Divestment of Southampton

Introduction

1. In our provisional findings, we said that we saw potential competition from Heathrow and Gatwick to Southampton (though not vice versa); we provisionally found that common ownership removes a competitive constraint on Southampton; hence we said that BAA's common ownership of the BAA London airports and Southampton is a feature of the market preventing competition.

2. In our Notice of possible remedies (Remedies Notice) we stated it was currently our view that, if Heathrow or Gatwick were under separate ownership from Southampton, this would effectively address the AEC resulting from their common ownership.

3. As Heathrow is likely to remain in BAA ownership while Gatwick is likely to be divested, we focus on potential competition between Heathrow and Southampton.

Selected comments on provisional findings and Remedies Notice re Southampton

4. Flybe commented that the separation of ownership of Gatwick and Southampton would not address all the AEC we had identified. In particular, Flybe argued that Southampton had the potential to provide domestic and European services which would be competitive with those from Heathrow; that the benefits of this competition were unlikely to be achieved if Southampton remained in common ownership with Heathrow; and that Southampton would consequently stagnate. Flybe referred to our statements in the provisional findings about BAA's lack of engagement with users and lack of ambition at Southampton. We did, however, also say that it was unclear to us whether BAA's ownership of the BAA London airports could in itself act as a disincentive to the development of Southampton, as Flybe had argued. Flybe

suggested that BAA should be required to divest Southampton either as well as Stansted, or instead of Stansted.

5. Among other points, BAA noted that, unlike in our analysis of the London airports, we had not supplemented our analysis of substitutability with analysis of possible impediments to competition under separate ownership, such as capacity constraints. However, we did refer to capacity constraints in relation to Heathrow's constraint on Southampton in paragraph 2.86 of our provisional findings.

Substitutability

6. We start by looking at the extent of substitutability between Heathrow and each of the three other BAA airports in the South-East. This is summarized in the Table 1.

7. As we noted in our provisional findings, Gatwick is clearly the closest substitute for Heathrow followed by Stansted. Southampton is quite a long way behind, reflecting its much smaller size (hence our conclusion in the provisional findings that Southampton is not a potential constraint on Heathrow).

TABLE 1 **Substitutability of other BAA airports for Heathrow, and Heathrow for other BAA airports**

	Gatwick	*Stansted*	*Southampton*
Extent to which other BAA airport is a substitute for Heathrow			
Catchment analysis: % of Heathrow's total passengers from airport's catchment at 20% threshold [% of passengers travelling to common destinations]	64% [63%]*	24% [19%]*	3%*
CAA survey: % of Heathrow respondents saying was first choice if flights available from all airports (ranking of all airports apart from Heathrow)	11% (1st)	5% (2nd)	3% (7th)
CAA survey: % of Heathrow respondents saying was first or second choice if flights available from all airports (ranking of all airports apart from Heathrow)	50% (1st)	12% (3rd after LGW, LTN)	N/A
BAA survey: % of Heathrow respondents saying best alternative airport (ranking of all airports apart from Heathrow)	36% (1st)	11% (2nd)	1% (8th)
Airport competitor analysis: score† out of 100 (ranking excluding Heathrow)	13 (1st)	10 (2nd)	0 (not mentioned)
Yield analysis: impact of change in competitor frequency at airport on Heathrow yields‡	Sig (0.4%)	Sig (0.7%)	N/A
Extent to which Heathrow is a substitute for other BAA airport			
Catchment analysis: % of airport's total passengers from Heathrow's catchment at 20% threshold [% of passengers travelling to common destinations]	81% [50%]*	73% [38%]*	99%*
CAA survey: % of airport respondents saying Heathrow was first choice if flights available from all airports (ranking)	21% (1st)	13% (1st)	N/A
CAA survey: % of airport respondents saying Heathrow was first or second choice if flights available from all airports (ranking)	51% (1st)	30% (2nd after LGW)	N/A
BAA survey: % of airport respondents saying Heathrow best alternative airport (ranking)	33% (1st)	17% (2nd after LGW)	N/A
Airport competitor analysis: score† out of 100 (ranking excluding airport)	22 (1st)	25 (2nd after LGW)	46 (1st)§
Yield analysis: impact of change in competitor frequency at Heathrow on airport yields‡	Sig (0.5%)	Sig (1.7%)	N/A

Source: CC analysis.

*The Gatwick and Stansted figures are from analysis of passengers travelling from Heathrow, Gatwick, Stansted and Luton (and London City although this was omitted from the analysis restricted to passengers travelling to common destinations). The Southampton figures are not directly comparable as they are from analysis of passengers travelling from Heathrow, Gatwick, Southampton and Bournemouth.
†See working paper for definition.
‡Subject to revision.
§Reflects results from only one airline (Flybe).

8. However, Heathrow seems to be a strong substitute for each of the other three BAA airports (although we have limited data for Southampton). The catchment analysis is based on all passengers. Since Heathrow's catchment may be widened due to its large number of long-haul passengers, we also looked at an analysis limited to passengers travelling to destinations available from all London airports. This showed that Heathrow's share remained high relative to levels we saw at other airports, even those we had found to be competitive. At a 20 per cent threshold, 50 per cent of Gatwick's passengers travelling to common destinations, and 38 per cent of Stansted's, came from Heathrow's catchment. We do not unfortunately have similar figures for Southampton.

9. The above data reflect the existing position and might change, for example if there is a major expansion in passenger numbers and routes from Stansted or Southampton.

Competition

10. In our provisional findings we said that we consider that Heathrow and Gatwick are stronger substitutes for Southampton than is Bournemouth. Nevertheless, Southampton already faces competition from Bournemouth, as Stansted does from Luton though, unlike Luton, Bournemouth is not currently constrained by capacity limits. Moreover, assuming as we do in this paper that BAA sells Gatwick, Southampton (like Stansted) will face additional competition from Gatwick. However, airports being imperfect substitutes for each other, it is likely that Southampton would face additional competitive constraints if it was under separate ownership to Heathrow, as well as Gatwick.

11. In Appendix 1 on divestment of Gatwick and Stansted, we identified four main ways in which divestment might bring competitive benefits:
    (a) short-run competition;
    (b) the creation of another independently-owned airport enabling regulators and investors to benchmark airport performance better;
    (c) the introduction of another new management team; and
    (d) long-run competition, for instance to build capacity.

    We now apply this framework to considering the separation of ownership of Southampton from Heathrow.

Short-run competition

12. Appendix 1 suggests that separating the ownership of Stansted from Heathrow might have competitive benefits (compared with common ownership) in prompting a

rebalancing of Heathrow tariffs. Any such benefits would be less likely to result from divesting Southampton given its smaller size.

13. Southampton is not price-capped, and there is consequently another method by which ownership separation could provide benefits (which would not apply at price-capped airports as long as the price cap is binding). As Flybe pointed out, under common ownership, a lower level of airport charge at Southampton, if passed through to lower airfares, would be likely to induce some passengers to switch from Heathrow flights to Southampton flights. A separate owner of Southampton would benefit from the whole of the Southampton passenger gain, whereas a common owner of Southampton and Heathrow would benefit only from the excess of its Southampton passenger gain over its Heathrow passenger loss. Consequently, a separate owner would have a greater incentive to cut prices. Most Southampton passengers fly to destinations also served from Heathrow, and as noted in our provisional findings, one airline (Flybe) provided us with data which seemed to show that passenger growth on some routes from Southampton was associated with reductions in passenger growth at Heathrow (and Gatwick).

14. Nevertheless, any additional incentive for a separate owner to cut prices seems likely to be quite weak. While BAA, as a common owner, may take into account the impact on Heathrow, any loss of Heathrow passengers and/or reduction in Heathrow fares would make the relevant services less profitable and would make it more likely that the relevant slots were sold or used for different services (which would most likely use larger aircraft and have more passengers per slot and hence be more profitable). Furthermore, the impact on Heathrow profits of any change in passengers in effect only continues until the price formula is reset—a maximum of five years—using new projections of passenger numbers, costs and commercial income.

Comparative competition

15. The sale of Southampton would in principle provide another independent comparator to provide information to a regulator. However, as Southampton is very different from the price-capped airports it is difficult to see this as adding any value. Furthermore, Southampton is not itself price capped and therefore its sale would not bring any of the 'softer' benefits to a regulator (for example, from managements criticizing each other) that independent ownership of Gatwick and Stansted would bring (as long as they continued to be regulated).

Variety of management approaches

16. As with Gatwick and Stansted, BAA's management of Southampton has been criticized by airlines and we provisionally found that BAA's management of it had shown a lack of ambition. As with Gatwick and Stansted, it may be that a new management could be more innovative. Nevertheless, it is not clear that independent management of Southampton could interact with Heathrow in any way as the two airports are so different.

Long-term competition

17. In relation to Stansted, we expect separation of its ownership from Heathrow's to have an impact on the incentives of both airports (and consequently on Gatwick and Luton) to develop new capacity and to provide relevant information to the government and regulators. This is much less likely in relation to Southampton as it is so much smaller and is a much weaker substitute for Heathrow.

18. The potential for expansion of Southampton to reduce flights and passengers at Heathrow is also limited by various physical features of Southampton, in particular the difficulty of lengthening its short runway. As shown in Table 2, the aircraft types

currently using Heathrow (and Gatwick) are mostly unable to operate, without payload or range restriction, at Southampton with its existing facilities.

TABLE 2 **Classification of Heathrow and Gatwick aircraft according to whether they can operate at Southampton**

	per cent of passengers		*per cent of movements*	
	Heathrow	*Gatwick*	*Heathrow*	*Gatwick*
Operable*	0.7	3.3	2.9	7.8
Payload/range restriction	45.7	65.5	59.6	69.5
Inoperable	51.8	28.3	34.3	19.7
No information	1.8	2.8	3.1	3.1

Source: BAA analysis using 2007 breakdown of aircraft type.

*Includes regional jets, though even for these there can be some restrictions on range. (BAA told us, for example, that operational feedback on the Embraer 145 highlighted that a number of European cities could not be served by this aircraft.)

Conclusion

19. Evidence suggests that Heathrow is a substitute for Southampton and hence separation of Southampton's ownership from Heathrow as well as Gatwick would increase the competitive constraints on Southampton. In the short term this might provide an incentive for a separate owner to reduce passenger charges at Southampton, although any such incentive seems likely to be quite weak. Separate ownership of Southampton could also bring more innovative management.

20. Southampton is a small airport and, as indicated in our provisional findings, can only be a very weak substitute for Heathrow. Separate ownership of Southampton would not therefore be likely to increase the competitive constraints on Heathrow (or the other London airports). We would not therefore expect to see similar benefits from interaction between separately-owned airports from divestment of Southampton as from divestment of Stansted.