

## Competition at Stansted

### Introduction

1. In its reference to us, the CAA requested our views on the degree of competition likely to be facing Stansted over the Q5 period and beyond, on the impact of regulation on investment incentives given this market context, and on the best approach to price regulation in the light of this assessment. In conducting our review, we considered that it was not necessary for us to consider whether Stansted should be expected to have market power in Q5, as the DfT had already made this decision and decided that Stansted should continue to be a designated airport, but we recognized that the degree of market power was relevant to the choice of the appropriate regulatory approach.
2. Our evaluation of a number of the CAA's regulatory options required an evaluation of competition. A RAB-based price cap could only have distorting effects on competition if it were binding, which we found would depend on the strength of competitive constraints faced by Stansted in Q5. The market-led and precautionary price-cap approaches were motivated by, and relied upon, an assumed level of competition between Stansted and other airports. As a result, we had to assess the competitive constraints likely to act on Stansted in the period relevant to our review and use this assessment to determine where we thought an unregulated price might be.

### *Potential competitive constraints*

3. We did not consider it helpful to perform a market definition exercise in our assessment of competitive constraints on Stansted in Q5. This is because we had visited the area of market definition in our market investigation, where we found a bundled product market for aeronautical services provided by airports to airlines and their ground handling agents. As for the geographic market, we noted that an assessment of competitive effects should ideally take into account all constraints on airports, including nearer and more distant airports. We therefore saw no analytical advantage in defining rigid geographic markets for airports.
4. We looked at a range of potential competitive constraints including the price-capped BAA London airports: Heathrow and Gatwick; non-BAA airports operating in the South-East: Luton and London City; non-London regional airports such as East Midlands and Birmingham International Airport Ltd (Birmingham); and Continental European airports.
5. We looked at the likely strength of each of these constraints in turn, in order to form a view on how strong their cumulative effect was likely to be. We considered a range of evidence including the types of passengers using different airports, catchment area analysis, isochrone analysis, passenger surveys, airline views, data from airlines and data from airports, as set out below. There were three broad categories to this evidence: evidence that could be used to estimate the airport charge elasticity; evidence that could be used to estimate passenger elasticity with respect to airfares; and other evidence on the substitutability of airports. The airport charge elasticity captures how passenger numbers respond to changes in airport charges and is most informative for the question of whether Stansted would be able to price up to a RAB-based price cap in Q5. We looked at this by analysing how passenger numbers at Stansted responded to recent airport charge increases, and also by comparing relative charges and passenger volumes at Stansted and Luton. The elasticity of

passengers with respect to airfares shows how passengers respond to changes in airfares, and can be used to infer the airport charge elasticity under certain restrictive conditions. We looked at airfare elasticity in the passenger surveys and the analysis of airline yield data. Because there were limitations to these analyses, we looked at other evidence on the substitutability of airports, including our catchment area analysis. This helped us to identify which airports could potentially constrain charges at Stansted, as well as those that could be affected by the level of charges at Stansted.

6. In considering potential competitive constraints, we were mindful of the distinction made between three related concepts in the market investigation, which we also considered relevant to our Stansted review:
  - (a) *substitutability*: the extent to which airports are substitutes for each other;
  - (b) *actual competition*: the extent to which airports actually do compete; and
  - (c) *potential competition*: the extent to which airports could compete.
7. In our market investigation, we also distinguished between competition in the short run, the effectiveness of which we considered could be influenced by capacity constraints, and competition in the longer run, where we considered that existing capacity constraints would be less relevant.<sup>1</sup> We found that competition in the short run was the more relevant concept for the purposes of this review, which relates specifically to Q5.
8. We found that the balance of evidence suggested that the other BAA London airports and Luton were the closest substitutes for Stansted from the perspective of airlines and/or passengers. It was our view that actual competition between these airports and Stansted would be limited for the period covered by Q5 because of capacity constraints and common ownership in the case of the BAA London airports. We recognized that BAA's recent announcement that it would seek to sell Gatwick implied that, in the course of Q5, actual competition between Stansted and Gatwick would no longer be precluded by common ownership. However, we found that the extent to which Gatwick could constrain Stansted during Q5 would be limited by capacity constraints at Gatwick, resulting in rivalry being largely confined to competition at the margin over off-peak slots. Therefore, the prospect of a change in ownership at Gatwick did not cause us to revise our view that constraints from airports currently within the BAA group on Stansted in Q5 would be insufficient to prevent Stansted from exercising its market power.

### ***Types of passengers***

9. We found the split of types of passengers at Stansted was broadly similar to Gatwick as well as to Luton, East Midlands and Birmingham. The proportions of business travellers at London City and Heathrow were significantly higher than at Stansted. This evidence suggested that London City and Heathrow could serve a different passenger type from Stansted, which could limit the substitution possibilities offered by these airports to passengers at Stansted.

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<sup>1</sup>This is because in the long run the potential for capacity expansion means that capacity constraints need not persist.

## ***Catchment analysis and isochrone analysis***

10. Our catchment area analysis, which looked at where Stansted passengers live, provided a rough indication of which customers were likely to be marginal. It is reasonable to assume that if everyone in a given area uses one airport exclusively, these passengers will be less likely to switch in response to a price change than in a region in which a large portion of the passengers already make use of a 'rival' airport.
11. We defined the catchment area of a particular airport as all the districts (and the passengers in those districts) where the airport concerned accounted for at least 20 per cent of all passengers with origins in that district. Our catchment analysis methodology is described in more detail in working papers published as part of our market investigation.
12. We found that 80 per cent of Stansted's passengers came from districts in the catchment area of another BAA airport and 12 per cent came from the catchment area of non-BAA airports. The latter was made up of 6 per cent from the catchment of Luton and 9 per cent from elsewhere: Birmingham (~3 per cent), East Midlands (~2 per cent), Leeds Bradford (~1 per cent) and Manchester (~2 per cent).<sup>2</sup> The non-BAA airport overlap for leisure passengers was broadly the same as for all passengers at approximately 14 per cent. The overlap figure with non-BAA airports for business passengers was 28 per cent. As a sensitivity check, we reduced the catchment threshold from 20 per cent to 10 per cent and found that no more than 23 per cent of Stansted's passengers came from Luton districts and 10 per cent from the non-London regional airport districts.
13. Although we found some limitations to this analysis, we considered the results suggestive of little overlap between Stansted and the non-London regional airports. This suggested that relatively few passengers would be likely to switch to a regional airport in response to a price increase at Stansted.
14. The CAA's economic advisers noted the significant catchment area overlap with London City for business passengers. We were of the opinion that, as business traffic represented a small proportion of Stansted's total traffic (18 per cent), the number of passengers likely to be marginal was small.
15. We recognized that one limitation of the catchment analysis was that it did not tell us anything about the price sensitivity of passengers and therefore whether they would actually switch to using a rival airport in the face of competitive activity.<sup>3</sup> Another weakness of the analysis was that the catchments we observed were a consequence of each airport's current offering, ie they were the outcome of existing route networks, pricing, service quality levels, surface access, marketing etc. We recognized that any of these factors could change over time.
16. The CAA argued, in the context of our market investigation, that, because existing catchments were influenced by the current market structure, our catchment analysis should be supplemented with other forms of analysis such as that of isochrones. Like catchment analysis, isochrone analysis seeks to identify marginal customers; however, it does so by constructing geographic areas served by airports based on drive times, rather than existing patterns of usage. We considered that analysis based on existing patterns of usage was more robust for the period relevant to this

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<sup>2</sup>The total is more than 12 per cent, as some passengers were in more than one catchment area.

<sup>3</sup>To mitigate the concern that overlapping catchments result from different airports being used by the same passengers for different purposes (eg one always for leisure and one always for business) rather than as substitutes for one another we analyse catchments by journey purpose (business vs leisure).

review as it captured features of the current market structure (such as existing airport size, surface access, route networks and ownership) that were likely to persist in Q5.

17. The CAA's isochrone analysis used the results of its previous analysis of the geographic distribution of passengers using London airports, which found that approximately 90 per cent of short-haul passengers travel less than 2 hours to their chosen airport. On that basis, 2-hour drive-time isochrones were drawn around a selection of airports. Our own catchment area analysis agreed that a 2-hour drive-time was more appropriate for the purposes of this review than a 1-hour drive-time. The CAA found overlaps between the 2-hour drive-time isochrones for Stansted and Luton, and between those of Stansted and both Birmingham and East Midlands, and noted that a large number of passengers in the Midlands area were within a 2-hour drive-time of three or four airports. The CAA considered that the overlaps between the 2-hour drive-time isochrone for Luton and, directly or indirectly, with those of Bristol, Birmingham, East Midlands and Manchester airports could suggest a geographic chain of substitution extending as far as Manchester, which could provide a further, if weaker, constraint on Stansted.
18. We recognized that isochrone analysis can play a useful role in assessing competitive constraints when there are a large number of local geographic markets as in our recent market investigation into the groceries market. However, we considered that, in the context of this review and our market investigation, isochrone analysis was a second-best to catchment analysis. This was because it runs the risk of abstracting from market characteristics that may persist and which might limit the area over which an airport can draw passengers: for example, airport size and surface access. Moreover, because it solely uses drive-times to identify zones of rivalry, isochrone analysis may include districts where there is no significant competitive interaction within these areas of overlap. For example, a district close to Stansted that was just within 2 hours' drive-time of a non-London airport (for example, Birmingham or Norwich) would be within the isochrone-based zone of rivalry even if the non-London airport's share of that district's passengers was zero. Overall, we considered that it was more robust to undertake catchment analysis based on current usage.
19. We were of the opinion that, based on the catchment area analysis, it was likely that non-London regional airports would provide only a weak competitive constraint on Stansted during Q5. On the whole, they did not offer a comparable range of destinations and frequency of services to Stansted, which we found would limit the ability of passengers coming from overlapping catchment areas to switch to these regional airports in the short term within Q5. Over time, we recognized that airlines could switch their services to non-London regional airports. However, since the number of passengers in the overlapping catchment areas was relatively small, we found it unlikely that an airline could expect to obtain the necessary passenger density at any regional airport in order to switch a route.
20. We found there were a large number of passengers in the London area who were more than a 2-hour drive away from any non-London regional airport, and we also noted that current estimates suggested between 12 and 14 million people live within the London metropolitan area. We considered whether, in response to a price rise at Stansted, Ryanair (or another airline) would move from Stansted to, say, East Midlands and compete for passengers in Stansted's catchment areas. Ryanair told us that it would never be able to market East Midlands to passengers wanting to travel to and from London, even if there were a significant price difference in airport charges and hence in its prices to customers. Ryanair also told us that its business model required it to be present in the London area. The lack of a significant response by Ryanair to the 2007 price rise at Stansted, considered in more detail in paragraph

67, confirmed these views. In particular we observed that when Ryanair faced a very large increase in prices at Stansted in 2007, it was paying a much lower airport charge at East Midlands, where there was significant spare capacity. We believed that, if it had been profitable for Ryanair to have switched to East Midlands in response to the price increases at Stansted, it would have done so. We discuss the possible consequences of further price increases in paragraph 75.

21. We also noted that survey evidence used for catchment analysis related to departing passengers, whereas it was likely that the large majority of inbound passengers would have no choice but to use a London airport. We received anecdotal evidence from the airlines that they could not offer the non-London regional airports as a means of accessing London because they were too far away. This evidence was consistent with our conclusion that these airports would not be able to compete with Stansted for inbound passengers because they could not offer London as a destination.
22. The CAA was concerned that our analysis ignored evidence that passengers substituted between destinations and that significant passenger overlaps could be achieved through relatively few route overlaps due to a concentration of passengers on the most popular routes. The CAA referred to our Emerging Thinking in the market investigation, which cited competition between East Midlands and Birmingham as an example of effective airport competition despite the fact that these airports overlap on only 50 per cent of routes. The CAA was also concerned that static analysis, based on current catchments, risked biasing the evidence base by understating the potential for smaller airports to expand their catchment areas, again giving East Midlands and Birmingham as an example, where route overlaps between these two airports had increased from 11 out of 38 routes in 2000 to 21 of the 41 routes currently offered.
23. We agreed with the CAA that significant passenger overlaps can be achieved through relatively few route overlaps, due to a concentration of passengers on the most popular routes. Beyond this implication, however, the competitive significance of any given level of route overlap is unclear. Indeed, as we stated in our provisional findings report for the market investigation, a high degree of route overlap at different airports does not necessarily imply strong competitive constraints between these airports, just as a lack of route overlap does not necessarily imply that competitive constraints are particularly weak. As regards Stansted, we found that only 4 per cent of short-haul leisure travellers surveyed indicated a preference to travel from East Midlands. We were unable to find out how many of these passengers were either willing to substitute between destinations or were travelling on one of the more concentrated routes. What we did observe is that they actually travelled from Stansted, despite significant available capacity for airlines at East Midlands.
24. Luton also expressed concern that we had underestimated the range of destinations available from non-London regional airports, such as East Midlands and Birmingham. We believed that the lack of observed switching to non-London regional airports in response to relative price changes suggested that these airports were weak substitutes for Stansted. We recognized that this may not remain the case if the regional airports continued to grow their route networks over time, but we did not believe there would be sufficient developments to constrain Stansted in Q5.

### ***Passenger surveys***

25. The CAA's survey of passengers in the London area travelling for leisure purposes on short-haul scheduled flights suggested that passengers at Stansted considered substituting to the other London area airports. Around 85 per cent of Stansted's

leisure passengers had used one of BAA's other two London airports in the past two years, and around 40 per cent had considered doing so. Approximately 20 per cent of Stansted's leisure passengers had used Luton in the past two years, and between 10 and 20 per cent had considered using Luton. Between 5 and 10 per cent of Stansted's leisure passengers had used a non-London airport in the past two years and between 10 and 20 per cent had considered using one of these airports. Very few of Stansted's leisure passengers had used or considered using London City.

26. The CAA survey asked leisure passengers at Stansted which their first and second choice airports would have been if their flights were available from all airports for the same price. We believed that these results needed to be interpreted with caution as the responses related to a hypothetical situation. The results suggested that: 43 per cent of leisure passengers viewed Stansted as their first-choice airport and 22 per cent as their second-choice airport; 6 per cent viewed Luton as their first-choice airport and 16 per cent as their second-choice airport; 13 per cent viewed Heathrow as their first choice-airport and 17 per cent as their second-choice airport; 12 per cent viewed Gatwick as their first-choice airport and 23 per cent as their second; and 6 per cent viewed London City as their first- or second-choice airport.
27. Approximately 22 per cent of Stansted's leisure passengers gave a non-London airport as a first choice and 19 per cent as a second choice. In each case, this proportion was divided between a number of airports, none of which individually represented more than about 4 per cent of respondents. As route and frequency availability is restricted at the non-London airports by comparison with Stansted, we found that passengers' ability and willingness to switch to these airports could be limited in practice. Furthermore, since the number of leisure passengers giving non-London airports as their first or second choice was relatively small for any individual airport, we found it unlikely that an airline could expect to obtain the necessary passenger density at a non-London airport in order to switch a route. Overall we believed that the CAA survey results were consistent with our view that the other BAA London airports and Luton were the closest substitutes for Stansted.
28. Similar results were obtained in a BAA passenger survey. Approximately 40 per cent of Stansted's outward respondents indicated that they had checked whether they could have flown from another UK airport. Of passengers who checked other alternatives, very few respondents viewed non-London airports as a second choice.<sup>4</sup> Luton was seen as a second choice by 13 per cent of respondents. The BAA survey also asked respondents which other airports they had used in the previous 12 months. Apart from the other BAA London airports, Luton was the only airport used by more than 5 per cent of respondents (15 per cent).

### ***Airline switching***

29. We found limited instances of switching of routes by airlines but those examples we did observe suggested a degree of competitive interaction between Stansted, the other BAA London airports and Luton. In particular, BAA data on switching identified three instances, during the period March 1996 to March 2006, of switching away from Stansted, one of which was to Luton and the other two of which were to other BAA London airports. There were also four instances of switching of routes from Gatwick to Luton.
30. The CAA provided further examples of switching, both of existing services and of growth of services. Seven new routes (offering between two and three services per

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<sup>4</sup>The phrase 'second choice' was used in the survey.

week), recently introduced at Luton by Ryanair, had corresponded with a reduction in services and/or frequencies at Stansted. The CAA also noted that Ryanair had opened a base at Birmingham, expanded bases in Valencia and Bristol, and introduced a new route between Madrid and Stansted with a Madrid-based plane, whilst reducing capacity at Stansted. SkyEurope had relocated from Stansted to Luton in 2007/08 and Transavia was due to open a twice-daily service to Rotterdam from Luton in October 2008, despite holding slots at Stansted. AirBerlin and easyJet had also recently reduced capacity at Stansted.

31. We found that these examples suggested a degree of competitive interaction between Stansted and Luton for off-peak services. Our discussions with Luton confirmed that recent switching activity was more a feature of off-peak activity, where there was spare capacity in both airports. It seemed to us that, generally, airlines could not credibly threaten to move based aircraft from Stansted to Luton with Luton's present capacity constraints. These capacity constraints are discussed in more detail in paragraphs 49 to 57.
32. The CAA also suggested that these switching examples were evidence of pan-European constraints. We did not think this was necessarily the case as capacity could be expanded in some areas and contracted in others to reflect changing demand and cost conditions on particular routes, without representing switching behaviour that would constrain prices at Stansted. We discuss this issue in more detail in paragraphs 37 to 39.
33. In our market investigation, we asked airlines to tell us their three closest airline competitors for each of their routes from each BAA airport, and the airports which each of these competitors flew to and from. At Stansted, competitors tended to be at other London airports. In aggregate, Gatwick was most important as the location of the closest competitor, but Heathrow was more important as the location of the second- and third-closest competitors. Luton was mentioned as the closest competitor for some routes. No airports outside London were mentioned. We found there were limitations with this analysis but noted that it supported the balance of evidence.
34. In our market investigation, we also asked airlines which airports were a substitute for each of the BAA airports from which they operated (assuming slots could be obtained at the substitute airport), and how they would respond to price increases at BAA airports. We received mixed evidence: some cargo operators said that they might be able to use other airports but others said they would not. We did not receive any views that suggested that non-BAA airports were effective substitutes for Stansted for passenger traffic because of capacity constraints at Luton. Although two airlines operating at Gatwick said that Luton and Stansted were potential geographic substitutes, and Ryanair said that Luton was a potential substitute for its Stansted operations, these airlines also stated that the lack of peak capacity and limits on the number of aircraft that could be based at Luton meant that it was not currently an effective competitor. As regards non-London airports, Ryanair told us that the importance of the London area to its network was such that it had to serve the London market.
35. The CAA suggested that these airline views were not consistent with assumptions about the sensitivity of passenger demand to airport charges made by York Aviation in its report on Stansted forecasts. This report forecast that if charges increased from £2.61 in 2004/05 to £8.50 by 2012/13, Stansted could see a reduction in demand of 6.3 per cent a year (in the period whilst charges were increasing). These forecasts were based on BAA's own central price elasticity of demand assumption of  $-1.3$  and 82.5 per cent pass-through, which is a relatively elastic response.

36. We placed more weight on actual responses by airlines and passengers following the 2007 price increase than on their forecast responses, because the latter were subject to forecasting error and there was an incentive for airlines to overstate their likely reaction to a price increase. The observed responses suggested a lower passenger elasticity and/or pass-through rate consistent with the current lack of switching options, and are discussed in more detail in paragraphs 67 to 74.

### ***Pan-European airport competition***

37. The CAA submitted to us that the larger airlines at Stansted operated on a pan-European basis and, therefore, could switch routes out of Stansted to many unconstrained airports across Europe in response to a charge increase at Stansted. It pointed towards recent announcements by airlines of intentions to reduce capacity at Stansted, whilst increasing capacity elsewhere in Europe, as evidence of this constraint. BAA made a similar point.
38. We were not convinced that Continental European airports were a constraint on Stansted's pricing. We noted that, whilst an increase in charges at Stansted would affect the relative profitability of routes, it was difficult to see, if a particular route were profitable prior to a Stansted charge increase, why it would not already be served. As no passengers would switch from the Stansted route to the Continental European route, there would be no increase in demand on the Continental European route following a price increase at Stansted. We concluded that airlines would only switch to this route if they had previously been constrained in the number of aircraft they could deploy. The evidence we received from the airlines on this was mixed. Ryanair confirmed that it would be parking planes pulled out of Stansted this winter rather than flying them elsewhere. Ryanair also told us that serving the London market was crucial for its business model and, given capacity constraints, the only airport from which it could serve this market was Stansted. easyJet told us that the ability to switch planes to different airports reflected capital mobility rather than a real competitive constraint, but at the same time told us that its flexibility over fleet size was limited and that it did try to create a competitive tension between non-neighbouring airports.
39. We concluded that there could be some profitable routes elsewhere in Europe to which Stansted operators could switch their planes if charges at Stansted increased, although they would only offer a constraint in the short term because in the longer run airlines could buy or lease more planes to take advantage of all profitable opportunities. We tested the strength of this possible constraint in conjunction with all other potential constraints by looking at responses to recent price increases and the scope to increase prices further still. These analyses are summarized in paragraphs 66 to 87, and supported the view that competitive constraints on Stansted, including from Continental European airports, were relatively weak.

### ***Analysis of airline data***

40. As we noted in our market investigation, airline yield data can be useful in assessing the potential for competition between airports. This is because estimating the effect of competition from services at different airports on airline performance can provide an indication of the relative strength of constraints on airline pricing behaviour imposed by passenger willingness to switch between potentially substitutable airports.
41. Analysis of airline yield data conducted by the CAA, by ourselves in relation to the market investigation and by BAA-NERA Economic Consulting (Nera) in response to

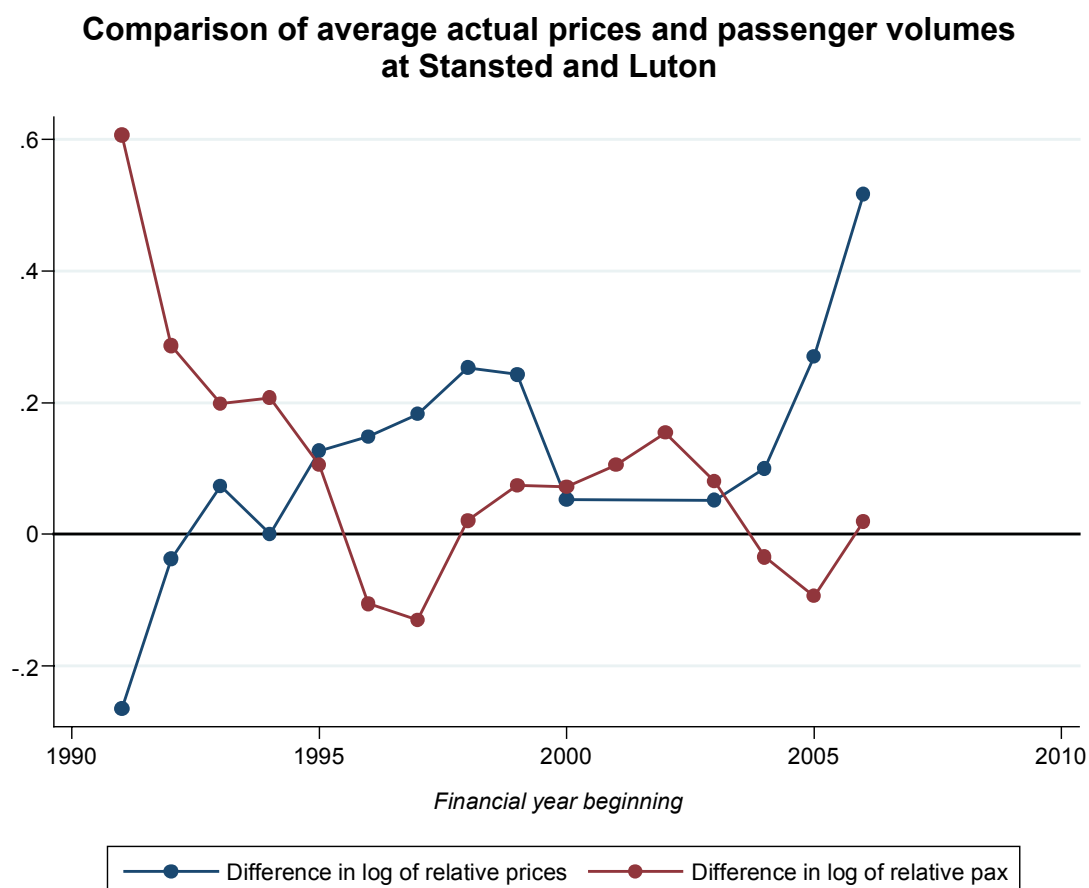
the CAA's 2006 Policy Issues Consultation Paper all supported the view that in the recent past Luton has been considered a close passenger demand substitute for Stansted, although we noted that there were some limitations to these analyses. The CAA's analysis conducted in 2007 suggested that the presence of a route at Luton might reduce air fares on that route from Stansted by 20 per cent. This analysis was based on average air fares for approximately 60 destinations departing on a particular day in 2006. Whilst the analysis controlled for route density and distance, we considered it likely that there were route-specific characteristics not included in the regressions but correlated with air fares that could bias the results.

42. Our own analysis of monthly data on airline yields showed that the correlation in yields was stronger between Luton and Stansted than between any other London airport pair, although the correlation between yields at Gatwick and Stansted, and between Gatwick and Luton, were of comparable magnitude.
43. Nera's cross-airport analysis of the determinants of air fares found that the proportion of flights from the four major London airports provided by LCCs was associated with a statistically-significant reduction in air fares at all of these airports. The analysis was based on monthly data from 1998 to 2005. This result was supportive of a competitive interaction between Heathrow and other London airports but it was not informative about a competitive interaction between the other London airports. This was because there are no LCCs at Heathrow, and so the impact of an increase in LCC services on yields at that airport must capture the effect of competition from rivals at another London airport. However, because there are LCCs operating at all of the other London airports, the analysis could not distinguish between an increase in LCCs at the same airport and an increase at a potentially substitutable airport. Finding a significant effect in the proportion of LCCs on yield at Stansted could therefore just be measuring the effect of intensifying on-airport competition at Stansted, and crucially did not necessarily mean that airlines based at Luton or Gatwick provide a competitive constraint on airlines based at Stansted. This is illustrated by the fact that, in their simulations, Nera could not distinguish between the impact of an increase in LCC services at Gatwick, Stansted or Luton on yields at Stansted because, in their model, all would have the same effect.
44. Nera also performed a correlation analysis on a time series of air fares, and found that air fares at Stansted were more highly correlated with air fares at Luton than at Heathrow or Gatwick. Their route level analysis of passenger numbers showed some evidence that the existence of LCCs serving a particular destination from Stansted was associated with a reduction in passengers travelling to the same destination from other London airports, although this evidence was mixed. Nera also examined the relationship between passenger share at Stansted and passenger shares at other London airports, and found that the relationship was stronger between Stansted and Heathrow than between Stansted and Luton, with the latter showing indeterminate evidence of switching.
45. The above analyses were based on data up to the end of 2006 (with the exception of our yield analysis, which used data up to September 2007). Therefore, we considered that the results were consistent with the view that binding capacity constraints at Luton were likely to mean that the competitive constraint imposed by Luton on Stansted would be weaker in Q5 than it had been in the past. We discuss this weakening of competition and capacity constraints in more detail in paragraphs 49 to 57.

## Actual prices and demand responses

46. We looked at the change in average actual prices<sup>5</sup> and at the change in passenger volumes at Stansted and Luton. This analysis aimed to capture the cross-price elasticity between Stansted and Luton airports directly, rather than infer this elasticity from competition between rival airlines based at these airports. The CAA suggested that it might be more informative to look at the percentage change in relative volumes and prices, as this could remove some of the confounding factors that might appear in the underlying trends. The CAA's analysis is reproduced in Figure 1. However, we and the CAA recognized that this analysis had some limitations as it only looked at the relationship between two variables.

FIGURE 1



Source: CAA, Companies House, Luton Borough Council.

47. This analysis showed an inverse relationship between price and quantity, which we considered could be evidence of substitution. We questioned how much weight could be placed on the absolute strength of the relationship shown, due to the partial nature of the analysis. As other London airports were also substitutes for Luton and Stansted, there were likely to be other factors affecting observed passenger shares. There were also problems with the data, as the average prices included revenue from cargo flights and did not adjust for marketing rebates. Furthermore, the data did not allow us to distinguish between changes in prices paid by specific airlines and changes in average price due to changes in airline shares. Nonetheless, we found that the strength of the relationship appeared to weaken over time, with the strength

<sup>5</sup>Average actual price is calculated by dividing aeronautical revenue for a financial year by the number of passengers in that year and by an appropriate deflator.

of substitution between Stansted and Luton appearing weaker towards the end of the period than towards the beginning.

48. Luton told us that it took published charges at Stansted into account when setting its own level of charges. This was supported by the fact that Luton invested significant effort in allegations of predatory pricing against Stansted in the 1990s. The CAA found that Stansted's pricing behaviour had affected Luton adversely and pointed out that the European Commission had imposed interim undertakings on Stansted to prevent any further adverse competitive effects. We also noted that rapid passenger growth at Stansted corresponded to a period in which Stansted's prices were lower than Luton's, and that rivalry between the two airports, when both were operating with substantial spare capacity, could have contributed towards the fact that Stansted did not price up to the allowable yield under the price cap (excluding the correction factor) until 2007. We also acknowledged the potential for an asymmetric constraint from Stansted to Luton in which Stansted constrains Luton's pricing behaviour but the reverse is not necessarily the case.

### **Capacity constraints**

#### *Luton*

49. We looked at whether capacity constraints at Luton could explain why the competitive constraint imposed on Stansted by Luton seemed to have weakened over the last few years. We found that both apron (in particular) and terminal constraints at Luton were likely to have limited the extent to which Luton could compete with Stansted for overnight-based aircraft, and so for peak traffic. This was because it was not possible for airlines to park additional aircraft at Luton overnight. We found that this would limit the extent to which Luton could compete with Stansted for existing or new LCC business, as these carriers operated a business model relying on access to early-morning departure slots to make their entire networks profitable.
50. We were aware of one external fact in particular that we considered likely to affect Luton's ability to undertake large-scale investment projects in the short term. This was the conditions of its lease with Luton Borough Council, [REDACTED].
51. Therefore, we considered it likely that these capacity constraints would continue at least in the short term, which would continue to limit the degree of competition. Although we received evidence to suggest there might be small incremental additions to stand capacity at Luton in Q5, we found that these expansions would not significantly increase Luton's ability to compete for peak traffic. However, we found there was still competition for off-peak travel, as noted below.
52. BAA submitted that its assessment of capacity at Luton suggested that it was only 50 per cent full. Luton currently handles approximately 10 million passengers a year. Luton agreed that its existing runway could accommodate over 20 mppa but said that this would require improvements to the taxiway network. These improvements were set out in its 2001 Development Brief, and included: parallel taxiways for the runway; airfield taxiway enhancements; aircraft stands; terminal and pier development; and additional car parking. [REDACTED] Without these improvements, Luton told us that it could still exceed the current level of around 10 mppa by encouraging greater off-peak usage and making incremental improvements to capacity. Luton stated that off-peak traffic was the main source of projected growth for Q5.
53. Both BAA and the CAA observed that capacity at Luton was not exogenous to the charges set at Stansted. Whilst we accepted this, we found there were reasons other

than price which were preventing Luton from expanding its capacity (see paragraph 50). Furthermore, [REDACTED].

54. With binding constraints on overnight stand capacity, we considered that Luton would be unable to compete for based aircraft. We considered that as easyJet and Ryanair accounted for 80 per cent of traffic at Stansted and both operated mainly based aircraft, Luton's ability to provide an effective competitive constraint on Stansted was weakened by it being unable to compete for based aircraft. However, we noted that there would be some competitive interaction between Stansted and Luton during Q5, for example for off-peak traffic. Whilst we recognized that off-peak slots might not be attractive for certain operations, there were some airlines (such as LCCs flying into Stansted with aircraft based elsewhere) that were likely to find these slots attractive. Indeed, nearly all the growth at Gatwick and Heathrow over the last decade has been via increased take-up of off-peak slots. One airport told us that it was achieving annual growth of over 5 per cent, largely as a result of a strategy of focusing its efforts on selling and marketing off-peak capacity. In addition, we found some scope for Luton and Stansted to compete for passengers by incentivizing airlines to increase the number of passengers they carry per runway slot. For example, we have been told that easyJet has recently renegotiated an aircraft order so as to be able to carry more passengers per flight at congested airports, replacing a request for A319 aircraft with larger A320s.
55. Luton told us that it would be impossible to add material stand capacity without triggering substantial cost. An additional six stands could accommodate six aircraft, but this would require a further [REDACTED] check-in desks and [REDACTED] security lanes, and these could not be accommodated within the existing terminal. As a result, the cost of adding six stands would not be just the cost of the stands, but would include the additional, and substantial, costs of expanding the terminal. Any more than six stands would require changes to the taxiway infrastructure at further substantial cost, in addition to even greater terminal expansion.
56. As any expansion to capacity at Luton would require considerable cost, [REDACTED], we concluded that capacity constraints at Luton were likely to continue to limit the strength of constraint imposed by Luton on Stansted in the short term.
57. We recognized the potential for competition between Stansted and Luton to develop over the course of Q5 if Luton made significant expansions to capacity and became able to compete for peak traffic and based aircraft. [REDACTED] However, we noted that there was no certainty that any of the necessary conditions could be met within this timescale, and concluded that this timetable must be regarded as optimistic. [REDACTED] As a result, we concluded that there was too much uncertainty surrounding the potential for competition from Luton to place any reliance on it protecting users of Stansted over the course of Q5.

#### *Other BAA London airports*

58. We found that Heathrow was subject to binding capacity constraints, as evidenced by the emergence of significant slot values in recent years. This also applied, though to a lesser extent, at Gatwick, where supply still exceeded demand at certain times of the day in the summer (typically late evening slots) and in nearly every period of the day in the winter. As a result of these capacity constraints, we found that, if Stansted increased prices, there would be a limited switching response by airlines to Heathrow and Gatwick, as the main scope for switching was to Gatwick in off-peak hours. Whilst these airports would provide airlines at Stansted with some opportunity for switching, they would not provide access to peak departure slots, which would weaken their competitive constraint.

59. The CAA's economic advisers were concerned that our analysis of substitution possibilities was static in nature, and so neglected the constraints imposed by potential entrants and those currently providing relatively limited substitution possibilities. They noted that pricing at Stansted was a material factor in stimulating the development of routes to and from Stansted, suggesting a high elasticity of demand. They were also concerned that we were ignoring the indirect effect of a price increase at Stansted, whereby a reduction in capacity by airlines would lead to further reductions in demand by passengers because of the value placed by passengers on a range of destinations and the frequency of services.
60. We did not disagree that low prices had stimulated demand in the past, when capacity in the South-East was relatively unconstrained. However, it was our view that the current situation was different from the past and in particular that the price elasticity was much lower because of capacity constraints that, we expected, would persist, at least in the short term.
61. We did not consider that potential entrants and those currently providing limited substitution possibilities would be likely to develop the capacity or the capability to compete with Stansted during the course of Q5. New airport development and significant airport expansion would take a considerable amount of time.
62. We did not see evidence of the indirect effect in practice because we did not see much reduction in passenger volumes in response to significant recent increases in airport charges at Stansted. Although airlines at Stansted had cut some routes out of their winter schedule in response to the price rises (and in response to oil prices and other macroeconomic factors), the load factors on their remaining flights had remained approximately the same.
63. In our market investigation we found that, whilst capacity constraints would tend to limit the incentives of Heathrow and Gatwick to exert competitive pressure on Stansted in the short term, there was nevertheless some scope for competitive pressure at the margin. However, we found in the context of this Stansted review that this competitive pressure would be fairly weak for the period concerned, and that the price cap in Q5 was likely to be binding as a result. Unlike our market investigation, our Stansted review covers the specific period of Q5. We believed that the prospects we identified for long-term competition in the market investigation would not materialize within Q5 and, therefore, they were not relevant for the Stansted review.
64. The CAA's economic advisers also noted that it was appropriate to recognize that airports could be characterized as two-sided markets because it had implications for the way that airports competed. Airports are two-sided platforms in the sense that they receive revenue from two distinct user groups, airlines and customers. In addition, the benefits which each user group derives from using the airport increase as the size of the other user group increases. In this setting, airports have strong incentives to compete with other airports for airlines to increase the number of destinations served from their airport because this increases the attractiveness of the airport to passengers, which in turn has the effect of making the airport more attractive to airlines, and so on. The CAA and its economic advisers felt that the implications of this incentive for airports to compete with one another meant that the competitive constraint of other airports, including Continental European airports, on Stansted could be far stronger than a short-term analysis would reveal.
65. We agreed that airports display some characteristics of two-sided markets, but did not consider that this should change the way we assessed competition at Stansted: namely considering all potential substitutes for Stansted and assessing their effect in aggregate by looking at recent responses to significant price increases, and the

scope to increase prices further still (see paragraphs 66 to 87). We believed that, if competition between airports across Europe resulted in a strong competitive constraint, we would have seen a greater reduction in the number of routes at Stansted as a result of the price increase, and a correspondingly greater reduction in passenger volumes. We recognized the potential in theory for these effects to materialize over the longer run but, given the airlines' own growth forecasts at current prices, this seemed unlikely. Furthermore, we noted that we were concerned with competitive constraints during the specific time period of Q5, and so we were interested in constraints that would materialize in the relatively short term. Finally, we felt that this analysis was based on the assumption of relatively fixed fleet size discussed in paragraphs 38 and 39 because, if airlines are not constrained in the number of aircraft they can obtain, an airport wishing to attract an airline must simply offer a profitable proposition rather than a proposition that is more profitable than those being offered by other non-neighbouring airports.

### ***Profitability of past price increases***

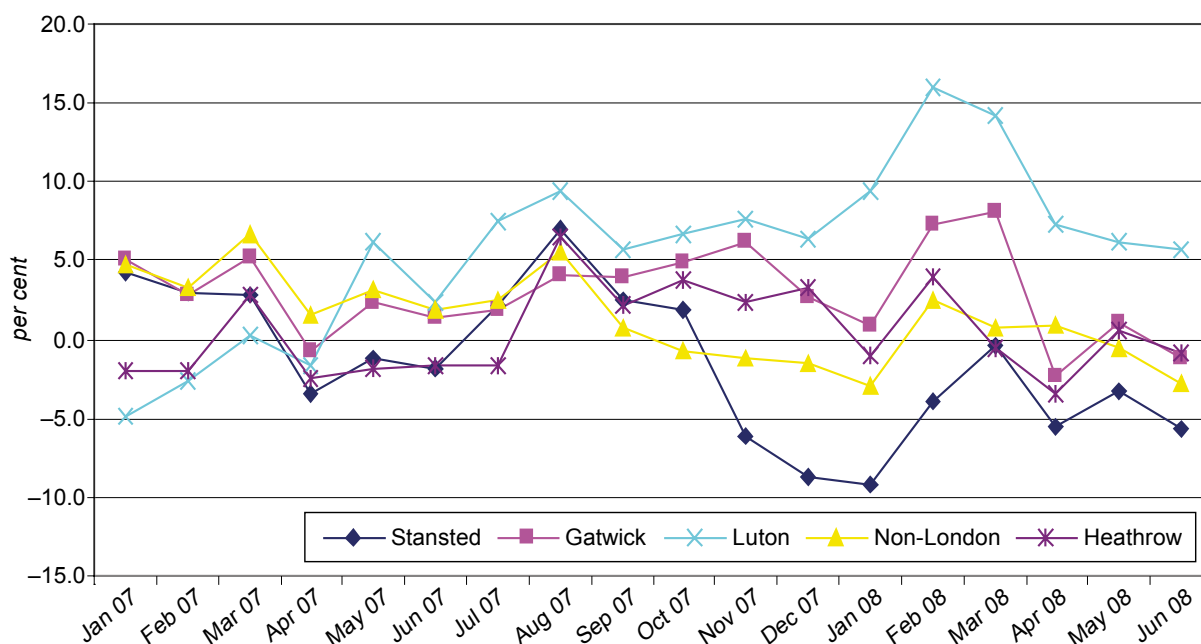
66. We found that airline responses to recent increases in charges at Stansted provided a natural experiment as to the strength of the cumulative effect of potential competitive constraints in practice.
67. In April 2007, published prices at Stansted increased to the level that enabled the airport to recover its allowable yield under the price cap, excluding any correction for previous under-recovery. The average increase in published charges was 8.7 per cent. However, more importantly, many (but not all) airlines had benefited from substantial discounts up to the end of 2006/07, which were agreed during a period when both Stansted and Luton had substantial spare capacity, (consistent with our view that Stansted was subject to a much stronger competitive constraint from Luton in the past, which has weakened in recent years (see paragraph 48)). The ending of these discounts meant that different airlines experienced very different net changes in prices, with Ryanair experiencing a very large increase in net charges (more than doubling) and charter airlines facing a much smaller increase (the 8.7 per cent increase in published rates). In April 2008, Stansted increased published charges by a further 15 per cent (including ANS charges).
68. We found a small reduction in scheduled seat capacity by airlines<sup>6</sup> and some limited switching of passenger volume to Luton and Gatwick in the period subsequent to these price increases, but overall we found that the increases in charges were very profitable for the airport. We concluded that this evidence supported our view that Stansted would face limited competitive constraints in Q5. We believed that the continued existence of capacity constraints in the South-East would limit the competitive constraints on Stansted in Q5.

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<sup>6</sup>Winter 2007 seat capacity was 8 per cent lower than the previous year at the start of the season, and summer 2008 seat capacity was 9 per cent lower than the previous year at the start of the season (although approximately 3 per cent of the difference between summer 2007 and summer 2008 was likely to be accounted for by the fact that the summer 2008 season was one week shorter).

FIGURE 2

**Annual change in passenger numbers: Stansted vs other airports**



Source: CAA.

69. The CAA suggested that growth in passenger volumes at other London area airports compared with growth at Stansted in 2007 and 2008 indicated some passenger switching in response to price increases. We found that there was some evidence to suggest that this was the case (see Figure 2). In a number of months subsequent to the price increase at Stansted, passenger volumes at Stansted fell relative to the previous year, whilst passenger numbers at one other London airport (at least) increased on the previous year. We noted that other factors could explain these movements, as capacity also fell on the previous year at Heathrow, Gatwick and the non-London area airports in a number of months in 2007 and 2008. Furthermore, we found that the largest quantity response occurred at Stansted in January 2008, when passenger volumes fell by nearly 10 per cent on the previous year. We noted that, given a very large increase in the average charge (nearly 80 per cent), this suggests a low price elasticity of  $-0.24$ , assuming a counterfactual growth of 9 per cent (the highest experienced by a London airport that month).
70. The CAA stated that observed reductions in capacity and/or growth rates were likely to have understated total reductions because airlines were aware that contracts were going to expire and would have withdrawn capacity in advance of the price increase occurring. We did not agree with this argument as we would have expected any adjustment to have been planned to coincide with the date of increase rather than to take effect beforehand, with airlines making use of the airport until the rise in charges was implemented. The fact that airlines anticipated the charge increases meant they had time to plan where, if at all, they wished to switch flights, and to negotiate with competing airport operators in order to do so. If airlines were able to anticipate the price increase, we would have expected it to lead to an even more immediate response, rather than being delayed over the subsequent months. More importantly, even if we accepted the CAA's argument and did look to see if there was an anticipated response to the price increase, the evidence suggested that there was not: Airport Coordination Limited (ACL) scheduling reports showed that overall seat

capacity in summer 2006 increased by 11.8 per cent on the previous year, and in winter 2006 by 6.7 per cent.

71. The CAA also suggested that the recent price increases could have represented a movement towards the competitive level if prices had previously been held below this level by the existence of long-term contracts. Alternatively, the CAA suggested that the price increases could have represented increases in the competitive price level caused by changing supply and demand conditions. BAA stated that prices at Stansted had previously been very low and that the increase, though significant, had been towards a reasonable level as it was still below the regulated price cap.
72. However, we considered that even if Stansted's previous prices were below the competitive level the analysis of the profitability of Stansted's 2007 price increase was still relevant as it provided an indication about the profitability of future price increases. This is because unless there is a big discontinuity (a kink) in the demand curve, it is reasonable for us to infer something about the slope of the demand curve immediately above the competitive price from the slope of the demand curve immediately below it. Moreover, we did not see clear evidence of changed supply or demand conditions that would obviously render irrelevant our analysis of the 2007 price increase.
73. We recognized that in industries characterized by lumpy investment and large sunk costs, it is not uncommon to see periods in which prices are below average cost and periods in which they are above average cost. Periods of prices being below cost typically result from capacity significantly exceeding demand, while periods in which prices are above cost tend to occur when the reverse is true. As the CAA observed in its reference to us, these periods of above cost pricing can help to signal to the airport operator when it is appropriate to undertake investment in significant capacity expansion in order to meet growing demand.
74. We noted that, whilst Stansted was relatively constrained during peak hours, it still had considerable scope to incentivize growth in off-peak traffic through the use of differential charging at different times of the day. Although current traffic levels were approximately 23 mppa, the airport had the capacity to handle 35 mppa. However, the fact that the allowable yield applies only to average yield per passenger means that Stansted could increase charges above the cap in peak hours, reflecting the capacity constraints in these hours, by charging below the cap for off-peak usage. This would provide appropriate price signals to airline users and incentivize the efficient use of available capacity. With regard to the signal for investment, our findings on Stansted's passenger forecasts suggested that we did not expect Stansted to need to begin construction work on SG2 in Q5 (see paragraph 8.47 of the main report). We noted as well that BAA was arguing for a continuation of the RAB-based regulatory regime in Q5, because it believed that this approach provided the best context for continuing with its capital development plans (both SG1 and SG2), and not for some form of above-cost pricing. We discuss this issue further in paragraph 89 (also see Appendix C).

### ***Profitability of further price increases***

75. We looked at whether Stansted could increase prices further above current levels to guide our view on whether a price cap would be likely to bind. We considered a number of pieces of evidence in relation to this question including: reasons given by BAA when deciding the level of charges to set; the CAA's critical loss calculation; Frontier Economics Limited's (Frontier) analysis of easyJet transaction data; counter-vailing buyer power; and airline profitability levels.

76. We asked BAA why it was not pricing up to the current cap. BAA told us that it did not think that it should recover discounts previously given to customers in good faith, even if the regulatory settlement, through the mechanism of the correction factor, allowed it to do so. When combined with our previous finding that competitive constraints were likely to be weak because of capacity constraints in the South-East, we concluded that Stansted could profitably increase charges above current levels.
77. The CAA suggested that BAA's reasons for pricing below the cap were still related to a loss of volume, but a loss that would materialize in the long term and not in the short term. We saw very little evidence to support this argument but, even if it was found to be the case, it would still suggest a lack of competitive constraints on Stansted during Q5.
78. To assess how much higher than current levels an unregulated operator could set charges, we looked at a range of other evidence.
79. The CAA's critical loss calculation found that passenger volumes would have to fall by 3.75 per cent for a 5 per cent price increase from a £5 starting price to be unprofitable. Extrapolating this analysis for larger price increases, we found that a £5 price increase from the then current level of £5.50 would be profitable. Our calculation found that approximately 42 per cent of passengers would have to switch to make a £5 price increase unprofitable. As its passenger survey had revealed that only 17 per cent of respondents would switch in response to a £5 price increase, the CAA concluded that passenger switching alone would not be sufficient to make a price increase unprofitable. However, the CAA also considered it unlikely that airlines' product offerings would remain the same in the face of significant charge increases and therefore concluded that looking at passenger switching alone would understate the actual response.
80. We considered whether airlines would switch from Stansted in this way so as to make a small price rise unprofitable. We found there was insufficient spare capacity in the South-East for airlines to do so, particularly given the business models of the majority of incumbent airlines, which relied on access to the London airports and early morning departure slots.
81. Analysis by Frontier using easyJet transaction data found that Stansted could profitably increase prices above current levels. We performed a similar analysis using the easyJet data but found that there were problems in using this data for this type of analysis.
82. We considered whether airlines at Stansted had countervailing buyer power that could limit Stansted's pricing power. Airlines could have such buyer power if they could threaten to switch a large volume of traffic in response to a price increase. Previous price negotiations suggest that this may have been the case when capacity at Stansted and other London airports was relatively unconstrained. However, capacity constraints at rival airports had recently reduced the value of airlines' outside options, reducing their bargaining power. Recent negotiations between Stansted and the airlines supported this view, as BAA was now only offering discounts for long-haul traffic, new short-haul routes and off-peak traffic. Although we noted that some of these offers were generous, we found that the tightening demand-supply balance was likely to have reduced airline bargaining power in recent years.
83. We considered that the maximum amount an unregulated operator would be able to charge would depend on airlines' willingness to pay. We used airline profitability data to investigate where we thought an unregulated price might be, and found average profitability per passenger (excluding commercial revenues) for Ryanair at Stansted

in 2007/08 was £[REDACTED]. Assuming that Ryanair had to continue to serve the London market, and capacity constraints in the South-East meant that there was no other airport to which Ryanair could switch, we concluded that an unregulated operator could increase charges by the full amount of profitability per passenger to £[REDACTED]. This analysis was confirmed by Ryanair, which told us that if charges increased to £12.50 it would have no option but to stay at Stansted and pay.

84. The CAA found significant shortcomings with the use of average profit figures and current prices as a means of estimating the marginal willingness to pay. We acknowledged that marginal willingness to pay might be significantly lower than average willingness to pay, but found that the concept of the marginal route is complicated by the economics of airline networks, in which the profitability of one route from Stansted often depends on the existence and frequency of another. We found that, as the profit figures we looked at excluded ancillary revenues, the profitability of the average route was likely to be higher than reported, although we recognized that Ryanair was one of the most efficient operators and that other operators' margins were likely to be lower (see paragraph 85). We also recognized that it was unlikely that an airport operator would price to leave airlines with no profit margin. However, we noted that our analysis of the CAA's critical loss calculation implied that a 42 per cent reduction in passenger volumes was necessary to make a £5 increase in price unprofitable, which suggested that nearly half the flights operating out of Stansted would have to have a lower willingness to pay than our estimate of £[REDACTED] in order for a doubling of airport charges to be unprofitable. We concluded that this evidence was consistent with our view that Stansted had a reasonable degree of market power, as it suggested that charges would have to increase significantly for flights from Stansted to become unprofitable.
85. Given recent macroeconomic events, including higher oil prices and the prospect of an economic downturn in the UK, we questioned whether we could rely on the past profitability of one of the most efficient operators to gauge airlines' willingness to pay in the future. We concluded that whilst these market conditions might lessen Stansted's pricing power in the short term, Ryanair was still forecasting strong profits in the medium and long term, even with prices at Stansted at their current levels.
86. The CAA looked at airline profitability at a group level (using the data available to it), and found that an increase in airport charges at Stansted would have a material impact on the group profits of both easyJet and Ryanair, and therefore could be expected to cause airlines to change their product offering in response to a change in airport charges. This in turn could lead to greater passenger switching as other airports became relatively more attractive with a wider range of destinations and services.
87. In contrast, airlines stressed to us the importance of the London market to their business models. We found that, whilst charges at Stansted may well have a significant effect on group profits, with nowhere else to go in London, particularly at peak times because of capacity constraints, the majority of incumbent operators at Stansted would remain there for as long as it was profitable to serve the London market.

### **Distortion to competition**

88. We found that a binding price cap might distort investment incentives for two main reasons:
  - (a) It might discourage or delay capacity-expanding investment at Stansted since, if the current form of RAB-based regulation were to be continued, a low return on

capital immediately after new capacity comes on stream (resulting from prices falling below the per passenger cap due to excess capacity) might not be offset by a high return on capital in the later years.

(b) If it resulted in prices being held below the competitive level, it could distort investment signals for potentially competing airport operators, which might require a higher price at Stansted to trigger investment.

89. With regard to the first concern, we noted that, if prices do not fall significantly below the cap, a RAB-based price cap provides incentives for the operator to invest as long as the allowed rate of return is at least as high as its actual cost of capital. (We discuss the incentives of RAB-based regulation on investment in more detail in Appendix C.) We also noted that we did not see evidence that regulation is currently deterring or delaying capacity-expanding investment at Stansted. Rather, we noted that BAA continued to progress its planning application for SG2, and BAA told us that it would continue to do so under a RAB-based regime in Q5. Although the focus of our review was just Q5, we noted that we would expect any future regulation of Stansted to take into account the need for the owner to have an expectation of earning the cost of capital on capacity-expanding investment, in order for it to have the incentive to go ahead with such investments.
90. With regard to the second concern, the competitive price is the price that results from a process of effective competition. In the absence of a process of effective competition, it is, in general, very difficult to know what the competitive price would be. Economic theory identifies the competitive price with marginal cost but, depending on the time period under consideration, we found this may give rise to a range of numbers because short-run marginal cost may differ from long-run marginal cost. Moreover, in the presence of fixed costs, firm viability may require price to be above marginal cost. A further important issue is that, in the absence of effective competition, existing or forecast costs may be an unreliable basis for estimates of the competitive price since, as we note in our market investigation guidelines,<sup>7</sup> firms with market power may be able to operate with higher costs than would be sustainable if there were keener rivalry in the market.
91. Nevertheless, we considered some speculative evidence on what the competitive price might be. ASA (our consultants reviewing BAA's capex proposals) estimated the cost of SG2 and, using these estimates, we calculated a long-run average incremental cost of £7.80 per passenger (in 2008 prices), with a range of £5 to £16 depending on many other assumptions. We also estimated the replacement cost of Stansted's existing facilities at £6.60 per passenger. Although very broad estimates, we recognized that they suggested at least the possibility that a continuing price cap at Stansted, at or around current levels, could constrain Stansted's prices below the competitive price. Therefore, we considered whether this regulated price at Stansted could have the effect of significantly distorting investment at other airports.
92. We looked at this issue in conjunction with our assessment of competition in order to identify which airports had sufficient competitive interaction with Stansted to be affected by its price level. In doing so, we recognized that the relevant constraints might be asymmetric and that airports which were not found to constrain Stansted's pricing could still be affected by charges set at Stansted. Such airports could include Luton and the non-London regional airports.

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<sup>7</sup>[www.competition-commission.org.uk/rep\\_pub/rules\\_and\\_guide/pdf/cc3.pdf](http://www.competition-commission.org.uk/rep_pub/rules_and_guide/pdf/cc3.pdf).

93. We noted that only Heathrow, Gatwick and Luton were currently constrained with respect to capacity. As a result, we concluded that distortions to major capacity expansions at other airports in the UK caused by the price set at Stansted would be unlikely. We also observed that Heathrow and Gatwick faced incentives under the RAB-based regime in operation at those airports to expand capacity as long as the allowed rate of return was at least as high as their actual cost of capital, so we did not think that a regulated price at Stansted would distort investment there either.
94. Luton told us that [REDACTED]. Furthermore, we found that there were other constraints acting on Luton's ability to make substantial expansions to capacity discussed in paragraphs 49 to 57. Therefore, we concluded that a binding price cap at Stansted not dissimilar to the current price would not distort Luton's investment incentives.

## Summary

95. We found that the actual competition likely to be faced by Stansted in Q5 was not strong enough to represent an effective constraint on Stansted at current prices. The strongest substitutes for Stansted from the perspective of airlines and/or passengers were the other BAA London airports and Luton. A fairly recent development, which has weakened the actual competitive constraint exerted by these airports, is that the BAA London airports and Luton are all constrained to some extent with respect to peak-hour capacity.
96. We noted there was scope for these airports to compete with Stansted for airlines in the off-peak periods and for passengers. However, we found that the restriction to competition in the peak periods would limit the degree to which these airports could act as a constraint on Stansted, at least in the short term. Unlike our market investigation, our Stansted review was only concerned with the period of Q5 and though in the market investigation we have identified prospects for long-term competition, we did not believe that they would materialize within Q5, and therefore they were not relevant to our Stansted review.
97. We found that non-London airports, including UK regional airports and Continental European airports, exerted a very weak constraint on Stansted. We were of the view that this was unlikely to change in Q5. We concluded that if a price cap similar to the existing level were to be applied at Stansted, it would be likely to bind over the course of Q5.
98. Our view that actual competitive constraints on Stansted were currently relatively weak was supported by recent reactions to airport charge increases at Stansted: we found that whilst airport charges increased significantly in 2007, we observed limited switching by airlines and passengers. We also found evidence to suggest that charges could be increased further above their current level. We placed particular weight on BAA's statement that it was not pricing up to the cap (including the correction factor) because of a commitment given in good faith to the airlines not to recover previous discounts. This evidence suggested to us that this pricing behaviour was not because of a consideration of potential volume losses from further price increases, which would be expected from an airport subject to strong competitive constraints.
99. Because we considered a price cap likely to be binding, we considered whether the investment decisions of potentially competing airports were likely to be affected by the level of charges set at Stansted. We noted that the affected airports could be more numerous than those identified as substitutes for Stansted because of the potential for asymmetric constraints.

100. We found that the non-London regional airports were not facing any significant expansions to capacity over the course of Q5 that could be affected by the level of charges at Stansted. Capacity expansions at Luton were dependent on the outcome of current discussions with Luton Borough Council over the terms of its concession agreement. [REDACTED] As a result, we concluded that the main factor limiting significant capacity expansion at Luton was not the level of charges at Stansted in Q5 but the terms of its concession agreement.
101. We found that there was potential for strong competition between Stansted and Luton to develop if Luton made significant expansions to capacity that would enable it to compete for peak traffic and based aircraft. We found that, [REDACTED]. As a result, we concluded that there was too much uncertainty surrounding the potential for competition from Luton to place any reliance on it protecting users at Stansted over the course of Q5.
102. Finally, we looked at the potential impact of a binding RAB-based price cap at Stansted in Q5 on the incentives to invest of both Stansted and other airports. We noted that an operator subject to RAB-based regulation faces incentives to invest as long as the allowed rate of return is at least as high as its cost of capital, and we did not see any evidence that the existing RAB-based regulation at Stansted was currently deterring or delaying its capacity-expanding investment. We also did not see any evidence that a binding price cap at Stansted would distort the investment incentives of non-London airports, all of which have some degree of spare capacity. For the other BAA London airports, we noted that the existing RAB-based regime appeared to provide sufficient incentive to invest and would not be distorted by a binding price cap at Stansted. Lastly, Luton told us that [REDACTED]. Overall, we did not believe that a binding price cap at Stansted, set at its current level or higher, would have any significant distorting effect on the investment incentives of Stansted or any other airport.
103. We concluded that, as the risk of distorting investment incentives at Stansted and competing airports in Q5 was likely to be low, it was preferable to guard against the exploitation of market power when determining the appropriate form of price regulation at Stansted in Q5. This decision informed our recommendation on the most appropriate form of price regulation at Stansted in Q5.