Consultation Response on the CAA's *Draft guidance on the application of the Market Power Test under the Civil Aviation Act 2012*

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Executive Summary

1. The CAA's draft guidance on the market power test is an important document. As the CAA notes, the existing guidance is out of date and Heathrow welcomes the CAA's decision to update that document. This revision is an opportunity ensure the CAA's decision-making process is clear, robust, predictable and reflects best practice.

2. Heathrow proposes some important improvements to the proposed draft which will help achieve these objectives. Key among Heathrow's suggestions are that:

    a. **the draft could more consistently put the interests of passengers and cargo owners first** – the proposed draft appears to give too much weight to the interests of airlines instead of addressing the end-user markets directly;

    b. **parts of the draft could tend to encourage so-called 'confirmation bias'** – embedding the existing "answer" by relying too heavily on a broad brush approach, generalisations and assumptions. Heathrow's suggested changes are intended to add specificity, which we believe is warranted;

    c. the current draft tends too much in favour of allowing flexibility rather than providing *specific* guidance and therefore **provides *less* rather than *more* regulatory certainty to the industry**. In this sense, the draft does not represent a step forward from the existing guidance; and

    d. **the guidance should better recognise the need for a rigorous and comprehensive impact assessment** which properly addresses the full range of alternative regulatory options, rather than relying on broad (and in some respects inaccurate) generalisations that such alternatives are likely to be ineffective and/or unsuitable.

3. Accordingly, we believe substantive revisions to the draft guidance could help maximise its benefit to the CAA, to the industry and to all stakeholders. We would be pleased to meet with the CAA to discuss the feedback provided in the remainder of this submission and discuss how the draft guidance could be amended to reflect best practice.

Introduction

4. Heathrow is grateful for the opportunity to comment on the CAA's *Draft Guidance on the Application of the Market Power Test under the Civil Aviation Act 2012* (the 'Draft Guidance').

5. As noted in the executive summary above, Heathrow welcomes the revised guidance; and we believe it can be significantly improved with the changes which we suggest in the rest of this document.

6. In this introduction we deal with some points of general application before moving on, in subsequent sections, to deal with Tests A, B and C in detail.

7. First and most importantly, Heathrow considers that the Draft Guidance needs to ensure that the interests of passengers are at the heart of the process. At the moment we do not believe the draft guidance achieves this; instead, it relies heavily on the interests of airlines as a proxy. This is critical on at least two counts:

    a. the CAA's general duty under the Act is to further the interests of passengers. If it fails to accord those interests proper place in the guidance, the CAA will not be giving effect to that duty; and

    b. best practice in a market definition exercise is to start with the end-user market – in this case, markets in which passengers make choices – and analyse upstream wholesale markets only as a function of derived demand. This approach, clearly, is consistent with the CAA's general duty and a failure to adopt this approach will lead the CAA to adopt an inappropriate presumption in favour of regulation.

8. We explain these points more fully elsewhere in this submission, in particular in paragraphs 30–36.

9. As a consequence, we consider that the Draft Guidance does not yet achieve its potential in ensuring the CAA's approach to the market power test will be legally robust. Core among our concerns are that the Draft Guidance:

    a. represents a step backwards from the existing guidance, by seeking to preserve the CAA's flexibility and providing *less* rather than *more* regulatory certainty to the industry;

    b. could be perceived as aimed at making the CAA's task easier rather than ensuring its decisions are robust. For example, the Draft Guidance encourages sweeping market definitions when it should distinguish more clearly between different markets; and appears to adopt a presumption in favour of licence regulation in its application of certain tests, such as in assessing the sufficiency of competition law; and

    c. should reflect the need for a rigorous and comprehensive impact assessment which properly addresses the full range of alternative regulatory options, rather than relying on broad (and in some respects inaccurate) generalisations that such alternatives are likely to be ineffective and/or unsuitable.

10. As will be clear from this submission, Heathrow considers that the Draft Guidance would benefit from some significant revision. In paragraph 1.7 of the Draft Guidance the CAA explains its view of the consultation process as follows:

> *Stakeholders' comments will allow us to ensure that this guidance is useful to them in explaining how we will apply our powers.*

11. While we are sure that the CAA was not intending to suggest that this consultation was only concerned with clarity of expression (rather than a consultation on the substance of the CAA's approach), to be clear, Heathrow expects that the CAA's intention is to take full account of stakeholders' comments and make appropriate substantive changes to the guidance. This is no more than is required by law.[1]

12. The remaining parts of this submission outline Heathrow's concerns with specific aspects of the Draft Guidance.

13. Heathrow's broader concerns are as follows:

Deviating from the Draft Guidance

14. As explained above, one of the core reasons for developing guidance is to improve regulatory predictability for businesses, investors and other stakeholders involved in the aviation sector. Regulatory predictability about the approach the CAA will adopt has value for all stakeholders even if they do not agree on the substance of that approach. Indeed, predictability is one of the UK Government's core Principles of Economic Regulation, which reflect that:

> *the framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence.*[2]

15. Stability and predictability is particularly important in relation to airports, which have very long term investments and a significant ongoing portfolio of capital projects. In this context, it is concerning that the Draft Guidance provides very little assurance that it will actually reflect the CAA's approach in practice. Instead, the Draft Guidance merely states that it intends:

> *to illustrate how we are likely to proceed in conducting MPDs. From time to time, given the specific circumstances of a particular case, we may need to deviate from this guidance* (paragraph 1.3).

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[1] In *R v North and East Devon Health Authority, Ex p Coughlan* [2001] QB 213, Lord Woolf MR said that:

> *To be proper, consultation must be undertaken at a time when proposals are still at a formative stage; it must include sufficient reasons for particular proposals and allow those consulted to give intelligent consideration and an intelligent response; adequate time must be given for this purpose; and the product of consultation must be conscientiously taken into account when the ultimate decision is taken*

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-for-economic-regulation.pdf page 4.

16. This caveat may significantly compromise the value of the Draft Guidelines, because it provides little assurance that the Draft Guidelines will be adhered to. Heathrow notes that the Draft Guidance is already high level and largely principles-based, and therefore it is not evident that there would ever be a need to depart from the Draft Guidance. To the extent there may be any such need, the circumstances should be specifically flagged in advance. If the CAA considers such a provision to be necessary, we believe the CAA should:

    a. provide a clear indication of the types of 'specific circumstances' it considers would justify departing from the Draft Guidance;

    b. emphasise that the circumstances would need to be extraordinary, given the costs to the sector as a whole that arise from regulatory unpredictability; and

    c. indicate how it will assess the costs and benefits of departing from the Draft Guidance and how any departure will minimise regulatory uncertainty.

Standard of proof

17. Heathrow considers that the Draft Guidance could be more consistent in describing the appropriate standard of proof the CAA will require when regulating.

18. On the one hand, the CAA explains that its assessments are made on the balance of probabilities, and refers to a Competition Appeals Tribunal ("Tribunal") judgment stating that 'the evidence must be sufficient to convince the Tribunal in the circumstances of the particular case, and to overcome the presumption of innocence to which [the parties are] entitled'.[3] We understand that the 'presumption of innocence' should be interpreted as a presumption that regulation should not be imposed unless there is specific, relevant and sufficient evidence that the tests for imposing regulation have been satisfied. It would be appropriate for the CAA to expressly set out this position in the Draft Guidance, rather than referring to the Tribunal judgment without expressly adopting its approach. We note that this approach is consistent with the CAA's specific duty to have regard to the principle that its regulatory activities should be proportionate and 'targeted only at cases where action is needed'. It is also consistent with the Government's *Principles for Economic Regulation*, which reflect that:

> *Economic regulation, as with most forms of regulation, imposes costs on regulated companies. These costs derive from the regulatory cost the regulators impose on their sectors and the administrative cost of running the regulatory institutions. Costs in these sectors tend to be passed through to end consumers.*[4]

[3] Draft Guidance paragraph 2.34, citing Makers UK Limited v Office of Fair Trading [2007] CAT 11, paragraph 46.
[4] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-for-economic-regulation.pdf paragraph 40.

19. However, in certain other parts of the Draft Guidance the CAA appears to adopt positions that are difficult to reconcile with the presumption that specific evidence is required to meet the tests for imposing regulation. We deal with a number of these elsewhere in this submission but note that these include:

    a. the CAA's indication that the Competition and Market Authority's ("CMA's") ability to conduct a market review under the Enterprise Act 2002 is 'not designed to guard against the risk of an abuse of dominance' and its implicit presumption that market reviews are therefore unlikely to be effective alternatives to economic regulation by the CAA; and

    b. the repeated emphasis throughout the Draft Guidance on the CAA's regulatory judgement and/or regulatory discretion (e.g., at paragraphs 2.35, 3.6, 4.26, 6.5 and 6.46). These references appear to be divorced from the presumption of innocence and the requirement for substantiated and adequate evidence which the CAA has indicated it will adopt.

Market power determination process

Initiating an MPD

20. Regulatory predictability is especially important in providing guidance about when the CAA will proceed (or not proceed) with a market power determination process. Although the Draft Guidance helpfully sets out the requirements of the statutory regime regarding market power determinations, the Draft Guidance provides almost no indication of:

    a. when the CAA may consider it appropriate to conduct a market power determination process – other than that this will be 'when we consider it appropriate to do so to discharge our [statutory] duty' (paragraph 3.2); and

    b. how the CAA will determine whether a 'material change in circumstances' exists. The Draft Guidance states only that the term 'is not defined in legislation' and that the change 'needs to be material in areas that are likely to be relevant to Tests A to C' (paragraph 3.5).

21. Heathrow accepts that the CAA may be unwilling to exhaustively explain in advance all circumstances in which a market power determination process will be undertaken, or when a material change in circumstances exists. However, as it stands, the Draft Guidance provides very little by way of certainty for market participants.

22. We would urge the CAA to provide more detailed guidance, for example explaining the types of legal precedents the CAA would be likely to consider relevant and refer to when determining whether a material change in circumstances has occurred. For example, Heathrow considers it may be appropriate to consider the interpretation of section 31B(2) of the Competition Act 1998, which allows a regulator to continue an investigation despite accepting voluntary commitments, if a material change in circumstances has occurred.

Timetable and stages

23. In relation to the overall timing for undertaking a market power determination assessment, while we welcome the CAA's ambition to complete the process and publish a determination within 18 months, we note that this is less than half the length of time it has taken the CAA to complete the process to date.

24. While a reduction in the timeframe could reduce uncertainty and regulatory costs, having predictability about the timeframes is also an important aspect of certainty – since firms have to make resourcing decisions and strategic planning based on an estimate of how long the process will take. Accordingly, we believe it is important for regulatory certainty that the CAA's indicative timeframes are realistic and capable of being reasonably relied on by market participants (while giving the CAA flexibility to extend the timeframe, but only if the circumstances are exceptional).

25. We also consider that, while the CAA should aim to conduct the process efficiently and quickly, this should not be at the expense of the quality or comprehensiveness of the

decision-making process. In other words, certainty about *timing* should never be at the expense of certainty about ***substance*** (i.e. certainty that the CAA will adopt an approach that is robust, comprehensive and credible). Market power determinations are complex and require consideration of a broad range of evidence – and in Heathrow's view even the CAA's past, much lengthier reviews have often failed to include an analysis sufficiently robust that all stakeholders can have confidence in the CAA's conclusions. In this context, it is important to reach the right result, even if this takes longer than 18 months.

26. Accordingly, we believe the CAA should consider carefully whether it is appropriate to indicate the 18-month target in the Draft Guidance, because a failure to meet this target (or to conduct a poor process in order to meet this target) would ultimately be less conducive to regulatory certainty than a longer but more realistic target. Given that 18 months represents a very ambitious reduction in timeframes, Heathrow believes it may be more appropriate for the CAA to adopt an indicative timeframe:

    a. which industry players can have full confidence that the CAA will be able to meet, except in exceptional circumstances; and

    b. which will not compromise the integrity and quality of the decision-making process.

Test A – Substantial Market Power

Summary of Heathrow's view on Test A

27. In summary in relation to Test A, Heathrow considers that the CAA's approach is misconceived and needs to be revisited. To ensure its approach is defensible and credible:

    a. the CAA should begin with the downstream passenger markets, not wholesale markets. Wholesale markets only exist as a function of derived demand from those downstream markets and should be defined on that basis. This is required by the Act and represents regulatory best practice;

    b. the CAA should start with narrow markets and broaden them if necessary. Again, this is as envisaged by the Act and is required by the relevant CMA and EC guidance to which the CAA must have regard. The CAA's proposed approach to lump every activity undertaken by an airport together and start from there is not a recognised approach to market definition; and

    c. this is likely over time to lead to narrower markets which may include:

        i. different markets for different types of journey e.g. short-haul and long-haul, transfer and non-transfer;

        ii. different markets for different types of services e.g. the landing and taking off or aircraft may be in an entirely different market from the market for facilities for shops and retail businesses; and

        iii. different temporal markets depending on demand patterns at different times of day.

28. We turn now to our detailed comments on Test A.

Defining the market

29. The purpose of defining a product market is to provide the CAA with a frame of reference to assess the level of competition. The Draft Guidance appears to depart from accepted practice and, if left unaddressed, will significantly impact the credibility of decisions made pursuant to the Draft Guidance.

<u>The Draft Guidance fails to respect the CAA's primary duty</u>

30. A key flaw in the Draft Guidance is its failure to properly reflect the CAA's own primary duty to protect consumers. It fails to do so by repeatedly assuming that the interests of passengers/cargo owners and those of airlines are of equal importance or, indeed, are interchangeable (for example at paragraphs 4.21, 4.22 and 4.33). This assumption is incorrect and, in any event, is the wrong legal test to apply and is bound to lead the CAA into erroneous over-regulation.

31. It is clear that different users of the airports, such as passengers and airlines, have interests which diverge. For example, a single airline may face very high barriers to 'switching' airports; however, if passengers have choices between airlines and airports when flying to a destination, the constraints faced by airlines do not necessarily

indicate any lack of competition at the retail level. Passengers' priorities in this regard are entirely separate to those of airlines.

32. In fact, airlines themselves may exercise market power if they have an established position either in the market generally or at a particular airport. It will be in the interests of such airlines to preserve and protect that power; but clearly not in the interests of passengers.

33. It is possible to think of many other areas in which the interests of airlines do not coincide with those of passengers. In fact, though, the point is moot because the Act is quite clear that the CAA must consider, primarily, the interests of passengers. It is not sufficient for it simply to adopt a proxy.

34. By conflating the interests of passengers with those of airlines, the Draft Guidance fails to properly differentiate between the wholesale and retail markets in defining the appropriate markets. Given the CAA's primary duty is to protect passengers and cargo owners, the assessment of competition must be directed at their interests. The wholesale market (i.e. the relationship between airports and airlines) must only be considered insofar as it directly affects the interest of passengers and cargo owners in accordance with the CAA's general duties.

35. The practice of directing an analysis at the impacts on the downstream retail market clearly represents best practice. For example, in a recent Wholesale Broadband Market Review,[5] Ofcom set out the importance of considering retail market conditions and their indirect impact on the wholesale market when making a market assessment:

> *Demand for [wholesale broadband] is derived from demand for retail broadband services. This suggests that products which are included in the market at the retail level impose an indirect constraint on prices at the wholesale level. Thus, products which are included at the retail level may be included in the market at the wholesale level. This has been the case for all previous [wholesale broadband] reviews....*

36. Other regulators such as Ofgem have similarly identified that it is not appropriate to assume that downstream market participants' interests are identical to those of end users. For example, when regulating energy network distribution companies, Ofgem do not assume that the interests of energy suppliers (i.e. the immediate downstream customers of the energy network distribution companies) are the same as the interests of consumers. Instead, Ofgem consults directly with consumer groups such as Citizens Advice.

37. The divergence of airline and passenger interests has, in any event, already been recognised by the CAA. The CAA has held discussions with Heathrow with a view to setting up a "consumer consultation group" modelled on similar groups in the energy and water sectors. It has specifically justified this proposal to Heathrow on the basis

[5] Ofcom Statement: 'Review of the wholesale broadband access markets Statement on market definition, market power determinations and remedies', published– 26 June 2014

that it "brings end consumer views to bear" on the process because "airlines may not always speak in their customers' interests". The CAA must be alive to the same considerations when making any market assessment rather than proceeding on an untested assumption (an assumption which it has already acknowledged is wrong) that passengers' interests will always align with those of airlines. A failure to do so constitutes a failure of the CAA to have regard to its primary duty.

The correct starting point is a narrow product market

38. Compounding this problem, the Draft Guidance also errs by taking as its starting point that the CAA is entitled to adopt a broad product market definition. This is also likely to lead the CAA to apply regulation in an inappropriately broad way.

39. Section 6 of the Act sets out that Test A is met only if:

> *(a) the market is a market for one or more of the types of airport operation service provided in the airport area (or for services that include one or more of those types of service), and*
>
> *(b) geographically the market consists of or includes all or part of the airport area*
>
> [emphasis added]

40. This wording suggests that the assessment to be conducted by the CAA is in relation to one or more specific services provided at the airport: for example, it allows the CAA to consider whether passenger services, cargo services, travel to/from the airport, use of land and facilities (e.g. the terminal buildings), perimeter/airside roads, maintenance bases, and so on should form separate markets within the airport area. This approach seems logical and proportionate when considering that the same competitive dynamics do not apply to each of parties involved in each elements of the airport operation services, particularly given that, like Heathrow, some parties' conduct is regulated by licence conditions (for example, the ground-handling and NATS licences) while other parties' conduct is not so constrained.

41. However, despite the clear wording of the statute and (in parts) the CAA's suggestion that it will start with a 'focal product or service' (e.g., at paragraph 4.23), in general the Draft Guidance appear to take it as read that the starting point is for the market to include a broad range of services:

    a. at paragraph 4.5 the Draft Guidance states that *'…when assessing market power at an airport as a whole, we will usually consider the overall bundle of AOS services and then determine the relevant market in which the airport offers those services…'*;

    b. at paragraph 4.10 the Draft Guidance states that *'…in defining the focal product in respect of which the airport area may have SMP, we will begin by looking across a bundle of goods and services and, where necessary, review differing subsets of products or services at the airport. We do not intend to start from a product-by-product inspection of the airport operator's position unless there is good reason to do so. This work would be both incredibly detailed and burdensome and may be of limited benefit, given the purpose of the analysis, as*

explained in paragraph 4.5. Instead, we propose to take a higher-level view of the airport operator's general market position'; and

c. at paragraph 4.16 the Draft Guidance states that *'there may be characteristics of the airport sector that make it difficult to define the market precisely. In Test A, we will therefore analyse all the competitive constraints faced by the airport operator, regardless of whether they arise from within or outside the relevant market or markets as we have defined them.'*

42. Whilst the CAA indicates in the Draft Guidance that they 'intend to have regard to the applicable Competition and Market Authority (CMA) and European Commission (EC) competition law notices and guidance' (paragraph 1.4) the approach outlined above appears at odds with the CAA's own statutory duties, the competition framework and the practice of other regulators.

43. The guidance from the EC and CMA indicates a process that is very different from that proposed by the CAA. Both the EC and the CMA guidance provide that a narrow market is the correct starting point and the market should only be broadened from that point if various tests are satisfied. For example:

a. paragraph 7 of the EC guidance sets out that: '*A relevant product market comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use*'; and

b. the CMA (previously the OFT) guidance sets out at page 7, paragraph 3.2 that: *'…the market definition process usually starts by looking at a relatively narrow potential definition. This would normally be one (or more) of the products which two parties to an agreement both produce, or one (or more) of the products which are the subject of a complaint about conduct, i.e. the focal product (or focal group of products). Previous experience and common sense will normally indicate the narrowest potential market definition, which will be taken as the starting point for the analysis.'*
[emphasis added]

44. The EC and CMA's approach has been adopted in a number of merger cases. For example, in reviewing the acquisition of BAA plc in 2006, the EC left open the possibility of further sub-segmenting the product market on the basis of type of customer (e.g. FSCs and low cost carriers) or short-haul versus long-haul routes (as suggested by some of the airlines).

45. Other regulators, such as Ofcom, also commence market review assessments with narrow product markets and expand outwards from a focal point based on demand-side or supply-side substitutability.

46. In addition to the above, the CAA's own approach appears to be internally inconsistent. The proposed approach to market definition at paragraphs 4.5 and 4.10, appears difficult to reconcile with later statements regarding the CAA's approach. For example, paragraphs 4.17-4.18 the Draft Guidance refer to a relevant product market comprising of 'all those products and/or services that are regarded as interchangeable

or substitutable for the focal product by the consumer by reason of the products' characteristics, their prices and their intended use' and the impact of the hypothetical monopolist test in discerning groups of customers, each of whom may form a separate market.

47. Accordingly, the Draft Guidelines require redrafting to ensure that the CAA's starting point is an appropriately narrow focal product so that its analysis will properly reflect the differences in competitive conditions between (for example) surface or origin and destination segments, and connecting/transfer sections of the passenger population.

Geographic market

48. Where the guidance sets out how the CAA will define a geographic market, the CAA fails to address vital considerations when determining whether an area in which the relevant services are supplied has competitive conditions which are sufficiently homogenous.

49. Paragraph 4.20 of the Draft Guidance sets out that 'there may be different relevant markets for different groups of users if they are considered in a separate product market'. However, the Draft Guidance offers no explanation of how this will be done and how the CAA might go about the process of assessing competitive differences between different passenger and cargo routes.

50. The Draft Guidance should set out clearly how the CAA will undertake this analysis, for example whether different passenger and cargo routes have different barriers to entry, a different number of operators competing, market share, price differentials and other evidence of geographical differences in the market and what the outcome of those assessments means.

Temporal market

51. Heathrow notes the CAA's observation that it might be necessary to differentiate across seasons and/or between peak and off-peak travel times.

52. When considered from a passenger (or retail market) perspective, Heathrow considers it entirely appropriate for the CAA to consider whether to define markets on a temporal basis. This is consistent with the approach taken by comparable regulators: for example, in the rail transport sector, it is well-accepted that many business passengers have to travel at certain times and will pay higher fares to travel during those times; whilst leisure customers will travel off-peak in order to reduce the cost of travel. In light of this, the price of commuter fares, certain long and short distance journeys, and 'anytime' day flexible fares are regulated; whilst advance fares, off-peak fares for short-distance travel, first class fares and anytime long-distance return fares are not. This type of regulation has arisen from the regulator developing a more sophisticated understanding of passenger demand and, specifically, demand elasticity between different times and for different groups of consumers.

53. In order to the CAA to fully understand the implications of peak and off-peak travel on its market assessment, it must conduct market research to properly understand the

impact of passenger demand on the wholesale market. Heathrow considers it likely that this would result in more proportionate and differentiated regulation.

Conclusion

54. On the basis of the above, Heathrow is concerned that the CAA's Draft Guidance on the market assessment is likely to lead the CAA into error. It is inappropriate for the CAA to dismiss the need to undertake a rigorous analysis based on established competition law principles, for example by citing that adopting narrow market definitions may be too 'burdensome'. Should the CAA's approach fall short of what it is required, its decisions would be left open to challenge.

Assessing market power

55. The CAA lists at a high level the factors that it may consider when assessing market power. However, these factors are dealt with relatively superficially. The Draft Guidance also doesn't appear to acknowledge the other factors the CAA should be having regard to when making a decision about market power.

56. Specifically, the CAA's approach to assessing countervailing buying power is inadequate and runs the risk of rending the market power determination assessment incomplete and ineffective. For example, the CAA's approach fails to take into account the competitive distinctions between airports and other factors that affect the buying power of the airlines at those airports.

57. In Heathrow's view, it is appropriate for the CAA, when considering countervailing buyer power of an airport, to review evidence relating to airlines' conduct and how it impacts on the competitive conditions at the airport, for example:

    a. Evidence on behaviour: historic and future;

    b. Evidence on prices/profitability;

    c. Economies of scope and scale;

    d. Impact of sunk costs at an airport;

    e. Elasticities in demand;

    f. Exclusionary behaviour – such as the offering excessive discounts; and so on.

58. Consideration of these factors is essential to ensure the CAA's market power determination assessment is robust and defensible. We would urge the CAA to consider comparable guidance issued by other regulators and the EC in order to illustrate the level of detail, specificity and certainty that stakeholders are entitled to expect in guidance about how market power will be reviewed. For example, the EC's

guidance on assessment of market power in electronic communications itself comprises 156 paragraphs and 26 pages (including notes).[6]

Lack of Certainty

59. As with other parts of the Draft Guidance, Heathrow has a general concern regarding the removal of detail regarding the proposed process for implementing Test A. The current draft sets out very little detail about the process the CAA will follow – far less than in the existing guidance.

60. This represents a significant step backwards and this appears to have privileged the CAA's desire for flexibility at the expense of the usefulness of the Draft Guidance for all other stakeholders. This lack of functionality is problematic as it creates inherent uncertainty regarding the regulatory processes that the CAA will be adhering to when conducting market power assessments in the future.

61. In accordance with the *Better Regulation Principles* and section 1(4) the Act the CAA must ensure that its regulated activities are 'carried out in a way which is transparent, accountable, proportionate and consistent'.' As the regulator, the CAA is aware of the importance of maintaining and reinforcing regulatory certainty (or consistency) in the market. Accordingly, the Draft Guidance should seek to achieve this objective and should clearly set out the market power assessment process including the principles the CAA will follow, the factors it will take into account and the way in which it is likely to treat those factors and different types of evidence. This clarity will assist Heathrow (and other stakeholders) to understand the regulatory landscape, which in turn will assist developing business and investment plans, as well as providing investors with confidence in the market and regulatory process. Heathrow therefore urges the CAA reconsider its approach.

Time period over which the assessment takes place

62. Finally, when setting out the CAA's general approach to how Test A is met, at paragraph 4.8 and Table 4.1 of the Draft Guidance, the CAA explains that the test includes a forward-looking element which looks at whether the airport operator is 'likely to acquire SMP in the future'. The CAA also set out that it will review potential scenarios where CAA expects that an airport operator's 'SMP is likely to diminish over time, such that we do not consider that the airport operator will have SMP in the future' (paragraph 4.9).

63. However, the CAA does not define the timeframe of this forward-looking assessment. If the CAA is truly planning to make such a forecast of expected or foreseeable events that are likely to impact on its assessment of the market, it is wholly appropriate for the

[6] *Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services*(2002/C 165/03).

CAA to stipulate the timeframe under review. In order to ensure regulatory certainty, it is vital that the CAA be clear about the number of years covered by its forward-looking assessment.

64. Market reviews published by other regulators specify the time period the assessment is intended to cover. For example:

    a. In the telecommunications industry, the regulatory framework (namely the Framework Directive) sets out that Ofcom shall carry out its analysis of the relevant market within three years from the adoption of the previous measures relating to the market in question (Article 16(6)(a)). This is a relatively short period as market conditions are constantly changing (for example, due to the emergence of new technologies). Therefore, it is necessary to conduct market reviews more frequently so as to ensure that the regulation remains current and adapts to market conditions.

    b. In the energy market, there is significant investment in infrastructure by stakeholders but assets typically have much longer lives of 50 years or longer. This has resulted in a more static market and a requirement for a much higher degree of regulatory certainty. Consequently, Ofgem has recently moved from a five-year price control review period (under the DPCR5 framework) to an eight-year review period (under the RIIO-ED1 framework). Ofgem's 'ED1 Price Control Financial Handbook' explains the reason for this change as being because it 'provides for a longer period of price control arrangements with the aim of facilitating improved strategic planning and a long-term approach to electricity distribution infrastructure management' (page 2). In order to deal with the potential for greater uncertainty that arises from longer price control periods, there is an option to conduct a mid-point review of output requirements (except for key financial parameters as set out in the price control) under certain circumstances.

65. Airport infrastructure, like energy network infrastructure, requires significant investment and fixed assets have long lives – much longer than would be expected in mobile networks, for example, where the last ten years have seen multiple generations of mobile technologies. Heathrow's average asset lifespan is approximately 25-30 years. This requires Heathrow and other airports to make capital plans on a long-term basis and to have the utmost confidence in the stability of the regulatory regime. Licence Condition B2 is already in place and provides a useful backstop by permitting a market power assessment to be reopened at any time should there be a material change, but the market power assessment at least needs to be sufficiently forward-looking to cover entirety of the intended price control period. In Heathrow's view, the CAA should therefore conduct its assessment with a long term view of at least 7 years, to address the 5-year period of the next price control and a 2-year period to address the timeframe between commencing the market power determination process and the start of the next price control.

Test B – Insufficiency of competition law

The burden of proof

66. The CAA's proposed approach starts from the wrong assumption – that competition law will not be sufficient. It is inappropriate to start with this assumption. It is also difficult to reconcile with the CAA's duty to act in a way that is proportionate and 'targeted only at cases where action is needed' (paragraph 2.31).

67. Further, the Draft Guidance offers no explanation of how the CAA will assess the detriment to consumers of not implementing ex ante regulation. Again, this appears to reflect a mere assumption that detriment to airlines automatically and necessarily represents a detriment to passengers and cargo owners. No evidence is provided in the Draft Guidelines to this effect and, as the CAA has itself acknowledged, the incumbent airlines enjoy valuable slot rights at Heathrow, having the freedom to set airfares at a market clearing price, while paying Heathrow charges which are (in light of Heathrow's capacity constraints) substantially below the market clearing price. In this context, it is not at all self-evident that consumers benefit from ex ante regulation, rather than such regulation allowing airlines to increase their own profitability.

The meaning of competition law

68. Section 6(9) of the Act specifically provides that, for the purposes of considering whether competition law would provide sufficient protection against the risk that an operator may engage in an abuse of its substantial market power, 'competition law' means:

    a. Articles 101 and 102 of the Treaty of the Functioning of the European Union;

    b. Part 1 of the Competition Act 1998; and

    c. Part 4 of the Enterprise Act 2002, which deals with market investigations.

69. Despite the express inclusion of the market investigation regime as part of 'competition law', the Draft Guidance appears to pre-empt a conclusion that the regime will not be relevant to assessing whether there is sufficient protection against abuses of substantial market power. The Draft Guidance states that the regime is:

    > *not designed to guard against the risk of an abuse of dominance, as the market provisions were developed to tackle structural rather than behavioural issues. In addition, market investigations … are based on an assessment of an adverse effect on competition, rather than a finding of an abuse of a dominant market position ...*

70. Heathrow has several significant concerns with this commentary:

    a. First, the market investigation regime is expressly included in the Act as one of three regimes which the CAA is required to consider. In passing the Act, Parliament clearly made the judgement that this regime was relevant and could, in certain circumstances, be sufficient to address potential abuses of a dominant market position. The dismissal of this regime in the Draft Guidance seems to implicitly suggest that Parliament was mistaken in treating the market

investigation regime as relevant. The CAA's duty is to administer the Act in accordance with Parliament's intention and therefore we do not believe it is open to the CAA to adopt an approach which treats provisions of the Act as irrelevant.

b. Secondly, contrary to what the Draft Guidance suggests, the market investigation regime is very capable of addressing behavioural issues. It is not entirely clear why the CAA draws a distinction between 'behavioural' and 'structural' issues – this is a distinction typically drawn in connection with *remedies* rather than *underlying issues*, since almost all competition issues have both structural and behavioural reasons (and many market investigations do result in behavioural remedies). But in any event, the Enterprise Act specifically directs that a 'feature … of a market' which might give rise to a market investigation reference includes:

> *(a) the structure of the market concerned or any aspect of that structure;*
>
> *(b) <u>any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned</u>; or*
>
> *(c) any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.*[7] [emphasis added]

c. It is therefore inaccurate to say that the provisions were only directed at addressing structural issues: conduct of market players was expressly contemplated. Indeed, there is a significant body of cases in which the CMA (or its predecessors) have successfully used the market investigation process to remedy behavioural issues. For example, these include the BT undertakings. Ofcom recently specifically identified that the underlying issues intended to be addressed by BT's undertakings were both structural (i.e. BT was vertically integrated) and behavioural (i.e. its market power gave it the ability to discriminate against competitors):

> *We recognised that BT's <u>market power and vertically integrated structure</u> gave it both the incentive and the ability to discriminate against competitors. We suggested that any solution would require a combination of equivalence at the product level, and behavioural change by BT.*[8] [emphasis added]

In addition, numerous CMA inquiries are addressing or have addressed behavioural issues in markets without there necessarily being underlying structural issues such as vertical integration. These inquiries include the current retail banking market investigation; the private healthcare market investigation (which found that HCA was able to price excessively); and the energy market investigation.

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[7] Enterprise Act 2002 s 131(2).
[8] Ofcom, *Strategic Review of Digital Communications: Discussion Document* (16 July 2015) paragraph 1.34.

d. Thirdly, the market investigation regime is not less relevant because it assesses adverse effects on competition, rather than abuse of a dominant market position. If anything, the test of 'adverse effect on competition' is *less* onerous and would encompass *more* types of conduct than abuse of a dominant market position – in particular, because it does not require any finding of substantial market power. Conversely, it is difficult to envisage an abuse of a dominant market position which would *not* produce an adverse effect on competition. Under the Enterprise Act:

> *there is an adverse effect on competition if any feature, or combination of features, of a relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom*.[9] [emphasis added]

The CMA has said that it:

> *interprets the phrase 'prevents, restricts or distorts' in the Act broadly to cover any adverse effect on competition, whether actual or potential. It will therefore consider features that affect potential competition in a market (for example, by preventing entry and expansion) as well as those that affect the existing market situation.*[10] [emphasis added]

e. Fourthly, the CAA does not appear to have referred to important case law such as the 2011 *Purple Parking Ltd v Heathrow Airport Ltd* case, which demonstrates that competition law may enable airport users to obtain redress in cases of alleged abuse of market power.

71. Accordingly, the Draft Guidance on Test B is in need of significant revision. Potential and actual abuses of a dominant market position can be – and have been on many previous occasions – successfully dealt with by way of remedies imposed following a market investigation. Heathrow considers that the Draft Guidance needs to be significantly reworked to appropriately reflect this.

Use of case law

72. In assessing the sufficiency of competition law, the Draft Guidance relies heavily on previous case law and, specifically, 'the extent to which there has been scope for dealing with particular types of abuse on the basis of previous case law'.[11] Indeed, the Draft Guidance suggests that this approach is inherent in the Act:

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[9] Enterprise Act 2002 s 134(2).
[10] Competition Commission, *Guidelines for market investigations: Their role, procedures, assessment and remedies* (CC3) (April 2013) paragraph 29. This document was subsequently adopted by the CMA board.
[11] Draft Guidance consultation document, paragraph 18.

Test B … assesses the risk of addressing various forms of anti-competitive behaviour by referring to case law. Case law illustrates how competition law has been used and how effective it has been (paragraph 2.32).

73. Contrary to what the Draft Guidance implies, there is nothing in the text of the Act that compels the CAA to look only at previous case law. Heathrow considers that this approach is misguided.

74. The test is intended to be future-looking: it addresses whether competition law will provide sufficient protection against the risk of an abuse of substantial market power *in future*. However, the CAA's approach is backwards looking and appears to give significant weight to whether or not there are previous cases which successfully addressed a similar issue. There are many reasons why past case law may not provide a sufficient or accurate understanding of the sufficiency of competition law. For example:

    a. There have been significant recent changes to the competition law regime in the UK, most notably the Consumer Rights Act 2015. This Act amends the collective action regime and expands the role of the Tribunal to hear standalone actions for damages. Such changes are intended (among other things) to encourage greater private enforcement of competition law, and follow changes in 2014 which resulted in the establishment of the CMA. Further reforms will undoubtedly occur in future. A reliance on past case law will therefore not adequately represent the prospect for future cases.

    b. The problem is compounded because the CAA appears to imply in the guidance that it will only look at case law at the time the guidance was prepared, not subsequent cases (paragraph 2.28). Clearly, to the extent any case law <u>is</u> considered, it is appropriate that the CAA take into account all relevant cases and ensure its understanding of the case law is up-to-date. The guidance should expressly state that the CAA will do so.

    c. Even assuming that current and prospective case law was considered, there are a significant number of factors that litigants, including public regulators, take into account when deciding whether to bring competition law complaints. These include resource prioritisation, the harm the conduct causes, commercial and strategic considerations, and options to address the harm without resorting to litigation ending in a finding of a competition law contravention and remedies – all of which may affect the existence and volume of previous case law without necessarily reflecting or influencing the actual prospects for success. In particular, the mere threat or commencement of competition law proceedings or enforcement action may in many cases be sufficient to persuade a firm to change course. A paucity of case law in these situations can actually *increase* the willingness of firms to accept an agreed settlement, since it means the outcome of any proceedings is more uncertain. An emphasis on the successful application of competition law in past cases, as proposed in the Draft Guidance, will take none of this into account.

75. The approach adopted by the CAA is markedly different from that adopted in the telecommunications sector, where Ofcom conducts a higher level assessment of whether competition law would be sufficient before imposing SMP remedies in a market not identified by the EC as susceptible to ex ante regulation. Ofcom's approach does not rely on whether there happens to be specific case law on point. It instead addresses the more fundamental reasons why competition law rather than ex ante remedies might be appropriate in the particular circumstances. For example, the relevant EC recommendation explains that:

> *Competition law interventions are likely to be insufficient where for instance the compliance requirements of an intervention to redress persistent market failure(s) are extensive or where frequent and/or timely intervention is indispensable*.[12]

76. The explanatory note further notes that:

> *where the regulatory obligation necessary to remedy a market failure could not be imposed under competition law (e.g. access obligations under certain circumstances or specific cost accounting requirements), where the compliance requirements of an intervention to redress a market failure are extensive and must be maintained over time (e.g. the need for detailed accounting for regulatory purposes, assessment of costs, monitoring of terms and conditions including technical parameters and so on) or where frequent and/or timely intervention is indispensable, or where creating legal certainty is of paramount concern (e.g. multi-period price control obligations).*[13]

Costs of reliance on competition law are not relevant

77. The explanatory note also notes that differences between competition law and ex ante regulation 'in terms of resources required to remedy a market failure should not in themselves be relevant'. Heathrow considers that this principle should also be reflected in the Draft Guidance, given that:

    a. the test set out in the Act is addressed at the *outcome* and *potential effectiveness* of competition law on the market, not the level of resources required by the enforcing party; and

    b. if the CAA was required to have regard to the costs of reliance on competition law, this would needlessly duplicate the requirements of Test C. As explained below, Test C requires the CAA to assess and balance the costs and benefits of alternative regulatory interventions, including (but not limited to) reliance on general competition law.

[12] EC, Recommendation on Relevant Markets (9 October 2014) recital 16.
[13] EC, Recommendation on Relevant Markets – Explanatory Note (9 October 2014) page 11.

Conclusion

78. In summary, Heathrow considers that, rather than engage in an extensive examination of the specific facts and findings in the case law, it would be more appropriate for the CAA to assess the overall context in which regulation is proposed. The CAA would need to be satisfied, for example, that the only feasible remedy is an ex ante remedy that required extensive, timely or repeated interventions in the market, and where such a remedy could not be imposed under competition law. This is a particularly significant requirement given the possibility, which the CAA is specifically required to consider, of referring the matter to a market investigation where broad remedies would be available. We consider that the approach set out above would provide a more appropriate and accurate assessment of whether competition law is sufficient.

Test C – Benefits and adverse effects of economic regulation

79. In general, Heathrow agrees with the CAA that it should assess whether the benefits of regulating an operator by means of a licence are likely to outweigh the adverse effects by way of an impact assessment, balancing the cost and benefits of regulatory intervention cost-benefit analysis. Heathrow also agrees that the conclusion in the Draft Guidance that the Act requires a 'proportionality exercise to … ensure that ex-ante regulation via a licence is only imposed where it is suitable, necessary and proportionate' (paragraph 6.13).

80. Our over-riding concern here is that the CAA appears to consider the impact assessment exercise to be primarily one of judgment. We disagree. The whole point of the exercise is that it should be empirical – it should rely on data. It is, essentially, an exercise in quantification to the extent possible. There is little room for judgement here and, indeed, it should be the CAA's role to minimise the scope for judgement by, for example, commissioning suitable research and using its formal information gathering powers.

An impact assessment should reflect best practice

81. However, best practice in conducting an impact assessment has been clearly established in various standards and documents, given the accepted role of such assessments in informing policy and decision making. Some aspects of the Draft Guidance appear consistent with this best practice, such as the commitment in the CAA's Draft Guidance that 'where it is reasonably practicable to quantify the respective benefits and adverse effects, we will do so' (paragraph 6.5). However, there appear to be other aspects of the Draft Guidance that fall short of this standard. While we address some of these specific issues below, we believe it would be appropriate for the Draft Guidance to commit to follow best practice in performing impact assessments in general. The Draft Guidance could, for example, provide that the CAA will reflect the standards set out in:

    a. the EC's *Better Regulation Guidelines* (2015), Chapter III of which sets out Guidelines on Impact Assessments;

    b. HM Treasury's *Green Book: Appraisal and Evaluation in Central Government*; and/or

    c. best practice and guidelines from other regulators such as Ofcom.

82. In reviewing these documents, it is apparent that the Draft Guidance does not adequately address all steps in the impact assessment process, such as:

    a. assessing the scale, cause and consequences of the problem (i.e. the existence of substantial market power). As the EC has acknowledged, 'high quality policy

proposals are built on a clear problem definition and understanding of the underlying factors and behaviours';[14]

b. the specific objectives of policy action should be identified so that there is a baseline against which to assess the benefits of regulation; and

c. the impact assessment needs to specifically assess the costs and benefits of economic regulation via licence against the available alternatives, and their respective costs and benefits – which might include not just a 'no change' option, but other credible alternatives such as increasing the CAA's monitoring of market behaviour and increased reliance on alternative regulatory instruments. We address this further below.

Identifying the correct counterfactual

83. The Draft Guidance correctly implies that the relevant counterfactual is not a situation with no regulation, but instead one that contemplates the potential application of competition law and other regulatory tools. These tools may well achieve all or much of the benefit of economic regulation via licence with fewer or lower disadvantages. As the EC has stated:

> *When badly done, [this] tends to be the most criticised [aspect of an impact assessment] and significantly undermines the credibility of the whole exercise and its usefulness for political decision making. Keeping an open mind is important even if, in many cases, the IA analysis may start from an idea, stakeholder view or political statement, about what a policy proposal may look like. Often there is already an existing policy framework in place in the area under analysis and this affects the breadth of choices realistically available but initial ideas should be comprehensively tested in the IA process.*[15]

84. In our view, although Test B is addressed narrowly at the sufficiency of competition law (regardless of the costs associated with reliance) Test C requires the CAA not only to perform a broader assessment of alternative regulatory options but to take into account their costs as well as their potential benefits.

85. In light of the warning from the EC about approaches that appear to have started with a pre-determined outcome, and the proper starting point for the CAA to be against regulation, Heathrow is concerned that the Draft Guidance appears to start from the position that regulatory intervention via a licence is generally preferable. For example:

a. paragraphs 6.25-6.26 of the Draft Guidance outline only the benefits of ex ante licence regulation, and provide no assessment of its disadvantages;

[14] European Commission, *Better Regulation Guidelines* (2015) page 19.
[15] European Commission, *Better Regulation Guidelines* (2015) page 22.

b. paragraphs 6.26-6.28 of the Draft Guidance outline only disadvantages of ex post regimes and express doubt about the effectiveness, remedies available and time required to enforce these ex post regimes; and

c. the generalisations set out in paragraph 6.39, which addresses factors that the CAA would take into account when deciding between ex post or ex ante regulation, contain a number of flaws and appear to make prejudgements to justify the imposition of licence-based regulation.

86. The generalisations and one-sided nature of this section of the Draft Guidelines are inappropriate, and in several cases appear to be factually inaccurate. We explain a number of these inaccuracies below.

87. First, the Draft Guidelines assert that 'ex-post powers are designed to protect the degree of competition that already exists within a market' (paragraph 6.28). Similarly, paragraph 6.39 repeats the assertion that ex post regulation relies on 'historical evidence of abuse that has occurred in an otherwise commercially competitive market'. However:

a. Competition law is perfectly capable of addressing market failures in order to enable effective competition where it does not previously exist: for example, in mid-2015, Ofcom issued a Statement of Objections to Royal Mail plc, setting out the provisional view that Royal Mail had breached competition law by unlawfully discriminating against its competitors, 'increasing barriers to expansion for postal operators seeking to compete with Royal Mail'.[16]

b. The market investigation regime is perfectly capable of addressing issues which have hindered the effective development of competition in a market. For example, the undertakings provided by British Telecommunications PLC were offered to address structural and behavioural issues that had prevented effective competition from developing.

88. Secondly, paragraph 6.39 states that 'ex ante market assessments may be defined in broader terms', whereas ex post regulation adopts 'a relatively narrow view of product markets'. We do not believe this is accurate. As explained above, Ofcom's competition assessments when imposing SMP regulation start by adopting a 'focal product' and expand the market to encompass additional products only where there is compelling evidence to do so (e.g., where the SSNIP test is satisfied). This approach is supported by European-level guidance and clearly represents best practice.

89. Thirdly, the Draft Guidance suggests that ex ante regulation can address market failures (and thereby implicitly suggest that ex post regulation cannot) and allows broader remedies. As explained in paragraph 87 above, ex post regulation is equally capable of redressing market failures and may result in a very broad range of remedies – up to and including the broad set of undertakings to which BT is currently bound and which affect both its organisational structure and its behaviour, and which

[16] http://media.ofcom.org.uk/news/2015/statement-of-objections-royal-mail/.

may well in future reflect a requirement for even stronger organisational separation. It is not, in any event, clear why the Draft Guidance attempts to draw a distinction between 'prohibiting future actions' (which it acknowledges ex post regulation can do) and 'addressing market failures' (which it suggests is the sole province of ex ante regulation).

90. Fourthly, while competition law proceedings may take longer to conclude, this is not always the case. For example, the CAA appears to have disregarded the importance of recent reforms which aim to make it easier for private parties to quickly obtain injunctions to restrain behaviour which may contravene competition law.

Impact on licence conditions

91. Although this issue lies outside the scope of the Draft Guidelines, we would also note that the obligations of proportionality and to perform an impact assessment reflect the need to ensure that any regulation that is imposed via a licence imposes the least possible regulatory burden. For example, it suggests that where different conditions could be adopted, the CAA should generally prefer the one that involves the least intervention and the lowest cost.

Conclusion

92. Accordingly, Heathrow agrees with the CAA that the proper way to proceed with Test C is to conduct an impact assessment. Our concerns are that the Draft Guidance needs to:

    a. properly reflect the need for an objective approach, which relies to the extent possible on quantification rather than being an exercise in regulatory discretion;

    b. explain in considerably more detail the specific steps in the process, such as how the problem (and its scale, cause and consequences) will be identified; the specific objectives of proposed policy action; and the manner in which costs and benefits will be identified, assessed and compared; and

    c. does not start with a pre-determined outcome but instead rigorously assesses the whole range of possible options, instead of relying on generalisations and untested assumptions.

Conclusion

93. Heathrow warmly welcomes the CAA's decision to prepare revised guidance about the application of the market power test. We are hopeful that the end result will be a document which both (i) holds the CAA to a high standard of decision-making; and (ii) provides certainty to the industry about timing and process, and instils more confidence in the outcome of the CAA's analysis. Achieving these goals is in the interests of all industry stakeholders including businesses, investors and passengers.

94. As will be clear from the body of this submission, Heathrow's fear is that the current draft falls well short of achieving these goals. The Draft Guidance in its current form seems likely to perpetuate concerns that the CAA's approach is influenced by 'confirmation bias', such that the application of the market power test is treated as a formality for an outcome which is pre-determined.

95. A revision would offer the opportunity to realign the Draft Guidance, so that its emphasis is on ensuring the CAA adopts a robust, defensible, objective and comprehensive analysis – one which puts the interests of passengers at the heart of the process.

96. Our expectation is that the CAA will consider this submission carefully and make substantive changes to the Draft Guidance in order to reflect our concerns. We would warmly welcome any opportunity to meet with the CAA to discuss further our concerns and how they might be addressed.