



CONFIDENTIAL

Response for BAA Limited

Response to working paper on
Assessment of competition
at Stansted Airport

BAA/CC2008/1080

BAA Limited
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BAA's Response:

1. Introduction

- 1.1. This paper is BAA's response to the Competition Commission (the "Commission") working paper on *Assessment of competition at Stansted Airport* (the "WP").
- 1.2. The principal purpose of the WP is to inform the Commission's deliberations as to what form of price cap arrangement is to apply at Stansted in Q5. The CAA has argued that Stansted does not have market power and that a market led price cap might be considered in place of the more typical RAB based price cap.
- 1.3. BAA has explained that it regards a RAB based price cap as the most appropriate form of regulation to apply while Stansted remains designated for price cap regulation. BAA's view is not based on any perspective on whether or not Stansted has market power (as discussed below BAA does not believe that Stansted has sufficient market power to warrant continued designation). Rather it reflects BAA's view of what framework provides the best incentives for investment in new capacity *given* that price cap regulation will continue for the time being. As we explained at the Hearing on 20 June 2008, the question before the Commission is not whether to regulate Stansted, but how to regulate Stansted.
- 1.4. Accordingly, BAA regards the debate on what degree, if any, Stansted can be said to have market power as of tangential relevance to the Stansted Q5 regulatory inquiry.
- 1.5. However, BAA believes that the Commission's assessment that Stansted has significant market power to be flawed in a number of significant respects. These are discussed briefly in this response.

2. The potential for competition from Luton

- 2.1. As BAA understands the WP, the Commission accepts that Luton could in theory be a significant competitor to Stansted, but that its ability to constrain Stansted's prices is Luton's lack of spare capacity.¹
- 2.2. Stansted and Luton are perhaps the most obvious airport pair that would be expected to compete (capacity availability permitting) in the UK. If it was concluded

¹ WP, paragraph 20.

that Stansted and Luton do not compete strongly (or would not compete if spare capacity was available), it would be difficult to imagine that there is *ever* scope for material competition between airports. If the Commission takes the view that Stansted and Luton do not even have the potential to compete strongly, BAA considers that that conclusion needs to be properly carried over to the Commission's consideration of ownership in the Market Investigation. It would be strongly suggestive that there would not be scope for competition between BAA's airports, even if there were no capacity constraints or price caps in place.

3. **Capacity constraints at Luton**

- 3.1. The Commission seems to accept that Luton could potentially offer a strong competitive constraint on Stansted, but that current capacity constraints limit Luton's ability to do this, at least in the Q5 period.
- 3.2. On the hypothetical assumption that Luton does have capacity constraints, BAA accepts that this will limit Luton's ability to compete with Stansted. That view is entirely consistent with BAA's submissions in the Market Investigation that there is no scope for material competition between BAA's South East airports in circumstances where Heathrow and Gatwick face capacity constraints and price caps. Capacity constraints at Heathrow and Gatwick are far tighter than those at Luton.
- 3.3. BAA also notes that Luton's capacity constraints are held to apply to overnight basing of aircraft, which limits the number of aircraft that can utilize the key peak periods as the foundation for the daily operations. The Commission does not suggest that there are capacity limitations at Luton in off-peak periods. That is consistent with BAA's view that once peak availability disappears, the scope for competition is largely extinguished.
- 3.4. If the Commission believes that capacity constraints at Luton preclude scope for competition between Luton and Stansted, there can be no credible case for concluding that there *is* scope for static competition between Stansted and either of Heathrow and Gatwick.
- 3.5. Turning to the question of whether Luton does have binding capacity constraints, the Commission fails to offer a complete and persuasive case to the effect that it does.
- 3.6. BAA defines a binding constraint as the aircraft movement capacity of a single runway and its associated taxiways. Based on this definition, Luton's runway has a capacity of 20 mppa (this is also the capacity assumed in BAA's recent forecasting

work) with current passenger numbers of 10 mppa, i.e. only 50% full. They may have surmountable problems in the lack of apron space but in BAA's treatment of its own assets it does not regard apron capacity as a binding constraint. This is because, in general, an airport operator does not require planning permission to extend apron area.

- 3.7. Even if the assumption is that Luton does have some constraints due to limited overnight basing at present, BAA does not see why Luton's capacity should be regarded as fixed. Luton has Government support for expansion of its capacity and could in principle expand its overnight handling capability. If Stansted were to unduly raise its prices, BAA can see no reason why Luton could not expand its capacity in response. Indeed it may well be strongly encouraged to do so by Stansted's main users (which are also Luton's main users).
- 3.8. The Commission argues that Luton's capacity is fixed for Q5. This seems to be based on having been told by Luton that "no significant developments are likely to occur".² That is a weak basis for an assessment. If Stansted were to attempt to raise prices unduly, it may be that Luton's position would change.
- 3.9. At BAA's Market Investigation hearing with the Commission on 3 July 2008 it appeared that the Commission believed that capacity expansion at Luton was precluded due to difficulties in reaching a long run agreement with the airfield freeholder.³ As BAA explained at the hearing, the fact that there may be contractual difficulties involved is not a credible basis for concluding that such expansions are precluded. If there is commercial value from expansion, then the normal presumption is that contractual difficulties would be overcome. To the extent that the Commission relies here on that sort of reasoning, BAA regards the Commission's view as very weakly based indeed. Certainly, a contractual restriction (such as Luton's) would appear easier to overcome than one requiring Government legislation to overturn (such as Gatwick's).
- 3.10. Finally, BAA again notes the inconsistency between the view that Luton would not compete by expanding its capacity (in circumstances where there is nothing to stop them from doing so) and the Commission's view in the Market Investigation to the effect that Heathrow, Gatwick and Stansted might compete to expand capacity to a greater extent than provided for by the White Paper.

² WP, 76.

³ Transcript of BAA hearing with Competition Commission, 3 July 2008; page 155.

4. **Bilateral bargaining**

- 4.1. The Commission argues that Ryanair and easyJet do not have countervailing buyer power in current market circumstances.⁴ The grounds for this are thin indeed.
- 4.2. At paragraph 106 the Commission argues that in the past airlines at Stansted had strong bargaining power forcing Stansted to offer large discounts, but that removal of these discounts calls into question whether it is still the case that airlines have strong bargaining power. But even if the balance of bargaining power may have altered to some degree, that does not imply that the bargaining position is all in Stansted's favour. BAA regards the situation as relatively balanced.
- 4.3. At paragraph 108, the Commission says that the 2006/07 price increase points to BAA having "a very strong bargaining position with all of its airlines". This claim is totally unsupported. The prices that BAA was previously charging were manifestly very low, and the increase was to a level that was entirely reasonable, indeed below the price cap set by the Commission and the CAA. The Commission asserts that further increases would have been feasible. Whether or not they will remain however uncertain. The mere fact that Stansted is now pricing at approximately the regulatory limit (after years of pricing below it) is no basis to jump to a conclusion that Stansted has "a very strong bargaining position".
- 4.4. At paragraph 107, the Commission goes on to argue that capacity constraints at Luton have altered Stansted's airlines' outside option in the bargaining game. That claim would only be correct if it is right to regard Luton's capacity constraints as essentially fixed. As to that, see the discussion above. The claim also requires a view that switching to Luton was and is Stansted's airlines' best outside option by a large margin. If in fact Stansted airlines regard re-basing their aircraft to other airports as an alternative, the removal of Luton as the best outside option may not actually reduce these airlines' bargaining power by a large amount. On that point, BAA reiterates its previous submissions (BAA/CC2007/191 and BAA/CC2008/961 and 948) that for the most part Stansted has not been threatened with switching to Luton particularly, but rather threats to move aircraft or new services to other EU bases.
- 4.5. The Commission dismisses this possibility on the grounds that all profitable opportunities at other airports will have been taken up.⁵ BAA understands the logic

⁴ WP, 25.

⁵ WP, 64.

of that view, but it is a matter of empirical fact as to whether that is indeed the case. In a bargaining context Ryanair and easyJet would no doubt withdraw their most marginally profitable services from Stansted, and the next best alternative for those services may well be at a geographically distant airport. BAA reiterates that its experience is that threats of this type have been common in negotiations with low frills carriers.

- 4.6. The Commission's argument on the role of capacity constraints at Stansted seems to be somewhat inconsistent. When discussing bargaining power the Commission refers to increasing capacity constraints at Stansted as having a role, stating that this makes it easier for Stansted to replace "any one of its airlines".⁶ That is difficult to reconcile with the Commission's apparent view that pricing at Stansted should be determined on the presumption that Stansted has extensive spare capacity.⁷
- 4.7. In any event, even though Stansted's capacity is increasingly constrained, that does not mean that reductions in Stansted airline activity can be presumed to automatically "back fill" in the way that would apply at Heathrow and Gatwick. The reason is that Stansted's user base is highly concentrated. Ryanair and easyJet are the main potential buyers of spare capacity that might emerge. If either or both were to act strategically to withdraw aircraft services, especially if it was in off-peak periods, there is little expectation that Stansted could back-fill those lost services.

5. Price benchmarks for appraising market power

- 5.1. The Commission argues that the main benchmark for whether Stansted has market power is whether its prices (or the prices that the Commission believes that Stansted might in principle be able to set if it was unconstrained) are above "the competitive level".
- 5.2. The Commission seems to regard the "competitive level" as being short run marginal costs. BAA does not accept that this is a prescriptive benchmark for evaluation of whether Stansted has market power. We note that the Commission does not take the same approach at Heathrow and Gatwick.
- 5.3. While pricing at short run marginal cost is the outcome of the theoretical framework of perfect competition, it is not the expectation at all in a situation where products and suppliers are significantly differentiated (as airports invariably are) and in which large and lumpy capital investments form a large element of the cost base.

⁶ WP, 107.

⁷ WP, 28.

5.4. If short run marginal cost is used as a valid benchmark for determining whether or not an airport has “market power” that may well point to many other airports requiring regulation, and indeed may point to large parts of the wider economy being regarded as having “market power”.

6. **BAA pricing policy**

6.1. In paragraph 26, the Commission explains its interpretation of two internal BAA papers. The Commission considers that these papers demonstrate that Stansted is not pricing to the cap in 2007/08 for ‘strategic reasons’. BAA accepts that as a regulated company it is going to consider the regulatory action to significant price changes. It is not surprising therefore that the Commission has uncovered such material.

6.2. However, the Commission in our view has unfairly misrepresented and misinterpreted the papers that BAA has supplied to the Commission. A more balanced interpretation of both papers shows that BAA had many factors under consideration when deciding on Stansted 2007/08 prices, of which the regulatory reaction was only one.

6.3. The most important consideration to BAA when considering the 2007/08 prices for Stansted was the commitments given to the airlines not to recover the Q4 under recovery in Q4. It is possible to challenge the Commission’s interpretation as to strategic reasons by reviewing, for example the decision letter with respect to 2006/07 price cap in Terry Morgan’s letter of 27 January 2006. We state ‘It is BAA Stansted’s intention to price to the allowable yield (excluding the correction factor) in 2007/08.’ This is well before any ‘strategic’ considerations with respect to the Commission.

6.4. We can also point out that in the Board paper that authorised the 2007/08 prices at Stansted there are twelve reasons for not taking the correction factor. The Commission has highlighted one of these twelve reasons and dismissed the other eleven.