



Response for BAA Limited

Response to Working paper on Market Definition

BAA/CC2008/930

BAA Limited
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1. Introduction

- 1.1. BAA has already provided some preliminary observations on the Competition Commission's approach to market definition in the response to *Emerging Thinking*.¹ This response sets out BAA's comments in greater detail, in light of the further analysis in the *Market Definition* WP.
- 1.2. Because of their likely key bearing on the outcome of the Commission's analysis, the response first discusses issues on geographic market definition. It then proceeds to some specific points in relation to the Commission's suggested product market definition.
- 1.3. The points raised in this response demonstrate that the Commission's evidence and analysis are insufficient to support its suggested market definitions. In addition, it would in any case appear that the Commission itself might regard the formal step of market definition in the present case merely as a system of categorisation, rather than an element of its substantive analysis.

2. Geographic Market Definition

- 2.1. BAA's observations in relation to geographic market definition² in the present case are, in summary, as follows:
 - the role or purpose of "market definition" in the Commission's overall framework of analysis is unclear;
 - the Commission's analysis appears to be often unsubstantiated and inconsistent, without the requisite consideration of competitive constraints and substitutability that would be required to determine meaningful competition policy markets;
 - the Commission also does not appear to have taken into consideration the key market definition implications from capacity constraints and price regulation;
 - the resulting conclusions can therefore not be relied upon as a foundation for drawing valid inferences and conclusions about competition and the actual or potential competitive constraints applying to BAA's airports;
 - to the extent that an exercise of market definition were to be attempted in the present case, it should be adapted to the common ownership and, on the basis of BAA's preliminary analysis, should therefore ask whether hypothetical separate owners would find it profitable to implement a "small but significant non-transitory reduction (i.e. the reverse of an increase) in price"; and
 - the Commission's proposed market definition would not pass this market definition methodology.

Unclear role or purpose of "market definition"

- 2.2. BAA is unsure about the Commission's intended purpose of market *definition* in the present investigation.
- 2.3. While the *Market Definition* WP states that a "*potentially important element in a market investigation is therefore to define the relevant markets*"³, the summary

¹ See *Response to Emerging Thinking*, chapter 3 (p51-54).

² Some of these concerns apply to market definition more generally; however, their implications are of particular significance in the context of the geographic dimension.

section of *Emerging Thinking* – which presumably includes all important issues in the Commission’s analysis – does not refer to “market definition” at all.

- 2.4. It would seem that in some places the Commission regards market definition as nothing more than a system of categorisation, with effectively no relevance to any substantive analysis.⁴ In fact, the *Market Definition WP* describes its content as “*a possible approach to market definition*” (emphasis added), which could indicate that in the Commission’s opinion there are other valid approaches (which are however not considered in either the *Market Definition WP* or *Emerging Thinking*)⁵.
- 2.5. In spite of several indications⁶ that in the present case, the Commission does not intend market definition to capture competitive constraints, other parts of the working paper – in particular the discussion of whether other modes of transport should be included in the relevant market(s)⁷ – suggest that the Commission is attempting to look at the strength of competitive constraints.
- 2.6. It is therefore not clear to BAA, either from the *Market Definition WP* or *Emerging Thinking*, how market definition fits into the overall framework adopted by the Commission in this investigation.
- 2.7. BAA is also unsure about the importance that the Commission is attributing to the market shares that follow from its chosen market definitions. The *Market Definition WP* states that “*assessment of market shares is unlikely to be a useful tool in itself for measuring market airport power [sic]*”. While this statement makes it clear that market share information provided by the Commission should not be relied upon in isolation, it also seems to suggest that it nevertheless has a residual role to play. However, the precise nature of any such residual role is difficult to glean from the Commission’s account.

Unsubstantiated and inconsistent analysis, not informed by considerations of competitive constraints and substitutability

- 2.8. Given that market definition is, in this case, clearly not a straightforward exercise, BAA would have expected the Commission to provide a much more detailed discussion and assessment of the complications and issues arising in the market definition exercise, how the Commission has chosen to address them, and an assessment of the likely overall effectiveness of the approach adopted.
- 2.9. Instead, *Emerging Thinking* gives very little detail on this matter (devoting less than 4 pages⁸ to the topic of “market definition”). The *Market Definition WP* is a little more detailed, but nevertheless contains only a minimal discussion of the conceptual aspects of market definition, culminating in the unsubstantiated opinion that “[f]or this purpose, based on the evidence we have received to date, we think it is helpful to identify two broad markets”⁹.

³ See *Market Definition WP*, para 6.

⁴ See e.g. *Market Definition WP*, para 44, which describes any market definition beyond a single airport as “to an extent, arbitrary”.

⁵ In the *Substitutability in Scotland WP* the Commission refers to the possibility that “the reason why so many airlines operate parallel services is precisely because [Edinburgh and Glasgow] serve distinct geographic markets” (para 8). In relation to the South East, *Emerging Thinking* states that “we have yet to reach a firm view on market definition” (para 109(b)(i)).

⁶ See e.g. *Market Definition WP*, para 44.

⁷ See *Market Definition WP*, paras 49-55.

⁸ See *Emerging Thinking*, p79-82.

⁹ See *Market Definition WP*, para 45.

- 2.10. BAA is not clear what “evidence” is being referred to in the statement. In fact, the Commission’s approach to market definition is highly unusual, in that it appears to “define” relevant markets before issues of substitutability have been considered:
- The South East market is defined as encompassing the five London area airports plus Southampton¹⁰ prior to the Commission’s discussion of demand substitutability between the BAA airports¹¹. Similarly, the definition of the Scottish airports as a market precedes the subsequent discussion of substitutability in Scotland.¹²
 - This process clearly departs from the conventional approach which is to look at substitutability as key part of the market definition exercise – indeed, the Commission’s own guidelines state that “[t]he key to market definition is substitutability. Inevitably, therefore, the Commission’s views on market definition are merely assertions, and – to the extent that it chooses to make any substantive inferences from its chosen market definitions – the Commission could be viewed as effectively prejudging the effect of common ownership.
- 2.11. The failure to base its market definition on an analysis of substitutability is further compounded by an absence of any detailed discussion of the market definition implications from the role of switching costs, the potential relevance of competitive conditions in airline markets (e.g. Ryanair’s and Easyjet’s pre-dominance at Stansted), or differentiation in market segments. The Commission’s analysis therefore fails to take into account most of the relevant considerations for market definition. (The discussion of the hub characteristics of Heathrow and the specific matter of transfer passengers is relevant, but does not amount to a comprehensive analysis.)
- 2.12. Within the relatively brief substantive discussion of (geographic) market definition in the *Market Definition WP* and *Emerging Thinking* there are also several apparent inconsistencies. For example, the Commission currently dismisses the role of relatively small non-BAA airports in terms of their potential to act as competitive constraints, whereas BAA’s smaller airports (in particular Southampton) are considered as part of the respective relevant markets.¹³
- 2.13. BAA also notes that the CC has not set out its reasoning for including Aberdeen in the same market as Edinburgh and Glasgow, and thus departing from the OFT’s explicit statement that Aberdeen operates in a separate geographic market.¹⁴

No account of the implications from capacity constraints and price regulation

- 2.14. The Commission does not explain in any detail how – if at all – it has addressed the matter of capacity constraints, slot allocation and regulatory constraints when defining the market.
- 2.15. For the most part, the Commission’s intention seems to be to ignore these constraints in the context of market definition, but to return to them as part of the examination of the scope for competition. In BAA’s opinion, such an approach would render the resulting market definitions essentially irrelevant, given that they would

¹⁰ See *Emerging Thinking*, paras 109-111. It is not fully clear whether or not the Commission is also including Bournemouth in this market; see, e.g. *Market Definition WP*, para 46(a): “We also include, as far as possible, Bournemouth (located in Dorset and hence in the South West of England) as it is near to Southampton” (emphasis added).

¹¹ See *Emerging Thinking*, paras 112ff.

¹² It is not fully clear whether or not the Commission is including Inverness in the market; see e.g. *Market Definition WP*, para 46(b): “We also include, as far as possible, Inverness as it is the closest airport to Aberdeen” (emphasis added).

¹³ See *Emerging Thinking*, para 109(b)(i), and *Market Definition WP*, para 46(a).

¹⁴ See BAA: *The OFT’s reference to the Competition Commission*, para 4.74.

then be too far removed from the key facts of the present case: for example, BAA has previously submitted extensive evidence on the fundamental implications of capacity constraints and binding price caps on the scope for competition in the South East.¹⁵ Assuming that these market features do not exist, when in fact they do, would clearly render the resulting market definitions inappropriate for purposes of substantive analysis in the present case - in BAA's view, an analysis of market definition is only valid if it is grounded in the facts of the marketplace as it actually operates.

- 2.16. However, *Emerging Thinking* is, in any case, not consistent in its treatment of these constraints. For example, the role of (formal and informal) regulatory constraints in relation to pricing is touched on¹⁶ but the Commission does not advance a consistent framework for dealing with it. In BAA's view, the Commission's analysis of market definition and the materiality of any (actual and/or potential) competitive constraints between BAA's airports needs at all times to be clear whether it is conducted under the assumption that these external constraints do or do not apply.
- 2.17. If, in particular, the Commission were to base its market definition analysis on the assumption of no price caps, then it would not be able to rely on the resulting market definitions in any world where price caps are a feature of the marketplace. To give an example, the Commission states that "[d]efining separate airports as separate markets may underestimate the adverse effects of common ownership"¹⁷. The Commission may have in mind a view that even if individual airports already have market power on their own, in combination those airports may have even more market power. But if regulation (formal or informal) applies, then airports will be prevented from exploiting even the market power that they have individually, and the possibility of having yet more theoretical market power by virtue of common ownership will be irrelevant. This highlights the importance of looking at the nature of competition in tandem with assumptions regarding the regulatory arrangements.
- 2.18. By contrast, although the Commission has in some instances made its assumptions clear, its overall methodology is not clear to BAA. For example, in the context of appraising competition for transfer traffic, the Commission discusses the implications from Heathrow's regulated price levels,¹⁸ whereas in relation to the issue of whether Heathrow is constrained by other BAA airports, the binding price cap is not mentioned.¹⁹

Unreliable basis for drawing inferences

- 2.19. Due to the absence of relevant evidence, the inconsistent methodology, and the failure to take into account key market features, BAA considers that the Commission's market definitions and resulting market shares are an unreliable basis for drawing substantive inferences and conclusions, including about the scope for competition and the actual or potential competitive constraints applying to BAA's airports.
- 2.20. BAA further submits that the Commission appears to be in agreement on this point: as stated in the *Market Definition WP*, "*any market definition beyond a single airport*

¹⁵ See e.g. NERA, November 2007, *Analysis of the Scope for Static Competition between BAA's South East Airports*, BAA/CC2008/570.

¹⁶ See *Market Definition WP*, para 42(b).

¹⁷ See *Emerging Thinking*, para 109(b).

¹⁸ See *Market Definition WP*, para 25(d). However, para 46(a) is less clear: it refers to the constraints on Heathrow from other hub airports on the assumption of the binding price cap and on the assumption of no price regulation – it is unclear to BAA what situation the CC is ultimately focusing on.

¹⁹ See *Market Definition WP*, para 45(a). The discussion of the cellophane fallacy (see *Market Definition WP*, para 42(a)) also ignores price regulation.

is, to an extent, *arbitrary*²⁰ (emphasis added) and an “assessment of an individual airport’s market power [...] is *independent* of market definition”²¹ (emphasis added). These statements might suggest that the Commission intends effectively to omit the market definition step altogether in the market investigation.²²

- 2.21. If the Commission regards the formal step of (geographic) market definition as superfluous in this case and therefore irrelevant for its conclusions, BAA submits that the Commission should state that view explicitly.
- 2.22. In light of the above, BAA is unable to follow the rationale that led the Commission to adopting its chosen market definitions, on the rather unsatisfactory basis that it sees “no advantage in defining narrow geographic markets for airports”²³. In fact, the reference to “no advantage” may open the Commission to the criticism that its market definitions are chosen to imply a particular conclusion on the effect of common ownership (which would amount to prejudging the case), rather than being determined by facts and evidence.

BAA’s observations on the appropriate market definition methodology in this case

- 2.23. In BAA’s opinion, the Commission’s analysis should focus directly on the ultimate key questions in this market investigation, rather than getting diverted by considerations over market definition.
- 2.24. However, if market definition were to be attempted seriously, it would have to “depend on the competition issue being addressed”²⁴. The Commission’s market investigation guidelines state that it will use the SSNIP approach “wherever it is feasible to do so”²⁵. However, *Emerging Thinking* does not discuss this feasibility in any detail, or provide an indication of whether the Commission has attempted such tests. In particular, while the Commission lists a series of difficulties (e.g. the issue of what is the “competitive level” of prices for the purposes of applying the SSNIP test), it makes virtually no attempt at all to get to grips with that issue. On the one hand, the Commission says that it is “difficult”²⁶ to assess the competitive level, but then immediately suggests that the competitive price level may be higher than current regulated prices²⁷.
- 2.25. BAA submits that, in undertaking any market definition analysis, the Commission should – in accordance with its own guidelines – give due consideration to these feasibility issues in relation to the SSNIP test, and set out its thinking in detail.
- 2.26. BAA accepts that the application of the SSNIP test in the present case is not straightforward. To assist the Commission in its analysis, it therefore sets out some initial and preliminary observations, on how the standard market definition methodology could be adapted to the competition issue being addressed in the present case:

²⁰ See *Market Definition* WP, para 44.

²¹ See *Market Definition* WP, para 44.

²² See also the *Substitutability in Scotland* WP, para 18: “Rather than testing over which combination of airports a hypothetical monopolist might be able to impose a SSNIP, we are seeking to evaluate directly the extent of potential competition between each of BAA’s Scottish airports.”

²³ See *Market Definition* WP, para 45.

²⁴ See *Market Definition* WP, para 42.

²⁵ See *CC3 Market Investigation References: Competition Commission Guidelines*, para 2.1.

²⁶ See *Market Definition* WP, para 42(a).

²⁷ See *Market Definition* WP, para 42(b).

- Since the common ownership analysis raises some issues that might be relevant in a merger investigation,²⁸ the appropriate market definition methodology could also be seen as the reverse of what is done in a merger case: on that basis, the Commission should examine whether hypothetical separate owners (i.e. the reverse of a monopolist) would find it profitable to implement a “small but significant non-transitory reduction (i.e. the reverse of an increase) in price”.
- The recognition that the common ownership analysis features close analogies to a merger investigation, also suggests a response to the Commission’s concern over “two major difficulties in applying the hypothetical monopolist test”²⁹ (namely a potential for the cellophane fallacy and the impact of binding price caps) both of which relate to the problem that the prevailing price might not correspond to the competitive level. In the context of merger investigations, the Commission’s guidelines state that “[i]n most cases the CC will use existing prices in defining the market because the impact of the merger on existing competition is the key issue in a merger investigation”³⁰.
- It would also appear that this approach addresses the Commission’s concern that “a narrow market definition may not be appropriate for assessing BAA’s common ownership of adjoining airports”³¹. Adapting the SSNIP test to the question of whether hypothetical separate owners would find it profitable to implement a small but significant non-transitory reduction in price leads to a very direct investigation of the common ownership question.
- This adapted SSNIP methodology would overcome the conceptual obstacles identified by the Commission. On that basis, the investigation of the substitutability between BAA’s airports should then be informed by standard considerations such as the sensitivity of users (passengers and/or airlines) to changes in relative prices, the scope for switching (including capacity constraints), etc. So far, the Commission does not seem to have attempted to link its market definition exercise to any such analysis, nor any other detailed examination of the extensive data that are available in relation to passenger and airline views and behaviour. Although it is ultimately for the Commission to set out its conceptual framework and thinking on market definition, BAA would have expected the Commission to consider some broad principles similar to what is set out above. BAA’s high-level suggestions are intended to provide the Commission with some preliminary input in response to *Emerging Thinking* and the *Market Definition* WP. It may have revisions and refinements as its analysis progresses and its understanding of the Commission’s overall framework develops.

²⁸ See *Emerging Thinking*, para 86.

²⁹ See *Market Definition* WP, para 42.

³⁰ See *CC2 Merger References: Competition Commission Guidelines*, para 2.10.

³¹ See *Market Definition* WP, para 43.

The Commission's proposed market definition would not pass the market definition test suggested above

- 2.27. While BAA's comments in the previous section should be viewed as initial and preliminary observations on the appropriate market definition methodology, they would have significant implications for the Commission's proposed market definitions.
- 2.28. The ingredients for the methodology proposed above are already available to the Commission. In particular, BAA has previously explained that:
- in the South East, the binding capacity constraints and price caps at Heathrow and Gatwick imply that separate owners of BAA's South East airports would be unlikely to lower prices;³² and
 - in Scotland, the data from the Commission's own survey analysis suggest that even under separate ownership Edinburgh and Glasgow would, in the absence of other constraints, have an incentive to raise, rather than reduce, their prices.³³
- 2.29. Accordingly, neither the Commission's "South East" market, nor its "Scotland" market would satisfy the appropriately modified SSNIP test.
- 2.30. BAA recognises that the next step in the SSNIP test, i.e. widening the candidate market, is not at all straightforward. However, it is in BAA's view also not necessary: the fact that neither separate ownership in the South East, nor separate ownership in Scotland would be likely to lead to lower prices (which also provide a good proxy for other static competitive dimensions such as quality) actually already answers the fundamental common ownership question. At that point, it becomes unnecessary to determine the precise relevant market.

3. **Product Market Definition**

- 3.1. This section sets out BAA's comments on some specific points in relation to the Commission's suggested product market definition. Although they may not be as fundamental as the comments on geographic market definition, BAA would, for the avoidance of doubt and the sake of completeness, like to convey its views or reserve its position.
- The Commission's claim that airport retail markets are separate from other retailing markets is not adequately supported. In BAA's view the Commission fails to establish a *prima facie* argument that airport retailing forms a separate market. It also fails to look at the different aspects of airport retailing.
 - The Commission's claim that there is a separate market for short term car parking is not substantiated. The only evidence relied upon is that BAA has raised prices in recent years to try and induce switching to public transport. That does not indicate that short term car parking is separate from other modes of transport, it merely indicates that if more passengers are to be induced to travel by other means, the relative price of short term car parking needed to rise relative to those alternatives. In other words, the motivation behind raising car park charges presupposed substitutability with public transport.
 - The Commission's *claim* that the product market(s) for long term car parking, taxis, buses and coaches are all separate is merely asserted and no evidence is advanced in support of those claims. Indeed, in the case of taxis, buses and

³² See e.g. NERA, November 2007, *Analysis of the Scope for Static Competition Between BAA's South East Airports*, BAA/CC2008/570.

³³ See BAA/CC2008/612.

coaches it is unclear whether the Commission believes that there is a single market for these three modes of transport, or three separate markets (one for taxis, one for buses and one for coaches).

- The discussion of Heathrow Express, advertising and property rental has not been considered in detail, but BAA is perplexed by the suggestion that “*similar considerations would apply as to retail and car parking*”. What are these considerations and why should the analysis of shopping and surface access apply to the quite different activities of advertising and property rental?
- 3.2. It should be noted that the above list is not exhaustive, specifically in relation to issues that appear in the *Market Definition WP*, but do not feature in any meaningful sense in *Emerging Thinking*. These issues include in particular the considerations raised at paras 275-276 of *Emerging Thinking*: since the Commission says that it is “*currently not clear to us that they are appropriately addressed under the terms of this inquiry rather than by other competition legislation*”³⁴ BAA is not discussing them in the present inquiry.

³⁴ See *Emerging Thinking*, para 276.