

The need for the divestiture of two BAA London airports

1. Introduction

1. We have provisionally found that BAA's common ownership of Heathrow, Gatwick and Stansted is a feature of the market which prevents competition between them. We noted that the effectiveness of competition between them, absent common ownership, was likely to increase in the longer term with the increased incentive to invest, although we also saw some scope for competition between them in the short term despite existing capacity constraints. We also noted that common ownership further restricted competition through its effects on capacity constraints and because it exacerbated the inadequacies of the regulatory system, reducing the benefits of regulation and thereby distorting competition between airlines.
2. In our Remedies Notice we put forward the view that divestiture of two of the London airports would effectively address the AEC identified, freeing BAA's London airports to compete with one another and creating comparators against which the regulator could benchmark airport performance. We noted that existing capacity constraints would be likely to limit the extent of this competition in the short term and that this implied that regulation in some form might need to continue at Gatwick and Stansted until more capacity came on stream. In the case of Heathrow, we also noted that its hub status might limit the degree to which it could be constrained by rival airports and therefore suggested that Heathrow might warrant longer-term regulation.
3. BAA has argued that our proposal to remedy the AEC associated with common ownership by divesting two of its London airports has not been supported by a proper analysis of potential remedies. It argued that it was incumbent upon us to consider whether the divestiture of one airport would be sufficient to address our concerns and, moreover, to assess whether regulatory/behavioural remedies might be an

alternative to divestiture (or could be employed in conjunction with a single divestiture).

4. According to BAA, the reasoning set out in our provisional findings¹ should lead us to conclude that the sale of Gatwick alone would address the AEC of common ownership, and that the continued common ownership of Heathrow and Stansted would not give rise to an AEC at all, or certainly not one requiring compulsory divestiture of a second airport. It argued that this was the case because the sale of Gatwick would achieve:

- the anticipated scope for competition between Gatwick and Stansted in off-peak periods (it termed this 1a);
- the anticipated scope for competition to attract more passengers per movement between Heathrow and Gatwick through the adoption of different aeronautical pricing structures (1b);
- the anticipated incentive for Gatwick to overcome the constraints on expanding runway capacity and anticipated competitive pressures to provide customer-led timing, delivery and specification of new capacity (2a and b); and
- the anticipated regulatory benefits arising from more comparators because it would provide the most appropriate comparator (among BAA's airports) for both Heathrow and Stansted as well as the anticipated benefits from the introduction of new management strategies (3a).

5. BAA stated that the only benefit we attributed to the double divestiture remedy that the sale of Gatwick would not achieve was what it termed 2c: potential for static competition once new capacity supported by the White Paper was developed. BAA

¹BAA did not accept our reasoning. BAA's comments in its response to the remedies document were based, without prejudice, on the general premise that our AEC finding and the reasons for it were well founded (except for '2c' discussed in paragraph 5).

submitted that there was no basis on which to rely on competition of this nature to justify divestiture.

6. BAA also pointed to competitive influences operating on BAA's London airports, which it suggested implied that we should carefully consider whether further divestitures were necessary. It cited the following constraints: competition from other European hubs in relation to a significant element of Heathrow traffic; Luton and London City; more widely dispersed airports (particularly for low-cost carriers (LCCs)); and airline buyer power.
7. BAA reinforced its argument by drawing attention to reasons why it saw the scope for competition between Heathrow and Stansted to be particularly weak (or, put another way, that the AEC associated with common ownership of both airports was negligible). It submitted that Heathrow and Stansted were poor substitutes for: the majority of airlines serving Heathrow; the majority of transfer passengers that used Heathrow; and a large proportion of non-transfer passengers that used Heathrow because of the differences in Heathrow's location, network and flight frequency. It also noted that the degree of excess demand at Heathrow was particularly large and the likelihood of de-regulation was less than at the other airports. This, it argued, implied that there was particularly strong reason to doubt that there was any scope for static competition between Heathrow and the other airports. It also submitted that it was overseas hubs that affected dynamic competition at Heathrow.
8. We disagree with BAA's arguments and consider that the divestiture of two airports is supported by the evidence. The following section sets out our rationale for requiring the divestiture of two BAA London airports to remedy the AEC associated with common ownership that we have identified. In doing so, we address the relevant points that BAA has made.

2. The framework for assessing the impact of divestitures

9. Prior to setting out the rationale for the divestiture of two airports (Gatwick and Stansted), it is useful to set out the analytical framework for assessing the appropriate remedy for the AEC identified in relation to common ownership. BAA has argued that we should employ the following framework to establish whether or not the divestiture of two airports is required:
- (a) establish the impact on competition of the sale of one South-East airport;
 - (b) establish whether continued common ownership of the two remaining airports would be a feature giving rise to an AEC and, if it would, whether divestment would be a proportionate remedy to that AEC; and
 - (c) establish whether regulatory or behavioural remedies would be an effective remedy either in their own right or in combination with the divestiture of one airport.
10. When applying the BAA framework in paragraph 9, it is important that we allow for the possibility that the impact on competition of the divestiture of Gatwick may be affected by whether or not Stansted is also divested and vice versa. This results from the interrelationship between the effectiveness of competition and the need for continued regulation. On the one hand, if competition cannot be expected to deliver outcomes that are associated with a well-functioning market, then some form of regulation is likely to be required. On the other hand, if regulation persists, then the effectiveness of any divestment remedy is likely to be reduced. It follows that if reliance on competition rather than regulation to deliver desirable market outcomes depends on the divestiture of both Gatwick and Stansted,² then, if only one is divested, the benefits from divesting the other will be reduced. Therefore, we need to be careful not to ignore this interrelationship, because doing so could result in under-

²For example, because divesting Gatwick alone would not inject sufficient rivalry to prevent the exploitation of significant market power.

estimation of the impact on competition of the divestiture of both Gatwick and Stansted, rather than just one of them.

11. In considering the impact on competition of the sale of Gatwick and Stansted, it is helpful to distinguish between two concepts: static competition, which we define as competition between airports whose capacity is fixed by existing infrastructure and which will be necessarily confined to competition on price and service quality, and dynamic competition whereby airports can also compete on capacity, ie seek to develop the level and configuration of runway and other necessary elements of capacity (subject to planning and other restrictions on development).³ It is also helpful to distinguish between the prospects for static competition in the 'short term' and prospects for static competition in the 'long term', after planned capacity expansions have occurred.
12. It should be noted, however, that the conceptual distinction between short term and long term is likely to be less clear-cut in practice. Decisions about the form and amount of significant additional capacity come into effect in the long term; however, the decisions themselves may take place in the short term and would be influenced by the pressures of rivalry following divestiture. Thus the benefits of dynamic competition may begin to accrue in the short term as decisions begin to reflect competitive pressures.
13. Also, the concept of the capacity of an airport is not straightforward in practice as it depends on the actions of a number of parties including the airlines. The passenger throughput of London airports has increased consistently over many years despite very limited investment in runway capacity due, for example, to new aircraft and new

³The nature of these restrictions on development and the implication for the way in which airports dynamically compete is discussed in more detail below.

operating procedures. Thus capacity may be less fixed in the short term than at first anticipated.

14. In line with the way in which BAA has presented its arguments, we will first consider the impact on competition of the sale of Gatwick before explaining why common ownership of Heathrow and Stansted would constitute an AEC. Evaluating the impact of Gatwick first seems appropriate given that BAA is already progressing the sale of that airport.⁴ Under this approach we look first at the impact of a divested Gatwick competing with Heathrow and Stansted. We then compare the impact of there also being competition between Heathrow and a divested Stansted with continued common ownership of those airports. In evaluating the impact of the divestitures, we also consider whether regulatory or behavioural remedies would be an effective remedy either in their own right or in combination with the divestiture of one airport.

3. The impact on competition of the sale of Gatwick

3.1 Short-term benefits

15. Our latest estimates indicate that the earliest dates that new runways could be completed at Stansted, Heathrow and Gatwick are 2015,⁵ 2020 and 2021 respectively. This suggests that the period which we characterize as ‘short term’ will be at least six years long and would be likely to span the whole of Q5 and at least part of Q6.
16. Given current forecast levels of demand, it seems likely that during this period capacity constraints may be binding at Heathrow throughout the day and at Gatwick and Stansted during peak times. However, the effect of recession on airline traffic along with planning approval for the SG1 developments at Stansted Airport means that there will be substantially more spare capacity in the South-East airports than we

⁴This does not tie us to any set of remedies or prevent us from finding, were the evidence to point that way (which it does not), that the sale of Stansted alone would be effective in addressing the AEC related to common ownership.

⁵Although we concluded in the Stansted airport price control review that it would not be required until 2017.

anticipated at the time of our provisional findings. As we noted in our provisional findings, capacity constraints affect the degree to which an airport can exercise a significant constraint on rivals, giving rise to a risk that unregulated airports might be able to exploit short-term market power. For this reason, we anticipate that, in addition to the longer-term regulation that may be needed to protect users of Heathrow, there is likely to be a need for transitional regulation until capacity comes on stream at Gatwick and Stansted. Therefore, when evaluating the impact on competition of the sale of Gatwick, we need to recognize that for several years following divestiture, these three London airports might continue to be regulated in some form. This will tend to limit the benefits rivalry will bring (as compared with the benefits one would normally expect from divestiture).

17. In our provisional findings, we based our analysis of short-term competition on an assumption that the current price control system would be maintained throughout Q5. The CAA subsequently highlighted that there was scope under the Airports Act for the intensity of economic regulation to be adapted to reflect the degree of competition airports faced (indeed, the CAA told us that it explicitly took into account the development of competition in setting the cap on Manchester Airport's charges in 2003).⁶ In relation to Q6 onwards, a review of the regulatory framework for UK airports has been launched by the DfT. We are ourselves in the process of formulating and consulting on appropriate recommendations on regulation to feed into this review.
18. Although there is some uncertainty as to how the regulatory regime will operate in the short term, it seems likely that each of the overall airport price caps, however determined, will continue to be binding at Heathrow, Gatwick and Stansted for much of this period. However, to the extent that the price caps are not binding, because, for example, demand decreases or because the CAA relaxes the price caps, then the

⁶CAA response to our provisional findings, Section 5.

benefits from divestiture will exceed those identified in the discussion below as the constraints on rivalry will be looser. We also anticipate that the regulatory system will continue to enable airport operators to offer individual discounts and to balance the different elements of airport charges⁷ within the constraint of the overall cap.

19. It is within this regulatory context that we need to consider the benefits of divesting Gatwick. As we have stressed in a number of places, where there is limited past experience to inform predictions it is difficult to forecast accurately the ways in which rivalry might manifest itself. It is unlikely that any regulator will have the ability to identify in advance all the benefits that divesting an airport will bring or that it will be able to predict with certainty the magnitude of the benefits that result. However, on the basis of the evidence we have collected, we consider that there is a strong case to expect the following five benefits to flow from divesting Gatwick:

- (a) the creation of another independently-operated airport, providing information for regulators and investors to better benchmark airport performance (ie permitting comparative competition);
- (b) the introduction of a new management team active in the South-East which may employ new approaches to airport operation and in so doing offer passengers increased choice.

Within the context of economic regulation, divestiture of Gatwick would result in:

- (c) competition between Gatwick and Stansted to fill off-peak slots;
- (d) competition between Gatwick and Stansted for passengers; and
- (e) competition between Gatwick and Heathrow for passengers.

We recognize that the effect of (c) to (e) may be limited to marginal improvements in pricing and utilization. However, they reflect important changes in incentives which could give rise to larger effects were more spare capacity to become available, were

⁷For example, the balance between off-peak and peak charges and the balance between landing, passenger and parking charges.

regulation to be relaxed or were airlines to prove highly responsive to rebalancing per passenger and per air transport movement (ATM) charges. We now set out the reasoning behind each of these benefits.

3.1.1 Comparative competition

20. We have noted that common ownership of airports reduces the quantity and quality of independent information available to the regulator and consequently reduces the quality of regulation by limiting the ability of the regulator to make cost and quality comparisons between different operators.

21. Under the current ownership structure, the CAA is dependent on a 'bottom-up' analysis of operating and capital efficiency, which involves examining the company's costs in detail to estimate the extent to which savings could be made. Similarly it has to form judgements about attainable service standards and what constitutes efficiently incurred capital expenditure by drawing on its own expertise and the advice of consultants. The effectiveness of this analysis is currently limited by the fact that the CAA cannot know the scope for cost reductions and performance improvements as well as BAA itself, and by the possibility that BAA may be selective in the information it supplies.

22. Divesting Gatwick will enable the CAA to collect two sets of accounts produced by independent and price-regulated operators, allowing it to benchmark their performance through a process known as comparative competition. We anticipate that this will have two main benefits:
 - to reduce regulatory costs through a reduction in the required level of scrutiny by the regulator and an increase in the likelihood that an appropriate regulatory settlement will be made; and
 - to improve service quality outcomes and opex and capex efficiency.

23. To understand how we expect these outcomes to be delivered, we first explain how comparative competition can work on a general level, before looking specifically at how it might be applied in the airports industry following the divestiture of Gatwick.
24. Comparative competition is often used by regulators to introduce competitive tension between firms operating in different geographic markets (and consequently enjoying a degree of market power) by comparing their performance and incorporating this information into the regulatory settlement. Comparisons are often performed on a cost basis, where they are used directly to inform the level of the regulated price cap.
25. In one form of comparative competition, known as pure yardstick competition, the regulator has two or more identical firms under separate ownership. Each firm is assigned its own shadow firm with a cost level equal to the average cost of all other firms with similar expenditure. This shadow firm's cost is used to infer what the original firm's attainable cost level should be, which is then used to calculate the price cap. This system 'rewards' firms with a low cost relative to the industry average and 'punishes' those with a high cost, creating incentives for cost efficiency.
26. In practice, firms face different costs for reasons other than differing efficiency levels: for example, because of physical size or number of employees. The method most commonly used to deal with this problem is to identify the impact of various cost drivers on total costs using statistical techniques, and to adjust the 'efficient' cost level appropriately for each firm, taking into account their individual characteristics and the impact these are likely to have on the attainable cost level. Such an approach has been applied in a number of regulated industries, including gas and electricity distribution, water and sewerage. It requires sufficient data to identify the impact of different cost drivers on costs in a reliable way, and so may only be possible with a minimum number of comparators.

27. However, comparative competition can still be applied in a more qualitative way where there are too few comparators to obtain a reliable estimate of efficient costs, serving in this case as a reporting tool rather than a direct input to the price settlement. One such application involves the regulator comparing cost forecasts of the different regulated companies, and using the lower-cost firm's projections to challenge the higher-cost firm for an objective justification as to why their costs need to be higher. Such comparisons can go a long way towards reducing the traditional information asymmetry between regulator and regulated firms, making it harder for the regulated firms to inflate costs to achieve a more favourable regulatory settlement. This can also reduce the costs of regulation, as improvements in the quality of information supplied to the regulator reduce the required level of scrutiny of costs and increase the likelihood that the regulator will make an appropriate determination.
28. Quality of service outcomes can also be significantly improved under qualitative comparative competition. This is because different management teams working for companies under separate ownership are likely to have very different approaches to similar challenges. Benchmarking these teams on a range of aspects of their performance helps the regulator to identify the approaches that could be considered best practice in the sense of delivering the best outcomes for consumers. The regulator can then encourage other teams not performing as well in specific areas of customer services to adopt the best practice approaches. In this way, the regulator can act as a hub, collecting and disseminating information on optimal management strategy.
29. Qualitative comparative competition can be used to enhance quality of service improvements further by creating incentives for firms to compete against one another, for example through the use of published league tables. League tables help

the regulator to identify companies that are underperforming and to apply pressure on them to improve their performance and possibly also to suggest how this might be achieved (as outlined above). League tables also help the regulated companies themselves to identify areas of their business where there may be room for improvement in performance. Finally, league tables can help the underperforming firms themselves identify which firms are employing best practice in particular business areas, reducing the extent to which the regulator would have to do this at the time of regulatory review and further reducing the costs of regulation.

30. We found a number of instances in which comparative competition has been used on a qualitative basis by some regulators to improve outcomes where the number of comparators has been too few to allow for a comprehensive modelling of cost drivers:

- Ofwat uses Overall Performance Assessments (OPA) across various service functions to produce and publish annual league tables of the regulated water companies' relative performance. The OPA incorporates both quantitative and qualitative elements to produce a single overall qualitative measure. These OPA comparisons have been credited with creating healthy tensions between water companies, in particular where they have been linked with management remuneration (for example, incorporating key performance indicators into staff bonus programmes). There is evidence that management strategy takes the OPA tables into account.⁸ In addition, when price limits are set, Ofwat makes a positive or negative adjustment to reflect how well each company has performed compared with others.
- Ofwat has also used qualitative competition to identify and implement best practice in other ways. For example, during a drought affecting ten water companies,

⁸For example, the acquiring party in a recent water company merger stated in the course of a CC inquiry into the merger that companies sought to avoid being at the bottom of the tables (although they did not necessarily compete to be at the top).

- Ofwat used a sub-set of these companies identified as having responded more effectively to the drought to challenge those firms that had been less responsive.
- Ofwat has recently used examples of historic performance at a subset of companies when considering whether price limits needed to take account of new water efficiency targets.
 - Ofwat has also used qualitative comparative competition to encourage companies to adopt what it considers to be best practice: for example, moves towards new tariff structures have been accelerated by comparative competition.
 - Ofgem uses ratio analysis (such as the HR cost per employee) to compare performance in indirect activities across the four ownership groups in the gas distribution network, with benchmarks being set at either the upper quartile or second-best performance level.
31. We now look at how we envisage that comparative competition between the new owner of Gatwick and BAA will lead to the delivery of lower regulatory costs and improved service quality and efficiency outcomes.
32. One of the current costs of regulation is the degree of scrutiny of BAA's accounts and performance that the CAA must undertake at the beginning of each quinquennial review period in order to determine the likely scope for improvements in operating cost and service quality outcomes over the five years in question. We recognize that the sale of Gatwick alone will result in too few comparators for robust estimation of efficient cost levels, or even the meaningful use of league tables, and so will not remove the need for regulatory scrutiny. However, it will allow the CAA to identify and challenge BAA on any areas of its business where the new owner of Gatwick submits lower cost estimates or outperforms BAA on quality of service measures or introduces innovative processes or services and vice versa. This has the potential to reduce the costs of regulation significantly, as it is likely to reduce the burden on the

CAA of establishing that BAA is underperforming if it believes this to be the case. It also increases the likelihood that the CAA will set appropriate targets for efficiency improvements and service quality standards by improving the information on which it bases these decisions.

33. We recognize that some benchmarking of costs between BAA airports already occurs under the status quo, but nonetheless envisage that divestiture of Gatwick will have a positive and significant impact on both the quantity and quality of current benchmarking activity for the following reasons. First, a number of functions are currently organized at group level in BAA, such as finance, IT and HR, and as such are more difficult to benchmark whilst the current ownership structure persists. Second, we expect to see a greater initial divergence in performance under separate ownership because different management teams are likely to have different approaches to similar problems. This makes it more likely that any scope for improvement will be identified and subsequently adopted across the industry. Third, information provided by an independent comparator is likely to be more valuable than the information provided by comparators that are owned by the same operator. This is because independent owners have less incentive to distort performance compared with the owner of more than one airport who will consider the impact an improvement in performance at one will have on the other airports in the group.
34. Whilst there are a number of similarly-sized international comparators, Gatwick is the closest comparator to both Heathrow and Stansted because it operates in the South-East. This means that it is subject to similar, if not always identical, government and CAA regulations, labour market forces, noise, pollution and planning constraints and congestion.

35. Some areas of an airport's operations lend themselves more to benchmarking than others. Generally speaking, benchmarking is most useful where:
- the activity is relatively discrete and standardized;
 - the outputs of the activity are easy to measure and relatively homogenous between comparators;
 - little subjective judgement on factors such as accounting policies and cost allocation, which can differ between companies, is required. International comparisons also often involve differences in exchange rates, which introduces a further complication;
 - there are few significant exceptional factors which need to be taken into account; and
 - those exceptional factors are easy to identify, quantify and allowed for in any analysis undertaken.
36. An example of an activity for which benchmarking is most appropriate, and indeed for which it has already been undertaken to a considerable extent in our Q5 reviews, is security queuing. The requirements of the activity are relatively homogeneous between UK airports, as they are prescribed in some detail in UK and EU regulation, and the output of the activity (passengers screened) is homogeneous. (International comparisons, however, are likely to be more difficult.) The only significant exceptional factor which may need to be taken into account is the local labour market, as security screening is a labour-intensive activity. This can be allowed for, however, as abundant data exists on local wage rates and unemployment levels, though judgements still need to be made about relative skill levels of comparator jobs.
37. Benchmarking of the following elements of airport opex (these cover roughly 80 per cent of Stansted's opex in 2006/07) might be expected to be useful:
- security staff costs;

- non-security staff costs;
 - constabulary costs (although the airport does not have any choice of supplier);
 - pensions;
 - cleaning; and
 - most central costs.
38. Benchmarking of the following elements of airport opex, which comprised around 20 per cent of Stansted's opex in 2006/07, might be expected to be more problematic, as they are largely determined by the design of the airport, or other local factors:
- rent costs;
 - maintenance and equipment costs;
 - exceptional costs;
 - rates; and
 - some central costs.
39. Most significant capex projects in airports have elements which can be benchmarked, and elements which are sui generis. It may be possible for the airport to argue that factors, other than its efficiency, need to be taken into account in evaluating top-down benchmarks. However, comparing, for instance, the cost of building a terminal at Stansted per square foot or overall measures of labour productivity with similar measures at other airports can be, and have been, used in assessing the reasonableness of overall costs.
40. In determining the cost of capital, benchmarking is useful, and the divestiture of some price-controlled airports may be expected to increase its usefulness significantly. A significant difficulty in estimating the cost of equity in the recent regulatory reviews was that there are few independent, privately-owned airports in the world. This is a common difficulty in industries where only one company is regulated (such as post or

rail). As we argued, however, in our provisional findings (paragraphs 2.130 and 7.43 to 7.46), separate ownership would be likely to lead to greater diversity in financing structures, facilitating innovation and competition.

41. We anticipate that the improvements in service quality as a result of comparative competition could be significant. This is because the CAA will be more confident in setting stricter performance targets at Heathrow and Stansted if it sees improvements in outcomes at Gatwick. As stated above, a diversity of managerial approaches means that innovations in service delivery are more likely to occur with Gatwick under separate ownership.

42. The benefits outlined above are difficult to quantify, although anecdotal evidence suggests that their impact could be large. Attempts to quantify benefits of comparative competition in the UK have found reductions in operating costs of up to 7.7 per cent.⁹ However, the savings are likely to be much wider than their impact on operating costs alone. For example, Ofgem found a relatively small (1.1 to 1.13 per cent) reduction in opex as a result of introducing comparative competition as part of its work on distribution networks sales. Further benefits of 1.4 per cent a year were identified through the Europe Economics and Reckon LLP work on total factor productivity supporting total ongoing productivity savings of 2.5 per cent a year. Ofgem considered that the main benefits of divesting four out of eight of National Grid Transco's gas distribution network came from the ability to introduce comparative competition, pointing towards innovations in service delivery such as the contracting out of opex activity.¹⁰ It is particularly relevant that the perceived benefits are large, given the relatively small number of separately-owned comparators in the gas industry.

⁹NAO, 2006, *Sale of gas networks by National Grid*. Report by the Comptroller and Auditor General; CEPA, 2003, *Productivity Improvements in Distribution Network Operators—Final Report*. Report for Ofgem.

¹⁰Ofgem, 2004, *National Grid Transco—Potential Sale of gas distribution network businesses. Final Impact Assessment*. Ref 255/04a; Ofgem-CC meeting, 2008.

3.1.2 Variety of management approaches

43. Separation of ownership creates scope for competition through new commercial or operating strategies, for example focusing on specific types of traffic or adopting new technologies. We would expect that the different management strategies and techniques that would arise through the divestiture of Gatwick might increase quality of service, efficiency, innovation and choice. In specifying criteria for suitable purchasers of divested airports, the CC will seek to ensure that purchasers have access to appropriate operating expertise to enable the divested airport to operate and develop as an effective competitor. A suitable purchaser may therefore have access to other airport operations within its sphere of influence that may make new approaches possible that enhance service quality and/or efficiency at Gatwick.

44. As a divergence of approach is likely to lead to a divergence in outcomes, we anticipate that this will have knock-on benefits for the effectiveness of comparative competition, as outlined above, as well as delivery of direct benefits to users. In particular, separate ownership is likely to encourage the development, identification and diffusion of processes and practices that will deliver a better outcome to passengers.

3.1.3 Competition within the context of economic regulation

Competition between Gatwick and Stansted

45. We noted in our provisional findings that there is a significant degree of substitutability between Gatwick and Stansted. The results of our quantitative analysis are summarized in the following table and support the view that Gatwick is the closest substitute for Stansted and that Stansted is the second-closest substitute for Gatwick, after Heathrow.

TABLE 1 **Substitutability of Stansted for Gatwick, and Gatwick for Stansted**

<i>Extent to which Stansted is a substitute for Gatwick</i>	
Catchment analysis: % of Gatwick's total passengers from Stansted's catchment at 20% threshold [% of passengers travelling to common destinations]	27% [27%]
CAA survey: % of Gatwick respondents saying Stansted was first choice if flights available from all airports (ranking of all airports apart from Gatwick)	4% (2 nd after Heathrow)
CAA survey: % of Gatwick respondents saying Stansted was first or second choice if flights available from all airports (ranking of all airports apart from Gatwick)	16% (2 nd after Heathrow)
BAA survey: % of Gatwick respondents saying best alternative airport was Stansted (ranking of all airports apart from Gatwick)	14% (2 nd)
Airport competitor analysis: score* out of 100 (ranking excluding Gatwick)	9 (2 nd)
Yield analysis: impact of change in competitor frequency at Stansted on Gatwick yields†	Sig (0.6 %)
 <i>Extent to which Gatwick is a substitute for Stansted</i>	
Catchment analysis: % of Stansted's total passengers from Gatwick's catchment at 20% threshold [% of passengers travelling to common destinations]	53% [44%]
CAA survey: % of Stansted respondents saying Gatwick was first choice if flights available from all airports (ranking of all airports apart from Stansted)	12% (2 nd after Heathrow)
CAA survey: % of Stansted respondents saying Gatwick was first or second choice if flights available from all airports (ranking of all airports apart from Stansted)	35% (1 st)
BAA survey: % of Stansted respondents saying Gatwick best alternative airport (ranking of all airports apart from Stansted)	26% (1 st)
Airport competitor analysis: score* out of 100 (ranking excluding Stansted)	27 (1 st)
Yield analysis: impact of change in competitor frequency at Gatwick on Stansted yields†	Sig (1.1%)

Source: CAA, BAA, CC analysis.

*See working paper www.competition-commission.org.uk/inquiries/ref2007/airports/pdf/working_paper_south_east_2.pdf for definition.

†Subject to revision.

46. In the absence of capacity constraints, and binding price caps, we would therefore expect there to be strong competitive interaction between Gatwick and Stansted. However, as we recognized in our provisional findings, Gatwick is constrained in respect of runway capacity at most hours of the day in summer and to a lesser extent in winter. There is also some suggestion of excess demand at Gatwick at current levels of regulated charges, and estimates of slot values at Gatwick suggest that the premium from operating a service at Gatwick could be as high as £4 to £5 per passenger. Stansted is also at, or close to, capacity in peak hours of the day. This will naturally limit the extent of static competition in the short term, as there are limited benefits from reducing prices to attract additional traffic when capacity constrained.

47. However, both Gatwick and Stansted have some available off-peak runway capacity. Both airports may be able to handle higher volumes of passenger throughput, even in peak hours of the day: Stansted currently processes around 23 mppa and has the capacity to handle 35 mppa, and Gatwick which has capacity for 40–45 mppa currently handles 35 mppa.
48. Gatwick and Stansted are also likely to be subject to binding price caps in this period. Therefore, before considering the reasoning behind the benefits in paragraphs 19(c) to (e) above, we summarize how the current price cap works in practice at the regulated airports. This is important because it affects the ways in which the airports under separate ownership, but continued regulation, could compete with one another.
49. The price cap applies to an average revenue per passenger, which is calculated as the sum of forecast revenues from landing, parking and passenger charges before any individually negotiated discounts are deducted, divided by forecast passenger numbers. The different charges can be structured as the airport operator sees fit subject to this overall cap. Also, the applicable rates can (and do) vary across factors such as time of day, destination and noise emission class of aircraft. Charges for 2008/09 are shown in Table 2. Currently, the average airport charge at Heathrow represents approximately 6 per cent of the average Heathrow fare.

TABLE 2 Charges at BAA London airports 1 June 2008 to 31 March 2009*

£

	Heathrow peak	Heathrow off-peak	Gatwick peak	Gatwick off-peak	Stansted peak	Stansted off-peak
<i>Landing charges (by noise category) per aircraft over 16 tonnes</i>						
Ch 3 high	1,054.80	1,054.80	851.75	273.86†	409.20†	230.33†
Ch 3 base	703.20	703.20	567.83	182.57†	272.80†	153.55†
Ch 3 minus & Ch 4	632.88	632.88	511.05	164.31†	245.52†	138.20†
<i>Other landing charges</i>						
ANS charge (per landing)	98.55	98.55	41.76	41.76	37.90	38.90
ANS charge (per tonne)	1.33	1.33	0.97	0.97	1.16‡	1.16‡
NOx charge (per kg NOx)	1.92	1.92	1.77	1.77	0.00	0.00
<i>Aircraft parking charges per hour§</i>						
Per aircraft	84.84	28.28	57.24	19.08	11.48	11.48
Per tonne	1.32	0.44	0.86	0.29	0.72	0.72
<i>Passenger charge per departing passenger</i>						
Domestic	11.50	11.50	7.11	7.11	6.01	6.01
Irish Republic	14.88	14.88	8.71	8.71	7.35	7.35
International	19.65	19.65	10.83	10.83	9.13	9.13
Remote stand rebate	3.23	3.23	2.42	2.42	1.97	1.97
<i>Peak period</i>	07.00–12.29, 1 April– 31 October		06.00–11.59, 1 April– 31 October¶		1 April– 31 October	

Source: BAA conditions of use.

*Lower charges applied at Heathrow and Gatwick between 1 April and 31 May.

†Lower charges apply at Gatwick off-peak to aircraft between 16 and 50 tonnes and at Stansted both peak and off-peak to aircraft between 16 and 55 tonnes. Higher charges apply at Stansted to aircraft over 250 tonnes.

‡Applies only to first 100 tonnes.

§Parking is charged per quarter hour.

¶The peak period for landing (but not parking) also includes 17.00 to 18.59, 1 April to 31 October.

50. An important implication of this price cap formula is that it is in principle possible to offset a reduction in published off-peak tariffs with an increase in peak tariffs, as long as it leaves average revenue per passenger less than or equal to the price cap. It is not possible, however, to offset higher individually negotiated discounts for off-peak tariffs with an increase in peak tariffs in this way because the price cap is calculated with reference to revenue before discounts. Accordingly, we have considered three sources of competition in the short term:

- competition between Gatwick and Stansted to fill off-peak slots by rebalancing peak/off-peak landing charges;
- competition between Gatwick and Stansted to fill off-peak slots by offering greater off-peak discounts to individual airlines; and
- competition between Gatwick and Stansted to attract additional passengers by rebalancing the landing, parking and per passenger charge.

We discuss each of these in turn below.

51. Under the current system of price regulation, an airport operating at full capacity in peak hours but with spare capacity in off-peak hours will have incentives to reduce off-peak landing charges to encourage greater off-peak runway utilization, whilst increasing peak charges so as to leave average revenue per passenger constant overall. This is because elasticity of demand is higher in the off-peak than in the peak, and so the resulting increase in off-peak traffic will be greater than the reduction in peak traffic following the change in charges. As passenger numbers increase and average revenue per passenger remains constant, total revenues will increase. Where there is excess demand in the peak periods, the incentive to pursue peak pricing is even stronger as increasing peak charges would not cause any loss in peak traffic.

52. In principle, Gatwick's and Stansted's incentives to compete to fill off-peak slots will be stronger under separate than common ownership. Under separate ownership, the operator of Stansted will no longer balance the effect on Gatwick¹¹ when contemplating an off-peak price reduction at its own airport and vice versa. (A similar intuition applies to rebalancing per passenger and per ATM charges. This effect is discussed in more detail in relation to Heathrow and Gatwick where we expect the effect to be more pronounced.)

53. The divestiture of Gatwick will remove this link. To test what effect this might have on the short-term pricing strategies of Gatwick and Stansted, we have performed some quantitative analysis using a range of assumptions about elasticities and the balance of peak/off-peak traffic. The analysis indicated that, even under separate ownership, it would be unlikely for either airport to vary charges to the degree that average

¹¹In terms of lost off-peak passengers and therefore the need either to cut off-peak landing charges so as to win back airlines or to lower on-peak landing charges to ensure the airport remains within the overall cap.

revenue per passenger would fall below the existing price cap. In other words, whilst the divestiture of Gatwick might result in a redistribution of charges across airlines, it would not lead to an overall reduction in the average tariffs charged unless the relevant elasticities were very high and/or spare capacity was much higher than today.

54. However, Gatwick and Stansted will both have stronger incentives under separate ownership to fill off-peak slots by offering discounts to individual airlines taking up off-peak slots (as long as this does not affect the amount they can charge existing users). This could lead to an out-turn price below the price-capped level, even in the presence of excess demand for peak slots, because, as noted previously, the price cap applies to revenues earned before discounts. A reduction in off-peak prices brought about through an increase in unpublished discounts cannot, therefore, be offset by an increase in peak prices whilst remaining within the limit of the price cap.

55. We are aware that Stansted has in the past offered substantial discounts to fill spare capacity that have been negotiated individually with airlines, and is currently offering some airlines discounts for off-peak services. BAA's submission on its general principles in negotiating discounts at Stansted said that one of three objectives was to increase passenger volume, where discounts are given in the form of reduced charges subject to volume thresholds being reached. There is certainly scope for such discounting to happen more to fill off-peak capacity and increase passenger numbers at both Gatwick and Stansted, as individual discounts do not affect revenue from existing traffic but increase revenue from additional throughput (albeit at a lower price). Moreover, we understand that off-peak slots are attractive for some operators (eg those flying into Stansted with aircraft based elsewhere, LCCs and long-haul operators). As we noted in our provisional findings, nearly all the growth at Gatwick and Heathrow over the last decade has been in increased take-up of off-peak slots.

One London airport also told us that it was achieving off-peak growth of over 5 per cent a year.

56. We consider it likely that off-peak discounts would be higher under separate ownership than common ownership because divestiture would change the relative bargaining position of the airlines and airport. This is because the level of discount an airline is able to negotiate will depend in part on the value of its outside option (ie where it could go if no agreement were to be reached). When Gatwick and Stansted are under the same ownership, airlines negotiating for discounts at Gatwick cannot use the existence of spare capacity at Stansted as a bargaining ploy. This is no longer the case when the airports are under separate ownership. Instead we envisage that airlines will use the existence of spare off-peak capacity at each airport during the course of their negotiations to secure much more generous off-peak discounts.
57. As these price reductions could not be used to increase prices in peak hours, competition between Gatwick and Stansted to fill off-peak slots in this way could lead to lower average prices at both airports.
58. The effect of recession on airline traffic along with planning approval for the SG1 developments at Stansted means that there will be more spare capacity in the South-East airports than we anticipated at the time of our provisional findings.¹² As spare capacity at Gatwick and Stansted increases, so do the incentives for the two airports to compete under separate ownership.
59. BAA has argued that peak pricing could be used as an alternative to divestiture of either Gatwick or Stansted to address the scope it claims we identified for

¹²This is illustrated in latest traffic figures, which showed a 1 per cent decline in traffic relative to the previous year at Heathrow and a 2 per cent decline at Gatwick for September 2008. Stansted saw sharper declines over the summer period of between 6 to 8 per cent on the previous year's levels. For more details see: www.caa.co.uk/default.aspx?catid=80&pagetype=88&sglid=3&fid=200807.

encouraging greater use of capacity in off-peak periods. This, BAA argued, could be implemented either by way of regulatory requirement or by increasing the incentives for airports to attract airlines to use spare capacity. We disagree. We do not view peak-pricing as an end in itself. Nor do we view making maximum use of runway capacity as a stand-alone objective, particularly if it results in poor service quality. Rather, we view competition over spare runway capacity as a mechanism to deliver benefits to users. As we have set out above, separate ownership could give rise to lower charges for some users and increased utilization if it led to more aggressive discounting targeted at individual airlines because of an improvement in their relative bargaining position. This improvement in airline bargaining position relies on the airlines having a choice of where to operate off-peak flights, which is only possible under separate ownership.

60. We also anticipate that the divestiture of Gatwick would generate incentives for Stansted and Gatwick to compete for passengers. The assumptions underlying this mechanism are laid out in more detail with reference to Heathrow/Gatwick below, where we expect that the effect is likely to be more pronounced because of a greater scope for increased overall passenger throughput, increased load factors and fleet upgrades at Heathrow compared with Gatwick and Stansted.

Competition between Gatwick and Heathrow

61. We now turn to the effect of the sale of Gatwick on Heathrow–Gatwick rivalry. In our provisional findings we concluded that Heathrow was the closest substitute for Gatwick and that Gatwick was the closest substitute for Heathrow for non-transfer passengers (these currently made up two-thirds of all passengers). The results of our analysis are summarized briefly in the following table.

TABLE 3 **Substitutability of Heathrow for Gatwick, and Gatwick for Heathrow**

<i>Extent to which Heathrow is a substitute for Gatwick</i>	
Catchment analysis: % of Gatwick's total passengers from Heathrow's catchment at 20% threshold [% of passengers travelling to common destinations]	81% [50%]*
CAA survey: % of Gatwick respondents saying Heathrow was first choice if flights available from all airports (ranking of all airports apart from Gatwick)	21% (1 st)
CAA survey: % of Gatwick respondents saying Heathrow was first or second choice if flights available from all airports (ranking of all airports apart from Gatwick)	51% (1 st)
BAA survey: % of Gatwick respondents saying best alternative airport was Heathrow (ranking of all airports apart from Gatwick)	33% (1 st)
Airport competitor analysis: score* out of 100 (ranking excluding Gatwick)	22 (1 st)
Yield analysis: impact of change in competitor frequency at Heathrow on Gatwick yields†	Sig (0.5%)
 <i>Extent to which Gatwick is a substitute for Heathrow</i>	
Catchment analysis: % of Heathrow 's total passengers from Gatwick's catchment at 20% threshold [% of passengers travelling to common destinations]	64% [63%]*
CAA survey: % of Heathrow respondents saying Gatwick was first choice if flights available from all airports (ranking of all airports apart from Heathrow)	11% (1 st)
CAA survey: % of Heathrow respondents saying Gatwick was first or second choice if flights available from all airports (ranking of all airports apart from Heathrow)	50% (1 st)
BAA survey: % of Heathrow respondents saying Gatwick best alternative airport (ranking of all airports apart from Heathrow)	36% (1 st)
Airport competitor analysis: score* out of 100 (ranking excluding Heathrow)	13 (1 st)
Yield analysis: impact of change in competitor frequency at Gatwick on Heathrow yields†	Sig (0.4%)

Source: CAA, BAA, CC analysis.

*See working paper for definition.
†Subject to revision.

62. Heathrow has excess demand for runway slots at all hours of the day and so cannot accommodate additional take-offs and landings. BAA suggested that this meant that there was no scope for material competition between Heathrow and Gatwick because Heathrow was unlikely to drop prices while excess demand persisted, and Gatwick would have to reduce prices by an extremely large amount to have any effect on Heathrow's profitability (because it would have to attract the full amount of excess demand away from Heathrow before further price reductions could have any impact on traffic at Heathrow).

63. Whilst it is true that Heathrow may be operating at its runway capacity, ie that it cannot increase the number of slots it makes available,¹³ it is not true that Heathrow is operating at its possible passenger capacity. As we explained in our provisional findings, the concept of the capacity of an airport is complex and depends on the actions of a number of parties, including the airlines. In other words, the maximum number of passengers that Heathrow can process is dependent upon the number of slots it can make available as well as the number of passengers per ATM, which is a decision the airline makes. However, this decision is not independent of the airport operator's behaviour: the structure of charges can also have an effect.
64. As noted previously, the current system of regulation enables BAA at Heathrow to earn a maximum amount per passenger. However, within this constraint, BAA can choose to balance landing charges, passenger charges and parking fees in any way that it sees fit. It would therefore be open to BAA to increase the landing charge and offset this with a lower per passenger charge to induce airlines to carry more passengers per ATM, potentially attracting some passenger traffic away from Gatwick.
65. Under common ownership, Heathrow's incentives to lower per passenger charges (and to increase landing charges) depend upon the effect this will have on Gatwick, and vice versa. The incentive to follow this strategy is stronger under separate ownership than common ownership¹⁴ resulting in lower fares and more efficient runway utilization so long as:
- (a) airlines are currently profit-maximizing in respect of fares and fleet capacity, and they have some market power;

¹³We suggested in our provisional findings that Heathrow could increase the slots it can offer if mixed mode were introduced. However, BAA told us that if mixed mode were to be approved, the extra runway capacity would be likely to be used to improve runway resilience, rather than to create additional ATMs.

¹⁴Because Heathrow no longer takes into consideration the cannibalizing effect that increasing passenger throughput would have on Gatwick in setting the balance of charges.

- (b) airports are currently optimizing in respect of the tariffs they currently charge—in other words, so long as they are currently optimally offsetting the benefits from lowering passenger charges with any costs (including costs of negotiating with airlines on this) from doing so;
- (c) airlines can expand the number of passengers per ATM, for example by increasing load factors on existing aircraft or by upgrading their fleets. The higher the incremental costs of expanding the number of passengers per ATM, the smaller the volume effect of lowering the passenger charge will be and the smaller the incentive an airport will have to re-balance charges; and
- (d) the impact lowering fares has on market growth is relatively small—if it is large then lowering passenger charges at Heathrow can in principle have a significant positive effect on passenger numbers at Gatwick (because lowering passenger charges at Heathrow leads to a reduction in Heathrow fares. This leads airlines at Gatwick to lower fares which would lead to an increase in passenger numbers through new growth). This might mean that, in practice, incentives to rebalance charges in favour of landing charges would be higher under common ownership. Under the assumption of linear demand, this effect is small and the incentive to rebalance tariffs is always higher under separate ownership. In practice, it seems quite unlikely that small changes in fares should have a large effect on market size.

66. In our provisional findings we noted that the scope for competition in this way could in principle be significant since there is a significant degree of spare terminal capacity, particularly at Heathrow. BAA's forecast passenger per ATM figures suggests that by 2020, passenger numbers at Heathrow and Gatwick could increase by 20 million and 4 million respectively, without increasing the number of runway movements. Whether it turns out to be significant seems likely to depend upon the ability of airlines to react to changes in the balance of charges (assumption c). In the very short term, an

airline's ability to increase passengers per ATM may be confined to the scope to increase load factors on existing aircraft, which may not be possible under yield management systems. Over time, airlines may be able to replace routes operated by smaller aircraft with those operated by larger aircraft and may deploy larger aircraft over existing routes. Their incentives to do this will depend on the proportion of total costs accounted for by airport charges, and on the costs of operating with larger aircraft.

67. The scope for competition in this way will also depend on the nature and scale of any other constraints that prevent an operator from rebalancing charges. If airlines are resistant to rebalancing charges, then separate ownership may not have a significant effect on the structure of tariffs even if incentives have changed in favour of rebalancing charges. Indeed, we have been told by BAA that the airlines are resistant to increasing landing charges and reducing passenger charges because this would shift more volume risk on to the airlines. It could be the case that airline negotiating power would therefore limit the potential for competition for passengers in this way. Indeed, the fact that BAA does not appear to have discounted passenger charges in favour of higher landing fees when (albeit weaker) incentives to do so exist under common ownership suggests that there may be other factors which are preventing it from doing so, and that they may limit the extent to which competition of this nature might deliver benefits.
68. Depending on the precise nature of the regulatory regime that prevails during the short term, incentives to compete for passengers may also be reduced if the benefits of attracting additional passengers disappear at the beginning of the next quinquennial review period. As a whole, therefore, we expect that the impact of competition for passengers is unlikely to be large. However, we would expect it to have a further marginal improvement on outcomes.

69. BAA has suggested that instead of divestiture, these benefits could be achieved by ensuring that airports rebalance charges either through a requirement within the regulatory system or by increasing the incentives for airports to accommodate additional passenger growth. Again, we disagree. Currently incentives are being distorted by common ownership (even if the effect is small). We believe that it is more effective to correct the distortion than to provide stronger financial incentives to compensate for the distortion. In relation to their regulatory solution, it seems unreasonable to expect that a regulator should be able effectively to mimic the market by setting the appropriate balance of charges. It also seems unnecessary, given that a divestiture solution exists which would effectively address the absence of competition in this regard.

3.2 *Dynamic competition*

70. In the long term, we consider that there is a significant prospect that competition can substitute for regulation at Gatwick and Stansted and eventually perhaps at Heathrow. This is because airports will no longer be constrained in their ability to compete by short-term capacity constraints. Instead, airports will be able to increase capacity, subject to planning constraints and government policy. In cases where there is strong rivalry, ie where airports are close substitutes for one another, and airlines can switch, we would expect that the capacity that airports seek to bring to market would be similar in nature and scale to the level we would expect to see in a well-functioning market.

71. We also noted in our provisional findings that the Government has always played, and continues to play, a significant role in any decision to invest in new runway capacity in the South-East. The extent of its involvement has changed considerably over time and it is possible that its involvement will continue to change. It is, therefore, difficult to predict precisely how government policy will evolve several

years hence. Nevertheless, whilst we accept that the role the Government takes in the airport expansion process will influence the way in which competition for capacity will develop, we do not accept BAA's view that it will preclude dynamic competition altogether. For reasons that we set out below, to accept the BAA hypothesis that there is no scope for dynamic competition would be to accept that there are no prospects for changes in policy or further capacity expansion beyond those set out in the White Paper; and this appears to be implausible.

72. We have set out two possible ways in which rivalry between airports could manifest itself in the long term. However, as we note in paragraph 12 above, whilst the outcomes of dynamic competition may not manifest itself until the period we define as long term, the decisions regarding capacity will begin to be affected by competitive rivalry following divestiture in the short term.
73. One possibility involves the Government playing an adjudication role between competing airports for the permission to expand runway capacity. In this scenario, airports would lobby the Government with their proposals for runway expansion which the Government would choose between when additional runway capacity becomes required in the South-East. As noted in our provisional findings, we would expect both separate owners to display a greater appetite for runway expansion than BAA has and to lobby the Government accordingly.
74. Moreover, instead of relying on one organization's (BAA's) assessment of the impact of runway development, the Government would now be able to compare alternative projects in terms of pricing, efficiency and impact on the environment. As a result, we would expect the Government's decision-making process to be better able to produce socially optimal outcomes since it would no longer be distorted by the

incentives a common owner has to minimize cannibalization and to ensure that its most profitable projects are approved.

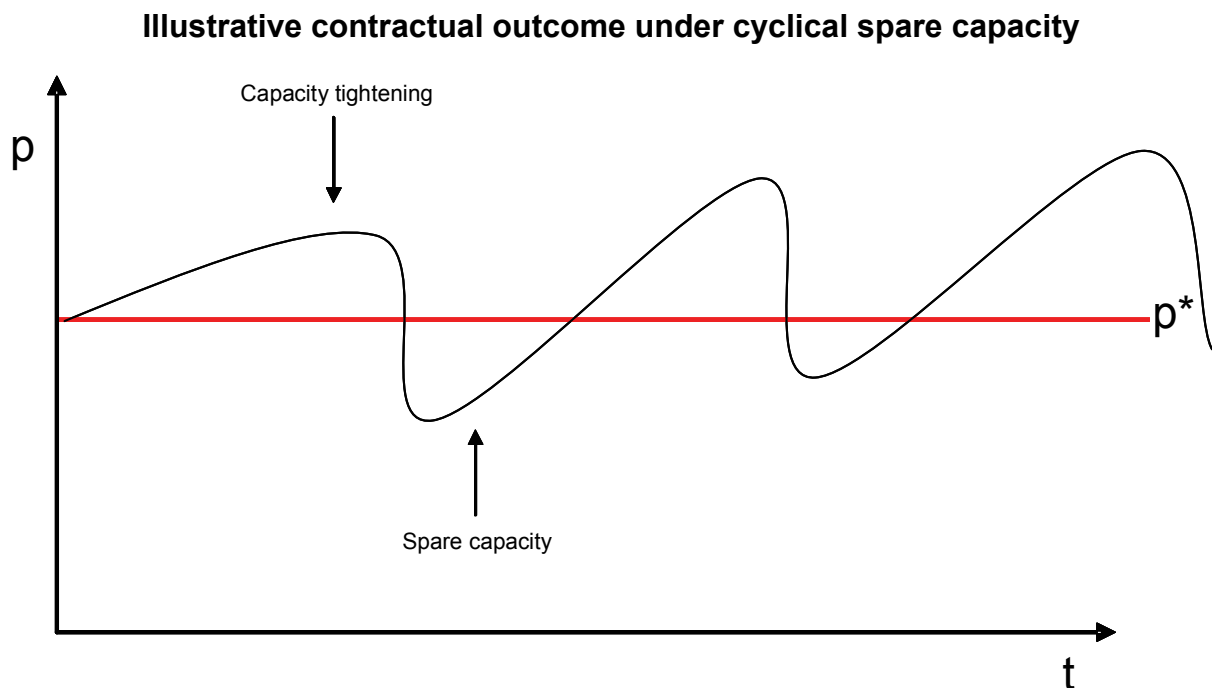
75. The sale of Gatwick would increase the likelihood that any future competition for capacity would lead to optimal outcomes. In considering future investment, the Government would receive one more independent proposal, and all the information and potential that it contains, supplied by the new owner of Gatwick. However, as we discuss in Section 4 below, we would expect any adjudication process to be significantly enhanced if Stansted were also under separate ownership.

76. The benefits from rivalry do not stop after the Government has awarded approval for capacity expansion. Having obtained the approval to expand capacity, we would expect the winner(s) (either Gatwick or BAA, or both) to roll out capacity quicker than BAA has done to date in order to gain as quickly as possible from the ability to increase traffic volumes (particularly if there is a first-mover advantage associated with being first to market with new capacity). We would also expect that rivalry could be particularly strong in the immediate aftermath of the development of a new runway. Once built, the marginal costs of expanding capacity are low (and in some cases offset entirely or more so by commercial revenues): this means that the airport operator will seek to make maximum utilization of the new runway and may offer discounts to do so. As we discuss in more detail below, the sale of Gatwick will lead to more aggressive pricing etc to fill the runway but will be less so than if Stansted were also divested (because competitive activity to fill a third runway at Heathrow would cannibalize Stansted traffic as well as win traffic from Gatwick).

77. Over time, as demand grows, we would expect spare capacity to diminish until the Government provides for a new round of capacity expansion (with airport operators lobbying for it to do so). We noted earlier that as capacity at rival airports tightens,

this confers on an airport a greater ability to exercise market power (ie gives it negotiating power). But we also noted that an airport will have strong incentives to price low in the immediate aftermath of a new runway development (giving the airlines negotiating power). As competition emerges, it seems likely that the South-East airports might move towards the model we observe at regional airports whereby airports and airlines enter into long-term contracts. In this way, airlines and airports will be able to trade off the differences in their negotiating strength and arrive at an overall arrangement which mitigates the market power an airport can exercise. For example, they may be able to contract for price= p^* (see Figure 1), rather than face the more volatile fluctuations in prices that the airport would charge if prices reflected the ebbing and flowing market power that resulted from the amount of spare capacity that was available at rival airports (see illustrative diagram below).

FIGURE 1



Source: CC.

78. The other possibility involves the Government taking the decision to approve specific amounts of capacity expansions at specific airport locations with minimal airport involvement—in other words, to adopt a solely government-determined approach to

airport development. Even if this were the case (which we think unlikely¹⁵), we still believe that there could be benefits from ‘static’ (ie price and service-quality) competition once capacity has been expanded so long as the Government does not restrict capacity to the point where the airports have insufficient spare capacity to enable airlines to broker competitive deals at any stage.

4. Does common ownership of Heathrow and Stansted constitute an AEC?

79. In this section we consider whether BAA’s ownership of Heathrow and Stansted would continue to constitute a feature that has an AEC once Gatwick has been divested. As before, we consider the impact of common ownership of Heathrow and Stansted in both the short term and the long term.

4.1 Short-term adverse effects of common ownership

80. BAA has argued that there was limited substitutability between Heathrow and Stansted. In particular it claimed that:

- (a) Heathrow’s hub characteristics limited the scope for competition with Gatwick and Stansted;
- (b) the majority of airlines serving Heathrow would not consider the other London airports to be close or effective substitutes, or even alternatives at all given Heathrow’s unrivalled network of long-haul and short-haul connections;
- (c) the vast majority of Heathrow’s transfer passengers would not consider Gatwick or Stansted as close or effective substitutes, or even alternatives for Heathrow at all; and
- (d) a large proportion of non-transfer passengers using Heathrow would not consider the other London airports to be close or effective substitutes given the significant differences in location, network coverage and frequency between these airports.

¹⁵BAA did not argue that airport capacity would be government-determined. Instead it argued that it was government-led, which seems more consistent with our first scenario in which we see scope for a government-led adjudication process to benefit from airport rivalry.

81. In our view, the evidence does not support BAA's view. The survey results and analysis we have collated (summarized in Table 4 below) indicates that, although some airlines may not view Heathrow and Stansted as substitutes, many of their non-transfer passengers do. Evidence from BA corroborates this view: it told us that competition from LCCs at Stansted has affected the profitability of a number of the short-haul routes that it operated from Heathrow.¹⁶ We recognize that approximately a third of the passengers using Heathrow are transfer passengers and most are unlikely to view Stansted as a substitute. However, non-transfer and transfer passengers travel on the same flights and there are important complementarities between the two sources of demand. This implies that the behaviour of non-transfer passengers will influence the strategic choices the operators of Heathrow and Stansted make. This view is also supported by BAA's own modelling which shows how passenger numbers and profitability at Stansted may be influenced by prospective capacity expansion (mixed mode and a third runway) at Heathrow.

¹⁶BA gave us a number of examples of competition at Stansted affecting its services from Heathrow. In one case, entry at Stansted by an LCC increased the overall market size of a particular route, but also increased price competition at Heathrow, with a reduction in yield of about one-third in economy class. BA moved its services to Gatwick, and then discontinued the route. Loss of passengers as a result of growing competition from LCCs at both Luton and Stansted more generally caused BA to change the commercial proposition for short-haul services, as a result of which it competed more effectively with the LCC sector.

TABLE 4 **Substitutability of Heathrow for Stansted, and Stansted for Heathrow**

<i>Extent to which Heathrow is a substitute for Stansted</i>	
Catchment analysis: % of Stansted's total passengers from Heathrow's catchment at 20% threshold [% of passengers travelling to common destinations]	73% [38%]*
CAA survey: % of Stansted respondents saying Heathrow was first choice if flights available from all airports (ranking of all airports apart from Stansted)	13% (1 st)
CAA survey: % of Stansted respondents saying Heathrow was first or second choice if flights available from all airports (ranking of all airports apart from Stansted)	30% (2 nd after Gatwick)
BAA survey: % of Stansted respondents saying best alternative airport was Heathrow (ranking of all airports apart from Stansted)	17% (2 nd after Gatwick)
Airport competitor analysis: score* out of 100 (ranking excluding Stansted)	25 (2 nd after Gatwick)
Yield analysis: impact of change in competitor frequency at Heathrow on Stansted yields†	Sig (1.7%)
 <i>Extent to which Stansted is a substitute for Heathrow</i>	
Catchment analysis: % of Heathrow 's total passengers from Stansted's catchment at 20% threshold [% of passengers travelling to common destinations]	24% [19%]*
CAA survey: % of Heathrow respondents saying Stansted was first choice if flights available from all airports (ranking of all airports apart from Heathrow)	5% (2 nd after Gatwick)
CAA survey: % of Heathrow respondents saying Stansted was first or second choice if flights available from all airports (ranking of all airports apart from Heathrow)	12% (3 rd after Gatwick and Luton)
BAA survey: % of Heathrow respondents saying Stansted best alternative airport (ranking of all airports apart from Heathrow)	11% (2 nd after Gatwick)
Airport competitor analysis: score* out of 100 (ranking excluding Heathrow)	10 (2 nd after Gatwick)
Yield analysis: impact of change in competitor frequency at Stansted on Heathrow yields†	Sig (0.7%)

Source: CAA, BAA, CC analysis.

*See working paper for definition.

†Subject to revision.

82. Within this context and the context of persisting regulation and binding runway capacity constraints at a number of the BAA airports, we see three ways in which the divestiture of Stansted, in addition to the divestiture of Gatwick, would bring competitive benefits in the short term and, as such, common ownership of the two constitutes an AEC:

- (a) the creation of another independently-operated airport enabling regulators and investors to better benchmark airport performance;
- (b) the introduction of another new management team active in the South-East airport market which may employ new approaches to airport operation offering passengers increased choice: and
- (c) competition between Heathrow and Stansted for passengers.

As in the case of the divestiture of Gatwick, the benefits of (c) seem likely to be marginal.

4.1.1 Comparative competition

83. We anticipate that one of the main short-term benefits of divesting Stansted in addition to Gatwick will be to improve the effectiveness of comparative competition by increasing the number of separately-owned comparators from two to three. We anticipate these gains in effectiveness coming from the following sources:

- more information from an additional, separately-owned comparator reduces regulatory uncertainty, leading to lower regulatory costs and improved outcomes. In particular, we anticipate there being greater certainty in detecting under-performance relative to benchmarked levels;
- going from two to three independent comparators may allow for the introduction of more formal comparative competition tools, such as league tables, particularly if comparisons are made at the level of the terminal;
- more innovative activity as a result of a greater diversity of managerial approach, leading to greater gains from the identification and diffusion of best practices that comparative competition enables and encourages; and
- removal of any incentives for Heathrow and Stansted to perform less efficiently so as to weaken the regulatory constraint placed on one another (although this would depend upon the way in which the benchmarking results in rewards and/or fines).

We now look at these benefits in more detail.

84. Divesting Stansted will provide the CAA with an additional set of regulatory accounts produced by an independent operator. This will obviously increase the amount of information it has available, with all the associated benefits described in relation to the sale of Gatwick. However, it will also have the additional benefit of making the information available from Gatwick's regulatory accounts more valuable. In this way,

we find that the benefits of divesting Gatwick are likely to be higher when Stansted is also divested. This is because the expected benefits of introducing comparative competition depend on the number of independently-owned comparators available. This is illustrated by valuations of the loss or gain of an additional comparator due to mergers in other regulated industries, which suggest that the incremental gains from having an independently-owned Stansted could be large.

85. The experience of other regulators suggests that the impact of an additional comparator also depends on the initial number available, with an additional comparator being more valuable when there are few to begin with than when comparators are initially numerous.
86. Related to the benefits of additional information is the fact that going from two to three independent comparators may allow for the introduction of more formal comparative competition tools, such as league tables and potentially even more quantitative modelling of costs. For example, if comparisons are made at the level of the terminal, the sale of both Gatwick and Stansted would lead to the creation of eight comparator terminals run by three separately-owned operators. Such a situation would then be similar to the regulation of the gas industry, where Ofgem determines benchmark cost levels using regression analysis based on eight gas distribution networks run by four separately-owned operators.
87. Finally, we believe that increasing the diversity of managerial approach by creating an additional separately-owned operator will increase the likelihood that cost reducing and service quality enhancing innovation will occur. This increases the gains to comparative competition, by making it more likely that the CAA will be able to identify and disseminate best practice to the regulated airports.

4.1.2 Variety of management approaches

88. Divesting Stansted would also bring benefits resulting from a different management approach (as described in relation to Gatwick in paragraph 43). The airlines based at Stansted have been associated with bringing significant innovation in terms of business models to the airline industry. It is likely that a new management approach at Stansted could bring significant benefits in facilitating further innovation.

4.1.3 Competition within the context of economic regulation

89. As we explained earlier, airlines have a significant role to play in determining the throughput of an airport. If it is possible for an airport operator to incentivize airlines to increase passenger throughput in this way, then—as in the case of Gatwick—the effect of a divestiture of Stansted would be to increase the prospect that Heathrow would compete for passengers by rebalancing charges in favour of the passenger charge resulting in increased runway utilization and lower fares. As in the case of Gatwick, however, we cannot be confident that the effect of this manifestation of competition will be more than marginal.

4.2 *Dynamic competition*

90. In the long term, we would expect the divestiture of Stansted to have significant benefits in terms of the additional rivalry that this would exert on the competition for capacity expansions, on the subsequent roll-out of capacity and on the level of competition observed between airports once capacity expansions have been completed.

91. The incentives to lobby for new capacity will be influenced by the degree of rivalry airports expect to prevail once capacity has been made available. The more independently-owned airports there are, the more rivalry they will expect and the more likely they will wish to lobby for additional capacity to compete for airlines and passengers (rather than withhold investment). However, this effect goes beyond

simple numbers—rivalry depends on the closeness of competitors and, as we outline above, the BAA airports (Heathrow, Gatwick and Stansted) are the closest competitors in the South-East. To assert that the divestiture of Stansted is not going to add any significant rivalry to the market implicitly assumes that competition from Gatwick, Luton and others will be sufficiently strong to prevent a common owner of Stansted and Heathrow from exercising market power. This seems unlikely given that:

- survey evidence indicates that there is a significant group of passengers which views Heathrow as the closest substitute for Stansted and, to a lesser degree, vice versa; and
- the non-BAA airports, including Luton, are generally much weaker substitutes for both Stansted and Heathrow than the BAA airports.

92. This implies that, even if Heathrow continues to be subject to price regulation and Gatwick and Stansted do not, the harm from BAA's continuing to own Stansted could be significant. Under this scenario, BAA would have an incentive to withhold capacity at Heathrow, which would be regulated to earn its cost of capital, in order to divert traffic through Stansted, which would be free to earn a positive profit. Divesting Stansted would completely remove this withholding incentive, and an independent owner of Heathrow would then face undistorted investment decisions regarding future capacity expansions.

93. Having an additional proposal from operators interested in expanding also provides the Government with additional information to help it judge where airport expansion should take place and prevents a common owner of Heathrow and Stansted from being able to distort the process.

94. It is possible that the divestiture of Gatwick alone may not be sufficient to guarantee the relaxation of regulation. If this is the case, imperfect regulation and its associated detriments will remain and the impact of the sale of Gatwick may well be restricted to the static and comparative competition benefits outlined above. The dynamic benefits which divestiture of Gatwick will bring will also be affected because incentives to bring forward new capacity will depend on regulatory factors (which may also limit competition in the phase after capacity is brought on stream). Therefore, the divestiture of Stansted, as well as bringing with it additional short-term benefits, and adding to the effectiveness of competition for capacity also increases the likelihood that regulation can be altogether relaxed.
95. BAA has suggested that the benefits we have identified resulting from the proposed divestitures on investment in new capacity could be achieved by a stable regulatory framework that provided increased incentives for airports to invest in such projects. For example, it suggested that the regulator could set returns on incremental outputs delivered by new runways at a higher level than for existing outputs. Alternatively, if this was not fully effective, trigger mechanisms could be introduced to provide greater assurance over the delivery of new capacity.
96. We recognize that there is a role to play for the regulatory system in encouraging capacity development. This is, however, predominantly a short-term role in order to overcome the capacity constraints that have resulted from the distortions caused by common ownership and thereby to aid the transition to a system in which the regulatory system can be relaxed. However, we consider that, in the long term, it is better to rely on the process of competition between airports to bring forward new capacity, rather than on a regulatory system which will always be an imperfect and therefore ineffective mimic of the market. BAA itself recognizes in proposing this alternative remedy that it would require the regulator to take a substantive view of the

appropriate basis for expansion with user perspectives properly accommodated in this process through enhanced consultation arrangements. We have documented extensively how challenging this process can be and, in cases where competition is unlikely to develop, we recognize that regulation and consultation arrangements have a role to play. But in cases where competition can be expected to generate the levels and configurations of airport expansion we would expect to observe in a well-functioning market, we consider that divestiture will be a more effective means than enhancing regulation.