

Airport Consultative Committee – Gatwick Airport (ACC)

ACC

Response to CAA document:

Consultation on Gatwick market power assessment

26 July 2013

Introduction

- 1.1 The ACC is pleased to respond to the CAA's consultation of May 2013 on its assessment of market power at Gatwick
- 1.2 Some ACC airlines will also be responding individually to this consultation, especially on market definition and on competitive constraints, which are not easy issues for competing airlines to discuss with each other.
- 1.3 This response focuses on the areas where the ACC airlines have a common view.
- 1.4 The ACC has responded separately to the CAA's initial proposals for economic regulation of Gatwick Airport and this response should be read together with that document. We are also preparing a response to the CAA's recent letter outlining a possible alternative regulatory approach, based on Commitments and Contracts.

Summary

- 1.5 In summary we support the CAA's "minded to" finding that parts A, B and C of the market power test are met in relation to Gatwick Airport, in that:
 - Test A: Gatwick Airport has substantial market power by virtue of the limited alternatives available to airlines at Gatwick, giving Gatwick the ability to increase prices and impose uncommercial terms without suffering a corresponding loss of revenues;
 - Test B: Competition law does not provide protection against the risk that Gatwick would abuse its market power, because of the retrospective nature of the remedy, the difficulty in obtaining data to prove the abuse and the lack of precedents, all of which would result in an excessively slow, uncertain and inefficient means of addressing problems; and
 - Test C: A licence-based approach is likely to provide greater benefits to passengers than the adverse effects of regulation. The airport has clearly stated its intention to increase prices even above the CAA's current assessment of a fair price, and there is now great flexibility to tailor the regulatory approach to avoid unnecessary burdens and to simulate the incentives of a competitive market.

TEST A – does the airport have or is it likely to acquire significant market power?

- 1.6 As explained above, we do not comment collectively on the CAA's proposed market definition, but some ACC airlines are preparing their own responses addressing these and other issues.
 - 1.7 Nonetheless the ACC supports the CAA's overall 'minded to' conclusion that Gatwick Airport has significant market power, which is unlikely to be eroded over the period 2014 to 2019.
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- 1.8 It is clear that the limited ability for airlines to switch away from the airport, also taking into consideration any potential marginal switching, means that the airport is able to increase prices and act in an uncompetitive manner and not suffer a material loss in profits.
- 1.9 In reaching this view, we note in particular the limited choices available to airlines to move to other airports, for the various reasons discussed by the CAA. We also agree with the CAA's view that passenger preferences mean passenger switching will not constrain airport charges, even at the margins.
- 1.10 With this in mind we agree with the CAA's assessment that Test A has been met and that SMP is evident at the airport and that airlines collectively (and therefore their passengers) are unable to constrain airport behaviour in the way they could in a competitive airport market.
- 1.11 Airlines also consider that GAL does not behave towards airlines as they would if operating in a competitive market. We strongly agree with the CAA's finding that there is no evidence to suggest that any airlines can exert any degree of buyer power over GAL. We continue to hold the view that despite a somewhat positive change in behaviour since the sale in terms of operational efficiency and improved delivery of service targets we do not attribute this to any increased competition in the market, instead we believe it is due to the beneficial impact of new owners. Additionally, GAL's lack of engagement particularly in relation to discussions on Commitments, lack of information disclosure during the CE process and behaviour in relation to the delivery of major capital projects (such as Atlantic House and runway re-surfacing) further illustrates their market power.

Test B - does competition law does provide sufficient protection against abuse of SMP

- 1.12 The ACC agrees with the CAA's view that it would be difficult to successfully discipline behaviour using competition law in circumstances of vertical abuse where the airport operator does not have a direct interest in the downstream market
- 1.13 We also agree that relying on competition law, as an ex-post measure, is not adequate when there are known market impediments. Relying on competition law is better suited to protecting markets that are already competitive.
- 1.14 We consider that at Gatwick there is high risk of the abuse of market power by the airport in the form of excessive prices and lower service levels in the absence of regulation.
- 1.15 The CAA judges that it needs to assess the adequacy of competition law, for test B, from the perspective of "users of air transport services." It is extremely unlikely that individual users of air transport services, or collections of users, would have the resources to mount any such challenge, but would instead rely on airlines to resolve problems on their behalf.
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- 1.16 However, the complexity, risk, cost and distraction of management time, along with the difficulty and uncertain outcome of private damages action (and associated risk of an adverse cost award), would act as a very significant deterrent, particularly for smaller airlines, and would be seen as a last resort. This would probably mean that only major abuses would be challenged, allowing the airport to accumulate many smaller abuses.
- 1.17 These potential detriments are likely to have a significant direct impact on passengers/users that could persist for some time.
- 1.18 The CAA has stated that in its view GAL's charges are probably at or above the competitive price level. Given GAL's stated intention to increase prices above this level and above the CAA's assessment of a "fair price", there is a high likelihood that GAL would attempt to increase prices or to reduce outputs/service quality in the absence of regulation.
- 1.19 In our view, therefore, competition law is unlikely to provide a sufficient deterrent to prevent abuse and would not provide an efficient or effective remedy if there was any abuse.
- 1.20 Test B of the MPT has been met.

Test C requires the CAA to assess whether the benefits of a licence outweigh the adverse effects

- 1.21 We accept that Test C does not require the CAA to define precisely the type of regulation that would apply.
- 1.22 However, we would question the CAA's assessment that the appropriate counterfactual should be the commitments proposed by GAL, as the counterfactual should be what would occur in the absence of regulation. It is not clear that GAL's proposed commitments would have occurred if there was no regulation.
- 1.23 In any case, there have been several versions of GAL's commitments, ranging from a 2012 version which covered only price, to a wider set of proposals in January (and a price of RPI+4%) and the latest version in response to the CAA's proposals with a price of RPI+2.5%. They could change again and indeed GAL's proposals permit the Commitments to be changed under certain circumstances even if they were adopted.
- 1.24 We also note that the CAA appears to be assessing the case for GAL's proposed Commitments on the basis that they would be implemented through a licence. The appropriate counterfactual would involve no licence, as the licence is in itself a regulatory tool.
- 1.25 For these reasons, we do not consider there are obvious licence based and non-licence based alternatives to compare and it is more appropriate to consider in more general terms the benefits and costs to passengers of licence-based
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approaches where there is market power, compared with non-licence based approaches.

Price impact

- 1.26 Prices would certainly increase more under a non-licence approach than under a licence approach, because GAL rather than the CAA would set the price level. The CAA would have no ability to regulate prices.
- 1.27 GAL considers that current prices are below the competitive level and in January made the case to increase them by up to RPI+7% over a 5 year period. Although they reduced this to RPI+4% for Commitments and then to RPI+2.5%, we believe this was only done as part of the airport's negotiation to try and secure deregulation. We believe that one of the airport's prime motivations in seeking a non-licence approach (full deregulation or Commitments) is to increase prices at the airport.
- 1.28 We agree with the CAA that the current price cap is not significantly below the competitive price following price increases of 56% in Q5¹ (we note that that the Leigh Fisher benchmarking report examined prices only up to 2010 for comparable airports). Note, this does not mean we endorse the current price cap as being competitive. Consequently, GAL's ability to increase prices is not justified and is not what would happen in a competitive market.
- 1.29 A licence based approach is therefore likely to deliver significant price benefits, which would be passed to consumers in the form of lower air fares and a greater choice of air transport services. Airlines would compete away to passengers any price reduction, so all the benefit would flow to passengers.
- 1.30 Based on GAL's proposals and their view that charges are currently too low, any potential benefits from lower regulatory costs under a non-licence approach would accrue to GAL's shareholders, and not to passengers in the form of lower prices.
- 1.31 It is difficult to estimate the amount of price benefit that would be delivered by a licence, but it would be significant for reasons discussed earlier. However, as an illustration, comparing the CAA's April estimate of a fair price for 7 years of RPI+0% with GAL's then price commitment price of RPI+4% (which GAL would have calculated as needing to be attractive for it to be seen as an alternative to a licence) is an annual aeronautical revenue difference of £55m, as shown in the table below:

¹ From £5.61 in the last year of Q4 to £8.78 in 2013/14. This 56% increase does not include the increase resulting from inclusion of some charges previously paid separately.

RPI+0% vs RPI+4% over 7 years

	13/14 (Q5)	14/15	15/16	16/17	17/18	18/19	19/20	20/21	7 year total
CAA profiled yield/pax @ RPI+0%	£8.31	£8.33	£8.34	£8.31	£8.28	£8.28	£8.28	£8.28	
CAA capex projections (£m)		35	35.5	36.1	36.8	37.6	38.5	39.3	
CAA aero revenues (£m)		£291.55	£296.07	£299.99	£304.70	£311.33	£318.78	£325.40	£2,147.83
GAL profiled yield/pax at RPI+4%		£8.64	£8.99	£9.35	£9.72	£10.11	£10.51	£10.94	
Revenue from RPI+4%		£302.48	£319.08	£337.45	£357.75	£380.15	£404.82	£429.76	£2,531.49
Difference (£m)									£383.67
Average annual difference (£m)									£54.81

Source: CAA yield/pax & capex projections, Figs 1.2 & 1.3 CAA Initial Proposals, April 2013. Other numbers calculated from them.
 Note: All numbers are in 2011/12 prices.

Efficiency

- 1.32 While a non-licenced approach might lead to the airport becoming more efficient, because the airport would be able to retain efficiency savings, then by definition it would be the airport's shareholders rather than passengers who would benefit. Even so, they might be less likely to pursue efficiencies, because it would be easier to make profits by increasing prices instead.
- 1.33 A licence does give the CAA direct tools to incentivise efficiency (for example by making specific opex, capex and WACC allowances and by setting the criteria for allowing capex into the RAB.) Price controls are specifically designed to drive efficiency benefits and to deliver the benefits to consumers through lower prices.
- 1.34 Therefore there is unlikely to be an efficiency benefit for passengers from an unlicenced approach.

Service quality

- 1.35 We think that given Gatwick's market power it will face limited incentives to provide good service levels to either passengers or airlines. Service is therefore likely to be better under a licence based approach.

Investment

- 1.36 We agree with the CAA that it is likely that some beneficial projects would be unlikely to be developed under a non-licenced approach.

Adverse effects

- 1.37 We do not accept that GAL's estimates of the cost of regulation reflect the necessary and efficient costs imposed by virtue of licence-based regulation and would invite the CAA to investigate this further, as we have been unable to

scrutinize the financial assessment of £10m pa in direct costs estimated by GAL. In our view GAL does not need to spend £8m pa on regulation, even if that is what they currently spend. This is also completely out of proportion to the CAA's expenditure of around £1m pa. It is important that the CAA investigate Gatwick's claimed costs in detail.

- 1.38 We would also question whether GAL's estimated costs truly reflect licence costs. Much of the expenditure is either necessary or desirable anyway, including the production of business cases (which we would expect GAL's Board to require) or some consultation with airlines over the design and implementation of new facilities (which often need to fit in with complex operational processes, so consultation helps ensure the airport operates efficiently).
- 1.39 Equally, some of the expenditure, especially at the time of a quinquennial review, brings forward work that would otherwise be done at a later date, or covers similar ground to a business plan, which most well run companies would produce and debate internally and share with their financing bodies. Responding to the challenges made by the CAA and airlines reflects the time and effort most companies would spend in responding to the challenges provided by the actions of competitors.
- 1.40 We are keen to understand from GAL how much of their cost is genuinely wasted or unnecessary, as we share their desire to reduce unnecessary burdens (which after all flow through into airport charges). In particular, some cost is probably driven by Annex G of the 2008 decision, which puts in place procedural consultation obligations on GAL to help the CAA determine whether or not investment should be added into the RAB at the end of the regulatory period. This seems to encourage a bureaucratic process whereby GAL does not need genuine buy-in, but rather needs to demonstrate that they have followed procedure. GAL appears sometimes to consult in a way that is not integrated with their decision making process.
- 1.41 A better alternative would be for the CAA to impose lighter process requirements, but to state that they will accept any project signed off by airlines. This would also reduce CAA workload to focus only on contentious projects and would incentivize the airport to consult efficiently and effectively. We also consider that the core and development approach at Gatwick should be tailored to minimize unnecessary burdens. Airlines share the desire of GAL and the CAA to reduce capex consultation costs and are willing to explore alternative approaches. We therefore do not accept GAL's assessment of their current costs as being a reflection of the inevitable cost of licence based regulation.
- 1.42 We agree with the CAA that alternative non-licence approaches could also be very costly to administer, especially as the approach would be new, and there are a large number of uncertainties and ambiguities that would need to be tested. Therefore the cost to airlines and passengers of securing a reasonable and effective outcome without a licence would be very high and would not necessarily be less than the administrative costs of an efficient licence based approach.
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Potential distortions from licence regulation

1.43 Perverse incentives and the opportunity for gaming by airports could arise from either a licence based approach or an unlicensed approach, depending on the particular solution designed and how effective it is in addressing the airport's market power. We do not accept that a licence based approach would be more likely to:

- distort investment (RAB based approaches traditionally over-incentivise capex, but this is largely due to how regulators have implemented RAB)
- distort pricing (regulatory controls should be able to replicate market pressures)
- reduce the scope for commercial arrangements such as contracts (the airport is free to sign contracts with airlines under the current approach)

Benefits of a licence based approach

1.44 A licence-based approach is therefore better able to constrain airport market power by limiting prices, encouraging desirable and efficient investment and providing a more certain environment for the airport and its customers. We see no evidence that regulation has or is likely to distort competition in a significant way. True regulatory costs are likely to be less than the costs assessed by GAL and in any case there is scope to reduce them. The costs and adverse effects of a licence based approach are small in relation to the benefits.

1.45 Overall, we agree with the CAA that Test C is met and that some form of licence regulation should apply to GAL.
