APPENDIX G

Evidence and analysis on Test B

Introduction

G1 As outlined in chapter 1, section 3 of the Civil Aviation Act 2012 (CA Act) prohibits the operator of a dominant area at a dominant airport from requiring payment of charges without a licence. The CA Act only permits economic regulation of an airport operator and the granting of a licence by the CAA if all three components of the market power test set out in section 6 of the CA Act are satisfied.

G2 This appendix sets out the CAA's evidence and analysis relating to Test B for the relevant market for Heathrow Airport Limited (HAL). In particular, it considers:

- The legal framework.
- The consultation process, including the CAA's Consultation on Heathrow market power assessment, CAP 1051 (the Consultation), stakeholders views' and the CAA's analysis.
- The application of Test B to HAL.

Legal framework

The statutory test

G3 In its assessment of the market power test, having established that an airport operator has substantial market power (SMP) in a relevant market, the CAA is required under Test B to consider whether competition law provides sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that SMP.[1]

G4 Although Test B is a separate test, it cannot be divorced from the wider regulatory context: i.e. that the CAA has already determined that the relevant operator has SMP in a relevant market. Under Test B, the CAA must consider whether there exists a risk of the relevant operator engaging in an abuse of that position in the relevant market and whether

[1] Section 6(4) of the CA Act.

competition law provides sufficient protection against it. Test B, is also a precursor to Test C: i.e. it is only if ex post intervention via competition law is inadequate that the CAA should go on to weigh up the relative costs and benefits of ex ante regulation via a licence.

G5 The assessment of Test B must be conducted in accordance with the CAA's general duty in section 1 of the CA Act, that is '*in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services'.*[2] Importantly, the CAA has to assess the adequacy of competition law from the perspective of '*users of air transport service*', which are defined in section 69(1) of the CA Act as passengers carried by the air transport service or a person who has a right in property carried by the service. Accordingly, when assessing the merits of competition law, the CAA has to further the interests of passengers and cargo owners.

G6 In doing so, the CAA must, inter alia, seek, where appropriate, to '*promote competition in the provision of airport operation services*'[3] as well as have regard to various matters set out in section 1(3) of the CA Act, including the need to secure that all reasonable demands for airport operation services are met.

G7 The CAA must also have regard to the regulatory principles in section 1(4) of the CA Act, namely that its regulatory activities should be transparent, accountable, proportionate and consistent and targeted only at cases where action is needed. In addition, it must also comply with its statutory duty under section 73(2A) of the Regulatory Enforcement and Sanctions Act 2008 to avoid the imposition of unnecessary regulatory burdens on operators of dominant airports.

The concept of abuse

G8 Section 6(8) of the CA Act clarifies that conduct may, in particular, amount to an abuse of SMP if it is conduct that is described in the Chapter II prohibition in section 18 of the Competition Act 1998 (CA98). Section 18(2) (a) to (d) of CA98 contains an illustrative list of exploitative and/or exclusionary behaviour, which includes unfair or excessive pricing, unfair trading conditions, market limitation or production limitation, discrimination and making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by

2 Section 1(1) of the CA Act.

3 Section1(2) of the CA Act.

their nature or according to commercial usage, have no connection with the subject of the contracts.[4]

G9 In competition law, a dominant undertaking has a special responsibility not to allow its conduct to impair undistorted competition in the relevant market.[5] It is not the position of dominance or SMP itself that is prohibited but the undertaking using that position to prevent or distort the effective competition in the market.

G10 The European Court of Justice has defined the term abuse in the following way:

An objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition in products or services on basis of the transaction of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition.[6]

G11 The essential objective of the Chapter II prohibition and its European counterpart (Article 102 of the Treaty on the Functioning of the European Union (TFEU)) is '*the protection of competition on the market as a means of enhancing consumer welfare and ensuring an efficient allocation of resources… This means that it is competition, and not competitors as such, that is to be protected*.'[7]

Competition law

G12 Test B focuses solely on the effectiveness of competition law as an alternative to a licence. These provisions include not just the CAA's concurrent competition law enforcement powers under sections 60 to 63 of the CA Act but also the ability of interested third parties to bring private actions before the courts to enforce directly Articles 101 and 102 and/or the CA98 prohibitions.

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4 This reflects the position established in European case law that the categories of abuse set out in Article 102 are not exhaustive: see Case 6/72 Continental Can v Commission [1973] ECR 215.

5 Case 322/81 *Michelin v Commission* [1983] ECR 3461, paragraph 57.

6 Case 85/76 *Hoffmann-La Roche* [1979] ECR 461.

7 DG COMP Discussion Paper on the application of Article 82 EC to exclusionary abuses, paragraph 54.

G13 Competition law is also defined to include the CAA's market investigation reference (MIR) powers,[8] which can be made when there are features of markets that restrict, distort or prevent competition. MIRs provide wider forms of remedy than are available under Articles 101 and 102 TFEU or CA98. It may be difficult to use MIRs to address individual conduct such as excessive pricing.[9]

G14 Generally, the Chapter II prohibition and/or Article 102 TEFU would be used to address an abuse of dominance and the remainder of this chapter concentrates on those provisions in order to determine whether they provide sufficient protection against abuse.

G15 Other sectoral regulations are applicable in the absence of a licence, which may protect against some forms of abuse but do not form part of 'competition law' as defined in Test B.[10] In any event, the CAA does not consider that those regulations prevent the risks of abuse of SMP which are identified below. The CAA will also give appropriate consideration to their role in the regulatory framework when it weighs the costs and benefits and proportionality of economic regulation via a licence as part of Test C.

Ex ante versus ex post regulation

G16 Viewed in context, Test B directs the CAA to assess the comparative merits of ex post regulation (through competition law) as a sufficiently effective alternative to ex ante regulation via a licence.

G17 The CAA's ex ante market review and economic regulatory powers[11] under the CA Act typically pursue different, albeit overlapping, policy objectives from its sectoral competition law powers. In particular, the CAA's general duty of furthering passengers' and cargo owners' interests, where appropriate in a way that will promote competition and to have regard to the various regulatory principles set out in section 1(3), allow it to address a wider set of objectives and employ additional remedies than it could under its European and UK competition law powers. The flexibility

8 Part 4 of the Enterprise Act 2002.

9 The Office of Fair Trading (OFT), for example, takes the view that MIRs are appropriate when it has reasonable grounds to suspect that there are market features, which prevent, restrict or distort competition, but not to establish a breach of CA98 prohibitions. Where abuse of dominance is an issue, the OFT would not see MIRs as appropriate, paragraph 2.4, OFT 511.

10 Examples include the Groundhandling Directive (GHD) implemented in the UK as the Airports (Groundhandling) Regulations 1997 and the Airport Charges Directive (ACD) (implemented as the Airport Charges Regulations 2011).

11 See Sections 15 to 21 and 31 of the CA Act.

of a regulatory licence also supports this. Both sets of powers are ultimately directed at protecting the interests of end users.

G18 Figure G.1 below summarises the different features of *ex post* competition law and *ex ante* regulation at a high level of generality.

Figure G.1: Features of ex post vs ex ante regulation

	Ex post	Ex ante
Perspective	Backwards-looking – i.e. relies on historical evidence of abuse that has occurred in an otherwise commercially competitive market.	Forwards-looking (insofar as prescribes or controls types of market behaviour regardless of particular circumstances, based on public policy priorities or market failures that are found to exist in the market and need to be remedied).
Market definition	A relatively narrow view of product markets driven primarily by demand side substitutability is normally adopted.	Markets are likely to be defined in broader terms than under ex-post competition law. Supply side substitution is equally as important as demand side substitution in determination of the relevant market. In the context of airports we note here that supply side substitution is unlikely to be viable.
Focus	On redress for past actions and prohibiting future actions of a similar nature.	Addressing market failures arising from a certain industry structure or history.
Nature of remedies	Results in remedies that are narrow in scope, essentially declaratory in nature and neutral in terms of broader implications for industry of the remedies sought in a specific piece of competition litigation.	Remedies generally are very specific in nature but general in scope affecting the majority of customers. Remedies are generally cost based assuming an efficient operator, they are defined in focus by the legislative context. With regards to airports this is in line with the CAA's section 1 duties.
Enforcement	Through the Courts, the European Commission (EC), the OFT (soon to be CMA), or other relevant designated national competition authority (in the case of airports the CAA).	Generally enforced through independent sector-specific regulators (who are most likely to be able to address complex technical detail and the economic disciplines which characterise a specific industry). In the case of airports, the CAA has this role.

The Consultation process

The Consultation

G19 In the Consultation, the CAA was minded to conclude that competition law alone would not be sufficient to prevent the risk of HAL abusing its market power in the two relevant markets identified. This was based on the following considerations:[12]

- The CAA found that HAL has SMP in the provision of airport operation services to full service carriers (FSCs) and associated feeder traffic at Heathrow.
- *Ex ante* regulation has a number of advantages over competition law in opening up markets to competition where there is a dominant incumbent.
- The most likely abuses of HAL's SMP are those of an exploitative nature. These are likely to manifest as either excessive pricing or abuses through service quality reduction.
- The application of the relatively limited available competition law precedents for exploitative abuses, such as excessive pricing, is hard to predict. The CAA considers that, given this uncertainty, cases in this area carry greater risks of failure compared to more common abuses such as predatory pricing and margin squeeze.
- Private actions, especially by passengers are likely to be challenging and complex given the lack of a direct contractual relationship with the airport and the likely low level of damage experienced by an individual passenger.
- The remedies available to the regulator via its power to impose and modify conditions in a licence are more comprehensive and forward looking in terms of scope than those available under competition law.

[12] The Consultation, pp. 208 to 233.

Stakeholders' views

G20 The London Airline Consultative Committee (LACC) & Heathrow Airline Operators Committee (AOC) and Virgin Atlantic Airways (VAA) submitted responses supporting the CAA's provisional conclusions on the application of Test B.

G21 HAL, in its response to the Consultation, considered that the CAA had erred in its approach in two respects:

- The CAA had not put forward sufficient evidence of the potential harm to passengers and other users of air transport service at Heathrow were ex ante regulation to be discontinued.
- The CAA had failed to take account of recent case law, draft legislation and deterrence effects that strengthen the position of airport users from a competition law perspective.[13]

G22 In relation to evidence of harm to passengers, HAL considered that there is evidence that airlines may not pass on rises in airport charge to passengers and that CAA had relied on this in its analysis of competitive constraints (Test A). It also noted that the CAA, in its submissions to the CC's market investigation of BAA, considered that there was scope for incumbent airlines at Heathrow to set fares in excess of the regulated price.

G23 HAL also considered that the CAA did not have sufficient evidence to support its view that even if increases in airport charges were not passed through to end users, there could be a reduction in choice or service innovation.

G24 In relation to the relevant case law and draft legislation, HAL considered that case law, such as *Purple Parking Ltd v Heathrow Airport* and prospective legislation reforms such as the draft Consumer Rights Bill being developed by the Department for Business Innovation and Skills (BIS), point to the sufficiency of competition law to address any risks of abuse of SMP.

[13] HAL, Response to CAA's Market Power Assessment, CAA/Q6/80, chapter 3.

CAA views

Passenger harm

G25 The CAA acknowledges that the degree of competition at the airline level may sometimes work against fare rises being passed on to passengers. However, even incumbent airlines at Heathrow may, in the long run, be compelled to raise prices.

G26 The ability for an airline to absorb prices may be affected by its overall profitability at the time in question. Where an airline faces a difficult trading environment it have may no choice but to pass on increases to users and/or reduce service quality. In the meantime, airlines would look to reduce frequencies, scale back passenger facing facilities such as check-in desks as well as staff numbers.[14] The risk to users therefore manifests itself in price rises or service quality reductions.

G27 While airlines may, at first, look to reduce frequencies or service quality, ultimately the pressure to push up the retail market price may become compelling[15] where margins are under pressure. A reduction in frequencies inevitably means less choice and availability of services for users and while the timing of any pass through may be uncertain, the CAA considers that there is a risk that this pass through (be it higher prices or reduced service quality) will occur.

G28 Airlines have also told the CAA that they have faced rises in airport charges at Heathrow leading, for example, to a 127 per cent increase in variable costs over a ten year period.[16]

G29 HAL has sought to point to there being some acknowledged restrictions on the scope for pass through but this assumes that the downstream airline market is very competitive and relatively homogenous, so prices are relatively invariant (at the market clearing level). Hence, airport charge changes lead to a reallocation of rents and little else.

G30 The CAA considers that the reality of downstream airline competition is more complex. The downstream market consists of many markets on many routes and on some there may be very limited competition. In those circumstances, there may well be scope for an increase in charges by an unregulated airport operator holding SMP to be passed through to passengers on that route. This would point to a risk to passengers from

14 Source: Cathay Pacific [✂].

15 Source: Lufthansa [✂].

16 Source: Lufthansa [✂].

excessive pricing in the form of increased fares without any benefit in terms of the service they would receive at the airport.

G31 Where branding and other marketing tools, such as frequent flyer schemes, have established strong loyalty incentives some pass-through of airport charges seems likely, though it may be difficult to quantify the exact amount of pass-through.

G32 For these reasons, the CAA considers that there is a risk of at least some pass-through to consumers of airport charges and not simply a rent reallocation. In addition, where pass through via fares is not possible, airlines would look to reduce frequencies and facilities at Heathrow for passengers. There is therefore a risk both in terms of pricing and service quality for users.

G33 Where this is the case, as is set out further below, competition law may not be a sufficient discipline on an operator with SMP.

Legislative reform

G34 HAL has pointed to the reforms set out in the Consumer Rights Bill and how these may, in time, improve access to remedies for consumers and, as a result, increase the deterrent effect of competition law from this perspective. However, the CAA is obliged to take a view on the current landscape. These reforms are some way from being enacted and their effect on the market for air operation services at Heathrow is therefore currently uncertain both in extent and timing.

G35 The fact that legislative reform is being pursued by BIS via this Bill also reflects a current shortfall in the effectiveness of private actions by consumers seeking redress for breaches of competition. This has also been acknowledged by the EC and is discussed in more detail below.

G36 HAL also considers that the CAA has, more generally, underestimated the deterrent effect of enforcement by competition authorities. In April 2012, the CAA acquired concurrent enforcement powers. It has not yet made any infringement decisions in relation to the provision of airport operation services.[17] It may take time to build up the necessary 'reputational deterrence' that HAL suggests already exists.

G37 The CAA would not consider this as a strong basis on which to conclude that competition law was sufficient to address the risk of abuse of the SMP held by HAL, although it acknowledges that this may change over time.

[17] The CAA has concurrent enforcement powers under both CA98 and the Enterprise Act 2002.

Abuses that have most relevance to airport operators

G38 To assess whether competition law would adequately protect airport users, it is necessary to consider what types of abuse are most likely in the sector generally and also by reference to the particular circumstances of HAL and how effectively they are addressed by competition law.

G39 By way of general background, there have been a number of cases taken at both a domestic and European level against airports.[18] This indicates that an airport is an undertaking for the purposes of competition law and they can be found to be dominant and abusive in the specific circumstances of particular cases.

G40 The case law illustrates that competition law has been successfully applied in what could broadly be considered as vertical exclusion cases, where the airport is active in the upstream market for airport operation services but also has a presence in the downstream market for air transport or other services. The defining feature of these cases is that they all involved the airport leveraging its market power to the advantage of either its own subsidiary in a downstream market or a closely aligned party.[19]

G41 As it outlined in the Consultation, the CAA considers that for exclusionary behaviour there are likely to be sufficient precedents which could be relied on, including in relation to airports as well as other regulated industries that are similarly regulated (such as telecoms or utilities).

G42 However, there are certain exploitative abuses where the CAA considers that there is the greatest likelihood of abuse occurring.[20] Where airports have SMP, the most obvious outlet for that market power is to bring it to bear on their customers in the form of excessive pricing; a type of abuse that would affect users to the extent that it was passed on.

G43 The CAA therefore considers that given the principle areas of risk in terms of HAL's SMP are in the area of supra-competitive pricing and abusive service levels. The CAA gives weight to the fact that, for excessive pricing, there are recognised difficulties in applying the legal test in

[18] Commission decision 95/364/EC, Commission decision 1999/199/EC, Commission decision 1999/198/EC, Commission decision 98/513/EC; T-128/98, C-82/01 Commission decision 98/190/EC and Purple Parking & Anor v Heathrow Airport Limited [2011] EWHC 987 (Ch).

[19] The early European cases are typified by a strong single market imperative. These cases in the main consist of a state owned airport supporting stated owned airlines.

[20] For certain exploitative abuses, for example, discriminatory pricing, the principles are well-established and can be more easily applied to situations involving airports: see, for example, Case C-82/01 P Aeroports de Paris v Commission [2003] ECR 9297.

practice and in the case of exploitative service abuses, there is a lack of case law. As a result, there is a lack of legal certainty, which reduces the prospects of successfully completing an investigation or private action alleging such abuse. It considers this further in the following section.

Applicable case law on excessive pricing

G44 For excessive pricing, there are recognised difficulties with applying the legal test which result in insufficient legal certainty for successfully completing an investigation or private action alleging such abuses in the airport sector. Even the case law that applies more generally is not clear cut.

G45 For price-based abuses, there have been a number of cases taken forward, such that there is a degree of clarity relating to the terms of the test to be applied. In United Brands[21] , the lead case, the Court of Justice recognised that *'charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied would be such an abuse*'.

G46 The court proposed a two part test; it should be shown that i) the price cost margin is excessive and ii) the price imposed is either unfair in itself, or when compared to competing products. This test has formed the framework in the assessment of excessive pricing in the cases that have followed. However, case law does not offer a simple rule against which any price above an appropriate measure of cost may be deemed unfair.[22]

G47 The United Brands case also involved a counterfactual whereby the current prices were assessed against a benchmark of an appropriate price. There are a number of issues that affect the accurate measurement of the appropriate price:[23]

- As the Competition Appeal Tribunal (CAT) observed in its judgment on excessive pricing in Albion Water: '*Despite the various cases in this area, no consensus has emerged as to what, if any, is the most appropriate method of measuring cost in excessive pricing cases*.'

21 United Brand v the Commission, Case 27/76. The finding of abuse was not upheld on appeal for lack of evidence establishing excessive pricing against the legal test the court had articulated.

22 Albion Water Limited v Water Services Regulation Authority [2008] CAT 31, paragraph 212.

23 Lyons B (2007), The Paradox of the Exclusions of Exploitative Abuses, in: Swedish Competition Authority (ed), The Pros and Cons of High Prices, pp. 65 to 87.

- A key challenge is that firms normally record their costs in a format designed for financial presentation rather than economic evaluation. When assessing prices from an economic perspective, the CAA is concerned with the marginal costs of production, which is not needed for standard accounting purposes. Therefore, cost data from firms may need to undergo some form of transformation.
- Where a firm supplies a number of products over a number of areas, such as an airport, there is an issue of cost allocation and cost recovery. There is no correct methodology for the allocation of common and sunk costs within a business. Based on two differing sets of clear and objective criteria the costs of a firm may look significantly different. For example, airport costs derived from the perspective of passenger use may look different from those derived from the perspective of airline use but may both be based on a rational allocation.
- Few products are charged on a basic unit cost. Costs are often dependent on volume or have multiple components. This is especially an issue at airports given the bundle of goods that are purchased by airlines. The nature of costs at an airport is such that there is a high fixed cost of provision therefore on a unit basis costs can decrease at a significant rate as volume rises.

G48 Finally, a further challenge is that competition law investigations into conduct necessarily focus on a point in time or at least a fixed period. Making a robust assessment of cost information in this context can be difficult. As it may not always be possible to gain robust information on past events.

Effectiveness of regulation and competition law in addressing abuses

G49 Competition law also offers a process that can only act to protect against abusive conduct by imposing remedies after the event. Where a market is making a transition from a state in which there were recognised barrier to effective competition to a fully competitive state, the ability of competition law enforcement to tackle the risk of abusive conduct as it emerges is uncertain. This reason on its own means that, competition law is not sufficient to prevent the risk of HAL engaging in abusive conduct.

G50 The adequacy of ex post competition law to deal with future anti-competitive behaviour has been discussed in the context of ex ante control of mergers. The argument is sometimes advanced that the incentives to adopt anti-competitive conduct post-merger are reduced, or even eliminated, by Article 102 TFEU and mergers should therefore be approved. The European Courts have accepted the relevance of Article 102 to merger analysis, but have also accepted that ex post

competition law may not be a sufficient deterrent in all cases. This may be the case, for example, if it would take considerable time and resources to detect, investigate and prove abusive behaviour. Interim relief may not be available or appropriate. In the meantime the behaviour of the merged firm could result in serious harm to the competitive process and harm to consumers.

G51 In *Gencor v Commission,* the General Court held that '*while the elimination of the risk of future abuses may be a legitimate concern of any competent competition authority, the main objective in [merger control] is to ensure that the restructuring of undertakings does not result in the creation of positions of economic power which may significantly impede effective competition*.' [24]

G52 Competition law (as defined) applies only once a 'restriction of competition', 'abuse of a dominant position' and/or 'adverse effect on competition' has been established. There are uncertainties and difficulties where the likely focus is excessive pricing and an emerging course of conduct of this type may cause damage to consumers before it can be effectively deterred by an investigation under Chapter II or Article 102.

G53 Commentators have noted the difficulty faced by competition authorities in pursuing enforcement action in respect of allegedly excessive pricing. For example, Whish notes:

...there are formidable difficulties in telling whether a price is really exploitative, by what standards can this be assessed?[25]

G54 Excessive pricing cases have often foundered on the difficulty of obtaining sufficient evidence to substantiate the other key element in the United Brands case, that of total economic value. In the airport sector, this can take in such matters as brand appeal based on attributes such as the reputation of the airport as a hub or as a holiday, business or low cost carrier airport. Similarly, an airport being situated by a major city provides additional value in terms of access for the airlines' target market. These components add up to the economic value of the service rather than the basic accounting value of the immediate costs of provision. Finding a credible value for these can prove difficult in practice.[26]

[24] Case T-102/96 Gencor v Commission [1999] ECR II-753, paragraph 106.

[25] Whish and Bailey, Competition Law, 7th Ed, pp. 718 to 719.

[26] See Scandlines SverigeAB v Port of Helsingborg Commission Decision of 23 July 2004 [2006] 4 CMLR 1224, paragraphs 241 to 242.

G55 Another issue for the consideration of excessive pricing is the role of high prices in the competitive process. High prices can be part of the mechanism of a well functioning market where they encourage entry by equally (or more) efficient competitors and are eventually competed down to competitive level. A core question is whether it is likely that, given the particular market dynamics, the high prices are likely to drive entry. Therefore, an assessment of price over an appropriate time period rather than a simple consideration of spot price is important.

G56 Furthermore, prices play a role in rewarding investment and innovation, either of which can be damaged if the airport operator considers it cannot gain the appropriate return on its investment. The market setting therefore plays an important and variable role in the assessment of excessive pricing. This can mean looking beyond whether a price represents covering costs plus a reasonable rate of return, and taking account of the wider market context.[27]

G57 Finally, an issue that has been cited with respect to excessive pricing is the reluctance by competition authorities to prescribe clear upper limits for market prices. This stems, in part, from the lack of specialised knowledge of specific industries and in part due to a reluctance to set what would effectively be a form of price control. This has traditionally been viewed as a rather different activity from competition enforcement.[28]

G58 Given that the CAA will have concurrent powers as well as its responsibilities as the sector regulator, it does not see this as weighing heavily in assessing the merits of competition law in the context of Test B. The CAA assumes that where appropriate, the CAA would be able to regulate prices if such a remedy was required as part of a regulatory decision made under competition law.

G59 There have been some infringement decisions with regards to excessive pricing.[29] This highlights that competition law enforcement based on excessive pricing can be the appropriate way to address some types of commercial behaviour.

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27 AtTheRaces v British Horseracing Board [2007] EWCA Civ 38, [2007] UKCLR 309. In the original hearing at the High Court excessive pricing was upheld, however it was quashed in the Court of Appeal.

28 OCED (2011), Excessive Prices, Background paper for Working Party No.2 on Competition and Regulation, available at: http://ssrn.com/abstract-1946779.

29 E.g. Case 2001/893/EC; Napp Pharmaceuticals Holdings Limited and subsidiaries – OFT CA98/2/2001 decision upheld at appeal CAT/1001/1/1/01, and more recently case brought by the Italian Competition Authority against Roman and Milan airports.

G60 However, the CAA considers that the recognised difficulty (detailed above) in applying the test in practice means that cases in this area carry greater risks of failure compared to more common abuses such as predatory pricing and margin squeeze. Given this uncertainty, the CAA cannot reasonably conclude that the threat of fines and/or directions is sufficient to offset the risks of conduct which amounts to excessive pricing.

G61 The CAA is also unaware of any competition law cases that have sought to correct an abuse where a dominant undertaking has exploited its SMP by supplying services of inferior quality compared to those that might be expected in a competitive market.

G62 The CAA considers that complex evidential issues may arise in the establishment of an exploitative service quality abuse. It is the CAA's consideration therefore that an abuse based on service quality is likely to be challenging to tackle through competition law, given the subjective nature of service quality. The CAA therefore considers that if HAL were not subject to a regulatory licence, there would be scope for it to abuse its SMP in ways that are detrimental to users and against which competition law would not offer effective protection.

Lessons from other industries

G63 The CAA has seen evidence which seeks to draw lessons from other regulated and deregulated industries around the world.[30] The Australian airports have, for example, been subject to ex ante regulation suggesting that this was deemed desirable even given the existence of a comparable set of ex post rules prohibiting anti-competitive conduct.

G64 It is also of note that at a European level, the EC has opted to put in place market opening legal frameworks in relation to both ports and airports driven by their importance in establishing a single market in Europe and for trade purposes.[31] This is despite the existence of a well established competition enforcement regime at European level suggesting that these sectors had characteristics which required an additional degree of market

30 Sectoral examples of market power, regulation and deregulation and implication for Gatwick Airport: A report to GAL, London Economics, Q5-050-LGW50, November 2012 submitted March 2013.

31 Council Directive 2009/12/EC of the European Parliament and of the Council of 11 March 2009 on airport charges; Council Directive 96/67/EC of 15 October 1996 on access to the groundhandling market at Community airports; Council Regulation (EEC) No 4055/86 of 22 December 1986 applying the principle of freedom to provide services to maritime transport between Member States and between Member States and third countries; Council Regulation (EEC) No 4056/86: Application of the competition rules in maritime transport; Council Regulation (EEC) No 4057/86: Unfair pricing in maritime transport.

regulation. The EC has opted to put in places safeguards against discriminatory behaviour by airport operators without any requirement that the airport operators in question have a specific degree of market power.

G65 The remedies offered by competition law have therefore been supplemented with mechanisms to ensure markets open up to competition. This suggests that where airports are transitioning into full competitive conditions, ex post controls may not always be sufficient. The structural remedies mandated by the CC in relation to BAA were only successfully completed with the sale of Stansted in 2013. This is therefore a market in transition with the full effects of the separation of ownership yet to be ascertained not least because of the continuing capacity constraints. The CC noted at the time:

Even under separate ownership, moreover, as a result of capacity constraints, competition in the short term may focus on particular types of traffic, for example in off-peak periods, and therefore be unlikely to be sufficiently effective to substitute for regulation. Separate ownership would also give rise to competition to invest in new capacity; but there would be a period of time before there could be confidence that competition between separately-owned airports was sufficiently effective to substitute for regulation.[32]

G66 The precedents from the EC would suggest that, in such circumstances, purely ex post controls may not be sufficient initially to provide the necessary protection to end users from anti-competitive conduct. Competition law can offer retrospective punishment but with limited scope to offer recompense to affected end consumers. Where a successful transition to competition does emerge over time, the CA Act makes provision to ensure that the CAA can, of its own motion or on request, revisit an earlier determination with respect to one or more of the three component tests under section 6.

G67 This is particularly important as the planning system for airports creates a level of uncertainty within the market. This is especially the case in the south east of England where the Government currently has a moratorium for expansion at the three largest airports. This affects both the likelihood and the timeframe for any expansion by an individual airport in the south east of England. The effects on Heathrow which currently operates at or very close to full capacity at all times are particularly acute. The Airports Commission is currently exploring potential solutions to airport capacity issues but will not produce final proposals until 2015. It is

[32] CC, 2009 Report, paragraph 6.87.

therefore highly unlikely that any new capacity at airports in the south east of England will be available before 2025 at the earliest.

G68 The CAA currently views this as an important factor. It also takes into account that airport operators have a safeguard against ongoing regulation where there is a material change in circumstances, whereby they can ask the CAA to review their position by asking for a fresh market power determination under the CA Act.

Potential for public and private enforcement of competition law to protect the interests of users of air transport services against the risk of abuse

G69 The CAA considers in this section the extent to which competition law (in the form of enforcement action by the CAA or a private damages claim before the courts) would be capable of disciplining HAL's behaviour so as to protect against the risk of excessive pricing and/or service quality abuses.

Administrative action before the CAA

G70 It is open to any person affected to lodge a complaint with the CAA about anti-competitive conduct in relation to the provision of airport operation services. The CAA was granted concurrent powers with the CMA to take enforcement action under CA98.[33] This would require some commitment of resources to providing evidence to persuade the CAA to open a CA98 investigation.

G71 CA98 also offers the possibility of the CAA imposing interim measures to prevent serious, irreparable harm damage being caused while the investigation is being pursued. This power has to date been rarely exercised. Changes to CA98, brought in by the Enterprise and Regulatory Reform Act 2013, aim to make recourse to interim measures easier for competition authorities in future but these new rules are as yet untested.

G72 Despite the economic complexities with proving excessive prices, there have been some infringement decisions by competition authorities with regards to excessive pricing.[34] This highlights that competition law enforcement based on excessive pricing can be the appropriate way to address some types of commercial behaviour.

[33] Section 62 of the CA Act.

[34] E.g. Case 2001/893/EC; Napp Pharmaceuticals Holdings Limited and subsidiaries – OFT CA98/2/2001 decision upheld at appeal CAT/1001/1/1/01, and more recently case brought by the Italian Competition Authority against Roman and Milan airports.

G73 However, the CAA considers that the recognised difficulty (detailed above) in applying the test in practice mean that cases in this area carry greater risks of failure compared to other forms of abuse.

G74 Given this uncertainty, the CAA cannot reasonably conclude that the threat of fines and/or directions alone will provide sufficient deterrence to prevent operators from engaging in conduct which amounts to excessive pricing.

G75 Once an infringement decision is taken, this may serve to deter future reoccurrence of the conduct in question both by the airport in question and in the market more widely. It is open to the CAA to impose financial penalties and such directions as it considers appropriate to bring the infringing conduct to an end. Although the CAA can order an operator to desist from such conduct in future, there is no guarantee that the conduct will stop as soon as an investigation has been started or that interim relief will be granted. Consequently, there may be a time lag until the conduct ceases at the end of the investigation, during which the abuse will have taken place and user detriment will have been suffered.

G76 Nevertheless, the shortcomings in terms of deterrence of enforcement under the CA98 are that investigations are essentially backward looking and aimed at examining and punishing a specific course of conduct by one airport over a fixed period of time. Moreover, the CAA cannot award any remedies directly to complainants who would have to look to bring a damages claim separately to recover any loss suffered.

Private litigation

G77 An additional deterrent is to be found in the potential for infringement follow on or stand alone damages actions by those affected by the infringing conduct.[35]

G78 Stand alone damages actions[36] are relatively infrequent. The difficult of bringing such actions has been acknowledged by the EC in its proposal for reform of damages actions in the field of competition law:

While the right to full compensation is guaranteed by the Treaty itself and is part of the acquis communautaire, the practical exercise of this right is often rendered difficult or almost impossible because of the applicable rules and procedures. Despite some recent signs of improvement in a few Member States, to date most victims of infringements of the EU

35 Section 47A of CA98.

36 In standalone actions the defendants are obliged to establish liability. In follow on actions, liability will already have been established by a competition authority.

competition rules in practice do not obtain compensation for the harm suffered[37]

G79 Injunctive relief from the courts is also relatively rare and is subject to proof of urgency and the balance of convenience, which is in favour of providing compensation as primary remedy. The test aims to preserve the status quo in the absence of compelling evidence why damages are not an adequate remedy.

G80 This shortfall in effective enforcement of competition law identified by the EC is, in the CAA's view, a reflection of the risks in bringing private actions in this area, including:

- Cases before the EU and UK courts can take many years without any guarantee of success.[38]
- Injunctions relief from the courts is relatively rare and is subject to proof of urgency and the balance of convenience, which is favour of providing compensation as a primary remedy. The test aims to preserve the status quo in the absence of compelling evidence why damages are not an adequate remedy.
- Calculating damages is difficult, requiring the use of complex economic models and accounting techniques and there is currently uncertainty as to the extent to which damages may be reduced by reference to the 'pass through' principle.
- The loser pays principle in the UK courts means that claimants can be exposed to a large commercial risk.

G81 While the CAA is aware of the reforms to private enforcement, which are being consulted upon at both domestic and EU level, there is nothing on the statute book at present and it may take several years before any EU Directive is implemented.

G82 In the present context, a private litigant would in principle face the same difficulties in seeking to prove a case of excessive pricing as the CAA, but would also lack the CAA's investigative powers in order to seek to make good its case. Obtaining such internal documents or confidential information through the disclosure process is likely to be time-consuming

[37] Proposal for a Directive on certain rules governing actions for damages under national law for infringements of the competition law provisions of the Member States and of the European Union: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0404:FIN:EN:PDF.

[38] Cf Crehan v Inntrepeneur Pub Company [2006] UKHL 38 which took 10 years and was overturned in the House of Lords.

and expensive. These evidential difficulties are likely to diminish the deterrent effect of this element of competition law.

Enforcement in passengers' interest

G83 In determining the effectiveness of competition law, the CAA considers the prospect of enforcement action being brought by airlines as well as by end users themselves.

Airlines

G84 Airlines as the direct purchasers of airport operations services will have a strong interest in protecting their interests. However, where the abuse is exploitative in nature, there may be lower incentives on airlines to resort to complaints or legal proceedings where they are able to pass on an increase in airport charges to passengers instead. As the interests of airlines and passengers are not necessarily aligned, it cannot be assumed that airlines will bring claims on behalf of users as many factors are likely to be involved in the decision to commence complex litigation around the appropriate prices for services and airlines may not necessarily with to jeopardise their commercial relationship with the dominant (or potentially dominant) airport operator.

G85 The CAA acknowledges however that some commercial airlines may be sufficiently well resourced and motivated to assume the litigation risks although it also notes submissions from some airlines that they consider there can be barriers to doing so.[39]

Air transport service users

G86 The level of individual damage is likely to be low for an individual user who is therefore less likely to bring an individual claim. Users of air transport services cannot separately identify how much they have been charged for airport services and so may not detect an abuse.

G87 Users are also not always aware of the existence of an infringement or of the extent of the losses they suffered due to this infringement.[40] Additionally, even if users are aware of the abuse, the costs, delays and burdens involved in taking such actions, are likely to be significant compared to the value of their individual claim.

[39] See, for example, VAA response to the Gatwick Consultation.

[40] EC DG COMP MEMO/08/216 dated: 03/04/2008.

G88 Standalone claims by consumers, in the absence of a decision by a competent competition authority, are rare and are unlikely to provide a source of strong deterrence for an airport operator like HAL. As explained above, air transport users will not have access to confidential cost information, access to relevant confidential files, and wider market data on which to establish a claim of abuse.[41]

G89 Similarly, the threat of damages actions by users is unlikely to have a strong deterrent effect. Air transport users are indirect purchasers of airport services; they have no direct contract with the airport and therefore no contractual claim.

G90 In these circumstances, establishing a causal link between an increase in the charges by the airport and an increase in tariff faced by air transport users and the consequent loss to the user would be complex. As acknowledged by the EC in its proposal for a Directive in this area, proving and quantifying harm is generally very fact-intensive and costly, as it may require the application of complex economic models. While the EC intends to issue formal guidance on quantification for national courts[42], this likely to remain a challenging area for end users, particularly given the considerable difficulties in establishing whether a price is exploitative and how the consequent harm to the end user should be quantified.

G91 There is also the prospect of class claims or group representative action. Class actions have not proved easy or effective in the UK as a remedy for breaches of competition law. For example, Which? (currently the only body empowered to bring class actions in this field) dedicated 20 per cent of its legal resource to a class action against sports retailer JJB Sports and incurred significant legal costs. Its view at the time was that it was not likely that it would undertake such a case again.[43] While the Government has proposed reforms to the private enforcement of competition law which aim to facilitate collective redress, it is not clear when the proposed reforms will be in place and whether the reforms, if enacted, will be effective. The CAA therefore has significant concerns as to whether, in practice, standalone competition law claims will adequately protect passengers.

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41 EC (2005) Green Paper - Damages Actions for Breach of Anti-Trust Rules {SEC}92005] 1732} COM/2005/0672 final.

42 Communication from the Commission on quantifying harm in actions for damages based on breaches of Article 101 or 102 of the Treaty on the Functioning of the European Union, C(2013) 3440.

43 Speech by Deborah Prince, Head of Legal Affairs, Which? at The Lawyer's antitrust litigation conference in 25 to 26 November 2008.

G92 In summary, the CAA considers that addressing abuses of market power through private actions would be challenging and complex. This is a result not only of the complexity of evidence required in establishing excessive pricing, but also practical challenges resulting from collective action and the low level of damage to any individual user.

Application of Test B to HAL

Market characteristics

G93 Airports, in part due to their nature as previously nationalised undertakings, have high and persistent entry barriers.[44] These barriers may result from a number of areas.

G94 Government intervention has also been a feature in the market in which HAL operates. In the south east of England, the Government currently has a moratorium for expansion at the three largest airports. This affects both the likelihood and the timeframe for any expansion by an individual airport in the south east of England. The effects on Heathrow, which currently operates at or very close to full capacity at all times, are particularly acute. The Airports Commission is currently exploring potential solutions to airport capacity issues but will not product final proposals until 2015. It is therefore highly unlikely that any new capacity at airports in the south east of England will be available before 2025 at the earliest.

G95 The CAA currently views this as an important factor. In a properly functioning market, prices would rise as capacity within a market contracts. High prices would stimulate entry into or expansion within the market. The addition of extra capacity would then erode the pricing power of the dominant market participants and prices would start to fall. Where there is an impediment to the functioning of the market such that entry or expansion is not possible, prices will continue to rise to the maximum extent that the market can bear.

[44] Of the world's 30 busiest airports, 19 are state-owned. Europe, with a large number of airports, still maintains relatively strong airport regulation. Many of the privatised airports in Europe are in the UK. Since the BAA privatisation in 1986, there has been partial privatisation in Austria, Germany and Italy, and it is planned in other EU airports. It is estimated that only 20 per cent of European airport operations are privately owned or public-private partnership.

G96 The level of potential competition has increased due to the recent changes of ownership of Gatwick and Stansted, but even if this were capable of affecting the competitive position at Heathrow, given the level of government intervention and the artificial nature of the impediments to competition and the artificial stimulation of excess demand, the CAA considers that this increases the likelihood of exploitative abuses taking place.. The market mechanism that would lead the market to invest in new capacity is prevented from operating as a policy choice. Should government policy initiatives bring material change, there is scope to revisit regulatory frameworks under the CA Act accordingly although given HAL's degree of dominance (as discussed above in the analysis of the application of Test A), this would require careful consideration.

Degree of competition and extent of HAL's market power

G97 As set out in its conclusions on the application of Test A, the CAA finds that HAL has, and is likely to continue to have, market power in the market consisting of the provision of aeronautical services to FSCs and associated feeder traffic airlines at Heathrow.

G98 In particular, the CAA considers that the evidence is clear in that it is unlikely that any of the airlines at Heathrow have countervailing buyer power. While most airlines at the airport, with the exception of British Airways (BA), have a relative small share of the airport's passengers, they lack the choice of substitutable airports. With respect to BA, which accounts for a high proportion of HAL's business, the evidence suggests that there is a lack of credible alternative airports for it to switch.[45]

G99 As noted in our evaluation of Test A, the Department for Transport's forecasts also suggest that the capacity constraints at Heathrow will increase over the short to medium term. In addition, with the Airports Commission only reporting final proposals in 2015, it is highly unlikely that any new capacity will be available before 2025 at the earliest. It is also unclear, after the excess demand is accommodated, whether there would remain sufficient new capacity at Heathrow to significantly affect the airport's market position.

[45] This issue is discussed in more detail in appendix E.

The risk of abuse and consequent detriment

G100 Given these conclusions, the CAA's concern is that HAL's SMP in the relevant market brings with it the risk of abuse of that SMP in the absence of ex ante regulatory controls. The most likely form of abuse, based on the evidence from its airline customers, is excessive pricing of the kind identified in the United Brands test, with the airport setting charges that bear limited resemblance to the economic value of the service.

G101 Excessive pricing could affect users of air transport services adversely. This may be through increases to ticket prices passed on by airlines. Although individually the amounts involved are likely to be limited over the passenger group as a whole these are likely to lead to significant sums. Passengers will either suffer detriment from high prices or decide not to fly at all. Even if airport charges are not passed through in whole or part, user detriment may also be manifested through reduction of choice if airline customers feel constrained to withdraw routes or scale back frequencies either because they become unprofitable or as an attempt to discipline the airport.

G102 The CAA has set out above why it does not agree with HAL's contention that it has over-estimated the risk of this kind of harm to interests of users. A number of factors underpin the CAA's conclusion.

G103 In terms of the risk around pricing behaviour, the CAA considered a range of evidence about HAL's approach to pricing in its examination of whether HAL had SMP under Test A. In particular, the CAA found: [46]

- Heathrow is relatively expensive, it does not offer any discounts to its prices and that there have been some significant price increases over the last 10 years.
- HAL's aeronautical charges were significantly above those of comparator airport operators.
- Since at least 2003/4, HAL has set the airport charges for Heathrow at the regulated price cap.
- A comparison of the five year average revenue in HAL's Q6 alternative business plan (£23.68 – unprofiled yield) with the one in the CAA's Q6 Final Proposals (£20.66) which indicates that the CAA's proposed price cap is £3.02 lower than HAL's proposal.

[46] See appendix F, paragraph 66 to 88

- There appears to be little scope for airlines to negotiate on an individual basis to bring prices down. HAL does not enter into commercial negotiations with the airlines and largely sets the terms that an airline will receive for using the infrastructure at Heathrow.[47]

G104 These risks around pricing seem likely to continue. The costs of slots at Heathrow are traded at substantial sums due to their high demand (and relative scarcity). HAL is the only operator in the relevant market. This suggests that in the absence of regulation, given the current capacity constraints, the market clearing price that would result would most likely be far above competitive levels (potentially at levels close to the price that would be set by a dominant operator).[48] HAL has also given evidence to the CAA[49] that it faces investor pressure in relation to the returns it can expect to make at Heathrow and the CAA considers this will create a continuing incentive to price as high as it can.

G105 Likewise, the ability to charge excessive prices by an airport can lead to reduction in the services that the air transport users (or particular classes of users with particularly limited countervailing buyer power) receive directly from the airport. Currently, service quality is regulated and CAA has seen evidence that suggests that passengers are, in general, satisfied with the service they receive from HAL.[50] It is unclear whether HAL's current service levels are attributable to regulation rather than competitive pressure. However, given the airport's recent issue with resilience to adverse weather conditions[51], it may be more likely that any abuse may manifest itself in a lack of resilience.

G106 In the absence of ex ante controls via a licence, HAL's customers and more critically its end users would face the challenge of establishing via a complaint to the CAA or private litigation that the prices had become excessive or service quality had been unreasonable degraded under competition law. As explained above, this can be a lengthy and uncertain process.

47 See appendix F, paragraph 98 to 100.

48 See appendix F, paragraph 67.

49 HAL evidence to CAA Board on 4 July 2013.

50 See chapter 7 of the HAL Consultation.

51 Aviation's response to major disruption, Final Report by CAA.

Final decision

G107 In light of the above, the CAA has concluded that competition law alone will not be sufficient to prevent the risk of HAL abusing its market power the relevant market. The reasons for this view are:

- The risk in light of the findings of SMP in the relevant market is that, given the lack of countervailing buyer power, higher prices, reduced choice or poorer quality in relation to service levels could result if HAL were not subject to economic regulation.
- Competition law, whether under the CA98 or the Enterprise Act 2002, is not well adapted to tackling conduct which amounts to abuse of SMP in the form of excessive pricing or reduced service quality. This is principally because the case law reveals the considerable difficulty of establishing with certainty what will be infringing conduct and there are considerable challenges for the users of air transport services affected by this kind of abuse in bringing challenges or seeking damages based on competition law.
- Where the market is impaired by the existence or likely emergence of SMP which brings with it the risk of abuse by the holder of that SMP, what is effective is the ability to open up markets and construct remedies that are detailed, timely and can be flexed over time. Competition law cannot, for the reasons give above, readily offer these remedies.
- It is only recently that extensive structural remedies resulted in HAL, GAL and STAL no longer being in joint ownership. Government policy and planning issues also mean that the structural constraints on capacity will remain a feature for the coming control period. The CAA's view is that competition in the relevant market remains impaired by the existence of SMP on HAL's part. Competition law cannot, for the reasons give above, readily offer a remedy that supports the opening up of the market and construct remedies that are detailed, timely and can be flexed over time.

G108 Overall, for all the above reasons, the CAA considers that competition law does not provide sufficient protection against the risk that HAL may engage in conduct that amounts to an abuse of its SMP.

G109 Consequently, the CAA has concluded that Test B is met in relation to HAL as the operator of the relevant airport area as competition law alone will not be sufficient to prevent the risk of HAL abusing its market power in the relevant market.