlybeDecision.pdf.

28 For example, in 2012, Ryanair comprised 72 per cent of Stansted’s passenger traffic while easyJet

G45 Market shares are not, however, a conclusive indicator of the level of market power that an airport operator may have. The CAA has therefore undertaken further analysis of the other indicators of market power to determine if STAL has or is likely to acquire SMP.

Efficiency

G46 An airport operator enjoying a position of SMP might face insufficient competitive pressure to enhance its efficiency by putting downward pressure on its operating and capital costs. However, as STAL is currently subject to price cap regulation, which includes incentives to increase operational and capital efficiencies, it is difficult to distinguish the extent to which observed operational efficiencies at Stansted reflect a response to regulatory requirements or to competitive pressures.

G47 An additional factor which complicates the analysis of STAL's efficiency performance is the recent change of ownership. Most of STAL's efficiency data covers the period where STAL was under BAA ownership and there is a much more limited range of evidence on this indicator under MAG's new ownership.

G48 However, there have been numerous statements made by MAG concerning its new approach to addressing efficiency. For example, MAG stated:

> *Through a combination of service improvements, operating efficiency, value for money and an increased focus on commercial revenues, we will make Stansted more competitive.*[29]
>
> And:
>
> *...Our ability to offer value to airlines will depend crucially on our success in growing other sources of revenue and making efficiency savings across the Stansted business.*[30]

G49 The likely impact on STAL's new approach to addressing efficiency issues is perhaps reflected by the words of Ryanair's Chief Executive Officer,

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comprised 19 per cent (and this concentration is also reflected in their share of ATMs in the same period). In the same year Thomson Airways and Germanwings comprised 2 per cent of the airport's passengers each while Pegasus, Thomas Cook and Air Berlin each had 1 per cent of Stansted's passengers, altogether totalling only 9 per cent of the passenger traffic at Stansted.

29 MAG, Civil Aviation Authority Stansted Market Power Assessment, Interim response of M.A.G to the CAA's 'minded to document', p. 22.

30 MAG, Civil Aviation Authority Stansted Market Power Assessment, Interim response of M.A.G to the CAA's 'minded to document', p. 22.

Michael O'Leary who, during a press conference announcing a recent deal with MAG (see discussion later), stated:

Stansted, freed from the BAA and a more forward looking manner of the management MAG, will work with us help us to deliver efficient facilities and lower fares.[31]

G50 The above is also consistent with the view expressed by LSACL, which noted that:

It takes time for a new owner to establish new policies, as for example at Gatwick, and the effect of Stansted's ownership change will likewise take time to settle.[32]

Minded to Consultation

G51 In the minded to Consultation, the CAA indicated that the analysis of relative cost efficiency might provide useful evidence to identify whether an airport is performing in a way that might be expected in a well-functioning market. It also noted that care must be taken to understand the underlying causes of any identified inefficiency, and whether there is evidence to suggest that relatively poor performance is transitory or can be explained by factors that do not relate to market power, for example the effect of regulatory incentives.[33]

G52 The CAA also indicated that STAL's efficiency was examined in the indicators of market power and, in more detail, in Test C. In its examination of these issues, the CAA considered that:

- There were reasons to consider that STAL had been slow at addressing inefficiencies.[34]
- The CAA had seen no evidence that competitive constraints had driven the efficiency initiatives that STAL pursued under BAA ownership.

G53 The CAA's analysis also suggested that:

31 http://www.youtube.com/watch?v=hQ2hiHoKPYE

32 LSACL, Minded to Consultation on Market Power at Stansted Airport, 6 March 2013.

33 CAA, '*Empirical methods for assessing behaviour, performance and profitability of airports'*, p. 13.

34 In 2008 and 2009, the CC identified a number of areas where there was scope for efficiency improvements, including with respect to employment costs, standards and procedures for baggage delivery and staff rostering – an issue that had previously been identified in 2006. More recently (2012), Steer Davies Gleave (SDG) identified a number of areas, including rostering, where improvements could be made. STAL has indicated that it has looked to implement initiatives to drive down absenteeism and implement rostering changes to increase security efficiency and flow.

- There was some evidence that the airport operator had been responding to some regulatory initiatives in this area.
- The consultancy studies commissioned by the CAA identified several efficiency opportunities for STAL in relation to its operational costs, including on security.

Stakeholders' views

G54 MAG considered that the change in ownership had enhanced STAL's competitive position and that one of the factors behind this was its approach to operating efficiency.[35] MAG also considered that its approach to efficiency was far removed from that of a dominant airport operator resting on its laurels and that it needed to compete to survive.[36]

G55 MAG, as part of the Q6 process, also submitted a business plan to the CAA outlining its forecasts and projected financial position for the Q6 period. As part of this, MAG noted that it would be able to:

.. achieve efficiency improvements as passenger volumes grow through more intensive use of existing resources and the introduction of more efficient operational processes.[37]

G56 However, MAG did not elaborate on how these potential improvements in efficiency would be achieved.

G57 GAL indicated (among other issues) that the new owners of STAL had signalled their intention to compete. It also considered that the behaviour of STAL under BAA ownership shed little or no light on its competitive significance in the future.[38]

G58 GAL also raised a number of concerns with the discussion on efficiency that was outlined in chapter on Test C of the minded to Consultation. These issues are discussed in more detail in the discussion on Test C in this document. However, in general, GAL considered that the CAA's analysis was underpinned by an underlying expectation that the airport under consideration should always be the most efficient in its benchmark group for each of the benchmarked activities. GAL considered that this was an extreme position.[39]

35 MAG, Interim response of MAG to the CAA's minded to document, p. 2.

36 MAG, Interim response of MAG to the CAA's minded to document, p. 22.

37 MAG, Business Plan Covering Letter, p. 2.

38 GAL, CAA Stansted market Power Assessment – Response from Gatwick Airport, p. 1.

39 GAL, CAA Stansted market Power Assessment – Response from Gatwick Airport, p. 11.

G59 Ryanair welcomed the opportunity to rebut STAL's views regarding efficiency, negotiations and airline attraction (or lack thereof).[40]

CAA views

G60 The analysis on efficiency that the CAA outlined in the minded to Consultation should be interpreted within the appropriate context, that being:

- The cost and efficiency data and related findings on Stansted's efficiency mainly reflect the ownership and management practices of its previous ownership and management under BAA.
- Given the recent change of ownership of STAL, there is limited information and evidence upon which to draw conclusion about MAG's present and future performance of operating and capital efficiency at Stansted.

G61 To better understand STAL's approach to efficiency the CAA has analysed a number of different studies focusing on different aspects of efficiency, each of which have used a different approach.

G62 The CAA has, for example, reviewed several pieces of opex benchmarking evidence related to Stansted, including studies by the Air Transport Research Society (ATRS) in 2011 followed by update in 2013, Leigh Fisher (LF) in 2011 followed by update in 2012 and Steer Davies Gleave (SDG) in 2012. All benchmarking studies are based on data covering the period prior to the sale of the airport in February 2013. In each of these studies, opex per passenger has been used to assess the relative efficiency of different airports adjusting for factors such as depreciation and irregular costs.

G63 In the above studies, opex per passenger at Stansted was estimated at between £6.92 and £7.73, compared to comparator averages of between £7.16 and £8.94. Stansted's opex per passenger is also shown to be higher than Birmingham, Edinburgh and Glasgow (airports which each could be considered more directly comparable to Stansted). This suggests that STAL is not at the efficient frontier of airport cost performance.

G64 In addition, the CAA has undertaken its own additional comparative analysis of the relative performance of STAL. This analysis indicates that adjusted opex per passenger at Stansted is £7.21 compared to a sample average of £7.92. The analysis also show that Stansted is outperformed by several airports, including Edinburgh, Glasgow and Copenhagen. This

[40] Ryanair, Ryanair's reply to the CAA's 'minded to' decision on STAL's market power, p. 2.

result is consistent with the analysis of the efficiency studies discussed above.

G65 The CAA's benchmarking analysis also shows that opex per passenger has risen by 35 per cent, from a low of £5.35 per passenger in 2007 to £7.21 in 2012. This coincides with large reductions in passenger numbers at the airport and is in stark contrast to the 13 per cent average reduction experienced across the sample. This suggests that STAL, under BAA's ownership, experienced a significant fall in efficiency and supports the conclusion that STAL, under MAG's ownership, is likely to have further scope for efficiency.

G66 In addition to the analysis of partial productivity metrics, the ATRS study provides an analysis of efficiency based on econometric Stochastic Frontier Analysis, which seeks to assess productivity based on the analysis of multiple input and output factors (such as passengers, flights, airport size, number of runways etc.) to provide a more comprehensive assessment of efficiency. This analysis shows that Stansted was the sixteenth most efficient airport in the European sample. Its productivity is estimated to be around 53 per cent of the frontier. Several comparable airports are ranked ahead of Stansted, including Copenhagen, Gatwick, Manchester and Zurich.

G67 Overall, while the available benchmarking evidence suggests that STAL's opex per passenger is relatively low in comparison with a wider sample average it is higher than several comparable airports and its own historical performance. This suggests that STAL has scope to improve opex efficiency.

G68 In preparation for Q6, the CAA also commissioned further several consultancy studies related to opex. The key findings of each of these studies are summarised below:

- **Mid Q Review of Stansted (undertaken by SDG in 2012)**[41]
  - This study reviewed the principle drivers of operating costs at Stansted, under BAA's ownership, and benchmarked levels of cost against other airports. The study estimated that there was potential for 10 per cent reduction in security costs based on the introduction of a more flexible roster system to cope with STAL's increasingly peaky passenger flows.

[41] SDG, May 2012, *Review of operating expenditure and investment consultation (Appendix D), Mid-term Q5*, available at: http://www.caa.co.uk/docs/5/SDGStanstedReport.pdf.

  - The report states that peak security processing flow rates have declined from 211 passengers per hour per lane in 2007 to 143 in 2011, increasing the number of security staff required to deal with peak periods. This has increased cost per passenger at STAL by around 40 per cent. Average flow rates of 143 passengers per lane per hour are relatively low compared with some other airports, with average benchmarks around 180 passengers per hour.
  - Benchmarking of electricity costs against other airports also indicated that unit electricity costs were the second highest of the sample at £0.090 per kWh against a range of between £0.074 and £0.104.
  - The study did not make a direct assessment of the potential for efficiency savings at the airport, however based on the 10 per cent roster efficiency target described above, in the Economic Regulation at Stansted from April 2014: Initial Proposals CAP 1030 (the Initial Proposals) for Stansted, the CAA estimated that costs could potentially be reduced by around £2 million per year.

- **Employee reward benchmarking study (undertaken by IDS in 2012)** [42]
  - This study examined levels of pay at Stansted, under BAA's ownership, in comparison with the wider economy and benchmarks within the aviation industry. Overall, the study concluded that if rates of total cash reward (basic salary, shift, overtime and bonus pay) at Stansted were brought into line with benchmark comparisons, staff costs could be reduced by between 16 per cent and 18 per cent.[43]
  - In the Initial Proposals for Stansted, the CAA estimated that such savings could amount to between £8 million and £9 million per year.

[42] IDS, January 2013, *Benchmarking employment costs, Stansted*, available at: http://www.caa.co.uk/docs/1350/Benchmarking%20employment%20costs%20-%20A%20research%20report%20for%20the%20CAA%20-%20nonconfidential%20version.pdf.

[43] On a total reward basis (including pension costs) staff costs at STAL are even further from benchmarks. The CAA estimates that total reward costs are between 37 per cent and 42 per cent higher than benchmarks on average.

  - The IDS study also benchmarked STAL's pension costs finding that STAL's Defined Benefit scheme made contributions of 41 per cent of salary compared with benchmarks of 17 per cent. Based on this analysis, the CAA estimated that if STAL was able to bring its pension costs into line with benchmarks, costs could be reduced by up to £2 million per year.

  - The study also found some evidence of grade drift at STAL with five leading fire fighters for every (junior) fire fighter in 2012, compared to 1:3 in 2006. There was also some evidence of grade drift in security supervisor roles. The study also found that rates of absenteeism were high with an average rate of 9.1 days per employee compared to an industry average of 6.8 days.

  - In the Initial Proposals the CAA stated that in combination the available evidence indicated that STAL, under MAG's ownership, should be able to reduce opex by between 1.0 per cent to 2.5 per cent per year by reducing staff wages and pension costs, improving efficiency in its security function and bringing other costs into line with benchmarks. The upper and lower estimates were based on the upper and lower estimates in the consultancy studies.

- **Additional studies**

  - Following the Initial Proposals, the CAA conducted two further studies related to Stansted's opex efficiency. The CAA commissioned SDG to update its Mid-Q5 review analysis to provide an estimate of the scope for further efficiency at Stansted, taking account of the recent sale. This study analysed STAL's updated business plan scenarios (comparing RAB to non-RAB) and found that Stansted had scope to reduce costs in several areas including those described above and further efficiencies from economies of scale in Air Navigation Services (ANS) and central support costs, based on joint contracts with MAG.

  - The CAA also commissioned the Government Actuary Department to review STAL's pension costs to take account of criticisms of the IDS study. This study determined that STAL could reduce pension costs by around £1 million per year based on reducing the generosity of its scheme into line with benchmarks.

  - Overall, accounting for this additional evidence, the CAA estimates that STAL should be able to reduce opex by between 1.7 per cent and 2.8 per cent per year.

G69 The CAA recognises that under new ownership the scope to address observed inefficiencies in a timely manner is likely to have increased. However, the change of ownership does not detract from the presence of various inefficiencies currently present at the airport.

G70 While MAG has stated that it expects increased competition and various initiatives to have benefits in terms of efficiency (including with respect to service quality), this was supported by a limited amount of evidence. When asked to provide detail on what its plans actually were MAG responded by noting that:

- [✄].
- [✄].
- [✄].
- [✄].[44]

G71 In July 2013, MAG also provided the CAA with its most current business plans and in that material it was stated that it would be *'able to achieve substantial efficiency improvements as passenger volumes grow, through more intensive use of existing resources and the introduction of more efficient operational processes*.'[45] However, MAG did not provide any details on how it planned to achieve this.

G72 MAG responded to the CAA's concerns on efficiency in its response to the Initial Proposals. These issues (and the CAA's response to those issues) are, however, examined in more detail in the Final Proposals. However, at the highest level, the CAA still considers that there are a number of areas at Stansted where efficiency could be improved.

G73 Given the limited amount of detailed plans provided by MAG it is difficult for the CAA to assess the merits of MAG's claims on its future approach to efficiency. That said, the CAA recognises:

- MAG's stated intention to enhance efficiency at Stansted.
- It can take time for new ownership and policies to settle.
- Greater competitive pressures in the relevant market may encourage efficiency improvements.

G74 With respect to GAL's view that there is an underlying expectation in the CAA's approach that the resultant airport operator should always be the

44 Source: MAG [✄].

45 Source: MAG [✄].

most efficient in its benchmark group for each of the benchmarked activities and that this was an extreme position, the CAA considers that benchmarking can provide a useful insight into the relative efficiency of different airports against the efficient performance frontier. However, the CAA also recognises that the results of benchmarking studies need to be interpreted carefully.

G75 In examining efficiency at Stansted, Gatwick and Heathrow the CAA examined a number of different benchmarking studies and undertook its own benchmarking exercise.[46] Overall, the CAA considered that:

- The evidence it analysed indicates that there is likely to be scope for further efficiency at Heathrow, Gatwick and Stansted relative to current levels of opex per passenger.
- All of the airports have higher opex per passenger than comparator airports and all have performed worse that the average in controlling costs since 2000 both in comparison to the CAA's benchmark sample and their own major airline customers.[47]

G76 The CAA also considered that drawing precise conclusions over the extent of the efficiency gap based on this evidence is difficult.[48]

G77 Based on the above, the CAA maintains the view that it is reasonable to use benchmarking exercises, recognising their limitations and caveats, to help inform its judgement on the relative efficiency of an airport and whether the levels of (in)efficiency seen at an airport may suggest that it is facing insufficient competitive pressures to drive up operating efficiency.

Conclusions on efficiency

G78 With respect to efficiency, taking into account the analysis of the various efficiency studies discussed above, the material submitted by MAG, including material submitted in response to the minded to Consultation, other stakeholder views and its own efficiency analyses, the CAA considers that:

- There are a number of areas where efficiency can be improved at Stansted (and this holds irrespective of who is the owner).

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46 For more information on the CAA's approach to benchmarking, please see 'CAA Airport Operating Expenditure Benchmarking Report 2012', available at: http://www.caa.co.uk/docs/33/CAP%201060%20Airport%20Operating%20Expenditure%20Benchmarking%20Report%202012.pdf.

47 CAA, CAA Airport Operating Expenditure Benchmarking Report 2012, p. 47.

48 CAA, CAA Airport Operating Expenditure Benchmarking Report 2012, p. 47.

- STAL should be able to reduce opex by between1.0 per cent to 2.5 per cent per year by reducing staff wages and pension costs, improving efficiency in its security function and bringing other costs into line with benchmarks.
- Overall, accounting for this additional evidence, the CAA estimates that STAL should be able to reduce opex by between 1.7 per cent and 2.8 per cent per year.

G79 However, the findings of the various efficiency analysis should be interpreted with caution and always within the understanding that:

- The cost and efficiency data and related findings on STAL's efficiency mainly reflect the ownership and management practices of its previous ownership and management under BAA.
- Given the recent change of ownership there is not sufficient information and evidence upon which to draw conclusion about MAG's present and future performance of operating and capital efficiency.

G80 As a result, going forward it is difficult to infer MAG's future performance on efficiency, its approach to addressing efficiency issues and whether this will reflect a response to competitive pressures. Therefore, notwithstanding there being signs of inefficiency at Stansted, given the recent change of ownership it is difficult for the CAA to draw robust conclusions on a forward-looking basis about STAL's future efficiency performance.

Pricing

G81 The economic concept of market power is reflected in European case law. For example, in Hoffman la Roche v Commission [1979] ERC 461, it was outlined that market power:

relates to a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of the consumers.[49]

G82 This case also highlighted that:

such a position does not preclude some competition, which it does where there is a monopoly or a quasi-monopoly, but enables the undertaking which profits by it , if not to determine, at least to have an appreciable

49 Paragraph 38.

influence on the conditions under which that competition will develop, and in any case to act largely in disregard of it so long as such conduct does not operate to its detriment.[50]

G83 The EC considers that an undertaking has SMP if '*it is capable of profitably increasing prices above the competitive level for a significant period of time*' and that the reference to '*increasing prices*' is used as shorthand for a variety of ways of influencing competition to the advantage of the dominant undertaking, including by decreasing output, innovation, variety or quality of goods or services.[51]

G84 By analogy, the EC's SMP Guidelines state that:

However, in an ex-ante environment, market power is essentially measured by reference of the power of the undertaking concerned to raise prices by restricting output without incurring a significant loss of sales or revenues.[52]

G85 Therefore, the assessment of an airport operator's pricing behaviour is an important indicator of market power. In particular, given that an airport operator having SMP will be able to profitably sustain prices above the competitive level over time, it is important to consider prevailing and historical prices in relation to the competitive price level. However, pricing at or even below the competitive level does not necessarily mean the absence of SMP.[53]

G86 The above is consistent with OFT's view that:

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[50] Paragraph 39.

[51] EC Guidance on Article 102 Enforcement Priorities, OJ [2009] C 45/7, paragraph 11.

[52] Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services, (2002/C 165/03), paragraph 73.

[53] Pricing at or below marginal costs (strategic foreclosure or predatory pricing) is an abuse by dominant firms (firms having SMP).

Market power can be thought of as the ability profitably to sustain prices above competitive levels or restrict output or quality below competitive levels. An undertaking with market power might also have the ability and incentive to harm the process of competition in other ways; for example, by weakening existing competition, raising entry barriers or slowing innovation. However, although market power is not solely concerned with the ability of a supplier to raise prices, this guideline often refers to market power for convenience as the ability profitably to sustain prices above competitive levels.[54]

G87 If a competitive price benchmark could be identified with certainty it would allow comparison of historical and prevailing prices with the identified competitive price. This information would, in turn, help identify if there was market power. However, there are a number of challenges associated with identifying precisely what the competitive price is for STAL and therefore a proxy (or proxies) of the competitive price needs to be used.

G88 The main approaches to identifying a proxy for the competitive price level are benchmarking and cost modelling replicating the cost and pricing structure of a hypothetically efficient entrant.[55]

Minded to Consultation

G89 In the minded to Consultation, the CAA considered STAL's pricing against the following:

- The regulated RAB price.[56]
- A long-run average incremental cost (LRAIC) based price.
- A benchmark based price derived by comparable airports.[57]

G90 The CAA commissioned Europe Economics (EE) to undertake work on the calculation of a LRAIC-based price – a proxy for the price that would arise under competitive conditions – and LF to carry out a price

54 OFT, Assessment of market power, December 2004.

55 Benchmarking: Under this approach, some kind of average price is calculated from the prices of the substitutes (or comparable products). Cost modelling: This approach entails the construction of a cost model designed to replicate the cost structure of a hypothetical efficient operator, operating in a competitive environment. The derived prices are assumed to proxy the competitive price level.

56 A regulated RAB price is a price based on a Regulated Asset Base (RAB), which is a proxy for the value of (in this context) the airport's regulated operating assets upon which the owners of the airport earn a return.

57 The CAA used the same set of reference prices as candidates for the SSNIP test. The considerations related to the use of the appropriate price level to be used for the SSNIP test are discussed in appendix D.

benchmarking exercise. The details of both these studies are discussed in appendix H.

G91 The CAA concluded that, based on the analysis that it had undertaken as well as the results of the independent analysis on price benchmarking and LRAIC, STAL's prices were likely to be above the level of prices that may be considered a proxy for prices under conditions of effective competition. In particular, the CAA:

... considers that the evidence, including the price benchmarking exercise by Leigh Fisher, suggests that STAL is pricing above the competitive level. In addition, the evidence suggests that free from any regulation STAL could seek to increase prices (further) above the competitive level.[58]

And:

...*With respect to price, the CAA considers that notwithstanding some heavily discounted prices being offered in some negotiations, the evidence suggests that the prices at Stansted may be above the prices charged by other comparator airports and may be above that which would occur in a competitive environment.*[59]

G92 With respect to STAL's historical pricing behaviour, the CAA also considered that:

- STAL has been pricing at or close to the regulatory cap for over five years and this suggests that it is likely to increase its prices if the price cap regulation was removed. The CAA also noted that the airport operator had indicated that one of its objectives is to '*achieve deregulation with no price cap but retain commitments in terms of service and investment levels*.
- As part of a meeting with the CAA, *STAL has suggested that its regulated price may not be a reasonable proxy for the competitive price level. In discussions with the CAA, STAL has noted that its current offers to new airlines tend to* [✂].[60]

58 Stansted Market Power Assessment: developing our 'minded to' position, p. 162.

59 Stansted Market Power Assessment: developing our 'minded to' position, p. 168.

60 Source: STAL [✂].

Stakeholders' views

G93 In its response to the minded to Consultation MAG noted, with respect to pricing that: [61],

- *The issue of Stansted's price level and profitability is important as it affects the analysis of airline switching, including the critical loss analysis, and market definition.*
- *[I]f it could be shown that [STAL] were pricing above the competitive price level, or making excess profits, this may be evidence of market power.*

G94 MAG also noted that:

- The minded to Consultation inappropriately relies on the LF report to assess the competitive price level at Stansted. This is despite the CAA recognising that the assessment of a competitive price is difficult and that it is due to this difficulty that the CAA did not perform a full SSNIP test.
- The CAA's reliance on the flawed LF study is a change of view since the Initial Views, even though the report explicitly states that it was not designed to measure the competitive price. According to MAG:

  Yarrow and Starkie[62] point out in their submitted report to use the LF report as evidence of a competitive price is to accept that (for example) Melbourne and Hong Kong airports belong to the same geographic market as Stansted, which is patently absurd.

- Even if the CAA were to use the LF study to assess the competitive price, the report does not show what the CAA appears to think it shows, since when comparing Stansted in terms of total revenues per passenger, LF concludes that '...*Stansted is exactly at the level that would be expected for an airport of its characteristics'*.[63]

G95 In addition, MAG noted that: [64]

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61 MAG, Interim response of MAG to the CAA's minded to document, p. 83.

62 Review of the CAA's Market Power Assessment, Report by Professor George Yarrow and Professor David Starkie, submitted as Annex to MAG's Interim Response to the CAA's minded to document.

63 MAG, Interim response of MAG to the CAA's minded to document, pp. 83 to 84.

64 MAG, Interim response of MAG to the CAA's minded to document, pp. 83 to 84.

- In addition to the futile nature of attempting to assess a competitive price in such a heavily regulated industry, and the fundamentally inappropriate use of the results, there are a number of concerns with respect to the methodology and approach of the LF study. These specific (technical) concerns are discussed in more detail in appendix H.
- It would be irrational for the CAA to rely on the LF analysis, given that it has accepted there to be a number of flaws.

G96 MAG also considered that: [65]

- There are a number of fundamental flaws with EE's approach invalidating the conclusions of the LRAIC study.[66]
- EE's finding that Stansted's price would be around £1 per passenger below the current level of charges based on scenario on the cost of redeveloping the existing airport based depends crucially upon the assumption that the airport would operate at the assumed full capacity of 35 million passengers per annum (mppa) from the day one it reopens. It considered this was an unrealistic assumption and as a result the conclusion reached was not valid. It also noted that, as a result, the minded to Consultation concludes that Stansted's charges are too high.
- Under a realistic approach, where demand grows progressively over time, the LRAIC based price is increased by £1 per passenger which is broadly the level of STAL's current charges.
- The margin of error stated by EE brings the LRIC measure set out in the minded to Consultation within pennies of STAL's current charges.

CAA views and conclusions on pricing

G97 Both EE's LRAIC modelling and LF's benchmarking study are consistent in suggesting that the price at Stansted which would result under conditions of effective competition is likely to be lower by about £1. While a number of technical issues have been raised with respect to these studies (see appendix H), the CAA considers that the approach it has taken with respect to price is reasonable.

G98 While the RAB-based price under the price cap regulation is a cost-based approach, the price that would arise under true conditions of effective

65 MAG, Interim response of MAG to the CAA's minded to document, p. 84.

66 MAG also submitted a detailed analysis of EE's LRAIC study. These issues are discussed in more detail in appendix H.

competition is likely to be lower since under truly conditions of effective competition, competing firms:

- Tend to ‘compete away’ their fixed costs.
- Do not earn a guaranteed ex-ante return on their assets.
- Face competitive pressures which force them to maximise their efficiency.
- Efficiency adjustments are imposed overnight without any gradual adjustments considered by regulators.
- Return on assets (weighted average cost of capital) tend to be competed away while regulators tend to err towards setting a higher weighted average cost of capital instead of a lower one to incentivise long term investment.
- Impose fierce competitive conditions without considering the financial viability of the competing firms while regulators have a duty to ensure the financial viability of the regulated firms by enabling them to recover their total costs.

G99 In addition, as discussed[67] in the minded to Consultation, there are also several other reasons why the regulated price may not represent the price that would arise under true conditions of effective competition, including:

- Statutory duties that have the effect of encouraging over-investment at an airport. For example, section 39 of the Airports Act places an obligation on the CAA in performing its economic regulatory duty for airport operators to (amongst other obligations) ‘encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports’.[68]
- The scope for the misalignment of proposed capex and current market requirements, due to the long term and ‘lumpy’ nature of the capex. For example, Stansted was designed and built to cater for a mix of aircraft, yet, in general, it is only catering to short-haul, LCC aircraft. Similarly, STAL commenced a project, consistent with Government policy at that time, to develop a second runway (SG2) to ensure sufficient capacity going forward. While this long term project has been abandoned, these costs are being recovered through current users of the airport.

67 Stansted Market Power Assessment: developing our ‘minded to’ position, pp. 154 to 155.
68 CC 2009 BAA airports market investigation, Report on the supply of airport services by BAA in the UK, p. 131.

- Difference in the valuation of assets, which will affect the calculation of the competitive price.
- The potential for opex inefficiencies which a regulator may be only partially able to mitigate due to insufficient information and/or the implementation of insufficiently strong incentives to address an issue. For example, issues with the security rostering at Stansted were identified several years ago and this issue remains alive today.
- The bias towards increased use of capital created by RAB-based price regulation may have the undesirable effect of encouraging inefficient investment. It may also provide incentives for strategic behaviour by the airport operator to inflate the size of the RAB and may discourage the application of charging structures that make efficient use of capital. While the CAA is aware of these concerns, these issues nonetheless lead to a number of general criticisms of RAB-based price cap regimes.[69]
- Common ownership of airports which can result in less favourable regulatory outcomes if efficient capacity expansion at one airport impacts passenger numbers, airline performance and airport performance at another. In addition, common ownership can impinge on the incentive under the RPI approach for an airport to outperform the forecasts used in the price determination so far as passenger numbers are concerned. This is because such outperformance at one airport would, to some extent, come at the expense of the others.[70]

G100 In addition, as discussed in the minded to Consultation, the evidence provided by both easyJet and Ryanair suggest that a price reflecting competitive conditions at STAL is likely to be lower than STAL's current price.[71] The above is also consistent with the evidence on the actual prices and their foreseen projections charged by Luton airport to its main airlines under long term contracts which appear to be considerably lower than STAL's prices.[72]

G101 Furthermore, despite STAL's views to the contrary, the competitive price is likely to be lower than its current price and this has been implicitly revealed by STAL's own actions, including through the recent discounts offered to the airlines as part of the long-term growth deals.

G102 However, the CAA considered also that:

[69] These concerns were set out in paragraph 6.18 of the CC's 2009 report.

[70] These concerns were set out in paragraph 6.62 of the CC's 2009 report.

[71] Stansted Market Power Assessment: developing our 'minded to' position, p. 161.

[72] Stansted Market Power Assessment: developing our 'minded to' position, p. 161.

- MAG's argument suggesting that EE's LRAIC-based price when taking into account the margin of error, suggests that the deviation between that current and the estimated LRAIC-based price is much smaller.
- EE emphasised that its long run incremental cost (LRIC) estimates of revenue per passenger of £6.3 are sensitive to the assumptions underpinning them, with estimates changing by +/- 10 per cent to 15 per cent with relatively small changes in assumptions.
- The above is consistent with the results of the LF study, which suggests that STAL's aeronautical revenue per passenger is approximately £1 above the average of comparable airports and about £1.5 above the subset of airport operators that are subject to lighter regulation[73]. LF also estimates the margin of error of its analysis to be +/- 10-15 per cent (equivalent to £0.60 - £0.90).

G103 Taking the above together, the CAA considers that it is reasonable to revise its conclusion about STAL's historical pricing behaviour to take greater account of the error margins of both the LRAIC-based and the LF benchmark based estimates. As a result, the CAA now considers that STAL has been historically pricing to the cap and that its prices have been either above or at the top of the range of the LRAIC-based and the LF benchmark price estimates, which may be considered to proxy the price that would arise under conditions of effective competition.

G104 Given the recent change of ownership of STAL, going forward is difficult to draw inferences about STAL's future pricing behaviour on the basis of the historical information. As a result, the CAA has been looking into more detail in STAL's recent approach to the commercial negotiations with its customers under MAG ownership to assess whether its future approach to pricing supports the rebuttable presumption of SMP that STAL's previous behaviour (and market share) suggested.

G105 As mentioned earlier, to enhance its understanding of STAL's approach on pricing under its new ownership of MAG, the CAA released in October 2013 the additional Consultation. This consultation sought stakeholders' views and evidence about the latest developments (among others) in relation to the long-terms deals signed between STAL and its major airline customers. These issues are discussed further in the next section.

[73] The analysis also shows that STAL's aeronautical revenue per passenger was below the average of comparable airports over the period 2002 to 2007.

Engagement with airlines and commercial negotiations

G106 The behaviour of an airport operator with respect to engagement with airlines and its commercial negotiations can provide useful insight into how an airport's management views the degree to which it can be constrained by competition (and the degree to which it may be possible to exercise market power).

G107 However, an airport operator may choose to enter into genuine commercial negotiations with its customers and therefore signal that it is willing to contract away its market power by signing bilateral deals with its customers. This is particularly relevant for STAL since following the recent change of ownership STAL has successfully entered into negotiations with its major airline customers, namely easyJet and Ryanair. These negotiations were concluded in June and October 2013 respectively with the signing of long-term growth deals.

Minded to Consultation

G108 In the minded to Consultation, following an assessment of the evidence on STAL's engagement and commercial negotiations with airlines (under BAA ownership), the CAA outlined that the evidence suggested that:

- STAL largely set the terms that an airline would receive and that the scope for negotiation was relatively limited, an approach that appeared to be different from its neighbouring airports.
- STAL had adopted a deliberate strategy that aimed to decrease the presence of some airlines at the airport in an attempt to improve the appeal of the airport to other airlines.
- Since it was pricing to the cap, and there was an absence of reasonable commercial negotiation between STAL and its airlines, STAL may have the ability to set its charges higher than would occur in a competitive environment.

G109 The CAA also considered that STAL’s historic approach to commercial negotiations suggested that:

- STAL’s willingness to offer discounts on its published tariffs to airlines currently at the airport appeared limited, with any potential being conditional on conditions largely determined by the airport operator.

- A number of airlines had indicated that STAL under BAA ownership had a unilateral approach to negotiation.[74]

G110 In addition, the CAA also noted that:

- STAL's historic behaviour of [✂] discounts for [✂] suggests that the airport operator is involved in price discrimination towards its airlines in the form of [✂] discounts. These discounts appear to be targeted on a case-by-case basis, as each airline tends to face different costs in setting up routes which in turn each have different costs.
- [✂].

G111 In coming to this view, the CAA indicated (among other issues) that:

- STAL had indicated it had put significant effort into engaging with airlines to compete for new business and that in pursuing new business it was a standalone business, albeit one that received some assistance from BAA.[75]
- Despite generous offers being made, STAL had been unable to attract new airlines and that its current mix of airlines may be contributing to the difficulties that it has.[76]
- A number of stakeholders had suggested that BAA's ownership of the airport may have influenced STAL's approach to negotiations and that its approach reflected broader BAA airport portfolio considerations.[77]
- STAL's strategy documents suggested that STAL considered changing economic conditions and 'spill' of traffic from Heathrow and Gatwick would contribute to its growth going forward.

Stakeholders' views

G112 In its response to the minded to Consultation, MAG noted its intention to strengthen Stansted's competitive position by striking long term deals with the airlines and its intention to work closely with the airlines:

- *... we are looking to agree long term deals with airlines to drive growth at Stansted.*

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74 Source: Thomson Airways [✂].

75 STAL noted that it had been able to determine its own strategy since at least 2005 and there has been little external control except with respect to the SG2 proposals and some marginal support from the centralised aviation team.

76 Source: STAL [✂].

77 Stakeholders who expressed this view included Southend Airport and Gatwick Airport.

- *...we also intend to offer commitments to airlines in terms of service quality, consultation and transparency, to provide appropriate assurance about the way we intend to run and develop the airport.*

- *We know from our experience elsewhere that generating traffic growth will also require us to take a long term view of the Stansted business, and to work closely with airlines to identify potential new services. In this regard, we recognise the need to share with airlines the significant risks that are associated with starting new services. We believe that these existing relationships with airlines will provide a strong platform for growing the Stansted business.*[78]

G113 MAG also indicated (among other issues) that:

- Competition is already underway and will continue to develop and strengthen as new owners adopt new strategies to attract airlines and passengers away from other airports.[79]

- Ryanair's significant presence is such that this can deter other airlines from flying from Stansted, even when STAL offers deep discounts.[80]

- It did not agree with the CAA's view that STAL was indifferent to losing further traffic from Ryanair – it noted that it has every incentive to maintain its customers.[81]

G114 In addition, with respect to STAL's negotiations with Ryanair when under BAA ownership, MAG indicated that:

- STAL had made considerable effort to reach an agreement and that its refusal to agree terms with Stansted was part of its long term regulatory strategy, and that with uncertainty surrounding Stansted's ownership it would be able to agree a lower price once new owners were in place.

- Refusing to accept a commercially unsustainable offer from a customer cannot mean that Stansted has substantial market power.[82]

G115 GAL indicated (among other issues) that:

- The new owners of Stansted have signified their intention to compete.

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78 MAG, Interim response of MAG to the CAA's minded to document, p. 22.

79 MAG, Interim response of MAG to the CAA's minded to document, p. 4.

80 MAG, Interim response of MAG to the CAA's minded to document, pp. 70 to 71.

81 MAG, Interim response of MAG to the CAA's minded to document, pp. 70 to 71.

82 MAG, Interim response of MAG to the CAA's minded to document, p. 70.

- The behaviour of Stansted under BAA ownership sheds little or no light on its competitive significance in the future. [83]

G116 easyJet welcomed the CAA's analysis that the market power test was met in relation to Stansted and that continued economic regulation was required.[84] It also indicated that it was:

unclear whether the new owners of Stansted will take the same approach as BAA. easyJet is seeking to negotiate a long-term commercial arrangement with MAG, as it did (without success) with BAA.[85]

G117 Following the easyJet submission referred to above, easyJet and MAG agreed a long-term deal at Stansted. Subsequently easyJet indicated that it does not consider that STAL has market power.[86]

G118 LSACL noted that '*it takes time for a new owner to establish new policies, as for example Gatwick, and the effect of Stansted's ownership change will likewise take time to settle*.'[87]

Other views

G119 MAG, in its response to the Initial Proposals, raised a number of issues relevant to the CAA examination of its negotiations at Stansted. For example, MAG indicated that:[88]

- [✂].
- [✂]
- [✂].
- [✂].
- [✂].

83 GAL, CAA Stansted market Power Assessment – Response from Gatwick Airport, p. 1.

84 easyJet, easyJet's response to the CAA's Minded to Consultation on Market Power on Stansted Airport, p. 1.

85 easyJet, easyJet's response to the CAA's Minded to Consultation on Market Power on Stansted Airport, p. 1.

86 In a reply email sent by easyJet to Tim Griffiths at the CAA on 29 July responding on whether easyJet's view of Stansted's market power had changed, easyJet responded that: [✂].

87 LSACL, Minded to consultation on Market Power at Stansted Airport, p. 1.

88 MAG, Economic Regulation at Stansted from April 2014: Initial Proposals, MAG's response to the CAA consultation, pp. 11 to 12.

G120 Although not a part of the response to the minded to Consultation, Ryanair's CEO, Michael O'Leary at a press conference announcing the deal with MAG stated (among other things) that:

[the deal] shows, or vindicates, the decision of the UK authorities to break up the BAA monopoly and allow competition and the partnership of Ryanair and MAG to deliver this kind of aggressive traffic growth at Stansted.

Stansted, freed from the BAA and a more forward looking manner of the management MAG, will work with us help us to deliver efficient facilities and lower fares.

In summary, we are wonderful, we think Stansted is wonderful; MAG is wonderful, feel the love emanating all over the room... [89]

Additional Consultation views

G121 As mentioned above, STAL (under MAG) negotiated and concluded long-term growth deals with its major airlines, easyJet and Ryanair, in early June and early October 2013 respectively.

G122 easyJet agreed heads of terms with STAL on 3 June 2013.[90] The easyJet deal incentivises the airline to grow at Stansted. The agreement with easyJet covers five years from 1 April 2013 [✂].

G123 STAL's press statement described the deal as *'a new long-term growth framework deal to enable the airline to more than double its passenger numbers at Stansted from a current 2.8 million passengers to six million passengers a year over the next five years.'* [91]

G124 The main features of the easyJet deal are:

- [✂].
- [✂].
- [✂].
- [✂].
- [✂].
- [✂].

[89] http://www.youtube.com/watch?v=hQ2hiHoKPYE

[90] Letter from MAG to easyJet dated 3 June 2013.

[91] http://www.stanstedairport.com/about-us/media-centre/press-releases/easyjet-sign-long_term-deal-to-double-traffic-at-stansted.

G125 Ryanair also agreed heads of terms with STAL on 3 September 2013 [✂].[92]

G126 Ryanair's press statement states:

The deal will see Ryanair grow its traffic at Stansted by over 50%, from 13.2 million passengers in 2012 to over 20 million per year in return for a package of lower costs and more efficient facilities at Stansted. The agreement will account for up to 25% of Ryanair's five year growth plans to 2019. Ryanair expects its Stansted traffic in year 1 of this 10-year deal to grow from 13.2 million to over 14.5 million.[93]

G127 The main features of the Ryanair deal are:

- [✂].
- [✂].
- [✂].

G128 To further inform its judgement about the effect of the latest developments on its market power assessment the CAA consulted on how it should consider those developments. In particular, the CAA sought to determine whether the net effect of these recent developments was significant enough to cause it to change its mind on STAL's market power in relation to the passenger market.

G129 As stated in the additional Consultation, the CAA's provisional view in relation to Test A of the Market Power Test (MPT) was changed from that outlined in the minded to Consultation. The CAA considered that in the relevant passenger market, Test A would not be met as the bilateral agreements with easyJet and Ryanair implied that there is a level of buyer power which, together with other constraints, would restrict STAL's market power.

G130 As part of the additional Consultation the CAA also asked for stakeholders' views on whether recent developments in the form of bilateral agreements between MAG and some airlines covering a significant majority of passenger traffic should be seen as evidence that STAL does not meet Test A of the MPT and/or does meet Test C of the MPT.

G131 The CAA also considered provisionally that:

92 Ryanair, Letter from Ryanair to MAG dated 3 September 2013.

93 Ryanair: http://www.ryanair.com/en/news/ryanair-agrees-10-year-growth-deal-at-stansted.

- The easyJet and Ryanair bilateral agreements include charges in their respective first years of operation that are below the current regulated charges for STAL.
- Both agreements offer the potential for discounts if growth targets are met.
- These lower charges are within the range of what the CAA considers to be a competitive level based on the analysis included in the 'minded to' MPA.[94]
- The other deals, of which the CAA is aware, offer reduced charges for passenger commitments.

Stakeholders' views on the additional Consultation

G132 The CAA received four responses to its additional Consultation from:

- MAG;
- SACC;
- Ryanair; and
- GAL.[95]

G133 In its response to the additional Consultation MAG considered that: [96]

- The agreed long-term deals indicated that STAL's behaviour was not consistent with an airport operator seeking to exploit market power since it would not have been able to persuade airlines to engage willingly in negotiations and to sign up to new deals so quickly.
- STAL's improved consultation and engagement processes showed its constructive approach to building relationships with airlines, as in the case of the Terminal Transformation Project that required a high degree of commercial and operational co-operation between airlines, handling agents and retail.
- Its positive approach to engagement with the Airports Commission where MAG played an active role in process by proposing short, medium and long term options.

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94 Paragraphs 6.38 to 6.69 Stansted 'minded to' Market Power Assessment January 2013.

95 Non-confidential versions of these submissions are available on the CAA's website.

96 Stansted Market Power Assessment, M.A.G.'s response to the CAA's additional consultation of October 2013, 11 November 2013, pp. 5 to 6.

- When the deal between Ryanair and Stansted was announced on 16 September 2013, Michael O'Leary of Ryanair stated that it is *'indicative of the new regime at Stansted and M.A.G that within a period of six months of taking over they are signing an aggressive and dramatic growth deal'.*[97]

- Since March 2013, it has entered into discussions with [✂] passenger airlines and [✂] cargo airlines and that they have agreed deals with [✂] passenger airlines and [✂]cargo airlines and made offers to [✂] other passenger airlines and [✂] other cargo airlines.

- The deals that it has agreed with passenger airlines have a number of common features:
  - The largest deals are all long term – covering at least the whole of the Q6 period.
  - Prices per passenger are designed to encourage Stansted and its airline partners to work together to increase passenger numbers at Stansted (which is currently 51 per cent utilised).
  - Prices per passenger are lower than the RAB-based price cap for the Q5 period – and will fall as passenger growth increases.

- These deals have been negotiated, and are being negotiated, in the face of strong competition from other UK and European airports since airlines choose where to allocate their aircraft by comparing offers from airports across Europe.

- Michael O'Leary's comments in a recent Ryanair call with investors before agreeing the new deal at Stansted:

  Regardless of whether or not we do anything at Dublin or Stansted this winter, we have a myriad of other airports' offers on the table. The challenge for us in the next 12 months, with no capacity growth, is to be very selective and very disciplined where we allocate our capacity because it's got to come from somewhere else within the system.

- The majority of Stansted's passengers (95 per cent) now benefit from long term deals. As a result, the majority of passengers using Stansted are likely to experience continued price reductions over the next decade.

G134 In its response to the additional Consultation the SACC noted that:

[97] Stansted Market Power Assessment, M.A.G.'s response to the CAA's additional consultation of October 2013, 11 November 2013, pp. 5 to 6.

- The deals are not structural changes and not relevant to assessing market power. Deals are outcome of circumstances, one of which is STAL's SMP – deals do not dilute SMP.
- An indirect consequence of removing regulation would be to remove incentive on MAG to re-negotiate or renew the easyJet and Ryanair deals.
- MAG has leveraged its SMP not to increase prices, but (in the face of regulation) to increase volumes.
- Only when it became apparent that the CAA would regulate STAL, was it possible for MAG (unable to increase unit revenue) to justify volume deals.
- Normal commercial behaviour includes reviewing/ re-negotiating over the course of an agreement and that this is only possible if the conditions remain in place. Therefore on this basis regulation must continue.[98]

G135 Ryanair in its response to the additional Consultation noted that: [99]

- Market power is a function of underlying conditions on the relevant market. The recent agreements between STAL and Ryanair/easyJet do not change these conditions.
- The importance of London, the capacity constraints at London airports and that other London airports are not sufficient to negate the airlines' ability to discipline STAL's abuses of SMP either through price or otherwise.
- Recent deals demonstrate that STAL continues to enjoy SMP since both Ryanair and easy Jet had to commit to high traffic growth to secure prices that are closer to the market price.
- Ryanair's agreement with STAL is not *'the best outcome" but damage limitation following the failure of regulation to deliver competitive prices at STN.'*

98 Stansted ACC, Response Letter to the CAA, Re: Assessing the Market Power of Stansted Airport, 8 November 2013.

99 Ryanair, Response Letter to the CAA, Re: Stansted Market Power assessment: consultation on relevant market developments, 11 November 2013.

- The CAA must recognise that the current agreements were finalised against the background of imminent regulations, and with a view to tying airlines into STAL long-term, in order to raise prices once the agreements expire. As a result regulation remains necessary to ensure constructive commercial discussions can continue and the effects of competition are replicated at STAL.
- Deals show seller power by STAL not buyer power by airlines.
- MAG's reversal of 6 per cent price increase was a strategic regulation move by MAG at a crucial time in CAA's evaluation of STAL's SMP.
- MAG was anxious to demonstrate that a threat from an airline was sufficient to force it to reverse the price increase.
- Ryanair's previous traffic cuts failed to discipline STAL's behaviour so Ryanair does not have the ability to impose substantial harm on STAL.
- London is a pivotal destination for Ryanair with significant capacity allocated for London suggesting STAL's SMP and the absence of Ryanair's buyer power.

G136 GAL responded to the additional Consultation by noting that:[100]

- It agreed that the change in ownership at STAL had been accompanied by a more commercial approach that was relevant to the assessment of SMP.
- The CAA appeared to rightly recognise that STAL was operating as an effective competitor and was winning significant business.
- The CAA was inconsistent is its approach to assessing GAL and STAL market power positions.
- It agreed that the multi-year pricing agreements that were below or consistent with the competitive price level were relevant to the CAA's assessment of market power. However, it considered that this development was only one factor relevant to SMP and should not be considered determinative.
- Its commitments were equivalent to STAL's bilateral agreements.
- It was unable to negotiate agreements under price-cap regulation.

100 GAL, Gatwick Airport's response to the CAA's Stansted market power assessment consultation on relevant market developments, 11 November 2013, Reference: Q5-050-LGW66.

CAA views and conclusion on engagement and commercial negotiations

G137 The CAA continues to consider that the evidence from STAL under BAA ownership suggested that STAL:

- Largely set the terms that an airline would receive and that the scope for negotiation was relatively limited, an approach that appears to differ from its neighbouring airports.
- Had adopted a deliberate strategy that aims to decrease the presence of some airlines at the airport in an attempt to improve the appeal of the airport to other airlines.

G138 However, the CAA recognises that events have moved on since the minded to Consultation was released, not least that STAL has been sold to MAG, and that as a result its views and conclusions on engagement and commercial negotiations need to be re-considered. However, there is limited evidence to evaluate STAL's behaviour under the ownership of MAG and for this reason it went further to consult on the latest developments concerning the signing of the long term growth deals with easyJet and Ryanair in June and September 2013 covering almost 92 per cent of Stansted's passengers.

G139 After considering stakeholders' views and having conducted its own assessment of the signed long-term growth deals, the CAA considers that:

- The signing of bilateral deals within such a short period following Stansted's change of ownership is indicative of a new approach to STAL's engagement and commercial negotiations with airlines. This is a significant shift towards a more competitive and dynamic approach to pricing.
- Given that deals are not predicated on securing some regulatory outcome for STAL and will continue to be in force for the Q6 period regardless of the CAA's MPD assessment, the deals appear to be the results of a genuine attempt by STAL, under MAG's ownership, to engage and negotiate with its customers.
- The deals are a product of a free negotiation process between the interested parties and as such their outcome in terms of prices, volumes, etc. is likely to be closer to a market outcome subject to similar conditions.
- The bilateral deals have been welcome and were advertised as a success story with public statements and declarations about their significance and value by all sides.

- The sequence of the signing (easyJet first followed by Ryanair) of bilateral deals suggests that Ryanair the largest airline at Stansted airport has fully considered and analysed the relevant provisions and implications of their deal fully prior to concluding it.
- The existence of signed deals suggests outcome that are likely to be superior to a regulatory outcome (which would be subject to informational asymmetries).
- The deals refer specifically to the price for each passenger as opposed to a RAB-based regulation where the average price is calculated by dividing the required revenue by the forecasted number of passengers. As a result, the deals appear to focus on price per passenger instead of the revenue introducing higher degree of certainty for both the airport and the airlines.
- The existence of the signed deals suggests a balanced sharing of market and buyer power by the parties involved.
- The presence of long-term deals suggests that it is reasonable to assume that bilateral deals were concluded and negotiated by the parties through a proper process. As a result their provisions, outcomes and its implications have been properly considered and rationally analysed so as to best serve the interests of all parties to an adequate extent so as to enable them to proceed and conclude bilateral deals.
- The timing of the signing of bilateral deals which coincides with the CAA's market power assessment of Stansted airport indicates that the parties involved had also considered the counter factual scenario that was the possibility of pricing on the basis of RAB-based regulation. However, all parties freely and willingly agreed to prefer the option of negotiated as opposed to regulated pricing regime.
- As a result, the bilateral deals indicate that STAL is restricted in its ability to exercise any market power for the period foreseen in the deals.

G140 easyJet, in response to a question posed by the CAA (29 July 2013) on whether easyJet's view of Stansted's market power had changed, responded that:

[✂].

G141 While STAL under BAA ownership was pricing to the cap, the deals that have been struck between STAL under MAG ownership and the major Stansted airlines are at prices, subject to certain conditions, much more in line with evidence suggesting a proxy for the competitive price level and likely to be below the regulated cap.

G142 The history of negotiations between STAL and the main airlines has been different to that under STAL when it was owned by BAA. No successful negotiations were concluded between Ryanair and STAL between 2008 and 2012. In the minded to Consultation, the CAA noted STAL's apparent indifference, in losing some of Ryanair's traffic, whilst it was under BAA's control.[101] Overall, Ryanair's countervailing buyer power towards STAL under BAA's ownership appeared limited given its share of overall Stansted traffic and the airport operator was likely to hold the stronger negotiating position in relation particularly to existing traffic.[102]

G143 Based on the past information, the CAA considered that the evidence on engagement and negotiations suggested that STAL may have had market power (in part due to its common ownership with Gatwick and Heathrow) and that under BAA ownership STAL had exercised this market power in its engagement and negotiations with airlines.

G144 However, since its separation from Heathrow and based on the latest information and developments (including the signing of long-term growth deals between STAL and easyJet and Ryanair), the CAA considers that the situation has changed significantly. The CAA now considers that following successful negotiations airlines, the signing of bilateral deals suggest that the risk of STAL abusing any market power in terms of price increases is minimal.

G145 Therefore, while alternative explanations can be put forward for the deals the CAA considers that the very fact that they were negotiated and signed and that their observed negotiated outcome can be considered as a quasi-market outcome is relevant evidence to the assessment of SMP for STAL.

Service quality

G146 Airports operating in a competitive market may face significant pressure to maintain or improve their service quality to prevent airlines and passengers switching to other airports. The level of service quality could, therefore, provide evidence about whether an airport faces significant competitive pressures.

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101 CAA, Stansted Market Power Assessment: developing our 'minded to' position, December 2012, p.165.

102 CAA, Stansted Market Power Assessment: developing our 'minded to' position, December 2012, pp.165 to 166.

G147 Where an airport has SMP, in addition to increasing prices and/or reducing levels of investment, it might be able to reduce the quality of its service offering. However, in 2009 regulation of service quality under the Service Quality Rebates (SQR) regime was introduced by the CAA at Stansted.[103]

Minded to Consultation

G148 In the minded to Consultation, the CAA considered that there was:

- A lack of evidence as to whether competitive pressures have led to improvements in this area.
- Evidence to suggest that the introduction of the SQR, as part of the price control at Stansted, resulted in an improvement in the quality at the airport.

G149 The CAA also noted that service quality was considered in more detail in Test C.

Stakeholders' views

G150 MAG did not directly address the analysis on service quality presented in the Consultation. However, MAG noted that the change in ownership had enhanced the competitive position of Stansted[104] and that it intended to:

- Build on the growth in passenger volumes by offering a better passenger experience (through a terminal transformation project).[105]
- Offer commitments to airlines in terms of service quality (among other issues).[106]

G151 MAG has also highlighted that it intends to take a strategic approach to Stansted, focussing on better customer service and value to airlines.[107]

G152 GAL indicated (among other issues) that:

- The new owners of Stansted have signified their intention to compete.
- The behaviour of Stansted under BAA ownership sheds little or no light on its competitive significance in the future. [108]

[103] This was in response to a public interest finding made by the CC.

[104] MAG, Interim response of MAG to the CAA's minded to document, p. 2.

[105] MAG, Interim response of MAG to the CAA's minded to document, p. 21.

[106] MAG, Interim response of MAG to the CAA's minded to document, p. 22.

[107] MAG, Interim response of MAG to the CAA's minded to document, p. 20.

[108] GAL, CAA Stansted market Power Assessment – Response from Gatwick Airport, p. 1.

G153 Southend noted that *'it takes time for a new owner to establish new policies, as for example Gatwick, and the effect of Stansted's ownership change will likewise take time to settle.'*[109]

Other views

G154 MAG, in its response to Initial Proposals similarly highlighted:

- The benefits that it expects from new ownership and greater competition.[110]
- Terminal redevelopments undertaken by M.A.G. at Manchester airport have positively impacted on the Airport Service Quality (ASQ) scores, with the score increasing from 3.5 to over 3.9 during the last few years.[111]
- Its willingness to provide voluntary commitments to airlines on quality (among other issues), backed up by transparent reporting.[112]

CAA views

G155 The CAA recognises that under new ownership and management, there may be scope for further improvement in service quality to occur.

G156 To better understand MAG views on this issue the CAA requested further information on how it was proposing to deal with service quality. In response to this request, MAG told the CAA that:

[109] Southend, Minded to consultation on Market Power at Stansted Airport, p. 1.

[110] MAG, Economic Regulation at Stansted from April 2014: Initial Proposals, MAG's response to the CAA consultation, p. 12.

[111] MAG, Economic Regulation at Stansted from April 2014: Initial Proposals, MAG's response to the CAA consultation, p. 20.

[112] MAG, Economic Regulation at Stansted from April 2014: Initial Proposals, MAG's response to the CAA consultation, p. 28.

The level of service provided under the Q5 SQR scheme provides an appropriate basis for monitoring the airport's service quality performance against a defined set of service targets. Monthly service quality reports would continue to provide airlines and the CAA with the ability to monitor service levels across a wide range of indicators. We would also be willing to commit to publishing our performance in the terminal building and on our website to enable passengers to monitor service levels. In addition, we agree that it may also be appropriate for the airport to pay rebates to airlines in some areas where minimum standards of performance are not met. These areas would need to be identified in consultation with airlines.[113]

G157 The commitments that MAG proposes for service quality would effectively use Q5 regulatory targets as benchmarks. This suggests that MAG has committed not to reduce its current service quality levels, with SQR scores reflecting discussion between the airlines at Stansted and STAL.

G158 In the latest business plans that MAG submitted for Stansted no additional information was provided to the CAA to enable it to assess MAG's future service quality plans.

Conclusion on service quality

G159 The CAA recognises that economic regulation can complicate the relationship between the level of service provided and the degree of market power held by an airport operator.

G160 In particular, the CAA considers that the level of service quality of designated airports might be an outcome of regulation rather than of market power or competitive pressures, which can reduce the degree to which any analysis of service quality might provide a reliable indicator of market power. In the case of Stansted, regulation of service quality under the SQR regime was introduced by the CAA in 2009, in response to a public interest finding made by the CC.

G161 Taking into account the material submitted by STAL, including material submitted in response to the Consultation, other stakeholder views and its own analysis, the CAA considers that it is not possible to conclude on the plans for quality improvements at Stansted. In addition, the CAA considers it is not possible to determine whether Stansted will be facing sufficient competitive pressures to drive up service quality.

G162 As such, consistent with the findings it outlined in the minded to Consultation, the CAA finds that there is:

113 Source: MAG [✂].

- A lack of evidence as to whether competitive pressures have led to improvements in this area.
- Evidence to suggest that the introduction of the SQR, as part of the price control at Stansted, resulted in an improvement in the quality at the airport.

G163 The issue of service quality is also considered in more detail in Test C.

Profitability

G164 An airport operator in a position to act independently of its competitors due to lack of sufficient of competitive pressure might be expected to increase prices above the competitive level, and/or deliver service quality below the competitive level, and do so to increase its profitability.

G165 In the minded to Consultation, the CAA noted that the working paper on the empirical methods for assessing behaviour, performance and profitability of airports stated that analysis of the financial performance of regulated airports is unlikely to provide particularly strong evidence about an airport operator's market position.[114] The CAA, recognising the limitations associated with profitability measures, also highlighted that it had explored other possible indicators of market power, including efficiency and pricing, to inform its minded to view.

Current profitability

Minded to Consultation – past and current profitability

G166 In the minded to Consultation, the CAA recognised the limitations of profitability analysis for regulated airports but that it had examined a number of indicators of profitability at Stansted and at other UK airports.[115]

G167 In assessing STAL's profitability under BAA's ownership, the CAA came to the conclusions that:

114 This document is available at: http://www.caa.co.uk/docs/78/ERG_Working_paper_Performance_and_Behaviour-26-11-10_FINAL.pdf.

115 For a discussion of the various measures of profitability, see the CAA, Empirical Methods working paper, paragraphs 4.1 to 4.19.

- Stansted's ROCE from 2006 to 2011 had been consistently at the lower end of the spectrum of UK airports that the CAA has examined, with a low of 1.9 per cent, a high of 5.6 per cent and an average of 4 per cent.[116]

- A number of additional financial metrics suggested that STAL's performance across the profitability benchmarks had been mixed but that, in general, its recent performance was in line with other UK airport operators.[117]

  There was no evidence of persistent and excessive returns being achieved at Stansted and this outcome was not surprising given that the airport is subject to price cap regulation.[118]

- Its finding on the overall profitability of the airport was consistent with the CC's 2011 study into possible material changes of circumstances of BAA, which found that the airport's '*financial results were healthy when compared with other, non-BAA airports*', notwithstanding a decline in passenger numbers in recent years.[119]

G168 The CAA also noted that:

- It has undertaken a limited amount of profitability analysis using publicly available information on different airports.

- It considers that it has struck an appropriate balance to be able to conclude that STAL's financial position does not suggest that persistent and excessive returns have been achieved at Stansted.

Minded to views – future profitability

G169 In the minded to Consultation, the CAA noted that the future profitability of STAL can be an important indicator of the potential for it to exercise SMP. In assessing STAL's future profitability the CAA noted that:

- In its submission to the CC on the Material Change of Circumstances, BAA stated that '*there has been a significant fall in the level of Stansted's profitability and there is considerable uncertainty at the current time around the airport's future prospects'*.[120]

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[116] CAA, Minded to Views, pp. 141 to143.

[117] CAA, Minded to Views, pp. 141 to143.

[118] CAA, Minded to Views, pp. 141 to143.

[119] CC, BAA Market investigation, Consideration of possible material changes of circumstances, 2011, paragraph 245.

[120] In particular, BAA noted that Stansted's passenger traffic fell from 23.8 mppa in 2007 to 19.9 mppa

- It considered a number of strategy documents from Stansted that detail its view on its prospects, including its profitability. One of these documents states that STAL's objective is to '*achieve deregulation with no price cap*' and that point to point long-haul spill to Stansted from the London system will help achieve its base case strategic scenario. In relation to this STAL noted that:

- *Our objective is to achieve deregulation with no price cap but retain commitments in terms of service and investment levels. That will be a significant value lever for the long term given that this will allow recovery of part of the return in the future (when utilisation is higher) that we have not been able to capture during the present recession.*[121]

- *We expect that traffic will grow 4.3 per cent from 2012 to reach 20.5 million in 2016....The EBITDA will grow 14.5 per cent pa from £86.3 million in 2012 to £145.5 million in 2016.*[122]

- STAL's projections for the period 2012–2017, which were also outlined in the May 2012 strategy document, suggested that STAL was expecting strong growth in EBITDA per passenger, increase in tariffs in 2012 and increases in passenger numbers.

Stakeholders' views

G170 In relation to the analysis's of STAL's profitability MAG indicated that:

...*this assessment of Stansted's profitability is superficial and opaque, thus further undermining the 'minded to' conclusions. Moreover, even in its own terms, the Consultation Document's summary of the comparison of return on capital employed (ROCE) is highly misleading.*

And:

Stansted's ROCE over the period 2006-2011 was consistently and significantly below the mean and the median of the group of airports which are compared. Stansted's ROCE averaged 4% over the period, compared with 10% for the arithmetic mean for the whole group and 7.5% for the median. Thus Stansted's profitability, on this measure, was 60%

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in 2009 and the current moving annual total (MAT) was 18.7 mppa. It also noted that it considered that the principal reason for the large fall in passenger numbers was the withdrawal of significant seat capacity from Stansted by Ryanair and easyJet since 2007. This information is available at: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/baa_submission_on_mcc_non_confidential_version.pdf , p. 20 (accessed December 2012).

121 Source: STAL [✂].

122 Source: STAL [✂].

below the mean and 46% below the median of the comparator group. This cannot, on any reasonable grounds, be described as "recent performance … in line with the other UK airports".

G171 Furthermore, MAG criticised the minded to Consultation for omitting to present any analysis of STAL's actual return compared with the regulatory return set at each successive price control period. As part of this, MAG also noted that:

- In recent years (2007–2012), its actual weighted average cost of capital (WACC), before exceptional, has been consistently below the WACC set by the CAA in its price control decision of 2003 and 2009.
- WACC has averaged 4.7 per cent compared with 7.3 per cent for the regulatory estimate of the WACC.[123]
- The CAA's use of profitability material from the CC was inappropriate and that a more robust analysis of profitability was required if the CAA was to rely on this.[124]

Other views

G172 In response to the Initial Proposals, SACC noted:

During the period 2003/04 to 2006/07, STN experienced healthy growth in passenger traffic, revenue and airport charges which is typical of growth profiles in competitive environments. Self evidently:

- *since 2007/08, airport charges at STN have been set above the competitive level; but*
- *despite a very significant decline, STN has been able to sustain increased revenues and profit.*
- *It is evident that in 2007, STN effectively sacrificed growth in passenger traffic for increased growth in revenue and operating profit – something organisations behaving competitively could not do*.[125]

G173 Ryanair, in response to the Initial Proposals, similarly indicated that:

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[123] MAG, Interim response of MAG to the CAA's minded to' document, 24 May 2013, pp. 85 to 87.

[124] MAG, Interim response of MAG to the CAA's minded to' document, 24 May 2013, pp. 85 to 87.

[125] Stansted ACC, RE: CAP1030 – Economic Regulation at Stansted from April 2014: Initial Proposals, p. 1.

- Since 2007/08 STAL has been sacrificing growth in passenger traffic and efficient asset utilisation for increased and excessive revenue and operating profits – something an airport operating in a competitive environment would not be able to do.
- STAL's doubling of charges in 2007 has been sustained and has led to increased profits despite the most dramatic fall in traffic of any London airport in the UK's post-war history.[126]

CAA's views and conclusions

G174 As set out in the minded to Consultation, an airport operator that enjoys a position of SMP might be expected to set prices above the competitive level, and/or deliver service quality below the competitive level, and do so to increase its profitability. An airport operator's financial performance may, therefore, provide useful information to understand airport behaviour.

G175 However, the CAA has re-evaluated its position on the usefulness of the profitability of a regulated airport as an indicator of market power and now considers that its value is more limited since price cap regulation is designed to prevent an airport operator from earning excessive returns.[127]

G176 Consequently, the CAA considers that the analysis of the financial performance of regulated airports is unlikely to provide particularly strong evidence about their market position, particularly if the airports choose to set their prices at, or near to, the allowed price cap.

G177 Recognising the above, the CAA considers that given Stansted is currently a regulated airport, an analysis of its past and present profitability is unlikely to provide any useful indication about its market power. In addition, the observed lack of excess returns cannot be attributed only to competitive pressures and are more likely to be driven by regulatory requirements.

G178 Furthermore, given the recent change of ownership of STAL ,the CAA considers that:

- In the limited interval since MAG's acquisition of STAL, there is insufficient evidence to assess STAL's profitability under the new ownership.

126 Ryanair, Economics Regulation at Stansted from April 2014: Initial Proposals, p. 1.

127 CAA, Empirical methods for assessing behaviour, performance and profitability of airports, paragraph 4.3.

- Various financial and EBITDA projections cannot be relied upon to draw conclusions about STAL's future profitability.

G179 Taken together, the CAA considers that it can place little reliance on the analysis of STAL's profitability as a reliable indicator of whether it has or is likely to acquire SMP.

G180 Based on the above, the CAA therefore considers that a further discussion of the specific responses in relation to the profitability indicator is no longer relevant and for this reason it does not provide any further comments in relation to those responses.

Conclusion on indicators of market power

G181 The CAA recognises that individual indicators of market power on their own may not be determinative of market power (as each may suggest slightly different assessments), but when considered as a whole, help to determine whether or not an airport operator has SMP. However, the CAA's overall assessment of SMP, presented in chapter 5 of the Statement of Reasons, draws on the evidence in this and other appendices.

G182 In light of the representations from stakeholders as part of the minded to and the additional Consultations, the CAA has re-evaluated the evidence on the indicators of market power and concludes that while market share analysis supports a rebuttable presumption of SMP, the evidence from other indicators of market power, notably engagement and commercial negotiations suggest that a presumption of dominance cannot be maintained.

G183 In coming to this conclusion the CAA recognises that there is a level of judgement over whether Gatwick should be included in the relevant market. If Gatwick was included in the relevant market, the resultant low market share that Stansted would have would make it unlikely to establish a rebuttable presumption of dominance. As a result, under this scenario, the CAA's analysis of the indicators of market power would also lead it to conclude that Stansted does not have nor is it likely to acquire SMP in the relevant market.

G184 While the past analysis of efficiency suggests a number of areas where inefficiencies have been identified by a number of studies undertaken by different consultants, there is insufficient information upon which to draw robust conclusions about STAL's future opex and capex efficiency performance under the new ownership of MAG.

G185 Indicators of market power such as profitability and service quality are unlikely to provide useful information about STAL's market power as they are driven mainly by the regulatory requirements.

G186 The CAA considers that STAL has been historically pricing to the cap and that when taking into account the error margins of EE's LRAIC and LF's benchmarking studies its prices have been either above or at the top of the range of the LRAIC-based and the LF benchmark price estimates.

G187 The evidence from the recent signing of the long-term growth deals between STAL and its main airline customers, namely Ryanair and easyJest, suggests the following.

- The signing of bilateral deals within a short period following STAL's change of ownership is indicative of the new approach to STAL's engagement and commercial negotiations with the airlines. This appears to be a significant shift towards a more competitive and dynamic approach to pricing.
- Given that deals are not predicated on securing some regulatory outcome for STAL and will continue to be in force for the Q6 period regardless of the CAA's MPD assessment, they appear to be the results of a genuine attempt by STAL, under MAG's ownership, to engage and negotiate with its customers.
- The deals are a product of a free negotiation process between the interested parties and as such their outcome is likely to be closer to a market outcome.
- The bilateral deals have been welcome and were advertised as a success story with public statements and declarations about their significance and value by all sides.
- The sequence of the signing (easyJet first followed by Ryanair) of bilateral deals suggests that Ryanair, the largest airline at Stansted has fully considered and analysed the relevant provisions and implications of their deal fully prior to concluding it.
- The existence of the signed deals suggests that their outcome is likely to be superior to a regulatory outcome which may be subject to informational asymmetries.

- The deals refer specifically to the price for each passenger as opposed to a RAB-based regulation where the average price is calculated by dividing the required revenue with the forecasted number of passengers. As a result the deals appear to be focus on the price instead of the revenue introducing higher degree of certainty for both the airport and the airlines.
- The existence of the signed deals also may suggests the possibility of a balanced sharing of market and buyer power by the parties involved.
- The very fact that they are long-term signed deals suggests that it is reasonable to assume that bilateral deals were concluded and negotiated by the parties bound through a proper process and their provisions, outcomes and its implications have been properly and rationally considered and analysed. As a result, the signed deals indicate that they were considered to best serve the interests of all parties.
- The timing of the signing of bilateral deals which coincides with the CAA's market power assessment of STAL indicates that the parties involved had also considered the counter factual scenario that was the possibility of pricing on the basis of RAB-based regulation. However, all parties freely and willingly agreed to prefer the option of a negotiated as opposed to regulated pricing regime.

G188 Therefore, based on the latest information and developments related to the signing of long term growth deals between STAL and its largest customers the CAA considers that the situation has changed significantly and that after successful negotiations the signed bilateral deals indicate that STAL is restricted in its ability to exercise any market power that it has.