



Civil Aviation Authority

Gatwick - Market Power Assessments Non-confidential Version

The CAA's Initial Views – February 2012

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Executive Summary

Rationale and context for the CAA's airport market power assessments

1. Where airports enjoy high levels of market power, it can be appropriate for the CAA to apply economic regulation, so as to improve outcomes for passengers, cargo shippers and airlines.
2. The CAA is committed to ensuring that its regulation of airports promotes choice and value for consumers, whilst also meeting the better regulation principles. In order to deliver on this commitment, during 2011 the CAA embarked upon a project to understand the extent and nature of market power held by the airports that are currently 'designated' for price control regulation: Heathrow, Gatwick and Stansted.
3. This document sets out our work to date to understand the market power held by Gatwick. These views are based on the evidence currently available to the CAA. As noted above, we expect that additional evidence will become available before the CAA takes a firm view on the position of each airport. Reflecting this, there are a number of issues that have been left open and, whilst the CAA has sought to highlight where the airport might sit on the market power spectrum, it has not reached a definitive view at this stage.
4. We would like to thank those stakeholders who have engaged with the CAA during 2011, and invested time and money in providing evidence and analysis.

The market(s) in which Gatwick competes

The relevant market for airlines

5. Gatwick provides services to a range of different airlines, including point-to-point short-haul, charter and long-haul operators, some of whom benefit from passengers who connect between services.
6. Some airlines appear to require a more highly specified product than others, including larger runways, infrastructure for connecting passengers, additional space for differentiated airline products (e.g. lounges, premium check-in services), cargo facilities, higher value catchment and surface access connections and higher passenger awareness for the airport. These are likely to be predominantly full service carriers, in particular those offering long haul services, although some charter business might also meet some of these characteristics.
7. Other airlines, on the other hand, appear to require a less complex, more streamlined and efficient product from the airport, in order to support their business model focused on cost and operating efficiencies that is reflected in lower air fares. These are likely to be predominantly low cost carriers offering short haul services, although some charter business might also meet some of these criteria.
8. The way in which the airport competes for airline business is likely to vary across these market segments. In some market segments, notably for long-haul carriers based at the airport, Gatwick appears likely to compete with

Heathrow for airlines, with the competitive pressure from Heathrow being limited by the capacity constraints that exist at that airport.

9. The airport is also a major base for easyJet and a number of other point-to-point short-haul airlines operating independently of connecting traffic. The airport is a significant base for some of these airlines, who argue that the airport delivers a level of profitability that is difficult to replicate elsewhere. However, these short-haul point-to-point airlines are generally very flexible in their operations, and are likely to face lower costs to reduce their use of any given airport. When competing for the most flexible (i.e. most marginal) airline services, the airport is likely to compete with other airports not only in Greater London and the South East of England but with other UK and potentially European airports. However, Gatwick offers airlines access to a large and prosperous catchment, which will not be available at all airports in this market. Further, in this market segment, the competitive pressure from Heathrow is limited as short-haul point-to-point airlines are unlikely to see Heathrow as a viable alternative to operating at Gatwick.

The relevant market for passengers

10. Gatwick is predominantly used by surface passengers, but after Heathrow still serves the largest number of connecting passengers (8 per cent of Gatwick's passengers). Similarly, the vast majority of Gatwick's passengers travel on domestic and short haul flights; only 21 per cent take long haul flights. But after Heathrow Gatwick still serves the largest number of long haul passengers.
11. Gatwick appears to attract passengers primarily from the Greater London area and the rest of the South East (about 80 per cent of its surface passengers). It also attracts passengers from the East of England and the South West, particularly when attracting passengers to long-haul services. Consequently, there are significant overlaps in the airport's catchment area with Heathrow, Stansted and Luton (and some other smaller airports).

Factors contributing to Gatwick's market position

Market shares

12. Gatwick's passenger market appears to be focused on the South East region, where the airport has a relatively high share of traffic (44 per cent of passengers from this region use Gatwick, constituting 38 per cent of Gatwick's passengers) and evidence suggests a degree of reluctance by passengers to use some other airports.
13. On the other hand, the largest share of Gatwick's passengers comes from the Greater London area (41 per cent, constituting 25 per cent of passengers from this region). The Greater London area is generally more contested than the South East region, and Heathrow holds a significantly higher passenger share (45 per cent) than Gatwick.
14. In the market(s) for passenger airlines Gatwick's market shares depend on which airports airlines regard as suitable substitutes for Gatwick, as discussed above. Market shares are therefore of limited explanatory value in

the context of airport markets. It is likely that the relevant market for most airlines operating at Gatwick stretches beyond the London area, involving other airports across the UK and for some airlines possibly also across the EU. In the UK Gatwick is the second largest airport by quite a margin, with Heathrow remaining the largest airport with about 22 per cent of flight movements. However, as many airlines operating from Gatwick might not regard Heathrow as a viable substitute, when excluding Heathrow from the analysis, Gatwick is the largest UK airport, but only with 14 per cent of all flight movements.

15. Further, when we consider how passenger-facing and airline-facing aspects interact, it suggests that the airport might have a particularly strong market position in some market segments. For example, it has a relatively strong market position when competing for point-to-point (no frills and charter) services serving passengers in the South East of England, as well as outbound holiday passengers.

Airline switching

16. The evidence gathered in the course of our assessment suggests that airline switching costs can differ significantly for different airlines. At one extreme, a full service carrier providing premium services, long haul routes and a degree of network dependency that has based a large share of its business at Gatwick is likely to face significant switching costs that would include sunk investments (that would need to be replicated at another airport) and a loss of network effects/economies of scale. At the other extreme, a low cost carrier whose point-to-point short haul business is highly geared towards operational efficiency and flexibility might not face these types of switching costs, at least not to the same degree.
17. Further, a number of airlines stressed the higher yields earned at Gatwick, explaining that the reduction in yield experienced when switching away from Gatwick contributed to the airport's market position. To assess fully the likelihood of airlines switching away from Gatwick in response to a price increase, and therefore the degree of Gatwick's market power vis-à-vis airlines, we need to understand better the magnitude of yield losses caused by switching away from Gatwick. We will be engaging further with stakeholders on this specific issue following the publication of this assessment.
18. Linked to this, Gatwick argued that the current price controls keep its prices at the airport artificially low, inflate airlines' route profitability, and increase the apparent market power of the airport. In order to assess these arguments, it is necessary to take a view on whether the current price cap keeps prices significantly below the level that would be seen in a competitive market. Whilst Gatwick presented evidence that supports their view, it was not sufficiently compelling to allow the CAA to conclude that this was the case (but equally, this is an issue that would need to be looked at again in the context of any revised price caps that were to apply at Gatwick beyond April 2014).

Passenger switching

19. Most of Gatwick's passengers appear to have a real choice between different London airports, with 76 per cent of short haul routes served from Gatwick also being served from other London airports. However, there is a lower degree of overlap for long haul routes, with only about 40 per cent of Gatwick's long haul routes also being served from Heathrow. No other London airport currently serves more than one long haul route.¹ This suggests that while passengers have, in principle, a reasonable choice of airports for short haul flights, passengers' options to use other airports are limited for long haul flights.
20. However, there is evidence to suggest that some passengers do not view Stansted airport as a particularly close alternative to operating at Gatwick, albeit that both airports have significant catchment overlaps. There are a number of possible explanations for this. The main reason cited by airlines is the inability to realise the same level of yields at Stansted as at Gatwick; with some regarding the two airports operating in distinct catchments.
21. Joint ownership of Stansted and Heathrow by BAA may have reduced Stansted's efforts to differentiate its service offering and to adopt innovative and aggressive strategies to raise passenger awareness of the airport and its relative strengths. Alternatively, the apparent unwillingness of passengers currently using Gatwick to travel to Stansted might reflect relative weaknesses in the surface access options offered to passengers, such as the congestion and cost associated with travelling to Stansted from South London, Kent and Sussex.

Airport behaviour and performance

22. Gatwick argues that its conduct since its sale by BAA is consistent with that of a competing airport, with improved service quality, greater efficiency and more competition to attract airlines to the airport.
23. It is certainly the case that the airport's conduct has changed and that – in a number of important ways – has delivered real improvements to airlines and passengers. Whilst not agreeing with every example of improvements, airlines generally accepted that these changes had been positive overall.
24. However, this is not sufficient to find that Gatwick no longer holds any SMP:
 - First, whilst some of this evidence supports the view that the airport is competing for passengers and for airlines more than it once did, the airport might still have SMP and sufficient market power to require economic regulation.
 - Second, it could also be argued that any change in conduct was driven by the change of owner attempting to maximise the return on its investment, rather than being driven by a step-change in the level of competition faced by the airport. It is difficult to distinguish this from changes brought about by increased competition.

¹ BA currently serves New York from London City Airport with a business-only aircraft, and EZY currently serves Tel Aviv, Sharm-el-Sheikh and Marrakech from Luton.

- Third, there is mixed evidence on the extent to which there has been a significant change in the airport's incentive to compete for airline business. In particular, whilst the airport emphasises its successes in attracting a number of airlines to the airport, including a mix of short and long-haul operators, the previous owner successfully attracted growth from easyJet, and a number of other carriers. A number of incumbent airlines based at the airport have also stressed that they have not been offered the discounts available to some new carriers. There is, therefore, mixed evidence as to whether recent trends represent a clear break from the past.
25. To the extent that ownership changes have affected the degree of competition faced by Gatwick, there is still a lack of sufficient evidence to support a clear, unambiguous decision on the airport's market power. The airport has been in separate ownership from Heathrow and Stansted for only a little more than two years, limiting the amount of information available about the airport's conduct.

The CAA's initial view on the degree of Gatwick's market power

26. On the basis of the evidence available to the CAA for this assessment, there is a reasonable prospect that Gatwick will hold overall substantial market power beyond the end of the current price control. Although the ownership change is benefitting passengers and airlines, the airport continues to have a strong market position that appears to derive, in particular, from its locational advantage, serving a large and wealthy catchment area and having good surface access infrastructure to London and within the South East of England. Its traffic has traditionally focused on outbound holiday passengers that still represent the largest passenger share, and Gatwick has (after Heathrow) the largest number of long-haul services in the UK. The higher yields airlines can achieve from this catchment means that airlines might face higher switching costs (loss of yield) when switching to other airports, therefore increasing Gatwick's market power over airlines.
27. On the other hand, however, there are clear competitive interactions;
- passengers have generally a wide choice between the London airports and neighbouring smaller airports;
 - LCC and, to a lesser degree charter carriers – that represent the majority of Gatwick's airline customers – tend to have lower switching costs. This is likely to allow them to switch airports more quickly than FSC, potentially increasing the competitive constraints on Gatwick; and
 - FSC tend to have a clear preference for Gatwick's nearest competitor airport, Heathrow, where capacity at Heathrow can be secured.
28. Overall, while Gatwick appears to still hold SMP on the basis of the evidence currently available, we are not able to come to a definitive finding at this stage and there are a number of issues that we need to assess further, in particular:

- additional evidence on the switching costs faced by airlines at Gatwick, including the extent to which yields might fall when moving services away from the airport;
 - whether there is evidence that the competitive pressure from Stansted represents a significant constraint on Gatwick's conduct; and
 - the emerging evidence on the extent to which other UK airports can attract passengers and airlines away from Gatwick.
29. We would hope to be able to work with airlines and the airport to obtain better information to reach a firmer view on all of these factors.

Way Forward

30. We welcome stakeholders' views on the information presented in this paper. The CAA is consulting during 2012 on its views, and will continue to work with stakeholders to develop its analysis and to resolve the issues that have been left open at this time. Information about the consultation process, contact information and the dates for a seminar are set out in chapter 1.

1. Introduction

- 1.1 This is the non-confidential version of the CAA's Initial Views on the degree of Gatwick's market power. Excisions from the text are marked with [X].

Rationale and context for the CAA's airport market power assessments

- 1.2 Where airports enjoy high levels of market power, it can be appropriate for the CAA to apply economic regulation, so as to improve outcomes for passengers, cargo shippers and airlines. This regulation currently takes the form of a cap on the prices charged by the airport and a series of financial incentives and other obligations to encourage efficient operation, appropriate service quality and efficient investment.
- 1.3 Most UK airports are not subject to this form of economic regulation. Airports are only subject to this regulation if they have (or are likely to have) 'Substantial Market Power' and if economic regulation is likely to improve outcomes. Further, when airports are subject to such economic regulation, it can take a number of forms, and be tailored to the extent and nature of market power.
- 1.4 The CAA is committed to ensuring that its regulation of airports promotes choice and value for consumers, whilst also meeting the better regulation principles. In order to deliver on this commitment, during 2011 the CAA embarked upon a project to understand the extent and nature of market power held by the airports that are currently 'designated' for price control regulation: Heathrow, Gatwick and Stansted. This work also addresses the Competition Commission's view that the CAA should keep competition between airports under review, and that the economic regulation of Gatwick and Stansted might need to adapt to facilitate competition.²
- 1.5 These assessments will inform the CAA's views on whether these three airports should continue to be subject to economic regulation, including whether – under the proposed reforms set out in the Civil Aviation Bill (2012) – these airports should be required to hold an economic licence. The work will also allow the CAA to work with stakeholders in developing future regulation of these airports that protects consumers.
- 1.6 We set out below the initial findings of our work to date to understand the market power held by Gatwick. These views are based on the evidence currently available to the CAA. As noted above, we expect that additional evidence will become available before the CAA takes a firm view on the position of Gatwick. Reflecting this, there are a number of issues that have been left open and, whilst the CAA has sought to highlight where each airport might sit on the market power spectrum, it has not reached a definitive view on the airport at this stage.

² Competition Commission *BAA Airports Market Investigation – Final Report*, March 2009, paragraph 10.339. <http://www.competition-commission.org.uk/our-work/baa-airports/final-report-and-appendices-glossary>

- 1.7 We would like to thank those stakeholders who have engaged with the CAA during 2011, and invested time and money in providing evidence and analysis.

The CAA's approach to the assessing airport market power

- 1.8 In reaching an initial view as to the degree of market power of Heathrow, Gatwick and Stansted, we have followed the approach set out in the CAA's *Guidance on the assessment of airport market power*³.
- 1.9 There has been extensive stakeholder engagement, including with the three regulated airports as well as Luton and Manchester, and the main airlines of Heathrow, Gatwick and Stansted. This engagement has taken the form of:
- meetings with stakeholders to discuss relevant evidence;
 - stakeholder feedback and discussion on work in progress;
 - the submission of evidence by stakeholders;
 - some stakeholders, including both airports and airlines, have commissioned reports by economic consultancies; and
 - the CAA's stakeholder workshop held on 15 November 2011 to set out its emerging views.
- 1.10 We have also published a number of working papers in 2011:
- on the general market context⁴;
 - catchment area analysis⁵; and
 - passengers' airport preferences⁶.
- 1.11 While undertaking the market power assessments, we also sought the advice of an economic and a legal consultant.
- 1.12 The initial views expressed in this assessment are based on the evidence currently available to us. We expect that additional evidence will become available before we take a firm view on the position of each airport. Reflecting this, there are a number of issues that have been left open and, whilst we have sought to highlight where each airport might sit on the market power spectrum, it has not reached a definitive view on each airport at this stage.
- 1.13 We would like to thank those stakeholders who have engaged with us during 2011, and invested time and money in providing evidence and analysis.

³ CAA *Guidance on assessing airport market power* April 2011

<http://www.caa.co.uk/docs/5/Final%20Competition%20Assessment%20Guidelines%20-%20FINAL.pdf>

⁴ CAA *UK Airports Market – General Context* September 2011

<http://www.caa.co.uk/docs/5/20110905%20Market%20Context-FINAL.pdf>

⁵ CAA *Catchment area analysis* October 2011

<http://www.caa.co.uk/docs/5/Catchment%20area%20analysis%20working%20paper%20-%20FINAL.pdf>

⁶ CAA *Passengers' airport preferences – Results from the CAA Passenger Survey* November 2011

<http://www.caa.co.uk/docs/5/Passenger%20survey%20results%20-%20FINAL.pdf>

Way Forward

- 1.14 We welcome stakeholders' views on the information presented in this paper. There are two periods over which interested parties can engage with the CAA:
- Those wishing to share their **initial views** with the CAA should aim to submit any material to the CAA **by 24 March 2012**, so that these can inform the CAA's next Q6 price control publication, which is scheduled for April 2012.
 - Those wishing to engage on the **detail of the competition assessments** are invited to engage with the CAA **during 2012**, so that any additional evidence and analysis can be incorporated in an updated assessment of airport competition, scheduled for publication in late 2012/early 2013.
- 1.15 If you would like to discuss the contents of this paper, and the CAA's work on assessing airport competition, in the first instance please contact Alina Jardine Goad on 020 7453 6229 / alina.jardinegoad@caa.co.uk or Alexander Düнки on 020 7453 6212 / alexander.dunki@caa.co.uk. You can also contact Chris Hemsley on 020 7453 6237 / chris.hemsley@caa.co.uk.
- 1.16 If you would like to discuss the economic regulation of Heathrow, Gatwick and Stansted, including the Q6 work programme, please contact Richard Moriarty on 020 7453 6203 / richard.moriarty@caa.co.uk.
- 1.17 The CAA will also be hosting a **seminar**, to take forward the work on price control design for Gatwick, on **6 March 2012**. The output of these seminars – and other discussions with stakeholders – will be brought together into a publication in April 2012, which will frame the debate on the development of regulation and, where appropriate, support the process of Constructive Engagement. If you would like to register your interest in the seminars, please contact Barbara Perata-Smith, on 020 7453 6202 or Barbara.PerataSmith@caa.co.uk.
- 1.18 There will also be an opportunity to engage on the CAA's initial views on airport market power during 2012, which will also allow the CAA to work with stakeholders to narrow down those areas of uncertainty that currently exist. Stakeholders will also be able to submit further evidence – and comment on the CAA's initial views – during this period. At this stage, the CAA expects to publish its next substantive analysis of airport market power in late 2012/early 2013.

2. The market(s) in which Gatwick competes

Introduction

- 2.1 This chapter describes Gatwick's business, its infrastructure and the customers it serves. It looks at the varying requirements of different customer groups and then goes on to analyse the product and geographic markets for Gatwick.
- 2.2 Reflecting the importance of the linkages between Gatwick's various customer groups, the final section of this chapter brings together the previous sections and draws out the implications of these interrelations for market definition.

Gatwick's business

- 2.3 Gatwick provides infrastructure and infrastructure services to its various groups of users, including passenger airlines, passengers, and cargo carriers. Each of these user groups has its own characteristics and infrastructure and service requirements from Gatwick, which are described below.

Provision of products and services to passengers

- 2.4 Gatwick provides a bundle of infrastructure and infrastructure services to passengers essential for access to passenger flights, including:
- aeronautical services, including security clearance, flight information, baggage process facilities and surface access infrastructure; and
 - non-aeronautical services, including retail space and car parking.⁷
- 2.5 Gatwick does not directly charge passengers for the aeronautical products and services it provides them.⁸ However, it nevertheless supplies a number of essential and non-essential services to passengers and can vary its offering in ways that vary the attractiveness of the airport to passengers.

Provision of products and services to passenger airlines

- 2.6 Gatwick provides aeronautical and non-aeronautical infrastructure and infrastructure services to passenger airlines. This includes essential facilities and services for the handling of aircraft, passengers and bellyhold cargo.
- 2.7 These services include:
- aircraft-related aeronautical services (e.g. facilities for landing, parking, and taking-off of aircraft);
 - airline-facing non-aeronautical services (e.g. information technology services, check-in desks and utilities); and

⁷ A fuller list of these services is set out in the annex published alongside this paper.

⁸ There is no statutory prohibition on the airport choosing to charge passengers. Indeed, a number of regional airports in the UK and a number of large airports overseas impose charges directly on passengers, for example in the form of 'Airport Development Fees' and 'Passenger Facility Charges'.

- providing access to staff and renting space to airlines and supporting service providers procured by airlines (access and office rentals to airlines and groundhandlers); and
 - cargo-processing facilities.⁹
- 2.8 We are adopting a working assumption that all of these services should be included in the product market within which Gatwick operates, as the failure to supply any one of these services would severely hamper the economic operation of a passenger airline, which means that any market power enjoyed by virtue of the ownership of the runways, taxiways and terminals would also be likely to be enjoyed over all of these services.¹⁰
- 2.9 Airports also provide other services that are, to a greater or lesser degree, ancillary to the operation of passenger services, such as office rental to airlines or tour operators for non-essential activities and services within terminals or at nearby locations. We are adopting a working assumption that the provision of these services forms part of a wider market for, in this case, office space.

Provision of products and services to cargo carriers

- 2.10 Gatwick provides infrastructure and infrastructure services to cargo-only carriers for the air transportation of cargo. This includes the provision of runway and apron space, as well as providing access to cargo-handlers, access to warehousing facilities, and infrastructure to allow the efficient onward transfer of cargo.
- 2.11 Some passenger airlines at Gatwick typically carry cargo (mail and/or freight) in the bellyhold of their passenger aircraft. This includes mainly the full service network carriers such as BA, Virgin or inbound US carriers, but also charter carriers carry cargo. Consequently, although the cargo-handling services are provided by a third party (cargo handlers), the passenger airlines would require the airport to provide suitable infrastructure which the cargo handler may then lease to provide its services. [X].
- 2.12 A number of Gatwick's airlines do not transport any cargo, particularly low cost carriers such as easyJet and Ryanair.
- 2.13 There are very few freight-only aircraft operating at Gatwick. Existing London Traffic Distribution Rules, set by the Government, currently constrain new cargo-only operations starting up at Gatwick in peak times. In 2010, only about 0.1 per cent of flight movements at Gatwick were cargo-only flights
- 2.14 In the course of our assessment, we have not received any evidence from airlines (cargo or passenger) or cargo shippers that they saw Gatwick's market position in the cargo market as a particular concern. Gatwick also has a very small market share in the cargo market (4 per cent in 2010). We are therefore not considering the cargo market any further for the purposes of assessing Gatwick's market power.

⁹ A fuller list of these services is set out in the annex published alongside this paper.

¹⁰ We note here that access to the airport, the construction and operation of its terminals and runways are all controlled by Gatwick Airport Limited.

Provision of access to Gatwick's infrastructure and services to third party service providers

- 2.15 Many services for airport users are provided by third party service providers. For airlines and cargo carriers, these service providers (contracted by them) include particularly groundhandlers and aircraft maintenance and repair providers.
- 2.16 For passengers, these service providers include food and drink and providers of other retail services (e.g. bureau de change). In order to provide these services, suppliers typically need to rent terminal space and to obtain access to the landside and airside facilities for their staff and to bring in stock.

The use of market definition

- 2.17 Defining the relevant market is usually the first step of any competition assessment. It provides the context for the analysis by setting out the relevant set of products and geographic areas which encompass the closest substitutes for the products and services of interest. This then provides a frame of reference for the analysis of competitive effects.
- 2.18 In practice, in differentiated product markets, it can be difficult to draw a line around a group of products with a varying degree of competitive constraint on each other to define the market. In such circumstances it is appropriate to consider the degree of competitive constraints faced by the product in question in the round, regardless of whether they arise from within or outside a defined relevant market.
- 2.19 Markets are generally defined in two dimensions: product and geographic. The CAA's Guidelines set out the basis on which we have carried out our market definition analysis. In particular, in the absence of sufficient data, rather than carry out a quantitative hypothetical monopolist test, we have assessed available evidence on airport offerings and airline and passenger needs using the principles of the test.
- 2.20 In particular, we have looked at the ability of airlines and passengers to switch their business away from the airport, the ability of other airports to begin supplying a substituted product to that of Gatwick and the effect of these factors on the profitability of any price rise by Gatwick.
- 2.21 The CAA's approach is set out in more detail in the CAA's *Guidance on the Assessment of Airport Market Power*.¹¹
- 2.22 The remainder of this chapter considers the product and geographic market definitions from the perspective of airlines and passengers, looking at both demand and supply-side substitutability. We then draw this evidence together and consider the effects of the interdependence of demand from the different user groups and the implications of this on overall assessment of the markets in which Gatwick operates.

¹¹ CAA, *Guidance on the assessment of airport market power*, April 2011.

Product market definition

- 2.23 The following sections consider each of Gatwick's main customer groups. It looks at the characteristics of these groups and whether there are separate segments¹² within these groups that have different product requirements.
- 2.24 By looking at the choice set available to each of Gatwick's customer groups (and, if relevant, subgroups) on a product dimension and the ability to switch between the different alternatives, we have assessed the potential for these customers to react to an increase in charges by the airport. We have then suggested product market definitions that include all alternatives that customers can easily switch between.

Passengers

- 2.25 As set out in our guidelines, a number of passenger sub-groups can be distinguished using various characteristics:
- journey purpose;
 - destination/flight distance;
 - passenger origin (inbound, outbound and connecting passengers);
 - travel class (non-premium and premium passengers);
 - sales channel (particularly, if the flight was bought separately or as part of a holiday package); and
 - route availability at other airports.
- 2.26 We consider the relevance of these subgroups at Gatwick and whether they have varying requirements that might imply separate product market definitions.

Journey purpose

- 2.27 The CAA¹³ and European Commission¹⁴ have both highlighted the differences between passengers travelling on business, holiday and to visit friends and relatives (VFR). In general terms, business passengers (who may not be travelling in business or other premium cabins) tend to place particular value on the timing and frequency of services, whilst being less responsive to changes in prices than holiday or VFR passengers. These different demand characteristics might encourage differentiation by the airport between the supply of services to business and holiday/VFR passengers.

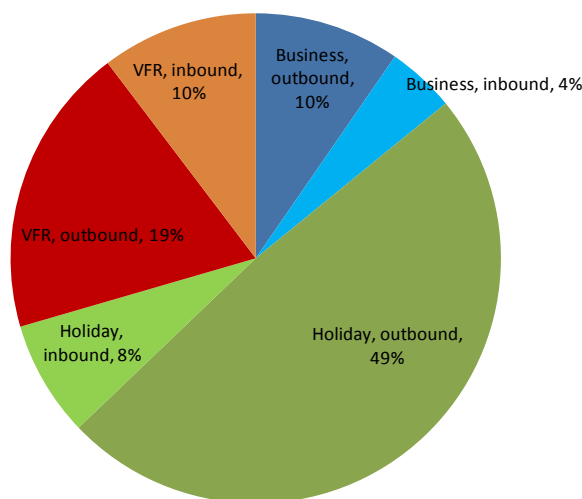
¹² We refer to market segments where we want to describe and delineate different groups of airlines and passengers that are likely to have distinct features. This is not the same as describing these as separate economic markets; we assess in this paper to which degree there might be separate markets for different market segments, or to which degree they might suggest one, albeit differentiated, product market.

¹³ The CAA published a number of studies into the market for passengers travelling for different purposes, including "Flying on Business"/November 2011, "Demand for Outbound Leisure Air Travel"/December 2005 and "International Relations – the growth in air travel to visit friends and relatives"/September 2009.

¹⁴ See for example the EC's approach to market definition in BA-AA-IB (http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=1_39596) or Ryanair-Aer Lingus (<http://ec.europa.eu/competition/mergers/cases/index/m88.html>).

2.28 Figure 1 below shows the passenger breakdown by journey purpose (holiday, visiting friends and relatives/VFR, or business) combined with passenger origin (outbound or inbound¹⁵) at Gatwick.

Figure 1 Gatwick's passengers, by journey purpose and passenger origin



Source: CAA Passenger Survey, 2010

2.29 Gatwick serves all three types of passengers (holiday, VFR and business). The majority of Gatwick's passengers (57 per cent) travel on holiday, most of which are outbound/UK resident passengers. This is consistent with the historically strong charter business using Gatwick, albeit that it has been replaced more recently by Low Cost Carriers (see the next section on the product market definition for passenger airlines below). Under one third (29 per cent) are VFR passengers, and only 14 per cent travel for business purposes.

2.30 The majority of the airport's services are offered to all passengers, irrespective of their journey purpose. Indeed, airports cannot directly distinguish passengers travelling for business, holiday or VFR purposes. However, airports might be able indirectly to differentiate passenger preferences typically associated with different journey purposes.

2.31 Business travellers might be more time-sensitive than VFR and Holiday passengers and might prefer to travel at certain times of the day (early morning and evening). Similarly, business passengers might prefer premium services offered either by the airlines (e.g. lounge access or fast-track check-in and boarding) or the airport (e.g. airport lounges, fast-track security search or near-terminal car parking).

2.32 Furthermore, as business travel is often contracted between airlines and large firms/corporate travel companies, business passengers' choice of airport might be constrained through these contracts. As Full Service

¹⁵ Outbound passengers are defined as passengers on their outbound leg of their journey, and inbound passengers are defined as passengers on their return leg of their journey. The data uses residency (UK or foreign) as a proxy.

Carriers (FSC) more typically make use of such contracts, the choice of airport is likely to be constrained to airports used by these types of airlines – around London, this is likely to be concentrated in Heathrow and London City and Gatwick. Furthermore, corporate contracts are likely to place a particularly high value on the range of available flights and the available flight frequency, to accommodate any short term changes in their travel plans. This is more easily provided at large airports, with smaller airports unlikely to be able to provide a similar range and frequency. This could suggest a narrower market for business travellers than for holiday and VFR passengers.

- 2.33 There are less obvious differences between holiday and VFR passengers (often combined to “leisure” passengers) in their travel preferences. In general holiday passengers are likely to be more flexible than VFR in terms of their destination, as they might regard similar holiday destinations as appropriate substitutes,¹⁶ and thereby be able to switch to airports that do not offer flights to the same destination. However, evidence from our passenger survey suggests that VFR and holiday passengers have similar degrees of price sensitivity.
- 2.34 In addition, it does not seem likely that the airport could reliably distinguish between VFR, holiday and, indeed, business passengers, and thereby vary charges to passengers on the basis of journey purpose. Consequently, there does not appear to be a strong rationale for identifying a sub-market of airport services to holiday or VFR passengers.

Destination/Flight distance

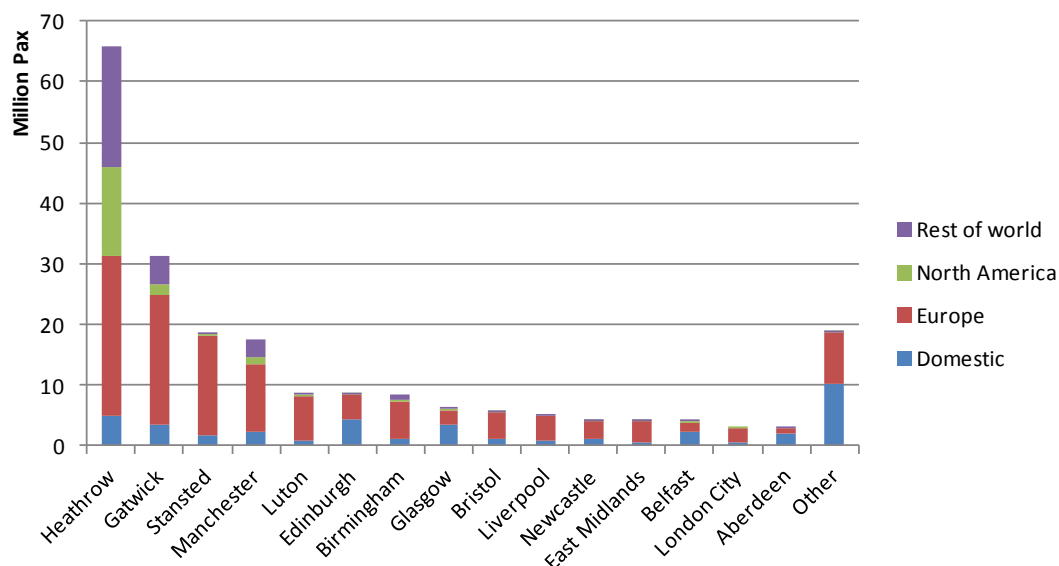
- 2.35 It might also be useful to distinguish between passengers on the basis of their destination. Destinations are typically divided into domestic, short-haul and long-haul destinations. Whilst the infrastructure provided to domestic¹⁷, short-haul and long-haul passengers is largely the same there are some differences: domestic and short-haul passengers tend to take less luggage, spend less time at the airport and tend to require no or less time for immigration and customs control. Furthermore, the airport is able to (and currently does) vary its passenger charges on the basis of destination type.¹⁸
- 2.36 Gatwick currently serves flights to all three types of destinations, as illustrated in Figure 2. Two thirds of Gatwick’s passengers fly on short haul routes, while 21 per cent are long-haul passengers and 11 per cent are domestic passengers.

¹⁶ Some passengers might be seeking a “city break”, “ski holiday” or “beach holiday” and be willing to choose between different destinations falling into the same holiday category.

¹⁷ Passengers flying to the Republic of Ireland (ROI) are often grouped together with domestic passengers due to the reduced immigration and customs checks required for passengers travelling to the ROI.

¹⁸ Gatwick currently charges less for domestic and Republic of Ireland passengers than for other destinations.

Figure 2 Passengers at UK airports, by destination



Source: CAA Airport Statistics, 2010

- 2.37 The propensity of passengers to vary their use of domestic, short and long-haul services will depend on the strength of their preference to travel to a particular destination. For some passengers – notably those travelling for holiday purposes, representing a large share of Gatwick’s passengers – there is likely to be a degree of flexibility between different holiday destinations, such as between different beach resorts, or cultural cities. It is also possible that short-haul holiday destinations might be regarded by some passengers as substitutes for long-haul holiday destinations. Indeed, the long haul services from Gatwick are largely focused on the holiday market, with many flights to long haul beach destinations such as the Caribbean or the Indian Ocean.
- 2.38 However, it is likely that generally other short-haul holiday destinations are more often regarded as close substitute for a given short-haul flight, not least because long-haul flights and holidays tend to be more expensive than short haul flights and holidays, and a switch between a long-haul and short-haul destination is likely to imply a significant change in the nature of the holiday.
- 2.39 For passengers travelling for business or to visit friends and relatives, there is likely to be a particularly strong destination preference, with the willingness to substitute between different destination airports being limited to those serving similar geographic areas.
- 2.40 It is possible that changes in the structure of short and long-haul charges might influence some passengers to switch from a single long-haul service from Gatwick to a connecting services involving a short-haul service followed by a further short or long-haul service (although currently there is no price differentiation between international flights, only between domestic/ROI and the rest of the world). However, the relative inconvenience involved in passengers accepting a connection between services, suggests that this form of responsiveness is unlikely to undermine differentiation between short and long-haul services.

- 2.41 Overall, even though the difference might be less pronounced than for Heathrow (given Gatwick's focus in the long-haul segment on holiday destinations), it might be useful to consider a narrower market for long haul passengers.
- 2.42 It is notable that 31 per cent of domestic passengers transfer between the domestic and another flight at Gatwick, whereas only 7 per cent of all short haul passengers transfer at Gatwick. Some domestic passengers might also be able to use other forms of transport (train or car) as a substitute for a flight¹⁹.
- 2.43 Gatwick currently does not differentiate passenger charges for short- and long-haul services; it only charges a lower rate to domestic and Republic of Ireland passengers.
- 2.44 Taken in the round, these factors suggest that – from a passenger-facing perspective – there might also be separate markets for domestic and short-haul passengers. However, domestic and short-haul services are more likely to be operated by similar aircraft types than is the case for short-haul and long-haul services. This suggests a degree of supply-side substitutability between domestic and short-haul services that could support a single market for short-haul and domestic services.

Passenger origin (outbound, inbound and connecting passengers)

- 2.45 Another potentially relevant distinction between passengers appears to be outbound and inbound passengers, or, in other words, whether Gatwick is their “home” or their “destination” airport. However, airports do not contract directly with passengers and have no access to passenger address or nationality information, and so seem unlikely to be able directly to distinguish between passengers on the basis of whether they are on the outbound or inbound leg of their journey.
- 2.46 The infrastructure services required by inbound and outbound passengers differ somewhat, as outbound passengers typically have access to more significant (airside) retail offerings, and also require security clearance. However, there is a significant overlap in the services offered to these two groups. Furthermore, given the significant proportion of passengers who travel through the same airport for both legs of their trip, any attempt to discriminate between inbound and outbound passengers would not appear likely to be effective, as it would still affect the overall trip cost faced by passengers.
- 2.47 Reflecting this, we do not consider that there is a need to distinguish between these groups in terms of the product market, despite Gatwick's current focus on outbound passengers. However, Gatwick's focus on outbound passengers does have implications for the geographic market, as a higher

¹⁹ However, a significant share of Gatwick's domestic passengers come from areas in the UK for which other forms of transport no appropriate alternative (e.g. Channel Isles, Scotland, Northern Ireland).

share of inbound passengers travel to Central London compared to outbound passengers, whose locations are likely to be more dispersed.²⁰

- 2.48 One important distinction between passengers appears to be between surface and connecting passengers. Not only do these different groups make use of some different airport infrastructure, but their choice sets are also very different: whereas direct passengers could use other neighbouring airports (provided it offers the flights passengers want), connecting passengers would have the choice between other airports at which they can connect between their flights, which might also be further afield, suggesting a different scope of the relevant market.
- 2.49 At Gatwick only a relatively small number of passengers (8 per cent) connect between flights. Table 1 shows the percentage of connecting passengers for different destinations. It appears that many passengers connecting at Gatwick arrive on a domestic flight in order to connect to an onward international destination (or vice versa), most likely one that was not available as a direct flight from their point of origin.

Table 1 Share of connecting passengers at Gatwick, by destination²¹

	Total Passengers (m)				% Connecting			
	1996	2001	2007	2010	1996	2001	2007	2010
Domestic	2.1	3.0	4.0	3.5	36%	39%	31%	31%
Charter	9.7	10.7	8.4	5.6	2%	3%	3%	3%
Short Haul Scheduled	6.6	8.9	15.3	17.7	28%	31%	11%	7%
Long Haul Scheduled	5.6	7.8	6.9	4.2	34%	31%	19%	16%
Total	24.0	30.4	34.5	31.0	20%	22%	13%	10%

Source: CAA passenger survey

- 2.50 Airports can, in principle, distinguish between passengers on the basis of whether they are travelling to the airport by surface access transport (i.e. they are surface passengers) or whether they are flying in to Gatwick to connect to another flight (i.e. they are connecting passengers), as long as these passengers intra-/interline²². The airport currently does not price these two groups differently.
- 2.51 Overall, it is useful to treat connecting and surface passengers as being in separate economic markets. It should be noted, however, that only a very small share of Gatwick's passengers would fall into the market for connecting passengers. The market for surface passengers is therefore more important to understand competitive constraints on Gatwick.

²⁰ See, for example, Figures A2 and A3 of 'Catchment area analysis: Working Paper', CAA, October 2011

²¹ These figures include passengers that connect between different London airports (for example arrive on a domestic flight at Gatwick and travel to Heathrow to catch a long haul flight). This results in a slightly higher share of connecting passengers (10 per cent) than stated in the text (8 per cent).

²² Self-connecting passengers cannot be identified either by the airline or the airport, as they need to pass immigration and customs and collect their luggage before checking in again airside alongside surface passengers. This means that these passengers also use more of the same infrastructure (except perhaps facilities to leave and/or access the airport, e.g. car parking) as surface passengers.

Travel class

2.52 As discussed in the context of travel purpose, airlines and airports might offer additional services to passengers willing to pay for a higher quality airport experience. This can include, for example, lounges, fast track check-in, boarding and security checks. Table 2 shows the share of passengers travelling in premium travel classes at London airports.

Table 2 Share of premium/non-premium passengers at London airports

	LHR	LGW	STN	LTN	LCY	Grand Total
First+Business	5%	1%	0%	0%	7%	3%
P Economy	4%	1%	0%	0%	4%	2%
Economy Flexible	3%	0%	0%	0%	7%	1%
Economy	88%	98%	100%	100%	82%	94%

Source: CAA passenger survey²³

2.53 A smaller proportion of Gatwick's passengers travel in premium travel classes than of Heathrow's or London City's passengers. As discussed in the section on passenger airlines, a large share of Gatwick's passengers are flown by airlines that do not offer any premium travel classes, particularly LCCs. Furthermore, short-haul flights tend to have a smaller share of premium passengers than long haul flights. The other two London airports Stansted and Luton, however, serve even smaller numbers of premium passengers than Gatwick.

2.54 Passengers could also switch between different travel classes in response to a price rise in one travel class, which is aided by their being a range of different service propositions, including economy, premium economy business and first class. However, perhaps more importantly, FSCs fly a mix of passengers in different cabin classes and control the configuration of their planes, whilst airports are not able directly to identify the cabin class that a passenger is travelling. There is, therefore, no obvious way for airports to distinguish between passengers on the basis of their cabin class (we discuss below the potential relevance of distinguishing between *airlines* on the basis of their business model).

2.55 We do not, therefore, consider it appropriate to distinguish between passengers on the basis of the cabin class in which they are travelling.

Sales channel

2.56 A significant share of Gatwick's passengers are outbound holiday makers. In this segment, many passengers book their flight as part of a holiday package through a tour operator and/or travel agent. Indeed, 28 per cent of Gatwick's passengers have booked their flight in this way. These passengers are likely to be constrained in their choice of airport by the bundles put together by tour operators and charter carriers.

²³ Given the practical difficulties of interviewing premium passengers (as they tend to go to the gate very late from the lounges) the survey results might understate the absolute number of premium passengers. However, the results give an indication of the relative importance of premium passengers of different airports.

- 2.57 As discussed in the context of journey purpose, some business passengers might also be constrained by corporate contracts. While these passengers might have narrower choice sets, as choices are determined by third parties, their use of Gatwick's infrastructure and services is unlikely to differ significantly from holiday makers or business passengers that booked their tickets through direct sales channels. It is also relevant that the airport cannot readily identify passengers' sales channel.
- 2.58 It therefore does not appear necessary to define separate markets for different sales channels. However, given the high share of holiday makers booking their flights as part of holiday packages or through corporate contracts, it is likely that Gatwick's competitive constraints depend more on the choices of the intermediary companies (including tour operators, charter carriers and travel agents) than is perhaps the case for other airports with a lower share of passengers on holiday packages and corporate contracts.

Route availability

- 2.59 The above discussion highlights that the passengers using Gatwick are relatively diverse, and despite sharing common key requirements and factors that limit the airport's ability to differentiate its offer, there might be some discernable sub-markets.
- 2.60 There are few direct costs to passengers switching between airports, other than the costs involved in travelling to an alternative airport - a factor that is considered in the context of the geographic market, below.
- 2.61 However, the ability of a passenger to switch away from the airport will depend on whether or not a suitable destination is available from an alternative airport. Whilst the airport can structure its charges in ways that can encourage particular services (such as targeted discounts to new destinations), route choice is determined by the airlines rather than the airport. Reflecting this, the impact of route overlaps on switching is examined in the final section of this chapter.

Summary – Product market: passengers

- 2.62 In terms of the airport product, there are a range of requirements of the various types of passenger at Gatwick, and, despite limits on the extent to which the airport can segregate its offer to passengers, it appears that some passenger segments could constitute relevant sub-markets, notably between surface passengers and those connecting at Gatwick between air services.
- 2.63 In summary, therefore, it seems that the appropriate product markets for passengers at Gatwick should be the provision of airport infrastructure and infrastructure services to passengers that could be differentiated by journey purposes (business/leisure), destination (domestic/short-haul/long-haul) and surface/connecting passengers. This is likely to cover a range of aeronautical and non-aeronautical services that are required for the reception, processing and boarding of passengers, and may include a subset of the retail offering at the airport.

- 2.64 However, as outlined above, the choice set for passengers will depend on whether or not a suitable destination is available from the alternative airport, which we have considered in the context of the geographic market, below.

Passenger airlines

- 2.65 The choice set of airlines at Gatwick is affected by the airlines' infrastructure requirements, which are likely to differ according to their business model and the type of service they offer. These differing requirements may affect the choices available to different airlines and the airports with which Gatwick competes.
- 2.66 In this section we consider different ways of distinguishing airlines and whether this has any implications for product market definition, including:
- short-haul²⁴ vs. long-haul services;
 - the airline business model; and
 - based vs. inbound services.

Short-haul vs. long-haul services

- 2.67 The infrastructure needs for operating a short-haul route versus a long-haul route are broadly similar, in that all airlines have a minimum requirement in terms of runways, aprons and terminal facilities. However, long-haul routes are more likely to be served by larger aircraft – requiring a higher specification of runway – and they are more likely to carry bellyhold cargo, which can add to the requirements of long-haul operations, relative to those operating short-haul. Furthermore, airlines tend to require a larger catchment area and a degree of connecting traffic to sustain the more expensive long haul operations.
- 2.68 Airlines at Gatwick serve a mix of both short-haul (domestic and international) and long-haul routes. While some airlines serve only short or long haul routes (e.g. easyJet or flybe only serve short haul routes, while Virgin Atlantic or Emirates only serve long haul routes from Gatwick), others, in particular British Airways and the large charter carriers (Thomson and Thomas Cook) serve a mixture of both short- and long-haul routes. While some aircraft could be used for both short- and long haul services, long-haul services are typically served by larger aircraft. From the airlines' perspective short- and long-haul routes are therefore unlikely to be substitutes in the short term.
- 2.69 Airports can, in principle, differentiate their charges on the basis of the destination. Heathrow introduced different charges for EU services and other international services last year. Gatwick currently only differentiates between domestic, Republic of Ireland (ROI) and other international services – a charging structure that the current owners inherited from BAA.
- 2.70 On the basis of the available evidence it appears that there could be separate submarkets for short- and long-haul services. However, as we

²⁴ The following discussion includes domestic flights under short-haul flights.

discuss in the next section, it appears that this distinction would be closely linked to a differentiation according to airlines' business models.

Airline business model

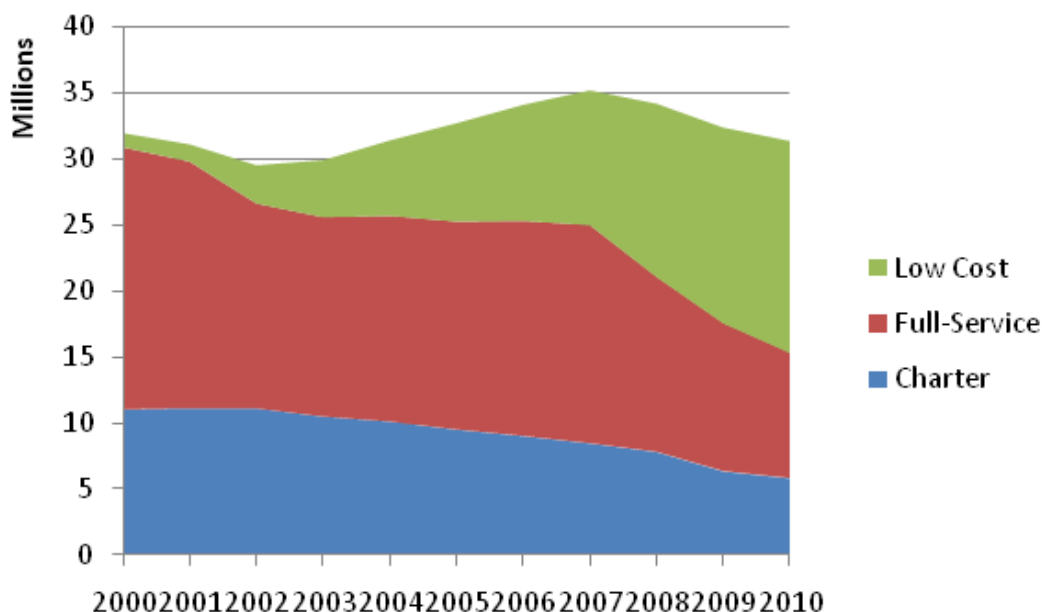
2.71 It is common to distinguish between three different airline business models, which we also described in our guidelines²⁵: Full Service Carriers (FSC), Low Cost Carriers (LCC) and charter carriers. Even though the boundaries between these three types are not clear-cut, with many FSC cutting extras on short-haul flights and some LCC introducing additional services, these three models can usefully be described having (all or most of) the following characteristics:

- FSC: serve a mixture of short- and long-haul services; offer intra/interlining services to connect between different flights; operate a network or are part of a network together with other airlines; offer premium services and a range of other additional services, for example loyalty programmes; provide a highly differentiated (and consequently complex) service offering.
- LCC: serve only short-haul services; emphasis is on price and operational efficiency; provide a highly streamlined service with relatively low levels of service differentiation; extras; serve point-to-point routes without supporting passengers to connect between flights.
- Charter: serve a mixture of short- and long-haul services; many passengers book flights as part of holiday packages; provide some premium services; also serve point-to-point routes (seat-only sales) without connecting facilities.

2.72 Of the three airports being assessed (Heathrow, Gatwick and Stansted), Gatwick has the most diverse range of airline business models operating from the airport. Figure 3 illustrates the growth of LCC at Gatwick since the early 2000's, which became particularly pronounced after 2007, including due to easyJet's acquisition of GB Airways. Not only did LCC provide the only net growth in traffic, they also replaced some charter and FSC traffic, increasing the LCC share from 3 per cent to 51 per cent over the last 10 years.

²⁵ 'Guidance on the assessment of airport market power', CAA, April 2011

Figure 3 Passenger shares of airline business models at Gatwick, 2010



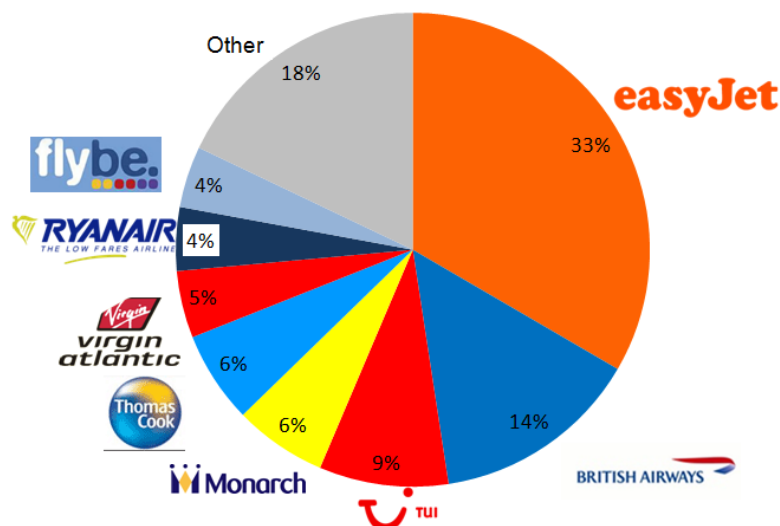
2.73 Charter carriers accounted for 47 per cent of passengers in 1994, since which time its share continuously decreased to 18 per cent in 2010. However, even after this decline in their share at Gatwick, the three largest charter carriers (Thomson, Monarch²⁶ and Thomas Cook) are all among the Top 5 airlines in terms of passenger numbers.

2.74 The individual airlines' shares of Gatwick are depicted in Figure 4. The airline concentration at Gatwick is significantly lower than at Stansted and similar to Heathrow, albeit that Gatwick serves fewer airlines that each hold comparatively higher shares than Heathrow, where a very large number of airlines each hold very small shares.²⁷

²⁶ Monarch announced in 2011 that it would significantly reduce its charter business and expand its scheduled flights.

²⁷ The Herfindahl-Hirsch-Index (HHI) is a measure of market concentration – the higher the number, the higher the market concentration. The HHI for airline concentration at Gatwick is 1,554 (based on airline shares of 2010 passenger numbers). This is marginally lower than the HHI at Heathrow (1,682) but significantly lower than the HHI at Stansted (5,034), reflecting the lower degree of airline concentration at the airport.

Figure 4 Airline shares of total passengers, 2010



Source: CAA Statistics

- 2.75 As suggested above, the different airline business models place differing requirements on airports.
- 2.76 In terms of their infrastructure requirements, LCC tend to place value on facilities that allow a highly efficient operation, which tends to imply a degree of simplicity in the airport's operation. This business model relies upon achieving high levels of utilisation of their aircraft, by reducing the time that aircraft are on the ground. This can be achieved by efficient turnaround times, short taxiing times and low levels of airfield delay. These requirements can limit – to a degree – the airports that CC view as being reasonable alternatives to Gatwick. In particular, relatively uncongested airports, or those supporting reliable and efficient turnarounds, may be close alternatives (for this dimension of comparability).
- 2.77 However, congested airports or those with relatively high levels of airfield delays and relatively low levels of punctuality might not be viewed as being close alternatives. For this reason, we consider that other airports in the London area such as Luton and Stansted might be considered alternatives by airlines, as well as other UK airports further afield and possibly also some airports across Europe. However, we do not consider that Heathrow is likely to be viewed as a reasonably close alternative airport for LCC operating from Gatwick given Heathrow's the complexity of Heathrow operations and higher operating costs.
- 2.78 FSC, on the other hand, require an airport that can accommodate their highly differentiated (and more complex) services and processes: from additional space for the processing and hosting of premium passengers, passenger and baggage transfer facilities to runway infrastructure that can accommodate small and large aircraft. These services are likely to be available only at the UK's largest airports. Therefore the choice set is likely to include airports such as Heathrow, Stansted, Manchester, Birmingham, Glasgow or Edinburgh. However, there might be other reasons that might prevent airlines wanting to switch to these airports (e.g. lack of connecting traffic),

and we discuss in more detail in the geographic market definition section below the effects of airlines' cost structures on their likelihood to switch to different airports.

- 2.79 The characteristics of charter airlines fall somewhere between LCC and FSC in terms of their airport requirements: while serving both short and long haul routes, they are not operated as a network but as point-to-point routes. Charters also tend to operate their departure flights in waves, which makes availability of slots at specific times more important. Further, despite offering some premium class services, the standard service level is somewhat lower (and less highly differentiated) than FSC, with fewer services being included in the ticket price, with some capable of being purchased at additional cost.
- 2.80 There are specific constraints on airports' scope for price differentiation according to the identity of individual airlines that arise from international agreements (including the Chicago Convention 1944 and bilateral agreements regarding the operation of air services between two countries) and the Airport Charges Regulations. However, given the different characteristics of different airline models, it is possible for the airport indirectly to price discriminate, for example on the basis of:
- surface/connecting passengers;
 - destination (short and long haul); and/or
 - intensity of airport usage (e.g. aircraft parking, terminal space usage).
- 2.81 Gatwick currently differentiates its passenger charges by destination (domestic, Republic of Ireland and other International) and its landing charges by size and the noise certification of the aircraft. This structure will tend to result in long-haul services incurring higher charges than short-haul services (on a per flight basis, but this might not be true on a per passenger basis), but it would not obviously result in significant differences in charges between FSC and LCC airlines that both serve short-haul destinations.
- 2.82 Overall, whilst airlines do not all neatly fall into being either LCCs or FSCs, with some combining factors of both ends of the spectrum, there remain important differences in the infrastructure requirements of airlines. In particular, there are a group of airlines, mainly FSCs that accept bellyhold cargo, facilitate connecting passengers and offer premium services which include access to lounges in the airports. These airlines are also more likely to offer long-haul services. On balance, these distinctions appear to have a significant impact on the switching costs faced by airlines at the airport, and different airlines are likely to view different sets of airports as reasonable alternatives to Gatwick.
- 2.83 The targeting by some airlines of premium passengers is also likely to affect the airports that are viewed as reasonable alternatives, as their business model relies on access to a large, and prosperous, geographic area. For example, an inbound long haul carrier, such as Emirates, might also regard a large regional airport such as Manchester or Birmingham as a reasonable substitute destination to Gatwick, as it satisfies the minimum runway

requirements for its aircraft and has reasonable surface access to an attractive metropolitan area.²⁸

- 2.84 This suggests that Gatwick competes in two (related) markets for airline business: a market that includes a large number of airports that can support the economic operation of LCCs (which is unlikely to include Heathrow); and a market which includes those airports that can also accommodate the economic operation of FSCs (which is likely to include Heathrow but might not necessarily include all other London airports).

Based vs. inbound airlines

- 2.85 Carriers basing a significant share of their operations at Gatwick are likely to have additional infrastructure and service requirements compared to airlines operating only a few routes to Gatwick from their bases elsewhere.²⁹ Based carriers might incur additional switching costs arising both from a loss of network benefits and economies of scale and from sunk investment costs that would have to be replicated at another airports. We discuss switching costs in more detail in Chapter 3. This suggests that non-based carriers, or flights, might be more flexible to switch in response to a rise in airport charges than based carriers and flights.
- 2.86 It appears that there is significant variation in the degree to which airlines are reliant on being based at the airport, with some carriers having all or a significant proportion of their operations operated by non-based (inbound) aircraft: For example, easyJet has a large number of aircraft (90 in 2011³⁰) based at Gatwick, but also operates a number of inbound flights with non-based aircraft. Ryanair currently only operates inbound flights into Gatwick. Virgin, on the other hand, bases all its aircraft using Gatwick at Gatwick. BA, flybe and charter carriers also use Gatwick as a base airport. However, all of these airlines also have large bases at other airports.
- 2.87 This suggests that even the largest carriers may have a number of marginal, more flexible, services which are more likely to be able to be relocated to an alternative airport without facing significant switching costs.
- 2.88 If the airport were able to price discriminate between based and non-based flights, this might reinforce a view that there might be distinct markets for based and non-based services. As LCC based aircraft in particular need to depart early in the morning in order to achieve commercially viable levels of utilisation, it is possible that the airport could vary charges by the time of day or vary overnight parking charges and, in these ways, differentiate between

²⁸ Indeed, Emirates operates long-haul services to its Dubai hub from Newcastle, and has recently announced its intention to deploy larger aircraft on this route.

²⁹ The notions of “based”/“outbound” vs. “non-based”/“inbound” carriers and flights apply differently to LCC and FSC. LCC operate “bases” where they overnight their aircraft. FSC have “bases” where they operate the centre (often the “hub” of their network), even though aircraft might also overnight at other, “inbound”, airports (in particular for long haul routes this is inevitable). For example, even though Emirates might overnight aircraft at Gatwick, their flights would be defined as “inbound”, as the flights come from Emirates’ home hub in Dubai. It is appropriate to use the same terminology for the purposes of this assessment as both LCC and FSC have additional product requirements for their “bases”.

³⁰ easyJet 2011 Annual Report. easyJet’s next largest bases are Malpensa and Geneva with 41 aircraft each.

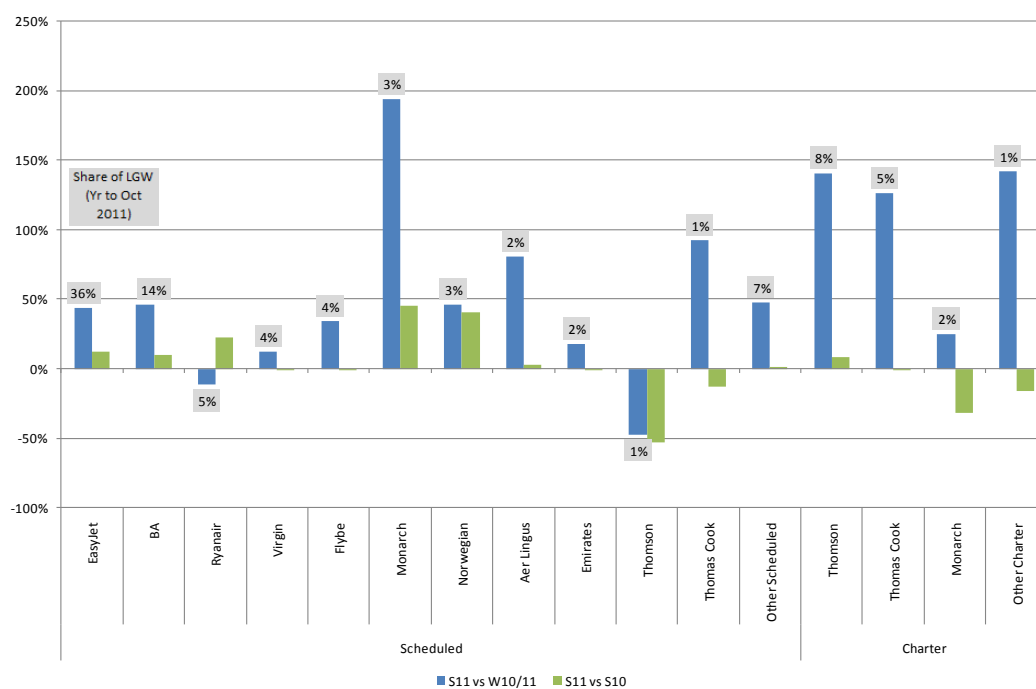
based and inbound services. The issue of differentiation of charges by the time of day is discussed in more detail below.

Temporal markets

- 2.89 Airports can vary their charges by time of day and/or year. Indeed, Gatwick currently differentiates its charges by time of day and by scheduling season. This could suggest separate relevant product markets, unless sufficient numbers of airlines could move services between periods.
- 2.90 The airport's ability to differentiate between time periods could be affected by:
- Passengers' preferences to travel at particular times of day (e.g. business travellers wanting to leave to arrive in time to carry out a full working day at their destination);
 - Operational constraints that mean that certain services tend to take place predominantly at certain times of day³¹; and
 - The need for airlines with aircraft based at the airport to operate services early in the morning, in order to achieve commercially viable utilisation of their aircraft.
- 2.91 Gatwick currently operates a peak pricing strategy, both according to time of day and of season (winter and summer schedules). Indeed, the airport has recently increased the differential between the summer and the winter seasons.
- 2.92 On the face of it, this could suggest that there are different markets as airlines might find it difficult to substitute between different seasons/times of day. Given Gatwick's focus on the outbound holiday segment there clearly is a higher demand in summer than there is in winter, and a number of services are only operated in the summer, whereas others are operated year-round. Figure 5 illustrates the seasonal differences on an airline basis. This highlights that a number of airlines vary their use between seasons significantly (blue bars, comparing summer 2011 to the preceding winter), and this pattern differs significantly from the underlying growth in traffic (a proxy for which is the growth between summer 2011 and 2010, shown in green).

³¹ For example, there is particularly strong demand for services from Heathrow to the east coast of North America departing early in the morning and late at night, to provide passengers with convenient arrival and departure times and to coincide with operational limitations at the destination airports, such as those relating to night noise.

Figure 5 Changes in passenger numbers between seasons, by airline



Source: CAA Airport Statistics

- 2.93 Gatwick’s recent changes to summer-winter price differentials appear likely to reveal useful information to assess whether there is sufficient responsiveness between seasons to mean that they should be treated as a single market for capacity. At the time of writing, we have not completed a full year since this change in pricing, making it difficult to make any inferences at this stage.
- 2.94 The airport also varies its charges by time of day, applying a summer peak charge.³² For example, landing charges in the summer peak are approximately three-times the summer off-peak charge, with a number of the winter landing charges being set at zero.³³ This is a significant degree of variation between time periods.
- 2.95 Based LCC operators and short-haul carriers with a strong business focus are likely to favour early-morning departure slots in order to allow a full-day aircraft operation for aircraft based at Gatwick, and/or to allow their business passengers a full day’s work at their destination. On the other hand, it might be possible for non-based airlines to swap some of their peak departure times for off-peak departure times, or to base the aircraft elsewhere and operate inbound services into the off-peak hours. Furthermore, Gatwick told us that when airlines could not immediately obtain slots at the optimal time, they would start operating at a less optimal time and moved to the better time as and when the necessary slots became available. This suggests that there is a degree of freedom for some airlines to swap different times of day for their operations.

³² The Summer Peak period (from 1 April 2011) is 0600-1159 UTC (GMT) and 1700-1859 UTC (GMT), from 1 April to 31 October. The Winter Off-Peak charges apply between 1 November and 31 March, with summer off-peak being outside of these two periods.

³³ See Gatwick Airport’s conditions of use, available at: <http://www.gatwickairport.com/Documents/Conditions%20of%20Use%202011.pdf>

- 2.96 However, at this stage it is difficult to say whether this is sufficient to discipline the airport's pricing in the peak periods. Consequently, we do not have sufficiently strong evidence to suggest there are different markets for different times of day at Gatwick.
- 2.97 However, given the very different demand conditions between summer and winter – and the very different reasons why, in particular, holiday passengers are travelling – there are likely to be significant barriers to airlines reducing their use of Gatwick at the summer peak and increasing usage at Gatwick in the winter off-peak.
- 2.98 Instead, if there is a competitive pressure limiting the pricing of capacity in the seasonal peak period at Gatwick it is more likely that it arises from airlines switching capacity away from the airport and relocating it at other airports. This form of switching would not, therefore, act to link the summer peak and winter off-peak periods.
- 2.99 Based on the evidence currently available, there may be a case for defining a narrow product market for airport capacity, reflecting the different demand conditions at different times of the year. However, we have not yet reached a firm view on this aspect of the Gatwick competition assessment.

Summary - product market: passenger airlines

- 2.100 On that basis of the evidence currently available, the relevant product market for assessing Gatwick's market power is likely to be affected by the following:
- The product market covers a relatively broad range of services, including the landing and parking of aircraft, and including the provision of terminal space for the processing of passengers.
 - However, there is a significant variation in the product offered by the airport to different airlines, reflecting the different services offered by airlines to their passengers. As a result, different airlines are likely to regard different airports as suitable substitutes.
 - Some airlines appear to require a more highly specified product than others, including larger runways, infrastructure for connecting passengers, additional space for differentiated airline products (e.g. lounges, premium check-in services), cargo facilities, higher value catchment and surface access connections and a higher passenger awareness of the airport.
 - Other airlines, on the other hand, appear to require a less complex, more streamlined product from the airport, in order to support their business model focused on cost and operating efficiencies that is reflected in lower air fares.
 - Whilst the evidence is relatively limited at this time, there may be a case for defining the product market to recognise the differing demand characteristics at different times of the year.
- 2.101 In summary, in respect of the supply of services by Gatwick to airlines, the relevant product market(s) for this assessment is the provision of airport

infrastructure and infrastructure services to airlines offering low cost point-to-point short-haul airlines and – related to this market – the provision of airport infrastructure and infrastructure services to full-service network airlines, which includes the infrastructure to accept long-haul services, connecting passengers, premium services and bellyhold cargo, together with convenient access to a large, prosperous population. The interplay between passengers and airlines is discussed further in the final section of this chapter.

Third-party suppliers

2.102 A number of services are provided at Gatwick, either to airlines or directly to passengers, by third party suppliers. These service providers rely on Gatwick to provide access to the airport and the necessary space and facilities for their specific service. The availability, price and quality of such services might also affect both airlines' and passengers' choice of airport.

Retail service providers

2.103 Retail service providers are one specific group that provides services directly to passengers. The airport provides terminal space, and typically controls the overall retail offering within the terminal, often with a revenue-sharing arrangement. It is useful to distinguish between retail services that are related to the passage of passengers through the airport, where passengers may have low levels of discretion as to whether they might make a purchase, and those that relate to highly discretionary purchases.

2.104 For those services where most passengers will have a choice as to whether to consume the product or service – such as fashion and electronics – we have identified no reason to suggest that passengers would be any less sensitive to the price and service offering than those in other retail environments. Further, the suppliers of these goods and services will generally have other options to providing their services at Gatwick, since they are part of wider retail markets. It is unlikely therefore that Gatwick would be able to profitably raise prices to these suppliers, or for the suppliers to raise prices to passengers, above the competitive level³⁴. Consequently, we do not consider them again in this paper.

2.105 Turning to those services that are less discretionary – which might include the provision of food and drink, and travel essentials, such as bureau de change – it is possible that a significant proportion of passengers have somewhat limited options as to whether or not to purchase these services. This will vary depending upon the individual service being considered. For example, given the waiting times that can be involved in air travel, and security restrictions, many passengers may face little choice but to purchase some food and drink. In such circumstances, the airport could limit the space available to particular retail offerings, and/or limit competition between different suppliers, and in doing so put upward pressure on prices to passengers and rental payments to the airport (including any revenue sharing arrangements).

³⁴ The locational characteristics of airports, with their consistent and high footfall might, however, justify a premium on retail rents over some other retail environments.

2.106 It appears, therefore, that if the airport enjoys a position of substantial market power over the provision of aeronautical infrastructure, it might also enjoy a similar position in respect of some retail activities.

Airline-facing service providers

2.107 Ground handling services are required by airlines to facilitate and enable the processing of aircraft and passengers at the airport. This encompasses a wide range of services, including, for example, fuelling, catering, cleaning, baggage handling, passenger check-in and boarding and cargo handling. Airlines also require aircraft maintenance and repair facilities. These service providers contract directly with airlines, but in order to provide their services they need to obtain access to the airport's premises, including security clearance and to rent offices, storage or other space necessary for the carrying out of their services.

2.108 Most of these services are essential for the operation of passenger and cargo flights. It appears, therefore, that if the airport enjoys a position of substantial market power over the provision of aeronautical infrastructure, it might also enjoy a similar position in respect of ground handling activities.

Supply-side substitutability

2.109 The CAA has adopted the OFT's view that "supply-side substitution can be thought of as a special case of entry – entry that occurs quickly, effectively and without the need for substantial sunk investment."³⁵

2.110 Airports that are able to begin quickly providing the same infrastructure and service as other airports in the relevant product market can be included within that relevant product market.

2.111 However, given the investment and timescales needed to upgrade an airport's facilities, it is unlikely that we would consider this kind of supply-side substitution quick and effective enough for this type of airport to be considered in the relevant market. Instead we will consider them as constraints through potential entry.

Geographic market definition

2.112 The previous section considered the types of airports that are likely to be included in the same product market definition as Gatwick. However, in order to understand exactly which airports compete with Gatwick for its customers, we must also consider the geographic market in which it operates. The geographic reach within which each type of airport user would consider be willing to switch is likely to differ, and to reach a view on the geographic market for Gatwick, the remainder of this section considers the ability of each type of user to relocate to airports nearby and further afield.

2.113 As with the product market definition, in the following section, we look at the choice set available to each of Gatwick's different user groups (and if relevant, subgroups) on a geographic dimension and the ability to switch

³⁵ Para 3.56 of the CAA's guidelines

between the different alternatives. We also assess the potential for these users to react to an increase in charges by the airport.

- 2.114 We have then suggested geographic market definitions based on the alternatives that users – passengers and passenger airlines – could switch between.

Passengers

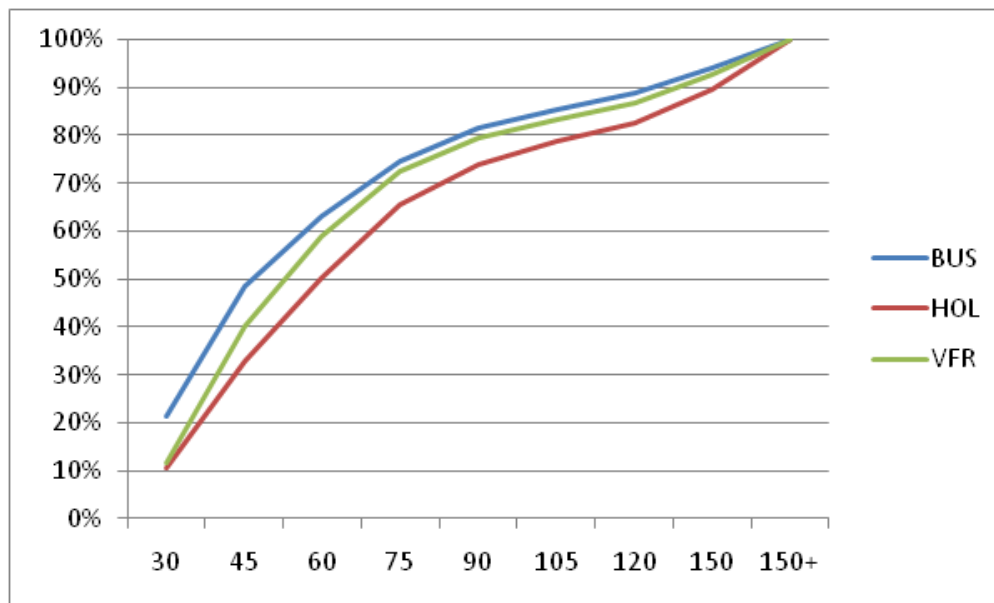
- 2.115 To form a view on the relevant geographic market for the provision of infrastructure and infrastructure services to passengers, it is useful to consider the airports to which significant numbers of passengers could switch in light of a price rise.

- 2.116 The ability of passengers to switch to different airports might vary depending on the passengers' characteristics. As for the product definition, the following sections look at the different passenger splits and considers whether there is any impact on geographic market definition resulting from different passenger characteristics. The last section considers results from a CAA passenger survey regarding passengers' stated willingness to switch airports.

Journey purpose

- 2.117 Figure 6 below shows the surface travel time for passengers using the four large London area airports (Heathrow, Gatwick, Stansted and Luton), distinguishing between business, holiday and VFR. It shows that while there is very little difference between the surface travel times of business and VFR passengers, holiday passengers tend to travel longer to the airport than business or VFR passengers.

Figure 6 Surface travel times according to journey purpose



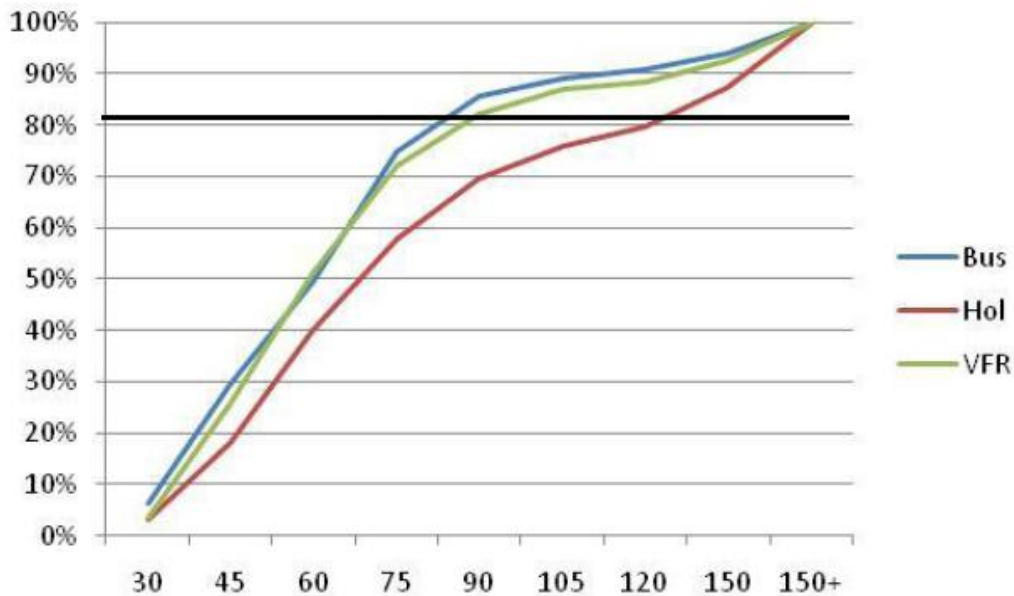
Source: CAA analysis of the CAA Passenger Survey 2010 and DfT surface access data

- 2.118 Figure 7 shows that Gatwick's outbound holiday passengers appear to travel even longer distances to Gatwick, while all inbound passengers (as illustrated in Figure 8) appear to have shorter travel times across all three journey purposes. This suggests that while different travel purposes do

indeed affect the airport's geographic catchment for outbound passengers, different journey purposes do not affect the geographic catchment for inbound passengers. We discuss possible reasons for this in the section on passenger origins.

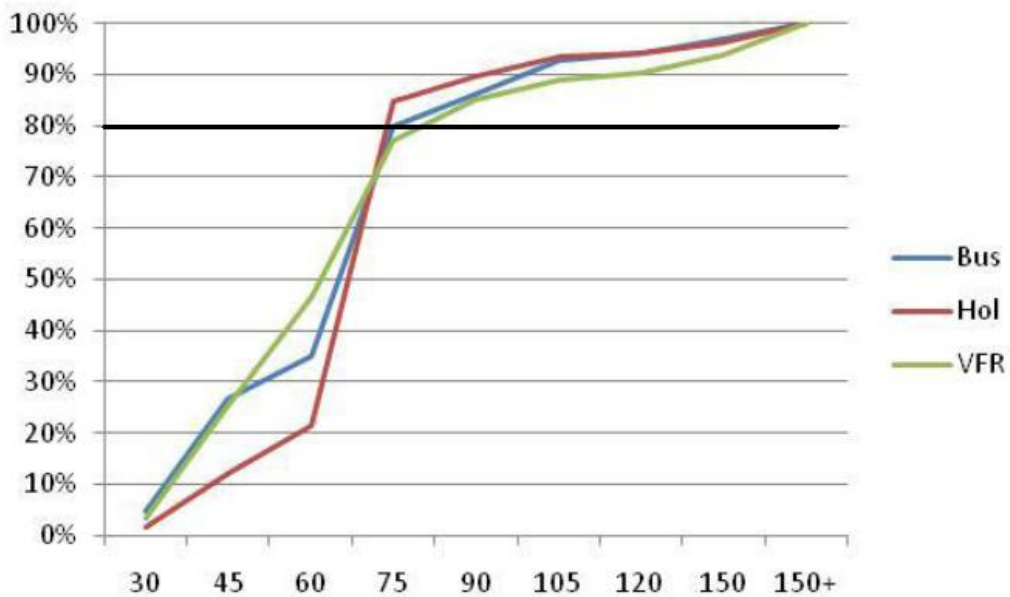
2.119 As the majority of Gatwick's passengers are outbound passengers, distinguishing between business and VFR passengers on one side and holiday passengers on the other to define the relevant geographic market might be appropriate.

Figure 7 Surface travel times for UK resident passengers at Gatwick



Source: CAA analysis of the CAA Passenger Survey 2010 and DfT surface access data

Figure 8 Surface travel times for foreign resident passengers at Gatwick

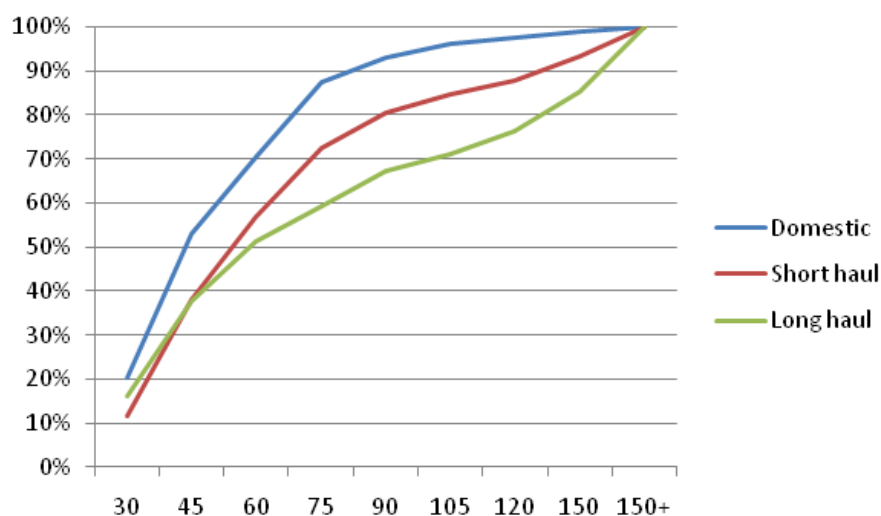


Source: CAA analysis of the CAA Passenger Survey 2010 and DfT surface access data

Destination/Flight distance

2.120 The willingness to travel to use an airport can vary depending upon the passengers' destination. Figure 9 below shows that the surface travel time for domestic passengers is less than that of short-haul passengers, which is less than that of long-haul passengers. This pattern might be explained by the larger proportion of domestic and short-haul passengers' overall journey time that would be accounted for by surface travel, when compared to long-haul services. Long-haul passengers also may have fewer airport choices as long-haul routes are only served from Gatwick and Heathrow, leading to longer surface journey times.

Figure 9 Surface travel time according to flight duration (4 major London airports)



Source: CAA analysis of the CAA Passenger Survey 2010 and DfT surface access data

- 2.121 Reflecting the large proportion of passengers that travel on short-haul services, this analysis suggests that a large number of Gatwick's passengers are willing to accept journey times of up to 90 minutes to reach an airport, with a relatively small proportion (20 per cent) accepting travel times greater than this. This provides an indication of the area over which Gatwick attracts passengers, which can then be used to inform an assessment of the strength of interactions with neighbouring airports.
- 2.122 However, 80 per cent of Gatwick's UK resident short-haul holiday travel up to 105 minutes to reach the airport³⁶, whilst foreign residents travel around 75 minutes to reach the airport, which suggests that competition for these passengers might take place over a larger area for UK residents than for foreign residents.
- 2.123 Similarly, the area over which Gatwick is likely to compete for domestic passengers is consequently smaller than for short-haul passengers, whilst the area for long-haul passengers is significantly larger: 80 per cent of Gatwick's outbound long haul passengers travel up to 120 minutes or longer (150 minutes for holiday purposes) to reach the airport.³⁷

³⁶ See Figure A. 10, 'Catchment Area Analysis – Working Paper', CAA, October 2011.

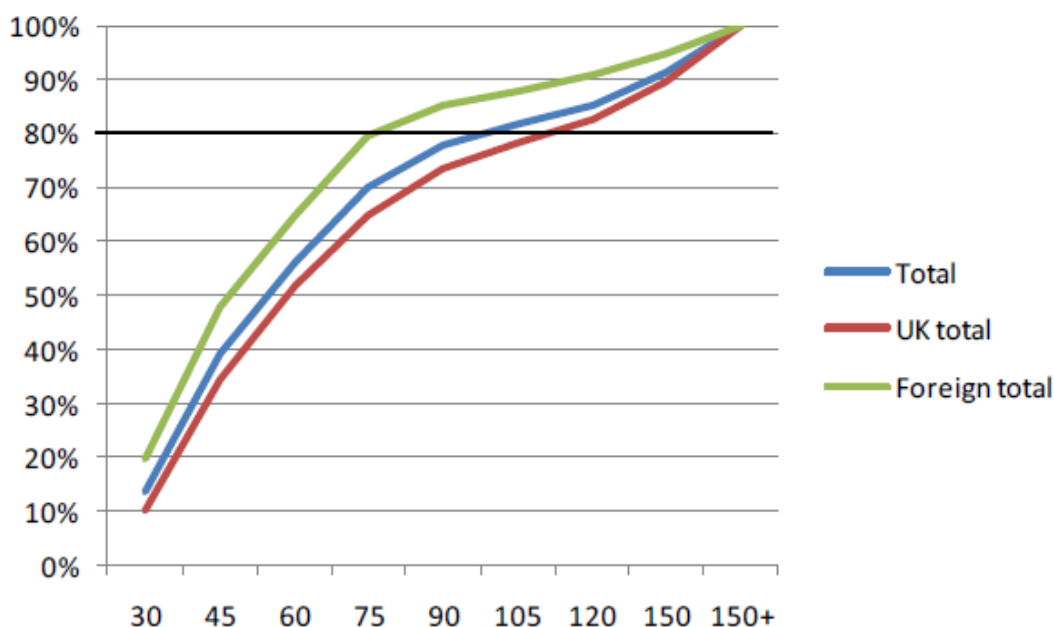
³⁷ See Figure A.14, 'Catchment Area Analysis – Working Paper', CAA, October 2011.

2.124 Given the clear travel time differences between domestic, short-haul and long-haul passengers, it is important to understand the impact that these differing preferences with respect to surface travel have on the relevant geographic markets.

Passenger origin (outbound/inbound and connecting)

2.125 As highlighted in the previous two sections, there often appear to be differences in the travel time of passengers depending on whether Gatwick is their “home” (outbound) or “destination” (inbound) airport, with inbound passengers tending to travel shorter distances to reach Gatwick than outbound passengers. This is likely to be influenced by the fact that the final destination of the large majority (63 per cent) of Gatwick’s inbound passengers is London, compared to the wider geographic distribution of UK resident outbound passengers (35 per cent from Greater London, compared to 41 per cent from the South East region). The differences in travel times are illustrated in Figure 10 below.

Figure 10 Surface travel time according to residence



Source: CAA analysis of the CAA Passenger Survey 2010 and DfT surface access data

2.126 Even though the airport cannot directly distinguish between inbound and outbound passengers, it is possible that it could vary other charges in ways that indirectly affect inbound and outbound passengers differently. For example, car parking charges are more likely to affect outbound passengers than inbound passengers. Furthermore, charter airlines typically focus on outbound passengers, whereas some foreign-registered airlines might transport more inbound passengers from their home countries. The airport could take these issues into account when negotiating with different airlines. However, as the airport cannot directly differentiate between the two passenger groups defining separate markets for these two groups might not

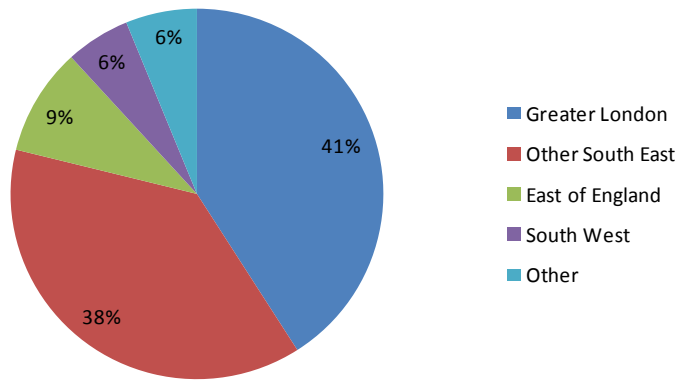
be appropriate, and these differences are more likely to be relevant to the understanding of the airline-facing aspects of market definition.

- 2.127 Connecting passengers have very different views from those travelling on a surface basis as to the airports that are reasonably close substitutes to Gatwick. In particular, connecting passengers are more likely to view an airport as a reasonably close substitute if it offers services that provide an equivalent set of connections that allow travel to their ultimate destinations with a comparable overall travel time.
- 2.128 However, it is possible, depending on their final destination, that airports further afield with connecting infrastructure could be seen as viable substitutes for connecting passengers. As Gatwick has a strong focus on holiday flights, it might be that, in addition to Heathrow and foreign hub airports, other holiday-focused airports including Manchester or Birmingham might be regarded as viable substitutes.
- 2.129 As a result, the geographic market for infrastructure and infrastructure services to connecting passengers could be somewhat broader, to include other UK and European airports offering comparable services to Gatwick.
- 2.130 It should be noted, however, that in any case only a very small share of Gatwick's passengers use Gatwick to connect between two flights. While this might be relevant for individual airlines it represents only a very small share of Gatwick's overall clientele.

Catchment area analysis

- 2.131 A common approach to analysing geographic markets of airports is to look at catchment areas. The evidence in the CAA's working paper on catchment area analysis suggests that the geographic market for Gatwick covers at least Greater London and South East of England, perhaps also extending to some districts in the East and South West of England.
- 2.132 About 80 per cent of Gatwick's passengers are concentrated in Greater London and South East of England, with a further 9 per cent from the East of England and 6 per cent from the South West of England. The largest overlap between all four large London airports (Heathrow, Gatwick, Stansted and Luton) is in the Greater London area, from which about 40 per cent of Gatwick's passengers originate. This is depicted in Figure 11.

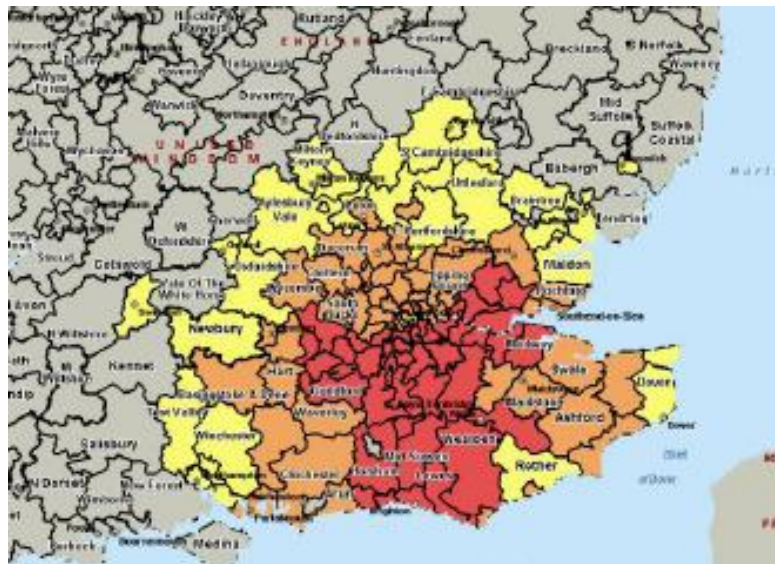
Figure 11 Regional distribution of Gatwick's passengers



Source: CAA Passenger Survey

2.133 Figure 12 shows the 60, 90 and 120 minute travel time isochrones around Gatwick. It shows that within 90 minutes, it is possible to travel across London and to most districts in the South East.

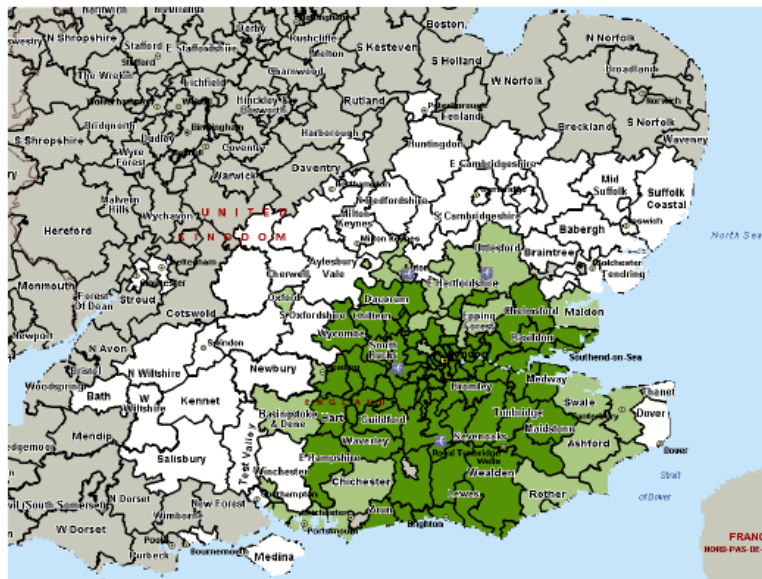
Figure 12 Surface travel time map for Gatwick



Source: CAA analysis of DfT surface access data
 Red: 60 minutes; Orange: 90 minutes; Yellow: 120 minutes

2.134 Figure 13 illustrates the historical distribution of passengers, ordered by the time travelled to reach Gatwick. Pale green and dark green shows the area covered using the travel time within which 80 per cent of passengers travelled. It is very similar to the chart above, reflecting the fact that 80 per cent of Gatwick's passengers travel 90 minutes or less to reach the airport.

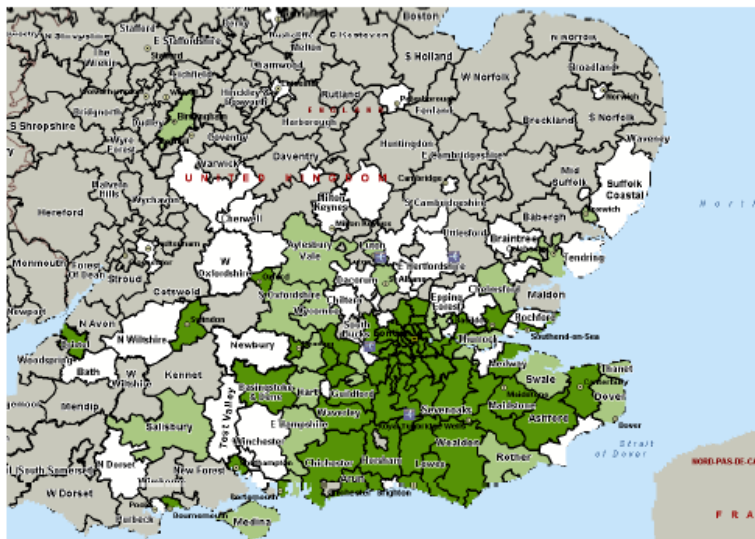
Figure 13 Gatwick overall surface travel time catchment area



Source: CAA analysis of the CAA Passenger Survey 2010 and DfT surface access data
 Dark green – 70%; Light green – 80%; White – 90% of passengers

2.135 Lastly, Figure 14 shows the historical distribution of Gatwick passengers, ordered in terms of the number of passengers travelling to Gatwick. Those districts encompassing the first 70 per cent of passengers are shaded dark green, those encompassing the next 10 per cent are shaded pale green, and the districts encompassing the next 10 per cent are shaded white. The districts with the lowest number of passengers using Gatwick – which together account for the final 10 per cent of passengers – are left grey.

Figure 14 Gatwick overall historical usage catchment area



Source: CAA analysis of the CAA Passenger Survey (2010)

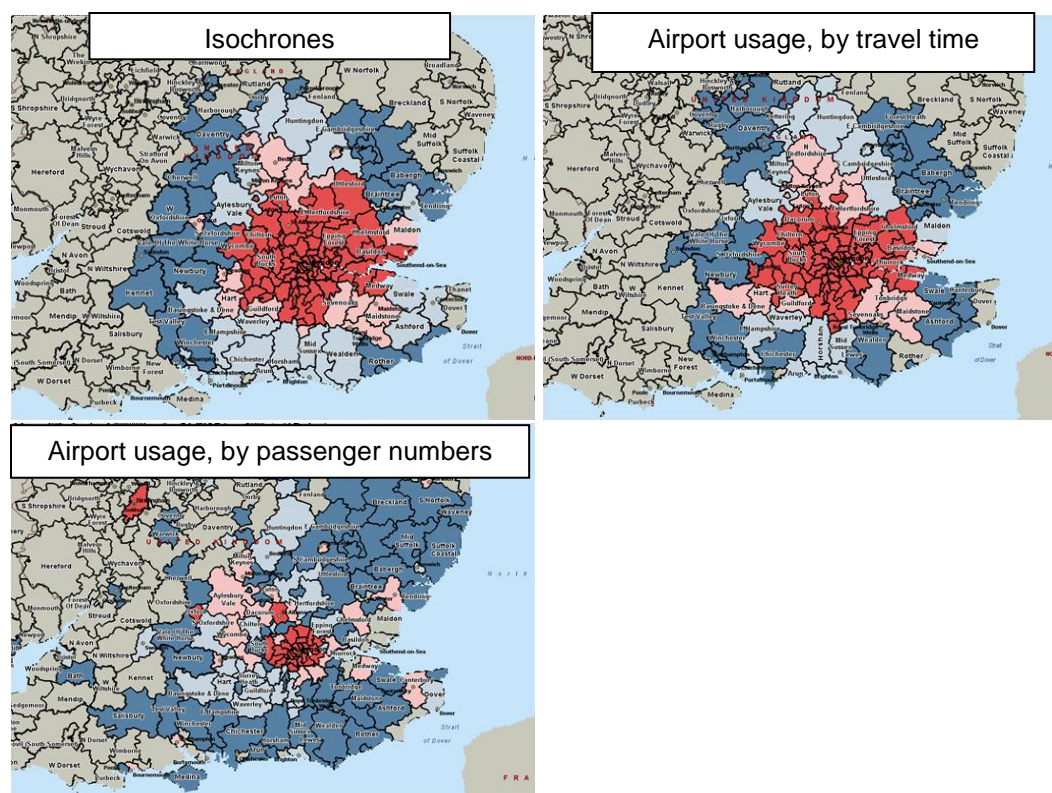
2.136 This figure highlights that Gatwick has drawn passengers predominantly from the Greater London area and the South East and also reaching into the South West. This is in contrast to the previous two charts that showed a catchment stretching much further north and east of London.

Catchment area overlaps and the geographic market

2.137 Under all calculation approaches, all four London airports have significant overlaps in their catchment areas in Greater London, where there is the greatest population and density of economic activity.

2.138 But different catchment area approaches suggested different degrees of overlaps between the London airports outside of the Greater London area, as is shown in Figure 15. While isochrones and proximity to airport analyses suggested a relatively large area around London as overlapping between two or more airports, the catchment analysis by number of passengers suggested that outside of central London passengers from a large part of South East of England only used Gatwick, and that catchment overlaps between the London airports were generally smaller.

Figure 15 London airport catchment overlaps



Source: CAA analysis of the CAA Passenger Survey (2010) and DfT surface access data
Blue: 1 airport; Light blue: 2 airports; Light red: 3 airports; Red: 4 airports

2.139 The first two approaches might be better at showing the potential ability of passengers to switch in response to a price rise, whereas the third reflects current choices under current conditions. It might suggest that passengers do give a lot of weight to travelling to the airport nearest to them if they can.

2.140 We need to explore whether this pattern of usage would still hold if Gatwick increased its prices – something that is explored in chapter 3, in the context of price sensitivity of passengers. This analysis reveals that there are some differences in the responsiveness of different passenger types.

2.141 The available evidence provides a strong basis to conclude that the relevant geographic market for Gatwick's surface passengers at least includes Greater London and the rest of the South East of England, possibly also

extending to include some districts in the South West and the East of England. In this context, it is also relevant that competition authorities have considered that the geographic market for passengers extends to include at least the south east of England. This is same geographic scope for the market defined by the Office of Fair Trading (OFT) in the context of the BAA airports market investigation, while the Competition Commission left it open³⁸.

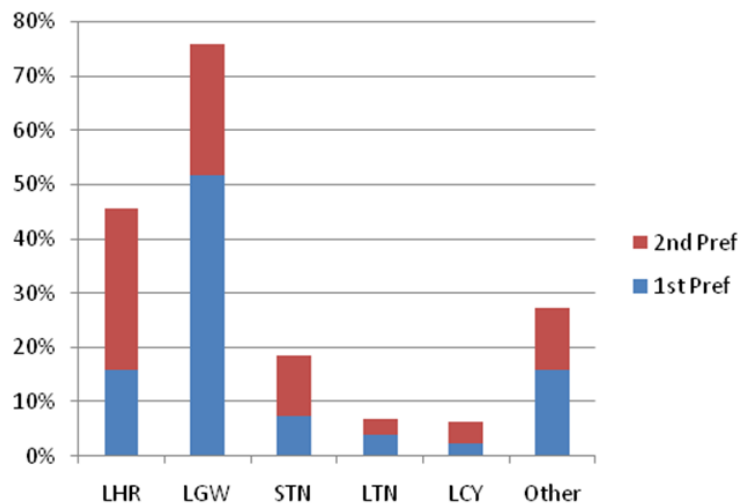
- 2.142 However, when considering the competitive effects in some market segments, such as long-haul holiday passengers, it may be appropriate to adopt a greater surface travel time (as it constitutes a smaller proportion of their overall travel time), which could mean that a number of airports in the UK beyond the south east of England may be seen as reasonably close substitutes.
- 2.143 Indeed, airports such as Birmingham and Manchester might be relevant sources of competitive constraint for long-haul services, and could be considered as being within the relevant market for long-haul, holiday passengers (if such a submarket were reasonable). More generally, the potential for strong interactions between a series of neighbouring airports – referred to as ‘chains of substitution’ – might act to broaden the geographic market for passengers.

Stated passenger willingness to switch airports

- 2.144 The CAA collected information about passengers’ airport preferences and their stated reactions to a rise of circa 10 per cent in their ticket price in a series of questions that were added to the CAA’s regular Passenger Survey at Heathrow, Gatwick and Stansted.
- 2.145 The results of this survey of passengers’ airport preferences showed that Heathrow was the preferred substitute for many passengers (around 45 per cent stated a first or second preference for using the airport). There was also a significant preference for Stansted, although less than 20 per cent of Gatwick’s passengers indicated a first or second preference to use the airport. In contrast, Luton and City both recorded significantly less than 10 per cent of passengers’ first and second preferences. This is illustrated in Figure 16 below.

³⁸ OFT and CC paper refs http://www.offt.gov.uk/shared_offt/reports/transport/oft882.pdf

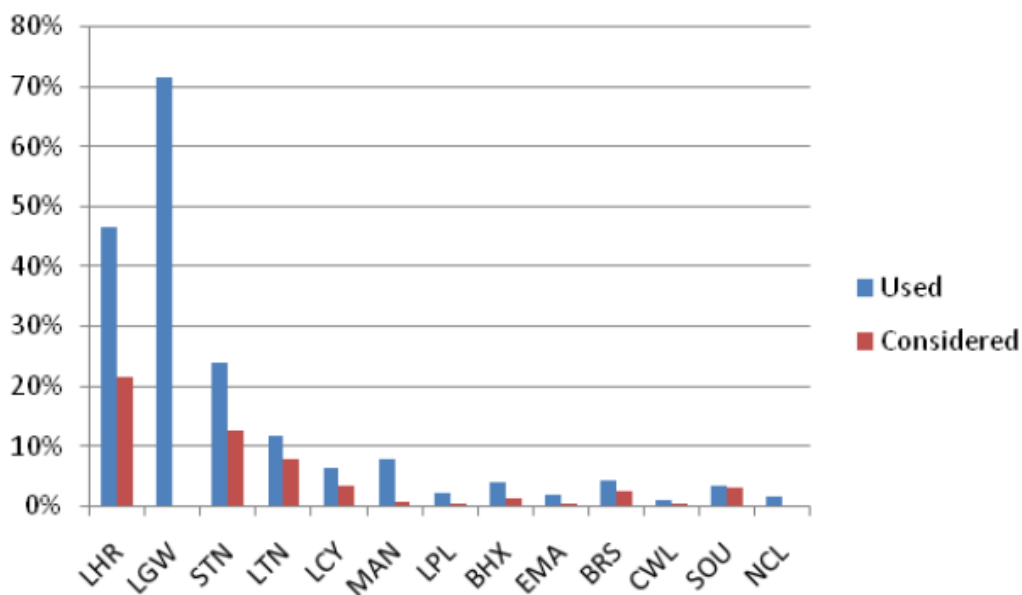
Figure 16 First and second preference airports for Gatwick short-haul surface passengers



Source: CAA passenger survey, supplementary stated preference questions, 2011

2.146 The passenger survey also asked passengers whether they had previously used other airports (in the preceding two years). These responses showed that Stansted and Luton have been used more often than they were named as preferred airport, as depicted in Figure 17 below. This might suggest a greater degree of substitutability between Gatwick and Stansted or Luton than indicated by the evidence on airport preferences. In particular, these responses might indicate that whilst some passengers have preferences to use Heathrow there are factors, such as cost and route availability, that lead them to choose between other airports.

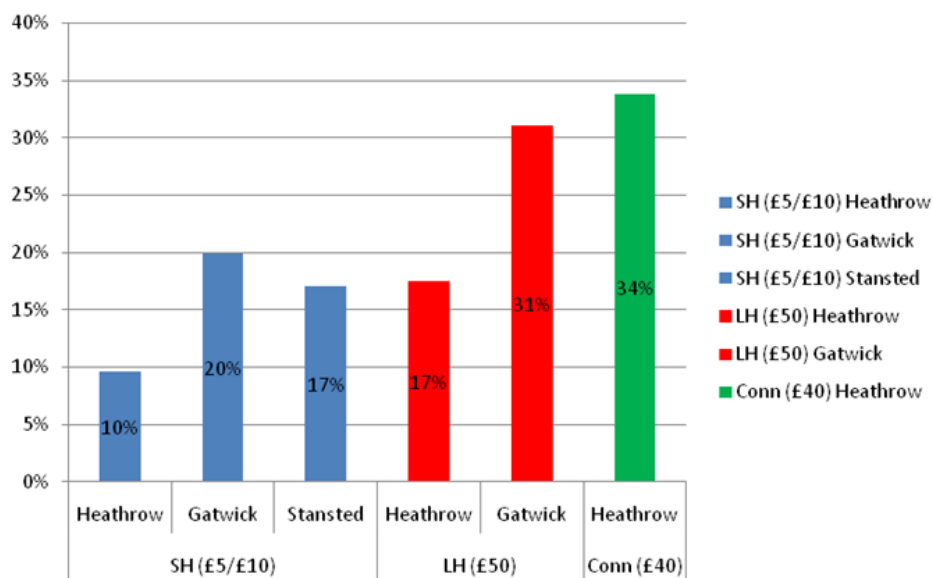
Figure 17 Airports previously used in the past two years and airports considered as alternatives for current flight by short haul passengers at Gatwick



Source: CAA passenger survey, supplementary stated preference questions, 2011

2.147 The CAA also asked passengers how they would react if their ticket price for travelling through the airport increased by a set amount (that was approximately 10 per cent of the average airfare). The results are shown in Figure 18 below. While difficult to compare in absolute terms, Gatwick’s passengers showed a higher willingness to switch to other airports than Heathrow’s and a similar willingness to switch as Stansted’s³⁹.

Figure 18 Passenger price responsiveness to an increase in the cost of using their current airport



Source: CAA passenger survey, supplementary stated preference questions, 2011

2.148 However, these results could be affected by a number of factors, including:

- At Heathrow the fares are generally higher than Gatwick’s and at Stansted the fares are generally lower than Gatwick’s, which means that the price increase used in the questions would have represented a smaller relative share of Heathrow’s ticket price and a large relative share of Stansted’s ticket price, therefore under-stating the price responsiveness of passengers at Heathrow relative to Gatwick and over-stating the price responsiveness of Stansted relative to Gatwick; and
- Stansted has the highest share of short haul routes that are not offered from other airports, which might limit the degree to which passengers would react to a price rise.

Summary - Geographic market: passengers

2.149 From the above, two relevant markets can be defined. The first is the market for the provision by airports of infrastructure and infrastructure services to surface passengers in the Greater London area and South East of England, possibly also extending to include some districts in the South West and the East of England. The second is the market for the provision by airports of

³⁹ Although 20 per cent of Gatwick’s passengers stated they would switch away, compared with only 17 per cent of Stansted’s the confidence intervals around these figures are such that the results cannot be interpreted with certainty as Gatwick having a higher share of switching passengers than Stansted.

infrastructure and infrastructure services to connecting passengers in the UK and, to some degree, Europe.

- 2.150 However, when understanding the competitive constraints on Gatwick it is also relevant that a number of passenger groups, such as domestic, inbound and business passengers, all generally travel shorter distances to reach the airport. This might reduce the airports that these passengers would consider as suitable substitutes.
- 2.151 Further, it is the interaction at the airport of the passengers in these markets with airlines in their respective relevant markets that affect the competitive constraints faced by the airport and affect the profitability of a price increase.

Passenger airlines

- 2.152 To form a view on the relevant geographic market for the provision of infrastructure and infrastructure services to passenger airlines, it is useful to consider the airports to which the airlines using Gatwick could switch a significant number of routes, a significant number of aircraft, or their entire operation, in light of a price rise.
- 2.153 The ability for airlines to switch between different airports on a geographic dimension will vary to some extent by the airlines' business models, combined with the destinations they serve and whether the airlines are based at Gatwick.
- 2.154 In order to consider the impact of different business models on the geographic market, we have distinguished between airlines on the basis of whether they base their operations at the airport, and whether they are FSC or LCC (their respective characteristics were discussed in the previous product market section).
- 2.155 Reflecting this, Gatwick's airlines can be split into the following groups:
- based FSC airlines, such as BA and Virgin;
 - based point-to-point (predominantly LCCs) and charter operators, such as easyJet, Monarch, Thomas Cook, Thomson;
 - inbound short-haul, point-to-point carriers, such as Ryanair; and
 - inbound long-haul carriers, such as Emirates, US Airways, Delta, Vietnam Airlines and other overseas airlines with hubs abroad.
- 2.156 There are airlines that do not fall within the above categories, but which do not account for a very significant proportion of the services flown from Gatwick. For example, Lufthansa operates services from Frankfurt to Gatwick, and would normally be considered as an inbound, short-haul network carrier.

Based Full Service Carriers

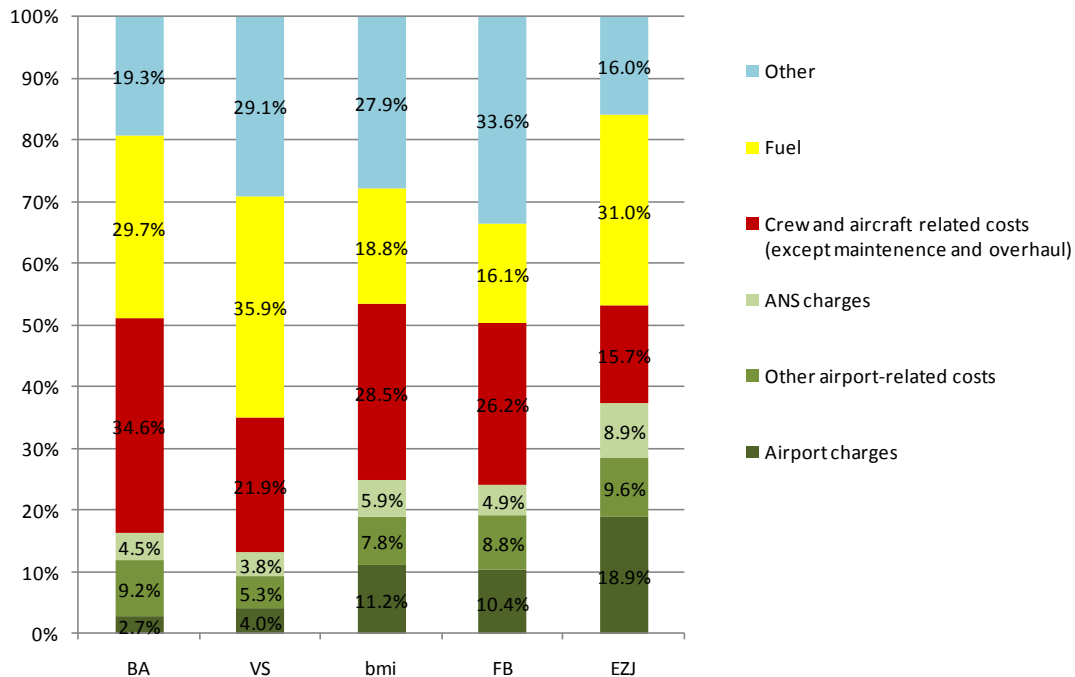
- 2.157 FSCs based at Gatwick operate a range of long-haul and short-haul services and/or rely, to a significant degree, on passengers connecting between services (e.g. BA). In both cases, these network carriers are likely to face switching costs that arise by virtue of these connecting passengers. In

particular, if these carriers relocate capacity away from Gatwick in response to a price rise, they will lose the benefit of the network of routes at the airport, in the form of the revenues from connecting passengers. This suggests that these carriers will only view airports with a significant number of network services as being close substitutes to operating from Gatwick. Indeed, for airlines with significant network effects and only a small number of current bases – such as BA and Virgin – the only close substitute might be Heathrow.

2.158 A further factor supporting a relatively narrow geographic market is the cost structure of these airlines. Due to the full-service nature of their offering to passengers, these airlines have invested significantly at the airports to tailor their offering to passengers, such as through the provision of premium lounges and branded check-in areas.

2.159 More generally, airport charges represent a lower proportion of the total costs of operating services, particularly for those airlines operating long-haul services, as Figure 19 illustrates.

Figure 19 Shares of operating costs of major UK airlines



Source: CAA airline account information, latest available financial years⁴⁰

2.160 This figure shows that, whilst some of the variations between carriers might reflect the differing accounting categorisations used, the share of operating costs accounted for by airport charges is significantly different between BA (2.7 per cent) at one extreme and easyJet (18.9 per cent) on the other. Where airport charges are a smaller proportion of operating costs, it is likely

⁴⁰ Figures taken from Table 6 of the 2009/10 airline accounts published regularly on the CAA's website: <http://www.caa.co.uk/default.aspx?catid=80&pagetype=88&pageid=13&sqlid=13>. For the purpose of this figure, airport charges include line items 22 and 27. Other airport-related costs include line items 24 and 25. ANS charges includes line item 23. There are likely to be overlaps between these line items. For example, line item 24 should also include parking fees, which is an element of airport charges at Gatwick. On the other hand, line item 22 should also include aerodrome ANS charges, although it is unclear whether these have been reported under line item 22 or 23.

that there will be a lower responsiveness to changes in airport charges, which will have the effect of reducing the likelihood that these airlines will switch to another airport in response to an increase in prices.

- 2.161 The impact of network effects on switching costs, when combined with the infrastructure requirements of FSCs, appears likely to narrow the geographic market for based FSCs to include only Gatwick and Heathrow. However, we also heard that airlines operating at both Heathrow and Gatwick might regard Gatwick as a closer substitute to other large regional airports than to Heathrow as it attracts a different type of passenger (holiday focused). [X] There might, therefore, be a case to extend the relevant market for these airlines to include the largest UK airports that can also accommodate long-haul flights, although the current evidence for such an approach is relatively limited.

Based point-to-point LCCs and charter

- 2.162 The largest based point-to-point airline at Gatwick is easyJet; the airport's largest airline. Low cost carriers (LCCs) have a different operating model to the FSCs at Gatwick, in that they base aircraft across a number of airports of different sizes from which aircraft fly on point-to-point services. This means that LCCs, including easyJet, typically have a large number of bases, across which the airlines compare relative profitability in order to make best use of their aircraft across Europe. For example, as at November 2011, easyJet operated from 123 airports, with 19 bases.⁴¹

- 2.163 This focus on point-to-point services also means that there are no significant network effects, in part reflecting the fact that these airlines do not sell connecting services or support passengers in connecting between their services. Consequently, the removal of a service from Gatwick will result in costs in terms of the lost profit from that service, but there are unlikely to be significant adverse impacts on the profitability of other services operated by the airline at Gatwick. This suggests that switching costs of LCCs are somewhat lower than those faced by network carriers, and that these airlines view a larger number of airports across Europe as being reasonable alternatives to flying from Gatwick. Indeed, easyJet also refers to its network optimisation across Europe, which includes opening and closing routes to improve overall financial performance⁴². In its most recent annual report easyJet states:

“easyJet has built flexibility into its fleet planning arrangements such that it can increase or decrease capacity deployed, subject to the opportunities available and prevailing economic conditions. The Company also has flexibility to move aircraft between routes and markets to improve ROCE.”⁴³

- 2.164 However, LCCs also typically have a significantly leaner cost structure, achieved by simplifying many business processes and by offering a less differentiated service offering to passengers than is typically provided by FSCs. This characteristic also means that these airlines tend to be more

⁴¹ easyJet, *Annual Report and Accounts 2011*

⁴² See, for example, http://www.easyjet.com/common/img/easyjet_results_YE_2007.pdf

⁴³ easyJet, *Annual Report and Accounts 2011*

sensitive to increases in airport charges, in part as airport costs constitute a higher share of their total costs than they do for the traditional FSC.

- 2.165 Set against this is the fact that easyJet, in particular, has adopted a strategy of serving convenient airports, and of targeting an increase in the numbers of business passengers that it carries.
- 2.166 In the case of charter airlines, it needs to be recognised that the product sold to passengers is a combination of a flight, hotel and other ancillary services; the flight is only one element of a larger product. The total cost base for this product therefore also includes the costs for providing the other services, reducing substantially the proportionate increase in total cost caused by a 10 per cent increase in airport charges.
- 2.167 However, the charter carriers based at Gatwick typically operate from a number of UK airports, which would reduce the costs of switching some services away from Gatwick and to another UK airport, particularly if that airport served a similar passenger catchment area. In light of these multiple bases, it appears likely that it is easier for charter carriers to switch away from Gatwick, and to other existing UK bases, than it might be for FSC.
- 2.168 It should, however, be noted that a number of airlines emphasised that Gatwick delivered higher yields than operating at other airports (other than Heathrow), which reduced their willingness to switch away from the airport. This issue is explored in more detail as part of the discussion of airline switching and the competitive price level in chapter 3.

Inbound long-haul airlines

- 2.169 Inbound long haul carriers might have the largest geographic choice set, with this being limited to those airports that can economically be reached from their bases with their existing fleet of aircraft. However, airport costs are likely to play a less important role in their route planning process, compared with the other groups of airlines, due to their cost structures. Indeed, the cost structure of a typical long-haul flight is likely to be affected more by other operating costs such as fuel and crew [~~X~~] than are short haul flights. This suggests that a 5-10 per cent rise in airport charges is much less likely to affect the overall profitability of a long-haul carrier to such a degree that it would change the route planning process, and prompt the airline to relocate significant capacity to other airports.
- 2.170 Instead, the route planning is likely to be more influenced by access to an attractive and prosperous passenger catchment area, the availability of the necessary facilities for long-haul, premium and transfer passengers and the passenger recognition of the airport. This suggests that the geographic market for some inbound long-haul carriers is likely to be determined by the need to access the Greater London passenger catchment area.
- 2.171 However, a number of long-haul airlines serve both Heathrow and Gatwick, in which case Gatwick has been commonly described to us as focusing on holiday traffic, with Heathrow having a stronger focus on the business, premium and transfer segments. This difference in focus might affect the

geographic choices considered by these inbound airlines, as other large regional airports serving large catchment areas (e.g. Manchester, Birmingham, Glasgow) might be considered close substitutes to Gatwick. One example that supports this view is the route choices by Qatar Airways that ceased operations to Gatwick in summer 2011 and grew its capacity at Manchester (whilst continuing to operate to Heathrow).

Inbound short-haul airlines

- 2.172 Inbound short-haul carriers are likely to be amongst the airlines most likely to relocate capacity away from Gatwick in response to a price rise. This is likely to be particularly true for LCC airlines, due to the relative impact of an increase in airport charges on the operating costs of these airlines. In the case of Ryanair – the largest inbound short-haul carrier at Gatwick – it is also relevant that the airline operates to a large number of airports across Europe (160 in 2011⁴⁴), giving it additional flexibility to move its inbound services away from Gatwick.
- 2.173 This suggests that LCC inbound carriers may view a number of airports as reasonably close alternatives to Gatwick, including those in the South East of England and others across Europe (including elsewhere in the UK). However, as noted above, the higher yield achievable at Gatwick might represent a switching cost that narrows the number of airports that are reasonably close alternatives to operating to Gatwick.
- 2.174 In contrast, inbound FSCs are likely to have higher costs, and so be less responsive to increases in airport charges. Furthermore, these airlines are more likely to place particular weight to flying to an airport that supports the provision of premium services (as noted in the product market definition). It is also likely that those airlines operating networks will place particular weight on ensuring that their networks are connected with major conurbations and business centres, such as London. Furthermore, these inbound carriers may see a connection to London as being an important component of their networks. This might suggest a narrow geographic market, potentially only extending to include Heathrow and London City airport.

Supply-side substitutability

- 2.175 Supply-side substitutability is not relevant to geographic markets in the context of airports since it is not possible for an airport in one geographic market to begin supplying passengers in another geographic market without relocating, opening a new airport or improving surface access. None of which would be possible in a short time frame.

Summary - Geographic Market: passenger airlines

- 2.176 As discussed in the context of the product market, Gatwick supplies infrastructure and infrastructure services to LCC airlines offering short-haul services and – related to this market – the provision of such services to full-service airlines, which includes the infrastructure to accept long-haul

⁴⁴ Ryanair, Q3 Results, 31 December 2011

services, connecting passengers, premium services and bellyhold cargo, together with convenient access to a large, prosperous population.

2.177 Mirroring these distinctions, the geographic market that Gatwick operates in for airlines varies by business model. In particular, the following factors affect this geographic market:

- The impact of network effects on switching costs, when combined with the infrastructure requirements of FSCs, appears likely to narrow the geographic market for based FSCs to include only Gatwick and Heathrow. However, the holiday focus of Gatwick – and the business-focus of Heathrow’s long-haul services – might suggest that some airlines view Gatwick as a substitute to other large regional airports.
- Point-to-point short-haul airlines appear to operate in a relatively broad market, particularly in respect of LCCs, where the flexible business model and multiple existing bases suggests that the airport competes – to a significant degree – with a number of other European airports for airline business. However, in light of the strong position of easyJet at the airport and the airline’s current strategy, might have the effect of limiting the set of European airports to those that offer convenient access to large conurbations and/or major tourist destinations. However, additional analysis is necessary to understand better the relative magnitudes of different types of switching costs for LCC to come to a conclusive view on this issue.
- Charter carriers, short-haul FSCs and those airlines operating long-haul services appear likely to be relatively unresponsive to changes in airport charges, due to their cost structures. This might suggest that these carriers are not likely to be the most likely to switch in response to a price rise and therefore less likely to determine the scope of the geographic market.

2.178 Combining the product and geographic market, this suggests that the airport competes for airlines with airports across two distinct geographic areas. First, for LCC short-haul services, the airport competes with a number of European airports, particularly those that offer convenient access to large conurbations and/or major tourist destinations. Second, for based network airlines, the product market narrows the range of airports that Gatwick could be said to be competing with, limiting the geographic market to be Gatwick and Heathrow and possibly other large UK airports with a degree of long haul operations, including Manchester, Birmingham Edinburgh and Glasgow.

2.179 However, to reach a view on the relevant market definition, the interdependences between the airline- and passenger-facing aspects of Gatwick’s operations need to be understood. This is discussed below.

The interdependence of demand from different user groups

2.180 Each of Gatwick’s user groups could be considered as different ‘sides’ of an airport market; each with its own characteristics and ability to respond to changes in the price and service offered by Gatwick.

- 2.181 Indeed, reflecting the linkages between them, it is likely that the reaction of passengers and passenger airlines, as well as cargo carriers and other third-party service providers, to changing prices and/or service quality will precipitate a reaction from the other (interdependent) users. These reactions may then act together to affect the profitability of such a change in price for the airport and, ultimately, determine the extent of the market power enjoyed by the airport.
- 2.182 This section presents a summary of the earlier findings and considers the potential interactions between the airline-facing and passenger-facing sides of the market and how these might influence the definition of the market within which Gatwick operates.

The supply of infrastructure to passengers

- 2.183 The relevant product market for assessing Gatwick's market power in respect of passengers is likely to cover a range of aeronautical and non-aeronautical services that are required for the reception, processing and boarding of passengers. This product is likely to include a range of non-aeronautical services, such as the provision of some (but not necessarily all) retail activities and surface access to the terminals.
- 2.184 It appears that this passenger product market might need to be segregated into the services provided to connecting and surface passengers. However, given the small number of connecting passengers at Gatwick, a separate assessment of this market is unlikely to be relevant for the overall assessment of Gatwick's market power. Furthermore, the strength of the outbound holiday sector suggests that the assessment of the market for surface passengers is likely to be highly dependent on the preferences and switching abilities of these passengers.
- 2.185 In respect of the geographic market, two relevant markets can be defined. The first is the market for the provision by airports of infrastructure and infrastructure services to surface passengers in the Greater London area and South East of England, possibly also extending to include some districts in the South West and the East of England. The second is the market for the provision by airports of infrastructure and infrastructure services to connecting passengers in the UK and, to some degree, Europe.

The supply of infrastructure to passenger airlines

- 2.186 Overall, in respect of the supply of services by Gatwick to airlines, the relevant product market for this assessment is the provision of infrastructure and infrastructure services, covering a broad range of aeronautical and non-aeronautical activities.
- 2.187 Gatwick has a particularly diverse airline base, with different airlines likely to consider a sometimes very different range of airports as appropriate substitutes to Gatwick, which might justify distinguishing two somewhat distinct, yet overlapping, product markets for different airline models.
- 2.188 First, Gatwick shares one product market with Heathrow for FSC, particularly those with a degree of network, long haul and connecting services, but also

with some larger “regional” airports for short haul services that are less dependent on a network. Second, in the product market for LCCs, Gatwick is likely to operate in the same market as a number of UK regional airports, and some airports further afield in Europe. Heathrow is, however, unlikely to be considered as a suitable substitute to Gatwick, for these airlines.

- 2.189 Furthermore there might be arguments to adopt a narrower product market by distinguishing between capacity provided at different times of year as passenger demand is such that certain services are only operated in the summer. This is particularly the case for holiday-focussed routes.
- 2.190 The geographic extent of these markets also is likely to vary somewhat depending upon the airline business model being considered. The narrowest geographic market appears to apply to FSC, and might include only Gatwick and Heathrow, particularly for those airlines based at Gatwick. In contrast, short haul point-to-point carriers (charters and LCC) are likely to include other large airports in the South East such as Stansted and Luton and possibly even nationwide. This market might also be relevant when considering inbound FSC services. However, for LCC airline business models (e.g. easyJet) it appears that the (airline-facing) geographic market is European-wide.

Combining the airline and passenger-facing markets

- 2.191 This chapter identified a number of areas where airlines and passengers interact making it more difficult to assess the impact of changes in price. In particular, in order for passengers to switch to an alternative airport, an airline must offer the desired route to the passenger. Similarly, in order for an airline to switch to another airport, there must be sufficient demand from passengers at that airport for any routes that they offer.
- 2.192 In particular, whilst there may be relatively low direct costs associated with an airline relocating to another airport, the willingness to do so will be affected by whether there are sufficient passengers at alternative airports and whether airline switching away from Gatwick typically involves airlines accepting a lower yield. To the extent that airlines are able to switch to nearby airports and attract many of the same passengers, this may reduce the adverse impact on yields. Similarly, for passengers to view an airport as a reasonable substitute they will need to be able to find a suitable alternative flight, which will often need to be to the same destination. The airlines’ ability to switch will, therefore, depend upon passenger decisions, whilst passengers’ choices are likely to be affected by those of airlines.
- 2.193 This interdependence can be particularly important where airlines operate networks, with passengers connecting between services, as the addition of services can attract more passengers, which itself encourages airlines to operate additional services. This is relevant for the airlines at Gatwick that rely on connecting passengers to support the commercial operation of their services, making it particularly difficult to replicate the network effects that current exist at Gatwick, and having the effect of narrowing the market for

these (FSC) airlines and their passengers to be Heathrow and Gatwick (i.e. airports with similar catchments and existing network airline operations).

- 2.194 It is also possible that similar virtuous circles exist at airports, with relatively low levels of passenger and/or airline awareness, as new routes can attract new passengers – who are then more familiar with the airport and likely to use it again – which then can be used in marketing to airlines.
- 2.195 Gatwick is a relatively large and well-established airport – indeed, survey evidence confirms a high awareness of the airport amongst passengers – we have not identified any significant airline-passenger interactions that significantly affect the market power enjoyed by the airport. However, the retail revenues generated from passengers are likely to have a significant impact on the airport’s incentives to raise prices to airlines, due to the adverse impact that lower passenger numbers have on profitability.
- 2.196 The interdependencies between passengers and airlines may also be an explanatory factor for why passenger airlines continue to regard Gatwick’s catchment as particularly attractive, supporting comparatively high airfares, even compared to comparatively close neighbouring airports such as Stansted. The range of airline routes and business models attracts a large number of passengers to the airport, building passenger familiarity with the airport, and attracting further airlines to open services.
- 2.197 Furthermore, we also identified circumstances where airports are unable to identify passenger groups and would therefore find it difficult to price discriminate between them, but where airlines would be able to identify these passenger groups as they collect more detailed information from passengers. Where different passenger groups have varying needs, it may therefore be possible for airlines to discriminate between them.
- 2.198 These varying needs are likely to make some passenger groups more or less price sensitive than others. This implies that, when an airport raises its charges to an airline, the airline may pass that increase on disproportionately to different passenger groups. The ability to price discriminate in this way may mean that passenger volume losses as a result of price increases are less than if the increase was passed on uniformly.

Further work

- 2.199 This chapter has set out the CAA’s views on the extent of the markets within which Gatwick operates. We have left a number of issues open at this stage, reflecting the strength of evidence currently available. During 2012 the CAA will be working with airports and airlines to develop further its views on the relevant market(s). At this stage, a common explanation for airlines’ reluctance to switch away from the airport was the fact that airline yields were higher at the airport than at comparable airports. In order to understand better the significance of this effect, we will engage on this issue further with airlines following the publication of our initial views.

3. Factors contributing to Gatwick's market position

Introduction

- 3.1 This chapter considers the factors contributing to Gatwick's market position, which is then used to support the CAA's overall assessment of the degree of market power enjoyed by the airport.
- 3.2 The previous chapter considered the market(s) in which Gatwick operates, in regard to its various user groups, with particular focus on passenger airlines and passengers. This analysis highlights the importance of understanding how passenger and airline choices affect the market power enjoyed by the airport, including how these two customer groups might interact to discipline (or not) the airport's conduct.
- 3.3 This chapter considers the evidence available on the strength of competitive constraints faced by Gatwick. In line with the CAA's *Guidance on the assessment of airport market power*⁴⁵, we will be considering the cumulative impact of competitive constraints arising from within and outside of the market(s) set out in the previous chapter.

Structure of this chapter

- 3.4 This chapter is structured in a number of sections, starting with a description of the size of Gatwick in its markets. This is then followed by three sections focusing on the potential impact of customer switching on the airport's incentives; looking at airline switching, passenger switching and how these two forms of switching interact to affect the incentives faced by the airport.
- 3.5 This is then followed by sections that discuss the impact of capacity constraints (together with barriers to entry and expansion) on the airport's market position, and that consider the relevance of evidence on the airport's pricing and behaviour.
- 3.6 The final section explicitly considers how these factors might change over time, to affect the airport's market power going forward.

Market shares

- 3.7 Market shares can provide a useful initial indication of market structure and potential market power, although they need to be interpreted in light of the market conditions and other evidence on the strength of competitive constraints faced by the airport. A further complicating factor – as noted in the *Guidance on the Assessment of Airport Market Power* – is that the airport faces potential competitive constraints from the choices made by different customer groups, notably passenger airlines and passengers.
- 3.8 However, the relative size of Gatwick in the markets it operates within provides a useful first step in understanding the likely market power of the airport.
- 3.9 Reflecting the analysis in Chapter 2, Gatwick operates in a number of related economic markets. In respect of airlines, the airport competes for short-haul

⁴⁵ CAA, *Guidance on the assessment of airport market power*, April 2011, available at: <http://www.caa.co.uk/docs/5/Final%20Competition%20Assessment%20Guidelines%20-%20FINAL.pdf>.

services operated by LCCs with a number of European airports, particularly those that offer convenient access to large conurbations and/or major tourist destinations. Second, the product market for FSCs narrows the range of airports that Gatwick could be said to be competing with, limiting the geographic market to be Gatwick and Heathrow, and possibly other large UK airports, such as Manchester, Birmingham, Edinburgh and Glasgow.

3.10 Chapter two also describes two markets within which the airport competes for passengers. The first is the market for the provision by airports of infrastructure and infrastructure services to surface passengers. The second is the market for the provision by airports of infrastructure and infrastructure services to connecting passengers.

3.11 The following analysis brings together analysis of Gatwick’s relative market position reflecting these different scopes.

Market shares of the passenger market

3.12 In the previous chapter we discussed that the relevant geographic market for passengers appears to include the Greater London area and South East of England, possibly also extending to include some districts in the South West and the East of England. There was also some evidence to support the potential segmentation into different groups of passengers according to their travel destination, travel purpose or travel direction can provide additional relevant information, without necessarily constituting separate markets. Consequently, we present market shares that explore these areas and these passenger characteristics.

3.13 Table 3 below shows Gatwick’s market share in this market (absent any further segmentation). Overall, Gatwick has the second highest share with 29 per cent, after Heathrow with just over 40 per cent. However, in the South East of England alone Gatwick has the highest share with over 44 per cent, closely followed by Heathrow with over 41 per cent. In the East of England Gatwick only holds the third largest market share, on a par with Luton, behind Stansted and Heathrow.

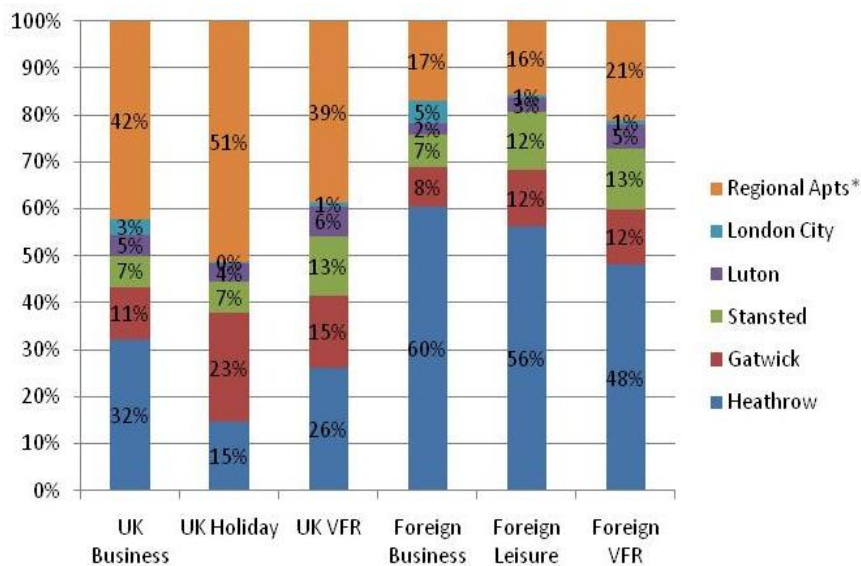
Table 3 Airport market shares for Greater London, South East and East of England

	Greater London		South East		East of England		Grand Total	
	Pax (m)	%	Pax (m)	%	Pax (m)	%	Pax (m)	%
LHR	20.9	45.3	9.8	41.1	3.5	24.2	34.2	40.4
LGW	11.4	24.6	10.6	44.3	2.6	17.9	24.6	29.0
STN	8.5	18.3	1.6	6.8	5.4	37.1	15.5	18.3
LTN	3.1	6.6	1.2	5.2	2.6	17.9	6.9	8.1
Other	2.4	5.2	0.6	2.7	0.4	3.0	3.5	4.1
Grand Total	46.3		23.8		14.5		84.6	

Source: CAA Survey

3.14 However, when segmenting surface passengers further by journey purpose and by residency, Gatwick has the largest market share of the outbound/UK resident holiday segment, as illustrated in Figure 20.

Figure 20 Airport share of passengers by journey purpose and residence, 2010

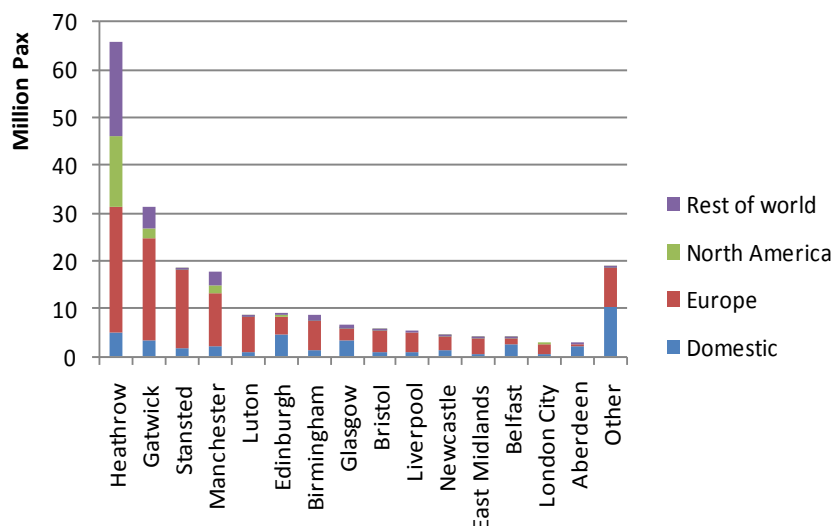


Note: excludes connecting passengers
Source: CAA Passenger Survey

3.15 Furthermore, Gatwick is one of very few UK airports outside of Heathrow that serves a significant number of long-haul routes and connecting passengers. The CAA’s Passenger Survey indicates that about 8 per cent, or 2.6 million, of Gatwick’s passengers connect between flights.

3.16 Figure 21 illustrates that about 50 per cent (34mppa) of Heathrow’s passengers fly on long-haul routes, whereas only about 20 per cent (7mppa) of Gatwick’s passengers fly long-haul. Manchester has the third largest long-haul operation, with about 25 per cent (4mppa) flying on long-haul routes, and Birmingham is fourth with about 15 per cent (1mppa). No other UK airport serves more than 1mppa on long-haul.

Figure 21 Airport passengers by world region of immediate destination, 2010



Note: includes connecting passengers
Source: CAA Passenger Survey

3.17 Gatwick also serves quite distinct long-haul routes to Heathrow, focusing more on holiday destinations. Consequently, in 2010 only 14 of its 36 long-haul routes overlapped with Heathrow. Gatwick has the second-largest share of holiday passengers travelling to long-haul destinations, albeit that its share is significantly lower than that of Heathrow.

Market shares of the airline market

3.18 As discussed in the previous chapter, the relevant product and geographic markets for airlines appear to differ, depending on the type of airline. Reflecting this, when considering market shares it is particularly useful to consider the following:

- full-service network carriers that operate long-haul routes; and
- point-to-point carriers operating largely independently of a network/connecting traffic (which largely serve short-haul routes).

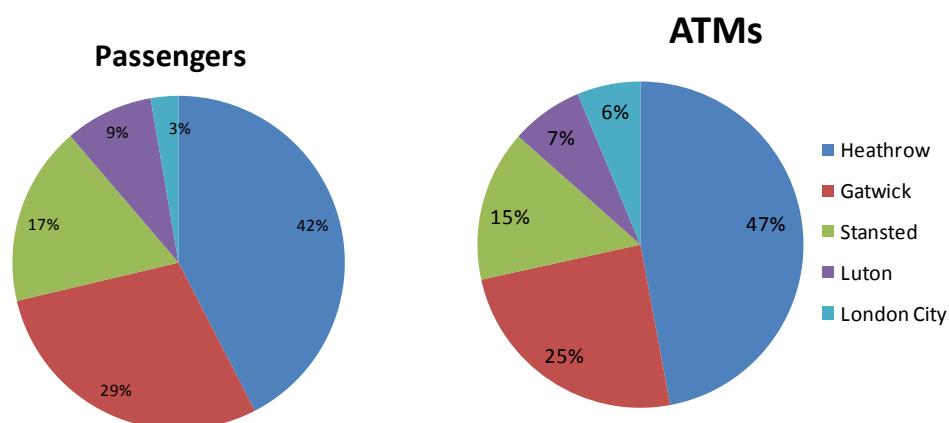
Full-service network carriers

3.19 The narrowest possible market definition for full-service network carriers operating long-haul routes might be restricted only Gatwick and Heathrow, if other catchments are not reasonably good substitutes for the London catchment (in the context of a 10 per cent price rise at Gatwick). On this basis, Gatwick's share of total commercial Air Traffic Movements (ATMs) would be approximately 34 per cent. However, given the differing traffic mixes at the two airports, this would tend to overstate Gatwick's share of capacity currently used by carriers that would consider Heathrow as a suitable alternative. When excluding LCCs and charters, Gatwick's market share of ATMs would only be 15 per cent, compared to Heathrow's 85 per cent.

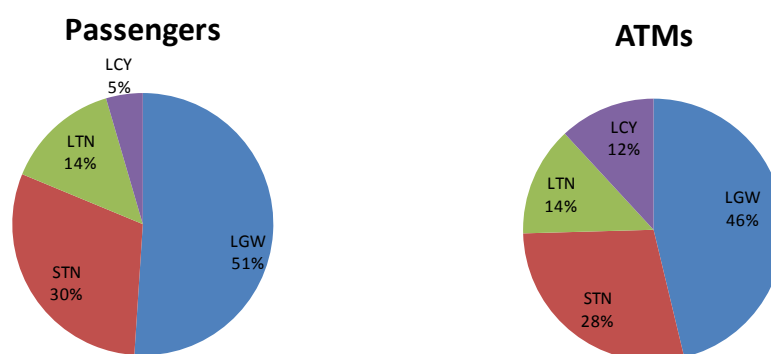
Point-to-point carriers

- 3.20 Point-to-point carriers, including both no frills and charter carriers, account for a significant proportion of the traffic at Gatwick. As discussed in Chapter 2, these airlines are likely to operate in a broad geographic market, extending to include airports across Europe. Whilst Gatwick is a large airport by European standards, its share of capacity available across Europe is not particularly high, and the airport is not one of the top 50 global airports movements, according to ACI.
- 3.21 As discussed in chapter 2, we also consider that a particularly important source of competitive constraints for Gatwick arises from its neighbouring airports in the South East of England, including Greater London. Furthermore, for LCC and charter airlines in particular, Heathrow might not represent a reasonable alternative to Gatwick, due to its operational characteristics.
- 3.22 Reflecting this, Figure 22 shows Gatwick's market shares of the London airports including and excluding Heathrow.

Figure 22 London airport shares by surface passengers and total ATMs, 2010



London airport passenger shares, excluding Heathrow, 2010

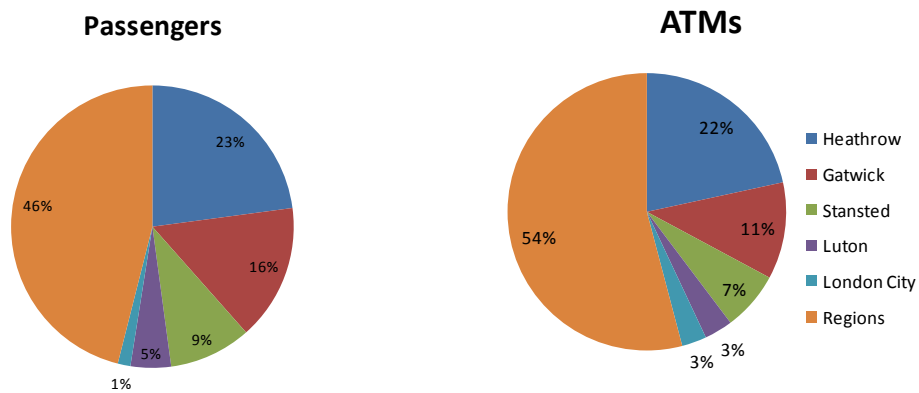


*Note: Passenger shares exclude connecting passengers
Source: CAA Airport Statistics*

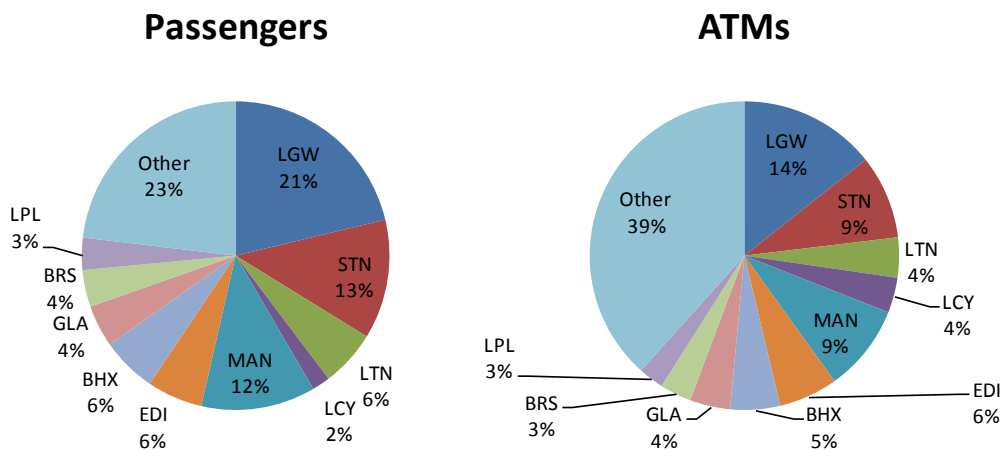
- 3.23 However, it could also be argued that some airlines at Gatwick compete across a broader market, and a number of airlines would be able to switch their services to other airports across the UK, particularly charter carriers that

already operate from a wide variety of regional UK airports. While not all UK airports would necessarily be suitable substitutes (particularly smaller ones) for simplicity we include all UK airports in Figure 23, including and excluding Heathrow (on the same reasoning as above).

Figure 23 UK airport shares by surface passengers and total ATMs, 2010



UK airport shares by surface passengers and total ATMs, excluding Heathrow, 2010



Note: Passenger shares exclude connecting passengers
Source: CAA Airport Statistics

3.24 For airlines, the share of ATMs might arguably be as relevant as of passengers. On both measures Gatwick has a relatively strong market position, with 21 per cent of passengers and 14 per cent of ATMs, when Heathrow is excluded. However, these shares are 16 and 11 per cent when Heathrow is included.

3.25 In chapter 2, we discussed the potential to distinguish between markets for capacity at different times of the year. When differentiating into different seasons, Gatwick's share is not significantly different in the summer than in the winter, as illustrated in Table 4. On the basis of market shares alone, therefore, it would appear unlikely that Gatwick has a different degree of market power in the different seasons.

Table 4 Airport Share of Passengers at London Airports

	Winter10-11 Share of Pax	Summer11 Share of Pax
Heathrow	55%	50%
Gatwick	23%	26%
Stansted	13%	14%
Luton	7%	7%
London City	2%	2%

Source: CAA Airport Statistics

Summary

- 3.26 On most measures Gatwick does not have market shares that would justify a rebuttable presumption of substantial market power. On a national and London level Gatwick remains the second largest airport after Heathrow, with significant shares of each of these markets.
- 3.27 However, for those markets where Heathrow is not a reasonable substitute for Gatwick – such as for point-to-point services operated by no frills and charter carriers – Gatwick’s market share rises considerably.
- 3.28 When considering Gatwick’s share of passenger markets, it is only when specific segments of the market (such as focusing only on the South East of England, or outbound holiday travellers) are assessed that Gatwick has market shares of over 40 per cent, although these segments are somewhat narrower than the markets described in chapter 2.
- 3.29 However, as set out in the CAA’s Guidance on the Assessment of Airport Market Power, there are aspects of airport markets that might reduce the reliability of market shares as an indicator of market power. A number of other factors will affect the assessment of market power, in particular, how easily airlines and passengers can switch between airports and how easy it is for competing airports to enter or expand. These factors are discussed further below.

Airline switching

- 3.30 This section considers evidence on the likelihood that airlines would switch away from Gatwick in response to an increase in price at the airport. It first considers available evidence on airline switching costs, before presenting evidence on actual airline switching behaviour.

Switching costs

- 3.31 As illustrated in the previous chapter on market definition, Gatwick’s airline customers are very diverse – more so than Heathrow’s (which has a focus on network-oriented FCCs) or Stansted’s (with a focus on LCCs).
- 3.32 This diversity affects the way airline switching costs need to be evaluated for Gatwick. In particular, it is important to consider how switching costs are likely to vary according to the type of airline and its level of usage of the airport.

3.33 Table 5 below illustrates the likely significance and magnitude of different types of switching costs discussed in the Annex on airline switching. However, it does not give any indications regarding the relative magnitude of different types of switching costs compared to each other. For example, it might be that “High” marketing costs might be lower than “Moderate” capital investment costs. We would welcome further evidence from airlines regarding the absolute levels of the different types of switching costs.

Table 5 Factors affecting airline switching costs

Type of switching cost	Higher if...	Moderate if...	Lower if...
Capital investment costs at new airport	Airline is based at LGW and moves significant share of operations to a new airport – e.g. might require new maintenance or cargo facilities Airline provides many own passenger-facing facilities, e.g. lounges	Airline moves significant share of operations to another existing base that require extensions to existing infrastructure Airline provides some own passenger-facing facilities	Airline moves small share of operations to another existing base Airline does not provide own passenger facing facilities
Crew and ground staff relocation	Airline has significant amount of own staff at airport Operations are moved to an airport further afield or cancelled	Airline has own staff at airport but operations are moved to neighbouring airport	Airline has few or none of its own staff at airport Operations are moved to neighbouring airport
Marketing costs	Operations are transferred to a route/airport that was previously unserved by the airline	Operations are transferred to a neighbouring airport (e.g. serve the same city)	Operations are decreased/cancelled/turned around (based aircraft now flies in from elsewhere)/rescheduled into the off-peak
Loss of route maturity and/or continuing yield loss	Operations are transferred to a previously unserved route New routes are substantially less profitable than original	Operations are transferred to a neighbouring airport (e.g. serve the same city) New routes are somewhat less profitable than original	Frequency is varied, timing of service is changed (peak to off-peak), or the same service is operated from an airline based at the other airport New routes are only

	routes	routes	marginally less profitable than original routes
Loss of economies of scale	A small part of a large operation is moved to a new airport	A part of a large operation is moved to an existing airport with small operations	Only small operations at the airport

- 3.34 Of Gatwick’s airline customers, we received some in-depth information on switching costs from Virgin Atlantic and easyJet relating to their operations at Gatwick. [X]
- 3.35 [X]
- 3.36 easyJet commissioned Frontier Economics to assess, among other things, the level of its switching costs to determine at which level of airport charge increase easyJet would start to switch routes away from Gatwick.⁴⁶
- 3.37 The Frontier report considered two types of switching costs: marketing costs and costs arising from a loss of route maturity. It acknowledged that switching to airports further afield might also attract further crew relocation costs but did not quantify these for its report. It concluded that the average costs of switching would significantly outweigh a 10 per cent increase in aeronautical airport charges at Gatwick, which is why it would be, on average, unprofitable for easyJet to switch any traffic away from Gatwick in response to a 10 per cent price rise.
- 3.38 The Frontier analysis uses a number of average values as input assumptions in its modelling. In particular, the values used to assess the switching costs that are incurred due to the fall in yield are calculated based on average yields, rather than the yields faced by the most marginal services at Gatwick (i.e. the yields of those services most likely to switch away from the airport). Consequently, the Frontier analysis is likely to over-state the magnitude of switching costs arising from the impact on yields and might provide an upper estimate of switching costs for easyJet’s operations.
- 3.39 The overall impact of Frontier’s approach is that it is likely to underestimate the degree of switching and overestimate the cost of switching, making it more likely that they reach a conclusion that switching would not be sufficient to defeat a 5-10 per cent price rise.
- 3.40 Despite this, the report clearly adds to the overall evidence base and is a relevant piece of evidence to consider in the round. We will also consider how we might build on the approach adopted by Frontier, in ways that might address the points that we make above, such as by investigating whether

⁴⁶ Frontier Economics, Market power assessment: Gatwick and Stansted Airport, prepared for easyJet, November 2011, available at: http://www.caa.co.uk/docs/5/rpt-easyJet%20Competition%20Assessment%20Final%20Report_Abridged.pdf.

there are different input assumptions on the adverse impact of switching on airline yields.

- 3.41 The Virgin evidence provides some evidence that long-haul carriers providing a premium product that also rely to some degree on network operations would incur higher costs from a loss of economies of scale, partly because of the loss of network effects and partly because of higher capital investment in infrastructure at their airports. Combining this with the easyJet/Frontier analysis, it supports the view that long-haul carriers, and those that rely on connecting traffic, face higher switching costs than those airlines operating point-to-point short-haul services.
- 3.42 As discussed in chapter 2, LCCs generally have flexible business models and operate on a pan-European basis. This might be expected to make them more able to switch their operations away from Gatwick, given their independence from any network and their lower capital investment costs. They also have more alternative bases to choose from to switch an aircraft to, without suffering significant losses of economies of scale. The available evidence supports the view that these airlines have lower switching costs, and are likely to operate some of the most marginal services at the airport (i.e. those most likely to switch). However, the Frontier analysis suggests that the switching of these airlines is not sufficiently strong to discipline the airport. In order to reach a more definitive view on Gatwick's market power, we will consider further the evidence on LCC switching, including the likely impact on yields, and consider how this affects the conclusions put forward by Frontier.
- 3.43 Charter operations are likely to fall in between FSC and LCC: Their business generally relies less on network operations (there are, for example, no interlining options), but due to their higher staffing requirements at airports pooling large numbers of flights at one airport is likely to create some operational economies of scale that might be lost when moving individual flights to other, smaller, airports. Similarly, long-haul charter flights might have higher airport infrastructure requirements, due to the larger aircraft sizes, that might only be available at a small number of airports across the UK. On the other hand, their focus on holiday passengers, with their higher sensitivity to price, might be willing to travel longer distances to airports, potentially reducing the yield and passenger losses from relocating services to other UK airports.

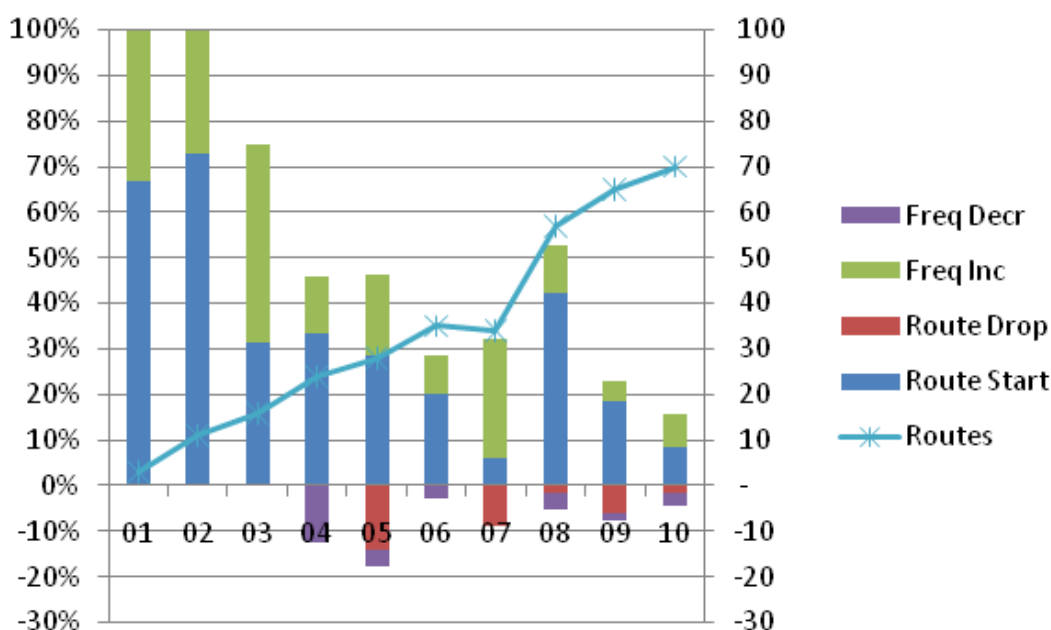
Evidence on actual switching

- 3.44 The above discussion highlights that the airlines at Gatwick face a range of different switching costs, with point-to-point LCC being the most able to switch away from Gatwick and airlines operating full service operations, notably those benefiting from significant connecting passengers, being the least able to switch away. This section considers the recent evidence on actual airline switching to and from Gatwick, and whether this supports the analysis set out above.

3.45 We have set out in the annex to this document data on the extent to which airlines vary their route offering, in terms of adding and removing frequencies and varying their route offerings. We refer to this variation in frequency and the routes offered as ‘route churn’.

3.46 The data on route churn reinforces the previous finding that FSC have lower levels of route churn than LCCs. For example, while Virgin’s route portfolio at Gatwick barely changed over the last ten years, easyJet had higher churn rates at Gatwick over the same period. This is set out in Figure 24 below.

Figure 24 easyJet route churn at Gatwick

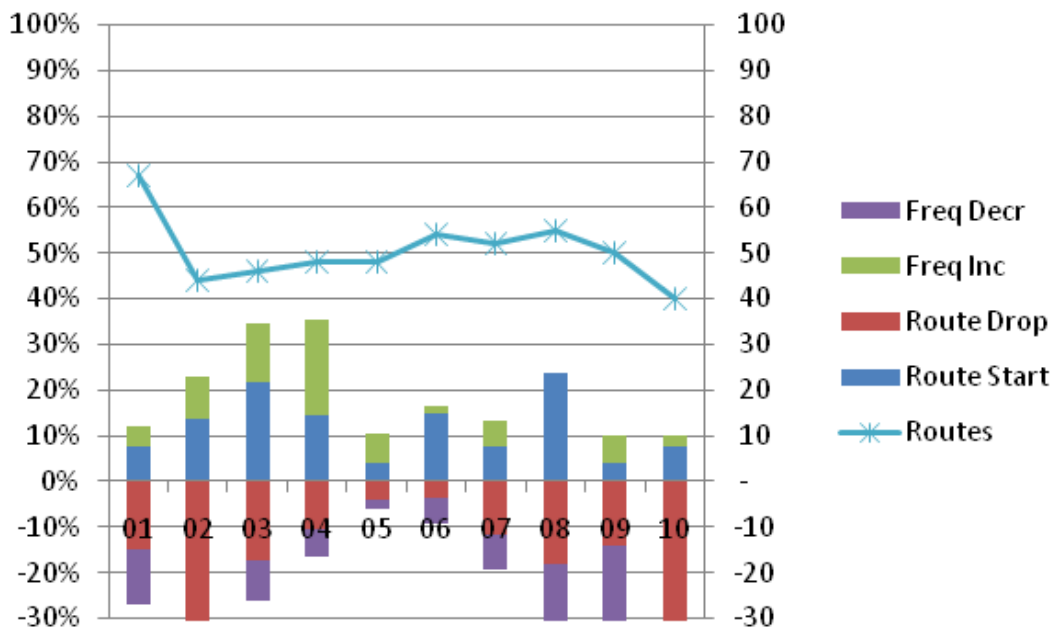


LHS: % of routes and frequencies changed as percentage of EZJ's total routes at LGW
 RHS: total number of EZJ routes at LGW
 Source: CAA analysis of CAA airport statistics

3.47 However, easyJet’s churn mainly consisted of a continuous increase in its operations at Gatwick, [X]. The evidence on churn – including that set out in the Annex relating to other airports – highlights the general principle that LCCs have higher levels of route churn, which supports the view that these airlines have more flexibility to respond to changes in airport pricing. However, in the context of Gatwick, the route churn is consistent with the view that LCCs – and easyJet in particular – have been attracted to the airport, rather than necessarily demonstrating that these airlines are able to switch away from Gatwick.

3.48 On the other hand, BA’s route churn is significantly higher than Virgin’s. In particular it decreased its presence at Gatwick significantly after BA abandoned its dual hub strategy, and following the takeover of its holiday franchise airline GB Airways by easyJet in 2007, as is illustrated in Figure 25.

Figure 25 BA route churn at Gatwick



LHS: % of routes and frequencies changed as percentage of BA's total routes at LGW
 RHS: total number of BA routes at LGW
 Source: CAA analysis of CAA Airport Statistics

- 3.49 Gatwick has also recently attracted new airlines to Gatwick, both inbound long-haul and based short-haul carriers. Some of these airlines, including Air Asia X, Norwegian and Air Berlin, had previously used Stansted and moved some or all their Stansted operations to Gatwick. Again, this switching illustrates the general flexibility of these airlines to respond to the differing offer between Stansted and Gatwick, but does not demonstrate that these airlines are able to respond to Gatwick's conduct, now that they are operating from Gatwick – albeit that Air Asia X has subsequently removed its services from Gatwick, and from Europe.
- 3.50 Some new airlines at Gatwick, including for example Vietnam Airlines or Hong Kong Airlines, had not previously served any other London airport but have recently commenced operations at Gatwick. [X] In light of this, the choice of Gatwick might not be a strong indicator of price competition between the two airports and, instead, reflect the combination of price and capacity availability at Heathrow.
- 3.51 Other recent new airlines at Gatwick – including Turkish Airlines, Air China and Lufthansa – are/will be serving the same routes from Heathrow and from Gatwick, which is consistent with the view that these airlines are operating from Gatwick as a result of the capacity constraints at Heathrow or even that they view the two airports as serving different catchments/markets.
- 3.52 There have been relatively few examples of airlines recently decreasing their use of Gatwick. Ryanair is a notable example, as it cancelled about one third of its 2011/12 winter flights to Gatwick, but this reduction took place against a background of a general volume reduction across Ryanair's entire network. It is, therefore, unclear whether this was a response to price or to wider economic factors.

- 3.53 Other airlines that decreased their overall use of Gatwick airport in recent years included BA and US carriers, who moved long-haul capacity from Gatwick to Heathrow. However, these switches were prompted by the introduction of the EU-US Open Skies agreement in 2008, and so appear more likely to be a response to a change in the legal constraints imposed on these airlines (namely a prohibition on operating from Heathrow) rather than a response to price and service competition.
- 3.54 More generally, the development of traffic at Gatwick over the last 10 years suggests that Gatwick is more resilient to economic downturns than other London airports such as Luton and Stansted, which might support the view that the airlines at Gatwick are less able to reduce their use of the airport.⁴⁷ Indeed, recent traffic growth at Gatwick shares some of the characteristics of Heathrow, albeit somewhat in a less extreme manner, with slower growth rates during years of UK traffic growth and slower declines during periods of UK traffic decline. This could reflect some of the characteristics shared between Heathrow and Gatwick, notably the fact that both airports are operating near their capacity limits for some time (albeit that the constraints at Heathrow are more significant).
- 3.55 This capacity position may have reduced the growth rates at Gatwick, relative to Luton, Stansted and regional airports, who greatly benefited from the growth of LCC traffic. While Gatwick also suffered some traffic losses since the economic recession started in 2007, its losses were less pronounced than those of Luton, Stansted and regional airports. It lost traffic mainly as a result of specific one-off events, such as BA's decision to abandon its dual hub strategy and of the introduction of the EU-US Open Skies agreement that removed an artificial barrier to enter Heathrow for transatlantic flights.
- 3.56 This suggests that Gatwick, on the whole, has been able to replace any lost operations with new routes or carriers; and has achieved this without a significant reduction in average airport charges below the maximum allowed level⁴⁸. [X].
- 3.57 This might suggest that any threat of airlines switching away from Gatwick has in the past not translated into a need to reduce prices. This suggests that the impact of airline switching on the airport might be mitigated by the potential for any vacated capacity to be taken up by other previously unmet demand that hadn't been able to secure the necessary slots. This potential for 'back fill' of capacity – which was also highlighted by easyJet/Frontier – would appear to be a factor that might significantly reduce the strength of competitive pressure faced by the airport.
- 3.58 However, such a conclusion assumes that the prices Gatwick can charge under the price cap reflect reasonably well the competitive price level that would prevail in a well-functioning airport market. If past and current prices were held below the competitive level, such observations could not be relied upon to suggest a high degree of market power. In particular, if prices are

⁴⁷ See Figure 4 in the Market Context Working paper.

⁴⁸ Indeed, as the price cap has been increasing, the airport has replaced traffic whilst also increasing charges in (nominal and real) terms.

being kept significantly below the competitive level, there would be an expectation that there would be greater demand than available supply, which would tend to result in 'back fill' at those prices. In such circumstances, this would not necessarily indicate that the airport enjoyed high levels of market power.

- 3.59 It is therefore important to have some understanding of the level of the historical prices charged by Gatwick and how these might compare to indicators of the competitive price level.

The competitive price level

- 3.60 In the CAA's Guidance on the Assessment of Airport Market Power, we considered a number of ways in which a competitive price level could be assessed, and stated that the long-term average price level would, in principle, be assessed using measures of long-run, forward-looking, cost such as depreciated replacement or incremental cost.

- 3.61 The Guidance also noted that:

"... it is important to understand, at a minimum, whether there is evidence that the prevailing and historical price levels are reasonably close to, or significantly above or below, the competitive level. Given the difficulties involved in establishing a competitive price level, it might not always be possible to derive an accurate measure. Nevertheless, where sufficient and robust evidence is available to determine a reasonable estimate, the CAA expects to take full account of it."

- 3.62 Gatwick commissioned economic consultants FTI to estimate measures of Long-run Average Incremental Cost (LRAIC) based on a number of different scenarios, basing the capital cost estimates on information on the costs of expanding Gatwick (in part, reflecting the availability of data).

- 3.63 In addition, we have considered evidence from comparative pricing data from other airports. Finally, we also consider whether we can gain insight into the relative level of airport charges at London airports from comparisons of airline yields using different London airports.

- 3.64 These approaches are discussed in turn below.

Long-run average incremental costs (LRAIC)

- 3.65 Gatwick commissioned the consultancy FTI to provide estimates of Gatwick's LRAIC. Its analysis has been shared with the CAA, and a non-confidential version using different data sources was presented to other interested parties at a workshop in early December. The non-confidential version of their report is available on our website.⁴⁹ Overall, the FTI analysis estimates a number of price benchmarks that are above the current price cap, and which would support the view that the historical (and current) prices at the airport are below the (long-term average) competitive price level.

⁴⁹ FTI Consulting, LRAIC for Gatwick Airport, Presentation for CAA Workshop, December 2011, available at: <http://www.caa.co.uk/docs/5/LRAIC%20for%20Gatwick%20-%20response%207%20Dec%2011.pdf>.

- 3.66 FTI produced estimates for three different scenarios:
- Option 1 estimated the LRAIC for a set of capacity-enhancing projects required to accommodate up to 43-45mppa (i.e. an additional 8-10mppa) by around 2025.
 - Option 2 estimated the LRAIC for a new runway including additional necessary terminal and other infrastructure. [REDACTED] the non-confidential report assumed an additional 27-37mppa (over and above 43mppa).
 - Option 3 estimated the replacement costs for a new airport, either on a comparable new site or on the same footprint that would accommodate 45mppa from the first day of re-opening after 2020.

3.67 The LRAIC estimates produced by FTI were (on a per passenger, per annum basis):

- Option 1: [REDACTED]; £10-11 (non-confidential version)
- Option 2: [REDACTED]; £14-28 (non-confidential version)⁵⁰
- Option 3: [REDACTED]; £15-20 (non-confidential version)

The forecast price cap for the charging period 2012/13 is £8.066.

3.68 Gatwick explained that the cost and passenger forecast assumptions underlying Option 1 were chosen such that the result would produce a lower bound estimate. Option 1 was based on capital costs that were drawn from the airport's capital investment planning, and thus are drawn from a set of projects that have been specified in reasonable detail. In contrast, Options 2 and 3 are based more heavily on broad cost estimates, deliberately used upper bound cost data⁵¹ and passenger forecast assumptions, so as to produce an estimate that tends towards being an upper bound estimate.

3.69 While the calculation of LRAIC numbers is relatively straightforward in methodological terms, any estimates are highly sensitive to the assumptions about the scale of costs involved and the expected scale of future passenger demand.

3.70 At the December workshop, it was argued that the accuracy of the LRAIC estimates was also adversely affected by the history of ownership and regulation of the London airports. In particular, the current specification of the airports resulted from the actions of BAA (as the common owner of Heathrow, Gatwick and Stansted) which means that the estimates of the incremental costs at the airport are higher than the costs of expanding an efficient airport. It is difficult to assess the strength of this argument, but it is true that the current airport configuration may not reflect that which would result from a well-functioning airport market – albeit that it is not clear whether this would increase or reduce the incremental costs.

⁵⁰ The significant difference between these estimates resulted mainly from different passenger forecast assumptions, see above. The cost estimates also varied somewhat, but not as significantly as the passenger forecast assumptions.

⁵¹ For example, the initial estimates of capital costs might be expected to reduce following stakeholder scrutiny and detailed review of costings.

- 3.71 Perhaps more importantly, the estimates produced by FTI are based on information about the cost of expanding Gatwick (reflecting the data available to Gatwick and to FTI). As FTI and others noted in the December seminar, Gatwick might not represent the next expansion project that might be expected in a well-functioning market. FTI are clear that its approach was designed to make best use of the most accurate information available; namely, cost information from Gatwick. However, as passengers in a well-functioning market would have a degree of choice between different airports, the relevant price benchmark might be the (lower) cost of expanding a competing airport.
- 3.72 Indeed, the estimates from FTI might support the view that expansion at existing airports might be delivered at a lower cost than a new entrant airport (where the replacement cost figures provide an indication of new entrant costs). Further, the estimates relating to a new runway at Gatwick are the highest cost estimates, again suggesting that the costs of this expansion might result in an estimate that is somewhat higher than the competitive price level.
- 3.73 Furthermore, to assess whether the investment costs truly reflect the outcomes of a well-functioning market, and where the next most efficient increment would be, we would require similar estimates for other airports that are likely to be in the same market as Gatwick, both other London airports and potentially also airports further afield, for example Manchester, Glasgow or Edinburgh airports. This is not to say, however, that the efficient investment would necessarily be at the airport with the lowest LRAIC; if passengers valued investment at Gatwick higher than at other airports, efficient investment might still be at Gatwick's LRAIC.
- 3.74 The combination of the inevitable uncertainty attached to the input assumptions, and the reliance on cost estimates that are based on expansion (only) at Gatwick, means that it is difficult to place much weight on the FTI estimates. [X]
- 3.75 We are currently considering whether it is necessary to investigate these issues further and would welcome views on this.
- 3.76 One way to put the FTI numbers in context, and to understand better the level of prices at other comparable airports, is to consider evidence on pricing at alternative airports, which is set out in the following section.

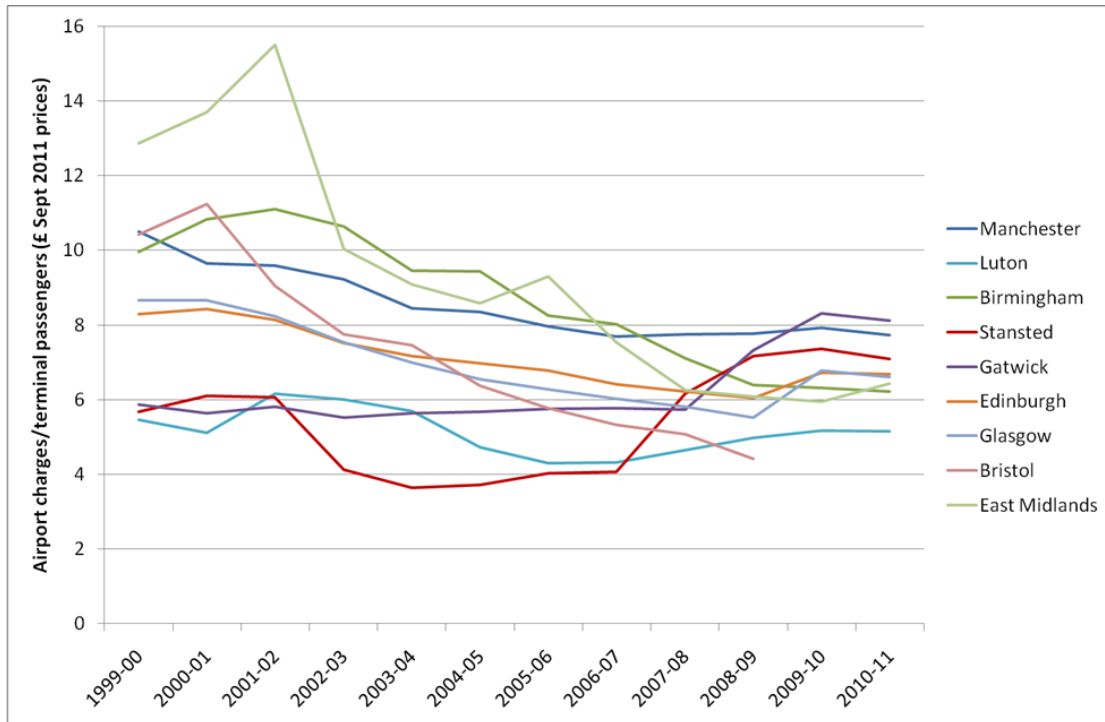
Comparisons with other airports

- 3.77 An alternative approach to calculations based on estimating long-run incremental costs is to consider evidence on pricing at comparable airports. This form of price comparison is complicated somewhat by the difficulty in clearly establishing the types of airports that are reasonably close comparators to Gatwick.
- 3.78 We had access to three sources for price comparison data, that we discuss in turn below:

- Revenue, passenger number and flight number data from eight London and regional airports collected from various sources;
- the ATRS Global Airport Benchmarking Report 2011, which surveys 156 airports worldwide, including 45 airports in Europe; and
- data obtained from easyJet and Ryanair about airport charges across their route portfolios.

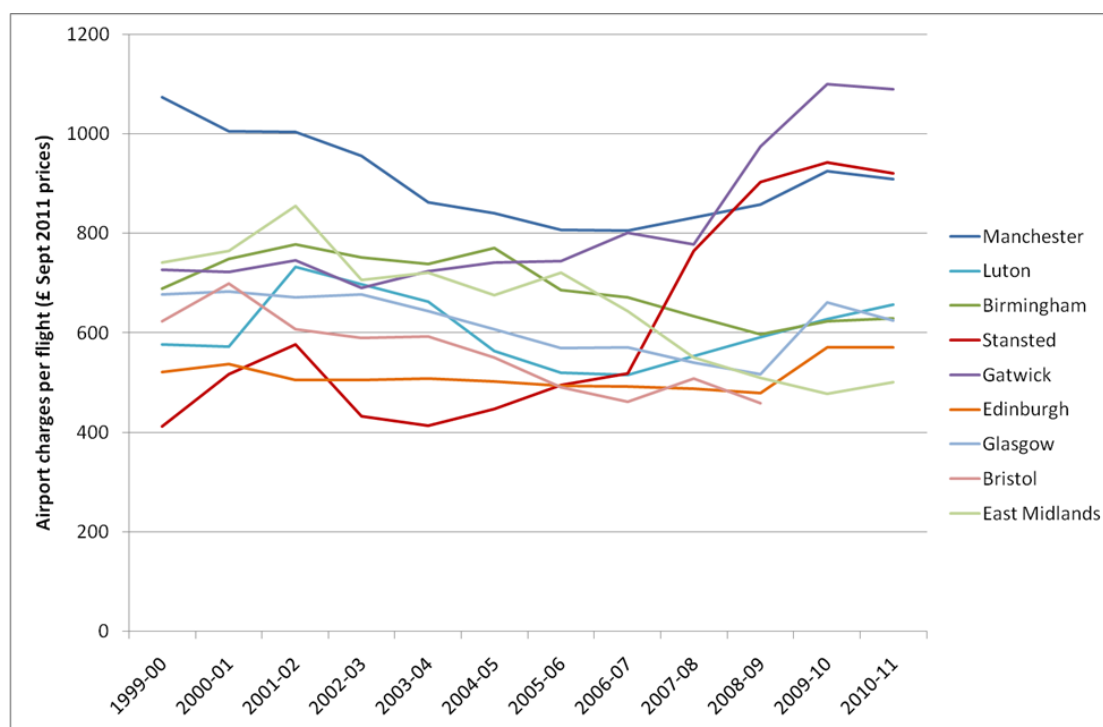
3.79 Figure 26 and Figure 27 below show the airport charges revenue per terminal passenger and per flight for eight UK airports. The charts show that up until 2008, Gatwick was one of the cheaper airports, with only Stansted and Glasgow having lower average charges per passenger. However, since this time, Gatwick charges have increased, whilst a number of other airports have reduced their average charges. This has left Gatwick as one of the more expensive airports (of the sample), albeit that Gatwick's average charges are very similar to those at Manchester and the sample chosen excludes Heathrow (which is substantially higher than all of the airports shown).

Figure 26 Airport charges revenue per terminal passenger



Source: CRI, CAA data, airport annual accounts

Figure 27 Airport charges revenue per flight

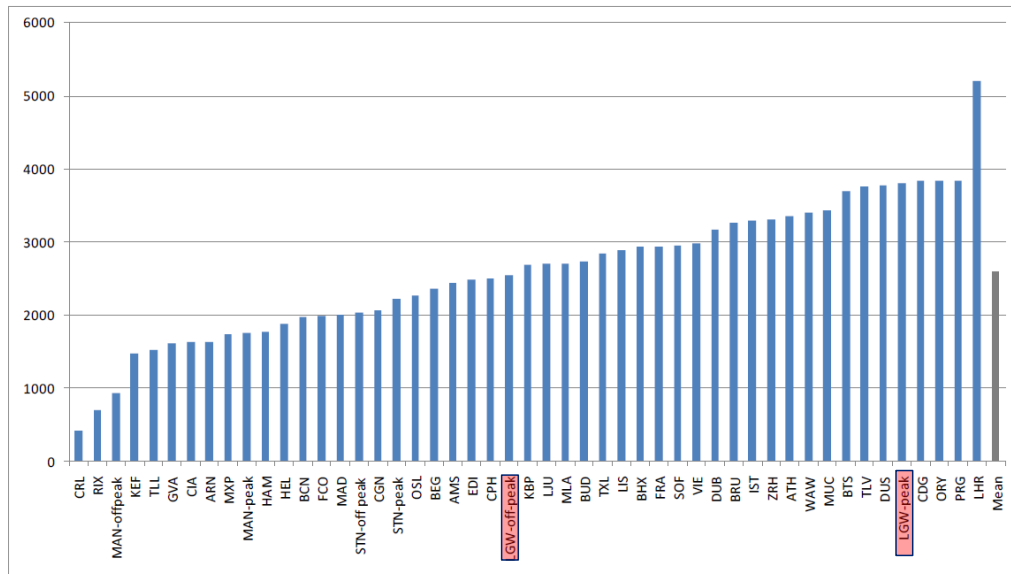


Source: CRI, CAA data, airport annual accounts

- 3.80 On a per flight basis, Gatwick’s charges have remained higher than many in the sample, with its charges increasing significantly in recent years so that it is now the most expensive in the sample, somewhat higher than Stansted and Manchester.
- 3.81 It is, however, worth noting that the measures based on ATMs will be affected by average aircraft size and load factors, which will tend to increase the measures of average charges per ATM at airports with high load factors and with larger aircraft (both of which apply at Gatwick). This might suggest that the analysis of per passenger charges is more useful.
- 3.82 Turning to the second comparison, this concentrates on larger international airports, and so is particularly relevant if the relevant comparators are considered to be large international airports.
- 3.83 Figure 28 below shows the ranking of the European airports according to the combined landing and passenger charge elements of airport charges, for an Airbus A320.⁵² While Gatwick’s off-peak charges appear to be very close to the mean charge, Gatwick’s peak charges are the 5th highest among the airports surveyed, with only the two Paris airports – Charles de Gaulle and Orly –, Prague and Heathrow charging higher fees.

⁵² It assumes an A320 with 150 seats and a 75 per cent load factor, hence 112.5 passengers. Per passenger charges are doubled as charges are levied only on departing passengers. The “peak/off-peak” differentiation for Gatwick, Heathrow and Manchester appears to refer to a differentiation for different times of the day, whereas for Stansted it refers to a differentiation for different months of the year, with peak referring to April-October.

Figure 28 Combined Landing and Passenger Charges at European airports for A320, 2010 (in USD)



Source: Air Transport Research Society, Key Findings of 2011 ATRS Global Airport Performance Benchmarking project, highlights presentation

- 3.84 While using an A320 with just over 110 passengers per flight as a typical flight appears reasonable for full-service scheduled short-haul airlines, it might be distorting the relative costs per flight for short-haul charter and LCCs, given they transport a higher average number of passengers per flight. For example, easyJet uses predominantly A320-family aircraft with 156 or 180 seats, and its average load factor in 2010 was 87 per cent, which corresponds to an average number of passengers of 135 and 156.
- 3.85 Figure 29 and Figure 30 show that while Gatwick has the highest peak landing charges for A320 aircraft, its off-peak landing charges are below the mean, and its passenger charges for international passengers are just above the mean. As the ranking of the combined charges depicted in Figure 28 relies on load factor assumptions that appear to be somewhat below the average load factor at Gatwick (on the basis of its largest customer easyJet, see previous paragraph), Gatwick's actual peak charge might be lower than depicted in Figure 28.

Figure 29 Landing charges for Airbus A320, 2010, Europe

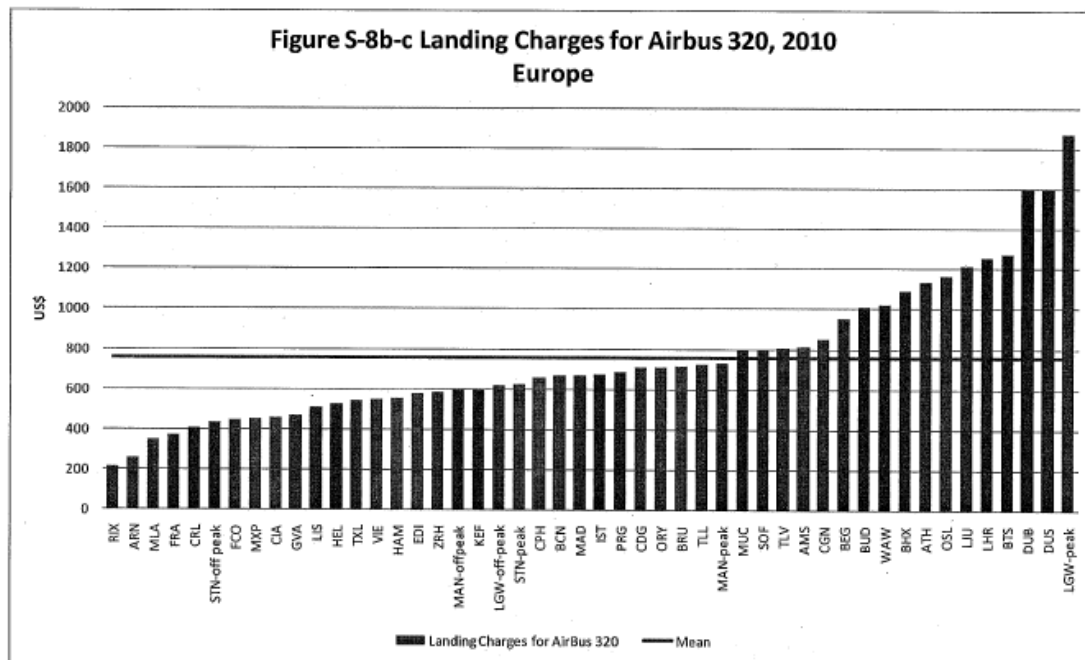
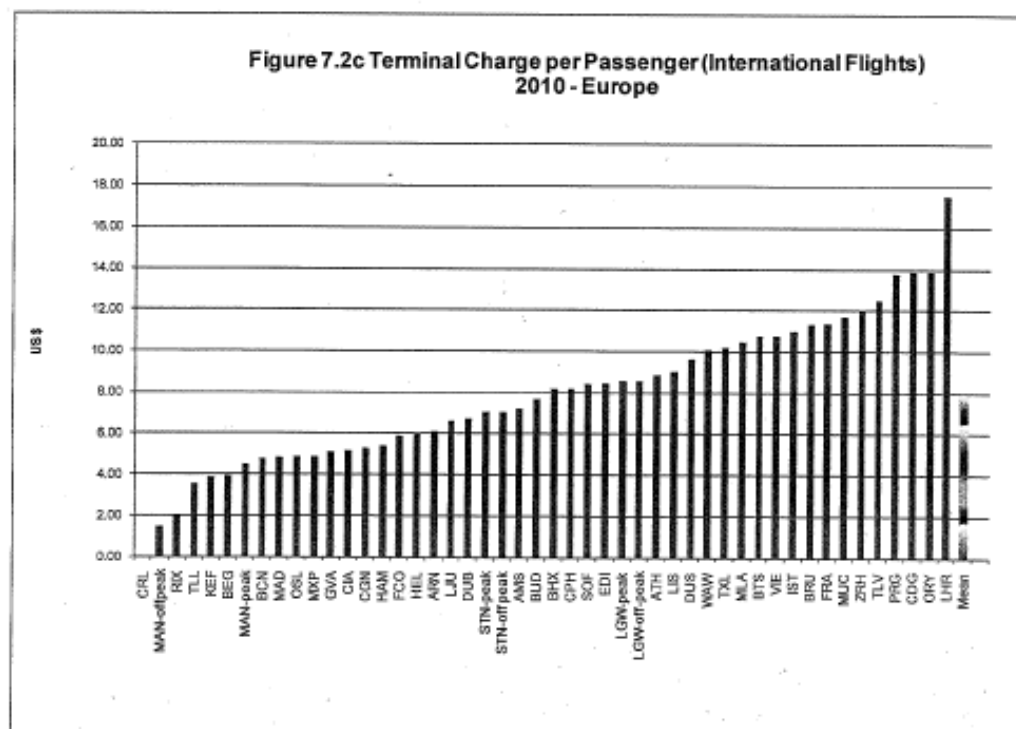


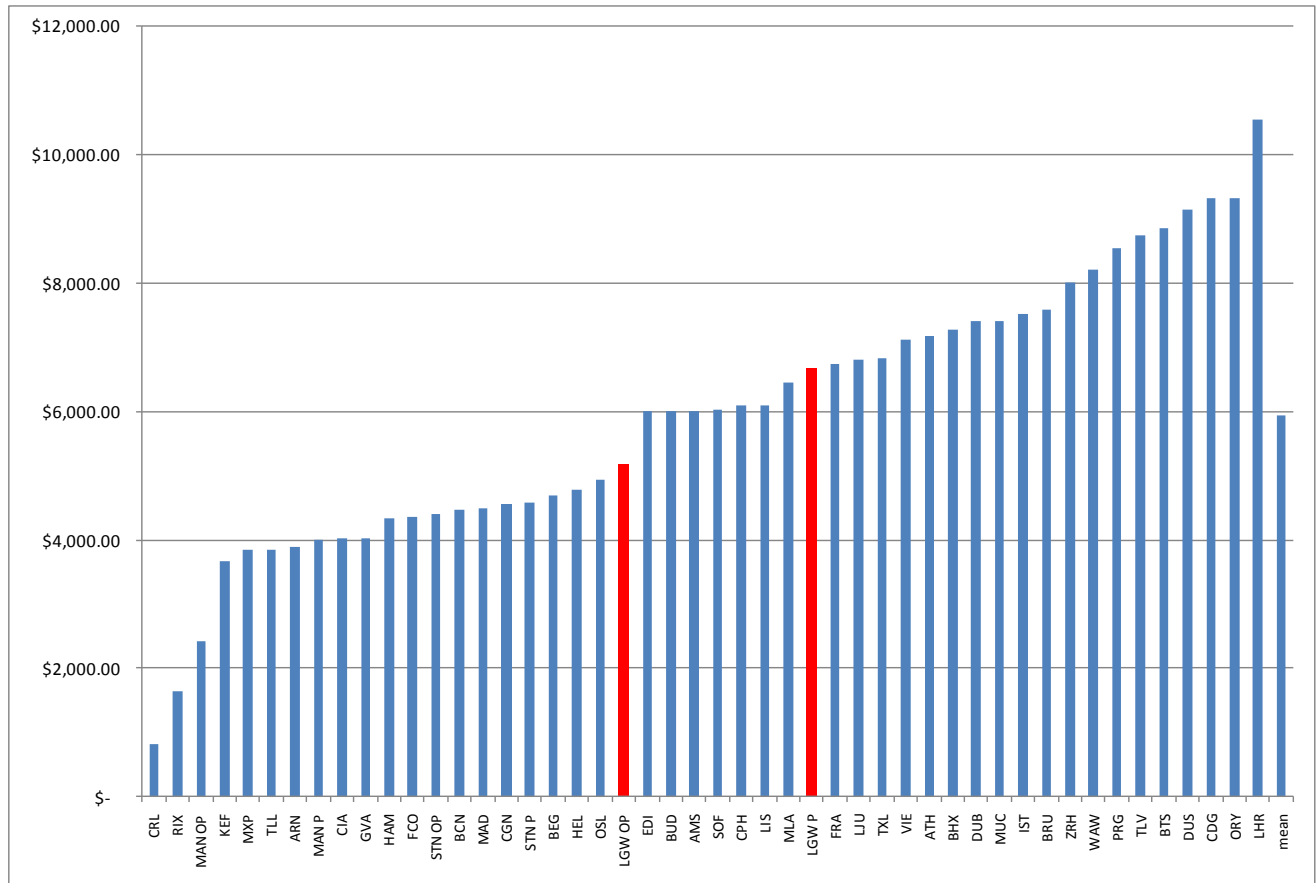
Figure 30 Terminal Charge per passenger on international flights, 2010, Europe



Source: ATRS Global Airport Benchmarking Report 2011

3.86 The report provides no combined passenger and landing charges for long-haul aircraft types but only the different landing charges. Using the example of a Boeing B767 with 260 passengers on board, Figure 31 shows that Gatwick’s peak charges for long-haul flights are about 10 per cent above the mean, while Gatwick’s off-peak charges remain about 10 per cent below the mean.

Figure 31 Combined Landing and Passenger Charges at European airports for B767-400, 2010 (in USD)



Source: CAA calculations based on ATRS Global Airport Benchmarking Report 2011

3.87 It should be noted, however, that not all airports on this list are necessarily meaningful comparators for long-haul traffic, and some airports currently have little or no comparable long-haul traffic to Gatwick, including, for example, Malta, Cologne or Charleroi airports.

3.88 While a useful source of information, these data are based on published tariffs. However, in practice a number of airports might provide specific discounts to airlines, either based on volume or to incentivise the opening of previously un-served routes. Such discounts can significantly affect average per passenger charges an airline pays to an airport, and therefore it would be relevant to base any comparisons on actual charges paid by airlines.

3.89 [X]

3.90 [X]

3.91 [X]

Figure 32 [X]

3.92 [X]

3.93 [X] However, Gatwick is also amongst the largest airports that Ryanair operates to and is also a major airport with good surface access links to a major city. There is, therefore, an issue as to whether Gatwick can be reasonably compared to many of the airports across Ryanair’s network. For

example, Ryanair operates from a number of ‘secondary’ airports that have less convenient surface access options to reach the closest major cities.

- 3.94 Overall, the price comparison information appears to suggest that Gatwick is one of the more expensive airports to operate from, albeit that it is not obviously out of line with larger airports serving major metropolitan areas. However, this analysis does provide evidence to support the view that Gatwick’s current charges are not significantly below the competitive price level.

Airline yields at Gatwick

- 3.95 A number of airlines [X] we spoke to quoted as one of their main reasons why they would incur high switching costs that they could achieve higher yields from Gatwick than from other London airports (except Heathrow) and from UK regional airports. [X].
- 3.96 However, this is not in itself a sign that one airport has more or less market power than another. For example, even though yields on flights from London City are generally higher than from other London airports it is generally accepted that London City does not hold substantial market power and provides a niche, higher-value product. Further, levying higher airport charges than are charged by competitor airports is not necessarily a sign of any abuse of market power, to the extent that it reflects underlying differentiated products (e.g. in terms of service quality).
- 3.97 It is difficult to identify whether the observation of higher yields is an indication of airport market power. In principle, the higher yields could reflect the combination of capacity scarcity brought about by underinvestment (or capacity hoarding) and a binding price cap that is preventing prices rising above a competitive level. Alternatively, the higher yields might reflect a superior product and/or locational advantages of the airport, such as its catchment and surface access connections.⁵³

Competitive price level - summary

- 3.98 We have drawn on a number of different sources of evidence in order to assess whether there is a significant divergence between historical prices and the competitive price level. These approaches provide a range of different answers:
- Analysis to consider forward-looking measures of cost – in the form of estimates of LRAIC – suggested that current charges are somewhat below the competitive level. However, there are significant uncertainties around the cost and passenger volume assumptions, and – due to the data available to FTI – the estimates reflect the incremental costs faced by Gatwick, rather than necessarily being those of the marginal supplier in the market. The latter might suggest

⁵³ In this respect, it would also be relevant if there was evidence of capacity hoarding and/or underinvestment. In this respect, as discussed elsewhere in this chapter, the CAA has identified no evidence to suggest that the airport is under-investing or hoarding capacity.

that the estimates were upper-bound estimates of the competitive price level, which limits the reliance that can be placed on these estimates.

- Comparisons across different airports suggest that Gatwick's current charges tend to be higher than average, but are broadly in line with a number of airports that serve major metropolitan areas (and are significantly lower than Heathrow). In relation to some comparators, for example Manchester (which serves a somewhat similar mix of traffic to Gatwick) Gatwick is somewhat more expensive.
- The evidence on airline yields suggests that airlines can realise higher yields than from many other airports, with the notable exception of Heathrow. However, it is difficult to interpret this evidence in a way that provides clear guidance on whether the airport enjoys high levels of market power.

3.99 The CAA's *Guidance on the assessment of airport market power* acknowledges the difficulties involved in estimating a competitive price level with the necessary accuracy. At a minimum it is important to understand whether there is reliable evidence that the current price level is reasonably close to, above or below the competitive level. Only where sufficient and robust evidence was available would the CAA attempt to derive an accurate measure.⁵⁴ Due to the inherent difficulties involved in estimating LRAIC estimates, and the limitations placed on the analysis by the availability of data, it is difficult to put much weight on the results of the Gatwick/FTI work.

3.100 The evidence from comparisons of prices across a number of airports suggests that Gatwick is one of the more expensive airports, which is perhaps to be expected, given its proximity to Greater London. However, this analysis does provide evidence to support the view that Gatwick's current charges are not significantly below the competitive price level.

Summary

3.101 Some airlines appear likely to face significant switching costs, which are likely to limit their ability to switch away from Gatwick. This is the case for airlines that operate long-haul services, and those reliant on premium services and feeder traffic. In part this may be due to these airlines only viewing Heathrow as reasonable substitute for their services, and the impact that capacity constraints have limiting switching in practice.

3.102 In contrast, LCCs and charter carriers – by virtue of their business models – are likely to face lower switching costs and be more able to move significant volumes of services away from the airport. We are, however, mindful of the fact that there is limited evidence of airlines switching away from the airport, and is a general pattern of airlines switching towards Gatwick whenever there is available capacity.

3.103 This differential in switching costs raises the prospect that LCCs and charter carriers might be able to switch away from Gatwick and discipline the airport's conduct towards these carriers. However, the airport has the ability

⁵⁴ CAA, *Guidance on the assessment of airport market power*, April 2011, pages 11/12.

to vary charges between services typically operated by long-haul carriers and those operated by LCCs and charter. Consequently, the marginal switching that appears likely to exist at the airport seems unlikely to protect long-haul and network/full-service carriers from the airport's market power.

3.104 Further, easyJet argues that the better yields achieved at Gatwick prevent it from switching from the airport. In this respect, the Frontier report has provided evidence to support the view that switching by LCCs is insufficient to discipline the airport. This analysis relies on information about average yields, rather than the marginal yields that are more likely to determine switching costs at the margin. In order to reach a more definitive view on this issue, the CAA will seek to investigate further airline yield data.

3.105 It is also notable that there are a number of examples of Gatwick attracting services away from Stansted. In light of the capacity available at Stansted, it will be important to continue to monitor the interaction between these two airports, including whether Stansted becomes a stronger competitor to Gatwick, either under BAA ownership or following its sale.

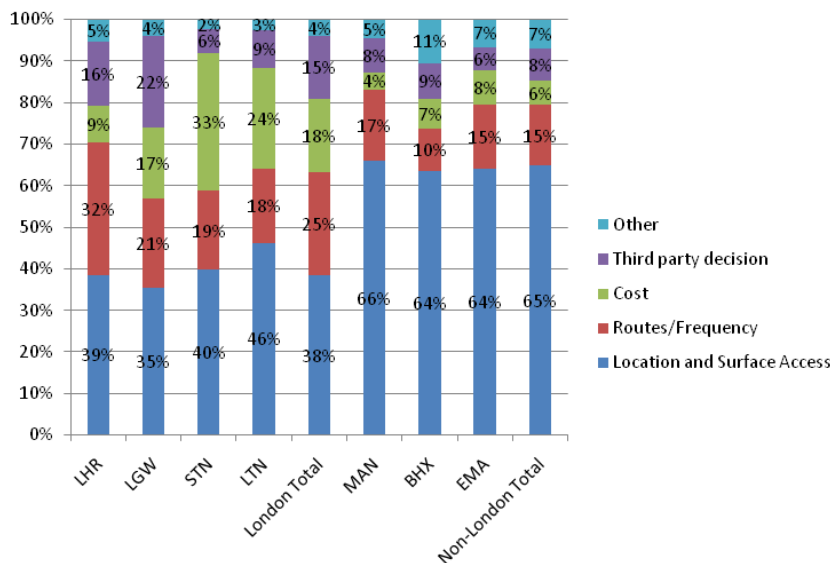
Passenger switching

3.106 Chapter 2 considered the types of passengers using Gatwick, their geographic origins and destinations and their stated willingness to switch airports. This section considers further the factors passengers are likely to consider when choosing their airport, and how these might affect passenger switching behaviour, considering survey evidence and then the results of passenger choice modelling.

Stated passenger preferences

3.107 The CAA asked passengers at Heathrow, Gatwick and Stansted, as part of a set of additional questions to its regular passenger survey in summer 2010, for the main reason they choose their departure airport. The results are depicted in Figure 33 below.

Figure 33 Main reasons for airport choice



Source: CAA analysis of CAA Passenger Survey data (January to July 2011 provisional)

- 3.108 The four main reasons across all airport passengers were: location/surface access; availability of routes/frequency; cost; and third party decisions. It is notable that Gatwick had the lowest share of location as the main reason (although location remains the most important reason) and the highest share of ‘third party decision’ as the main reason. This could reflect the high share of package holiday passengers whose flights were part of a holiday package, which might limit passengers’ choice over the departure airport. It might also reflect that Gatwick is predominantly used by outbound holiday makers that tend to show a higher willingness to travel longer distances to their airport.
- 3.109 We discuss these four factors in more detail below.

Airport location and surface access

- 3.110 We discussed the issue of location/surface access in the section on market definition above and in more detail in our working paper on catchment area analysis.⁵⁵ The main findings of the catchment analysis is that while Gatwick passengers have, in principle, a good degree of choice of airports (when assessed in terms of travel time isochrones), it appears that a large share of passengers from the South East of England do not use airports other than Gatwick.
- 3.111 This is corroborated, to some extent, by findings from the passenger survey, which asked passengers about their airport preferences and previous usage.⁵⁶ Other than Heathrow, London airports do not appear to be considered adequate substitutes for passengers to the extent that the travel time isochrones and other indicators (see e.g. route availability and cost below) might suggest.
- 3.112 It has been put to the CAA that one of the reasons is that passengers “do not tend to travel across London to reach an airport” as passengers might regard surface travel connections as less reliable and time consuming (e.g. travelling by car through central London – or across the Thames via the Dartford crossings – can be slowed down significantly by traffic, whilst having to connect between two different London train stations by tube introduces inconvenience and additional potential for delays) than a transport connection avoiding London.
- 3.113 This would help explain the seeming preference of passengers living south and south east of London to use Gatwick and of passengers living north and northwest of London to use Stansted or Luton. If this were an important factor in passengers’ airport choice, it might be difficult to overcome and might be expected to persist over time. However, this is not supported by evidence from the passenger preference survey: A high share of Stansted passengers have previously used Gatwick (more than 50 per cent), while only 24 per cent of Gatwick’s passengers had previously used Stansted. However, a similar share of Stansted’s passengers (30 per cent) would

⁵⁵ CAA, Airport market power assessments – Catchment area analysis, October 2011, <http://www.caa.co.uk/docs/5/Catchment%20area%20analysis%20working%20paper%20-%20FINAL.pdf>.

⁵⁶ CAA, Airport market power assessments – Passengers’ airport preferences, November 2011, <http://www.caa.co.uk/docs/5/Passenger%20survey%20results%20-%20FINAL.pdf>.

consider Gatwick their first or second choice airport, compared to the share of Gatwick's passengers (20 per cent) that named Stansted as their first or second choice airport.

- 3.114 Another possible explanation is that while Stansted would be a viable substitute for a number of passengers living south/southeast of London in terms of travel time, passengers simply do not perceive it as equally attractive as Gatwick, or do not expect to find the connections they need to get to their desired destinations.
- 3.115 Given the strength of LCC operators (and Ryanair in particular) at Stansted, it is also possible that the airport is perceived as being a LCC airport, with short-haul services, which might make it difficult for the airport to attract full service carriers, or long-haul destinations.
- 3.116 To some degree, passenger perceptions of the airport could be changed by the airport itself, for example through marketing itself more aggressively than takes place at present. In this respect, the increased marketing of Gatwick as a separate brand following its sale by BAA might suggest that, should Stansted be sold, it might seek to differentiate itself from other airports and market its offer more aggressively than it has in the past.⁵⁷
- 3.117 It is notable that location/surface access plays a much more significant role for passengers using regional airports than it is for London airports. This might suggest that passengers using a London airport perceive at least one other airport as a viable alternative in terms of location/surface access and therefore choose between these two or more alternative airports on other grounds, for example route availability or costs. Regional airports might have fewer neighbouring airports, which is why passengers living in the airport's vicinity would need to travel a lot further should they choose not to use their closest airport.

Third party decision

- 3.118 We heard from charter operators that their airport choices largely follow their tour operators' needs. With respect to Gatwick, we were told that it had an exceptionally attractive catchment area with very good surface access options that other London airports could not replicate. [X] However, we were also told that new aircraft types (e.g. Boeing 787) will also be able to use smaller airports, therefore potentially widening the choice set for long-haul flights in the future.
- 3.119 We were also told that spreading operations across too many airports was not efficient as there were economies for scale from basing a large number of aircraft at one airport. Smaller regional airports could be served by flying a "W" pattern to a smaller regional airport and return to the base airport in the evening, rather than representing a close alternative to Gatwick for based operations.
- 3.120 The reasons for tour operators' choice of Gatwick therefore appears to depend upon Gatwick's attractiveness to passengers, as well as the scale

⁵⁷ [X]

economies generated by basing large numbers of aircraft at one airport and the operational flexibility offered by the airport.

Route availability

- 3.121 Many passengers are likely to have a strong preference for a particular destination, or at least a strong preference for a particular type of destination.⁵⁸ Passengers travelling for business and to visit friends and relatives (VFR) are particularly likely to have strong destination preferences, to the extent that they are only likely to switch between destination airports that serve the same cities and/or regions. For example, a number of major cities are served by multiple airports (e.g. Rome Fiumicino and Ciampino would both be captured by a city pair London-Rome), and other airports could be considered as serving the same region (e.g. Valencia, Alicante and Murcia could be considered as reasonable substitutes to go to the South East coast of Spain).
- 3.122 A relatively simple way of assessing the strength of route overlaps is to consider the extent of overlaps between city pairs⁵⁹. It should be noted, however, that this is only a snapshot, as airlines regularly change their route network, so that the degree of overlap might change in both directions over time.
- 3.123 Table 6 shows the level of city pair overlaps for short-haul flights, and Table 7 shows the level of city pair overlaps for long-haul flights, in the London area.

Table 6 Number of short-haul and domestic route overlaps between LON airports, 2010

	Cities Served	Overlaps	% overlap	LHR	LGW	STN	LTN	LCY
LHR	64	55	86%		47	33	28	16
LGW	121	92	76%			65	48	21
STN	131	79	60%				42	16
LTN	69	59	86%					13
LCY	26	24	92%					

Source: CAA Airport Statistics

- 3.124 The above analysis shows that a large share of short-haul and domestic passengers in the London area can use other airports for their particular flights – about three quarters of Gatwick’s short-haul/domestic routes are available from at least one other airport, and more than one half of Gatwick’s routes are available from Stansted.

Table 7 Number of long-haul route overlaps between LON airports, 2010

	Cities Served	Overlaps	LHR	LGW	STN	LTN	LCY
LHR	86	15		12	1	1	1
LGW	36	14			0	2	0
STN	1	1				0	0
LTN	3	3					0
LCY	1	1					

Source: CAA Airport Statistics

⁵⁸ Some passengers might be able to switch between different destinations, for example for a beach holiday or city break.

⁵⁹ However, this would not capture route overlaps to destinations serving the same region.

- 3.125 For long-haul there is a lower degree of overlap, with about 40 per cent of Gatwick's long-haul routes being available from Heathrow.⁶⁰ A high share of Gatwick's long-haul routes are to holiday-focused destinations, are served relatively infrequently (less than daily), and are not served from Heathrow.

Cost

- 3.126 17 per cent of Gatwick's passengers chose the airport primarily on the cost grounds. This is likely to be interpreted mainly as the price the passengers paid for their tickets or holiday package, but it might also include other elements of their use of the airport, including cost for surface access/car parking or any essential shopping or refreshments bought at the airport. Among the London airports, only at Heathrow did a smaller share of passengers quote cost as their main reason to choose the airport (9 per cent).
- 3.127 [X] There is, perhaps, a relative hierarchy of airports in terms of the cost of airfares, with Heathrow generally the most expensive of the four major airports, followed by Gatwick, with Luton and Stansted offering lower fares. This pattern is consistent with the results of the passenger survey, where a relative minority of passengers at Gatwick stated price as a particular important factor behind their decision.
- 3.128 In our passenger survey we asked passengers whether they would leave Gatwick in response to a 10 per cent price increase. The results indicated that Gatwick's passengers were more price sensitive than those at Heathrow and that the price sensitivity at Gatwick and Stansted were of a similar magnitude.

Evidence on passengers' willingness to switch airports

- 3.129 In its report for easyJet, Frontier estimates the number of passengers that would leave Gatwick in response to a 10 per cent rise in the airport's aeronautical charges.
- 3.130 Frontier used the DfT's passenger demand forecasting model NAPALM⁶¹. It estimated that about 1.28 million passengers (per annum) would want to switch from Gatwick to other airports, in response to a 10 per cent increase in charges, provided there were no capacity constraints at any of the other airports.
- 3.131 In an alternative scenario Frontier assumed that passengers could not switch to either Heathrow (due to capacity constraints) or London City (due to the limited number of available routes and constraints on aircraft size), which reduced the number of passengers willing to switch away from Gatwick to 0.95 million (per annum).
- 3.132 Using the DfT's NAPALM model in this way, despite being primarily designed to estimate long-run passenger demand forecasts rather than short-run

⁶⁰ Since 2010 the two long haul routes at Stansted have been withdrawn from Stansted, and new long haul routes have been added at Gatwick.

⁶¹ The National Air Passenger Allocation Model is a fully-estimated multinomial choice model that is used to convert unconstrained forecasts of air passenger demand into forecasts of passenger demand by airport.

reactions to price increases at one specific airport, is a useful contribution to attempting to assess the impact on passenger numbers at Gatwick resulting from a unilateral price increase.

3.133 Nevertheless, its methodology and underlying assumptions involve a number of features⁶² that suggest that the estimated number of passengers is likely to be at the lower end of the spectrum:

- The calculation assumes a full pass-through of the airport charge increase to passengers. However, airlines have previously told us that in the short-run such price increases would be absorbed fully by the airlines and only incorporated over the following scheduling seasons.
- The model holds total passenger demand fixed, meaning it assumes that no passengers would leave the market but always switch to an alternative airport. It might be that a number of passengers, instead of going to a different airport, might abandon their flight altogether.
- The model treats passengers of FSC and LCC separately; for example, LCC passengers faced with a price increase at Gatwick cannot substitute to FSC services at Heathrow.
- The model does not seem to allow for route substitution; for example, a passenger flying to Charles de Gaulle airport can only switch to another flight to Charles de Gaulle.
- An initial analysis of the model suggests that regional UK airports would generally lose a lower percentage of their passengers in response to a similar price rise than would any of the London airports. Given that regional airports are generally regarded as competitive, we need to understand better whether a high or low share of estimated passenger switching can indeed be interpreted as suggesting a high or low degree of market power, absent any further explanations.
- Furthermore, we do not think it is appropriate to prevent passengers from switching to Heathrow. The results of our survey discussed above indeed suggest the opposite, that Heathrow would be considered the next best alternative airport by many of Gatwick's passengers. While Heathrow's runway capacity might be constrained, there is still capacity to accommodate additional passengers (through larger aircraft and higher load factors).

3.134 Overall, the modelled responsiveness of passengers to price may appear relatively high, considering that a 10 per cent rise in the airport's revenues would only constitute a fraction of a passenger's total travel costs. However, a large number of Gatwick's passengers originate from the Greater London area, which is the most contested geographical area, and a very high share of Gatwick's routes are also offered from at least one other London airport. It

⁶² While these may be appropriate assumptions for a long-run forecasting model, they are likely to understate the level of short-run passenger switching away from a single airport in response to a price increase.

might therefore be plausible that passengers could react even to small differences in price, as the model suggests.

Passenger switching – summary

- 3.135 Overall, the cost of switching airports for many passengers using Gatwick are unlikely to be large, given the number of alternative large airports in the London area and smaller airports in the wider south east, and the large degree of route overlap on short-haul routes between Gatwick and other London airports.
- 3.136 However, it appears that long-haul passengers currently are less likely to have many alternatives to Gatwick; therefore these passengers appear to be less likely to switch away in response to a price increase.
- 3.137 Despite seemingly low switching costs for short-haul passengers, many of Gatwick's passengers appear to prefer Gatwick to other airports, for a number of reasons, including the location of the airport (which is, of course, a permanent feature), but potentially also due to the low profile of potential alternative airports and the influence of third party decision makers, in particular tour operators selling charter flights from Gatwick as part of holiday packages.
- 3.138 It might be that these two last issues can change over time, which would likely have an impact on Gatwick's degree of market power.
- Stansted airport has been consistently rated as a significantly less desirable airport than Gatwick, despite the fact that a large number of Gatwick's passengers are within both Gatwick's and Stansted's catchment areas, and despite the fact that Stansted's facilities are similar in nature to those at Gatwick. This could also be influenced by the lack of active promotion of Stansted as an attractive alternative to Heathrow and Gatwick. A new owner of Stansted might take a different approach in the future and, as Gatwick's new owners did, invest more resources in passenger awareness of Stansted as a suitable alternative to Heathrow or Gatwick.
 - The charter model that relies on the decisions of tour operators has been decreasing over time. Should this trend continue, the influence of tour operators on airlines' and therefore passengers' airport choice might therefore decline decrease over time, too.
- 3.139 The results of passenger modelling, however, suggest that there is a relatively high degree of responsiveness to changes in airport charges, which may be consistent with the strong overlaps between the catchment areas of the major London airports, and the high level of route overlaps, particularly on short-haul routes.

The impact of airline and passenger switching on Gatwick

- 3.140 The preceding sections consider the potential for different groups of passengers and airlines to switch away from Gatwick in light of a price rise and the set of potentially suitable alternative airports. When assessing the market power of Gatwick, we also need to consider whether the airport's

sensitivity to passenger and airline switching is sufficiently high to discourage the airport from raising prices significantly above the competitive level.⁶³

- 3.141 Critical loss analysis provides an indication of this by asking for what volume (passenger) loss would a price increase of 5 or 10 per cent become unprofitable⁶⁴, under a set of assumptions⁶⁵. This price rise can be applied by the airport in different ways, for example across aeronautical charges or across a combination of both aeronautical and non-aeronautical charges. Reflecting this, the critical loss figures in Table 8 are calculated for 5 and 10 per cent increase in these two different ways. Additionally, fluctuations in an airport's operating costs may be linked to some degree to changes in its passenger numbers. As a result, critical losses are calculated assuming fixed operating costs, and assuming a staff to passenger elasticity of 0.3 between operating costs and passengers⁶⁶. That is, only 30 per cent of operating costs per passenger are variable.
- 3.142 Frontier Economics calculated the critical loss for both Gatwick and Stansted airports in a report commissioned by easyJet⁶⁷ that was submitted to the CAA in the context of these market power assessments. Frontier calculated the number of passengers that needed to switch away from Gatwick to make a 10 per cent increase of the aeronautical charges unprofitable. Frontier's results have been re-calculated in the table below (in the column "increasing aeronautical revenue"/10 per cent); however, we included all of Gatwick's non-aeronautical revenues in the revenue loss calculation, rather than, as Frontier, only retail and car parking revenues.⁶⁸

⁶³ Critical loss analysis is also relevant to understanding the relevant market within which an airport operates. We have chosen to present the information within the assessment of the market power for ease of exposition. The conclusions are, of course, relevant to the analysis of market definition.

⁶⁴ The critical loss is therefore the volume loss that would make the airport indifferent between raising prices and keeping them at their existing levels.

⁶⁵ See the CAA's working paper on empirical methods for more detail.

⁶⁶ This staff-passenger elasticity was used by the CAA and Competition Commission during the Q5 price control review. http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/539ah.pdf. [X]

⁶⁷ Frontier Economics, Market power assessment: Gatwick and Stansted Airport, prepared for easyJet, November 2011, available at: http://www.caa.co.uk/docs/5/rpt-easyJet%20Competition%20Assessment%20Final%20Report_Abridged.pdf.

⁶⁸ We note that retail and car parking income represents about 70 per cent of Gatwick's total non-aeronautical revenues. Other non-aeronautical revenues are also likely to vary, to some degree, with the volume of passengers, including, for example, revenues from check-in desks and baggage charges. Other incomes, for example rental income from non-aviation-related property rentals, might not vary directly with passengers. We have not attempted to differentiate clearly between variable and non-variable revenues here.

Table 8 Critical loss calculations for Gatwick

SSNIP increment	Increasing aeronautical revenue		Increasing total revenue	
	5%	10%	5%	10%
Passengers	31,647,000	31,647,000	31,647,000	31,647,000
Aeronautical Revenue	£ 241,900,000	£ 241,900,000	£ 241,900,000	£ 241,900,000
Non-Aeronautical Revenue	£ 217,100,000	£ 217,100,000	£ 217,100,000	£ 217,100,000
Total Revenue	£ 459,000,000	£ 459,000,000	£ 459,000,000	£ 459,000,000
Operating Costs	£ 268,000,000	£ 268,000,000	£ 268,000,000	£ 268,000,000
Current				
Aeronautical Revenue per Passenger	£ 7.64	£ 7.64	£ 7.64	£ 7.64
Non-Aeronautical Revenue per Passenger	£ 6.86	£ 6.86	£ 6.86	£ 6.86
Total Revenue per Passenger	£ 14.50	£ 14.50	£ 14.50	£ 14.50
Operating Costs per Passenger	£ 8.47	£ 8.47	£ 8.47	£ 8.47
After price increase				
Aeronautical Revenue per Passenger	£ 8.03	£ 8.41		
Non-Aeronautical Revenue per Passenger	£ 6.86	£ 6.86		
Total Revenue per Passenger	£ 14.89	£ 15.27	£ 15.23	£ 15.95
Increase in Revenue	£ 12,095,000	£ 24,190,000	£ 22,950,000	£ 45,900,000
Critical loss with fixed costs	812,512	1,584,348	1,507,000	2,877,000
Critical loss with cost savings	979,717	1,900,596	1,808,738	3,421,902

Source: Gatwick 2010 Regulatory Accounts

- 3.143 The second and third columns of Table 8 show the critical loss calculations for cases where the airport would increase only its aeronautical charges to yield a 5 or 10 per cent increase in its aeronautical revenue, and keeping non-aeronautical revenue unchanged⁶⁹. The required loss of passenger volume for a price increase to be unprofitable is 0.8 million for a 5 per cent increase and 1.6 million for a 10 per cent increase of aeronautical charges when assuming operating costs per passenger to be fixed. These required volumes increase when there is a cost saving for each lost passenger, since the marginal loss of revenue from each passenger switching away is partly compensated by the associated cost saving.
- 3.144 However, Gatwick could in principle increase a combination of its aeronautical and non-aeronautical charges to increase its total revenue per passengers by 5 or 10 per cent overall⁷⁰. For example, as well as modifying airport charges to airlines, it could also increase car parking charges or levy passenger access fees such as “kiss and fly” charges⁷¹. The fourth and fifth columns in the above table set out the critical losses required when the airport increases its total revenue per passenger overall, meaning that the airport can increase its aeronautical and/or non-aeronautical revenue. The required losses in passenger volumes to make an increase unprofitable are 1.5 million and 2.9 million for a 5 and 10 per cent increase in total revenue per passenger respectively. These rise to 1.8 million and 3.4 million if the airport experiences a cost saving for each lost passenger.

⁶⁹ This methodology was employed in the Frontier Economics report for easyJet.

⁷⁰ As a third alternative not further assessed here Gatwick could also increase only its non-aeronautical revenue.

⁷¹ Such charges are already in place in Edinburgh and Leeds Bradford airports, among others.

- 3.145 On the basis of Table 8, it would appear that Gatwick would need to lose a significant proportion of its passengers (around 10 per cent) to make a 10 per cent increase in its total revenue per passenger unprofitable.
- 3.146 However, this analysis can only provide a qualified estimate of the required drop in passengers, as the calculation reflects certain underlying assumptions. A particularly relevant limitation is that critical loss analysis only considers the change in passenger numbers, as the interdependence of demand between passenger airlines and passengers cannot be captured. As a result, the critical loss does not include any potential airline response to the drop in passengers that may lead to a greater overall loss of passengers at Gatwick. For example, airlines might drop services in response to a small decrease in passengers on these services, which may lead to even greater passenger losses.
- 3.147 On the face of it, however, when the critical loss figures set out above are compared to the estimates of potential passengers switching away from the airport, it supports the view that the airport would be able to increase its charges from the current level. As noted above, these calculations involve a number of approximations and assumptions, which limits the extent to which this comparison can be relied upon to determine the overall market power assessment. It is, therefore, important to consider this evidence alongside the evidence available from other sources.

Capacity constraints/Barriers to entry

- 3.148 The preceding sections considered the responsiveness of airlines and passengers to changes in price, and whether these users would switch in sufficient numbers to an alternative existing airport to constrain the airport's conduct. However, competitive constraints can also arise from entry and/or expansion of airports in Gatwick's market. The impact of this form of competitive constraint can be limited by the magnitude of barriers to entry and expansion.
- 3.149 Barriers to entry and expansion can affect the competitive constraints faced by Gatwick, as they may create capacity scarcity. The CAA's Guidance on the assessment of airport market power sets out different kinds of capacity scarcity, not all of which bestow, or arise from, market power. In the context of the airports in London and the South East of England, and in the UK more generally, the likelihood of new entry in the short to medium term is very low, due in part to the very large irreversible investments required, and it is incumbent expansion that would in principle be the most likely source of capacity increase in the airport market.

Capacity constraints at Gatwick

- 3.150 Gatwick has been operating with consistently high utilisation rates of its single runway for the last 10 years. In summer the utilisation rate is around 80 per cent and in winter between 70 and 80 per cent. There are higher utilisation peaks across individual days (which can go up, in individual time frames, to near 100 per cent), e.g. in the 5-7am time window for departures in the summer peak week.

- 3.151 There is currently somewhat more capacity available than there was in the past, although passenger numbers at Gatwick are increasing again. This capacity availability results, in part, from the move of transatlantic airlines to Heathrow in 2008/09, and as a result of the general economic downturn that has affected all UK airports over the last two years.
- 3.152 [X]
- 3.153 There is also some scope for airlines to increase capacity in terms of passengers carried by increasing their aircraft size.
- 3.154 There are also additional barriers to capacity, such as night flight restrictions imposed by the Secretary of State. Furthermore, Traffic Distribution Rules restrict the use of Gatwick airport by cargo-only and General Aviation flights in the hours of peak congestion other than with the express permission by the airport operator.
- 3.155 Further details regarding Gatwick's capacity and capacity utilisation are contained in the supporting annex to this paper.

Relative capacity scarcity in the South East of England

- 3.156 There remains limited capacity at most of the other London airports, and capacity scarcity is likely to develop further, given current government policy. In particular at Heathrow there is very little scope to accommodate additional traffic at any time of the day or year. Luton operates at approximately 80 per cent of its capacity, but its runway infrastructure is unsuitable for airlines operating certain wide-bodied aircraft.
- 3.157 In contrast, there remains a considerable amount of capacity at Stansted, which is operating at approximately 55 per cent of its capacity. On the basis of capacity alone, there is scope for airlines to switch certain services away from Gatwick, in particular point-to-point short-haul services could use either Stansted or Luton. Other services, in particular those involving long-haul routes and a degree of network services, are likely to have fewer options, given Heathrow's severe capacity constraints. Further, while Stansted might be able to provide the necessary infrastructure that can accommodate large long-haul aircraft, it does not, at present, provide any long-haul services and cannot offer new long-haul airlines access to significant volumes of connecting passengers.
- 3.158 In summary, it would appear that the capacity constraints in the South East of England are contributing to reduce competitive constraints faced by Gatwick in particular for FSC relying on a degree of long-haul and network services. Capacity constraints are likely to be less of a constraint in the market for low cost carriers focusing on point-to-point short-haul services, particularly in light of the potential for this market to be pan-European in scope.

Airport performance and behaviour

- 3.159 In our *Guidelines on the Assessment of Airport Market Power*, we stated that an airport's conduct and its effects could be a useful indicator of market power. This included particularly evidence concerning the:

- service quality;
- the airport's relationship with its users;
- the airport's financial performance;
- its pricing behaviour; and
- the airport's investment record.

3.160 We also published an additional working paper on methods that could be used to assess an airport's behaviour, performance and profitability.⁷² However, many of these methods came with significant caveats as the results of many of these methods were unlikely, on their own, to provide strong evidence on market power.

3.161 Furthermore, the principal difficulty in assessing behaviour-related evidence in the context of Gatwick is that in many cases evidence of changing behaviours at the airport that have taken place following the airport's sale by BAA could be consistent with a change prompted by an increase in the degree of competition faced by the airport, or be consistent with the changes being prompted by the new owners of the airport.

3.162 In respect of the latter, it could also be argued that any change in conduct was driven by the change of owner attempting to maximise the return on its investment, rather than being driven by a step-change in the level of competition faced by the airport.

3.163 Furthermore, it is important to differentiate between evidence that supports the view that the airport is facing *more* competition than it once did and evidence that the airport is facing *sufficient* competition to remove any position of SMP. It is, of course, possible that the airport faces more competition than previous and yet still enjoys a position of SMP.

3.164 In addition, the presence of regulation further complicates the interpretation of observed behaviour, and judgement is required whether the company would have behaved in the same way absent any regulation.

3.165 Nevertheless, it is important to assess the airport's behaviour and, as far as possible, reach a view about the drivers of that behaviour and its implications for the assessment of market power held by Gatwick.

3.166 Following Gatwick's sale by BAA to a GIP-led consortium in November 2009, there have been a number of noticeable changes in the way the airport is run. Gatwick has argued that its changed behaviour is wholly consistent with behaviour of a competing business in a well-functioning airport market and met expectations formulated by the Competition Commission regarding the behaviour of the BAA London airports post-sale. In the following sections we assess evidence we received from Gatwick and other sources regarding Gatwick's track record since the change in ownership, following the order set out in our guidelines.

⁷² CAA, Empirical methods for assessing behaviour, performance and profitability of airports - update, June 2011, available at <http://www.caa.co.uk/docs/5/Performance&BehaviourWP.pdf>.

Service quality and relationship with its users

3.167 In its submission to the CAA of November 2011⁷³ Gatwick pointed out the following service quality improvements since Gatwick was sold by BAA:

- Gatwick consistently met or exceeded the regulatory obligations in respect of security queues and other SQR metrics;
- Gatwick opened an extended new security search area in the South Terminal with a number of innovations that are well received by passengers, including:
 - dedicated security lanes for families and other passengers requiring special assistance;
 - improvements to the priority lanes; and
 - all security staff being trained in a Tourism South East City and Guilds qualification in customer service;
- Gatwick re-opened the inter-terminal transit system two months earlier than originally planned by BAA in order to meet the summer peak;
- Gatwick swiftly changed the provider of PRM services to provide top class services; and
- Gatwick took swift action to improve its snow resilience after early heavy snowfall in November 2010, including purchasing of additional snow clearing equipment costing £8m and improving the command and control structures for disruption management.

3.168 With regards to the first point (that Gatwick consistently met or exceeded the regulatory SQR metrics) we note the following:

- The CAA wrote to Gatwick in October 2011 raising concerns with Gatwick's security queue measurement that had been identified during an audit carried out by consultants for the CAA.⁷⁴
- In October 2011 Gatwick argued in its response to the CAA's Q5 Setting the Scene consultation that "the incentives created by the service quality regulation imposed by the CAA are not adequately aligned with the passenger interest". It pointed out that Gatwick had slipped from 98th (out of 143) to 145th (out of 180) rank in the ACI's annual Airport Service Quality index, with a score of 3.79, compared to a European average score of 3.84, despite having consistently met all of the CAA's SQR targets.⁷⁵ This argument suggests that the airport was focused more on satisfying the regulator's targets rather than meeting passengers' expectations. Whilst we accept that regulation can serve to distort airports' incentives, it goes against Gatwick's

⁷³ Gatwick Airport, Airport Competition: Competing to grow and become London's airport of choice, November 2011, available at

<http://www.caa.co.uk/docs/5/GatwickSubmissionOnCompetition05122011.pdf>.

⁷⁴ CAA letter to Gatwick airport, October 2011, available at

http://www.caa.co.uk/docs/5/SWingate03102011_IO.pdf.

⁷⁵ Gatwick Airport, Setting the Scene for Q6: Gatwick Airport's Response, October 2011, available at <http://www.caa.co.uk/docs/5/rpg2011/GatwickAirportResponse.pdf>.

argument that it improved its SQR performance because of higher competitive pressures.

3.169 Gatwick also argued that it had significantly changed the way in which the airport was cooperating with its users and other service providers to find mutually beneficial solutions to improve the passenger experience and operating efficiency. This included the following:

- Gatwick started measuring check-in and immigration queues to identify and address problems;
- joint working with UKBA to improve the immigration process;
- working together with an airline (Norwegian Air Shuttle) to introduce extended and more efficient self-service check-in facilities;
- publication of ground handler baggage performance to make this part of the process more transparent for passengers and to incentivise service improvements; and
- the introduction of passenger commitments in 2010, which have been agreed with a number of airport partners.

3.170 The innovations regarding the security search processes, Gatwick's more proactive approach regarding the performance of third parties at the airport (including Border Agency, airlines and ground handlers) as well as its flexibility to adjust investment decisions on short notice to improve its operational resilience (e.g. snow clearing equipment and early opening of the inter-terminal transit system ahead of the summer peak) appear to us to evidence a higher focus on service quality and resilience, and some of its measures (namely the dedicated security lanes, certain crisis response protocols and the purchasing of the snow clearing equipment) have subsequently also been adopted by other airports, particularly Heathrow.

3.171 Behaviour of this kind could indeed be consistent with an airport reacting to more competitive pressures. But it is, in itself, insufficient to show that the airport does not hold SMP. Further, it does not allow the CAA to determine that the changes indicate that there is more competition, rather than being the result of a change to a more focused owner.

Airline acquisitions and marketing activities

3.172 Gatwick also argued that it had been working hard at trying to attract additional airline traffic. [X] This led to the acquisition of new services by Vietnam Airlines, Hong Kong Airlines (both new to London) and Air Asia X (that switched from Stansted and subsequently announced the cessation of all its European operations) as well as new long-haul routes by existing airline users (BA switched some routes to Gatwick from Heathrow). [X]

3.173 Nevertheless, it also attracted a number of new short-haul services, both from new and from existing airlines. Most notably, Norwegian Air Shuttle and Air Berlin moved their services from Stansted to Gatwick. Lufthansa opened a new route to Frankfurt, parallel to its Heathrow operations, the first of the

large inbound network European carriers to connect Gatwick to its hub abroad.⁷⁶

- 3.174 On the other hand, Gatwick also lost some services, including Ryanair services this winter as part of Ryanair's overall capacity reduction (Ryanair grounded 80 aircraft in the third quarter of 2011⁷⁷) and Qatar Airways, that increased its operations at Manchester.
- 3.175 Furthermore, it is unclear whether the latest developments do represent a significant change in the airport's incentives to compete for airline business. In particular, whilst the airport emphasises its successes in attracting a number of airlines to the airport, including a mix of short- and long-haul operators, the previous owner also successfully attracted growth from new airlines following the departure of a number of transatlantic services for Heathrow following the introduction of the EU-US Open Skies agreement. This included new operations from easyJet, and a number of other carriers, including Aer Lingus and flybe. There is, therefore, mixed evidence as to whether recent trends represent a clear break from the past.
- 3.176 Gatwick also undertook additional marketing activities to passengers to raise Gatwick's profile as an independent airport to BAA's Heathrow and Stansted. While again this would be consistent with raising passengers' awareness of the airport, it is not on its own sufficient to argue that these actions arose from higher competitive pressures or merely from the new ownership. In this respect, it is relevant that Heathrow has also undertaken significant marketing campaigns to raise Heathrow's public profile.

Financial performance and pricing

- 3.177 The financial performance and pricing of a company can provide evidence regarding the airport's level of market power: generally speaking, a company with substantial market power would be able to realise higher profits than a company without market power under the same circumstances. More generally, a company could set its charges independent of the wider market if it has substantial market power (or is dominant). Prices that were out of line with the wider market could therefore also be evidence of the company holding substantial market power.
- 3.178 However, as we highlighted at the beginning of this section, in the case of Heathrow, Gatwick and Stansted evidence on the airports' financial and pricing performance is strongly affected by the presence of economic regulation. This regulation limits the average revenues the airports are allowed to earn, by capping the average price per passenger the airport are allowed to charge to airlines. As a result, the level of prices or profits cannot be used as a reliable indicator of whether the airport is operating competitively or enjoys high levels of market power, as pricing and profitability are substantially affected by economic regulation.

⁷⁶ Some smaller European network carriers, including Aer Lingus, TAP Air Portugal and some Eastern European carriers also operate flights to their respective home hubs.

⁷⁷ Ryanair Press Release, 30 January, available at: <http://www.ryanair.com/en/news/ryanair-delivers-q3-profit-of-15m-euro>.

- 3.179 In addition to these general considerations, Gatwick was sold by BAA to GIP in November 2009, and Gatwick told us that the process of separating Gatwick's systems and processes fully from BAA took until February 2011. This also affected Gatwick's results, particularly its cost base, over this period.
- 3.180 In light of the limited reliance that can be placed on these aspects of behavioural evidence, we do not assess in detail the costs, revenues and profitability of the airport.
- 3.181 However, economic regulation does not bind Gatwick's structure of aeronautical charges underneath the price cap, nor does it directly bind Gatwick's pricing and revenues from non-regulated charges within the price control period.⁷⁸ Depending on the price responsiveness of different sides of the market and the market power of the airport vis-à-vis these different sides, the airport could increase charges for those user groups who are least price responsive, while decreasing charges for those user groups who are most price responsive.
- 3.182 While this type of price differentiation would indeed be expected in a well-functioning market, the level of charges could be higher where the airport faces high levels of market power. Looking at Gatwick's pricing strategy might therefore be useful to identify areas in which Gatwick might have higher or lower degrees of market power.

Revenues

- 3.183 During the current price control quinquennium⁷⁹ Gatwick has been consistently pricing up to the allowed price cap. The price cap is expressed as the average aeronautical revenue per passenger, based on forecasts of the airport's costs, non-aeronautical revenues and passenger volumes.
- 3.184 If the current price cap can be said to be sufficiently close to the competitive price level, then the fact that Gatwick has been charging up to the cap would support the view that the airport could increase prices above the competitive level/the price cap should the price cap be removed. As discussed above, we do not consider that we currently have sufficient and convincing evidence that Gatwick's current price cap is significantly different to the price cap – suggesting therefore that Gatwick continues to have a high degree of market power.
- 3.185 Gatwick's revenue shares of aeronautical and non-aeronautical revenues have remained stable since the start of Q5: in 2010/11 aeronautical charges accounted for 53 per cent. Similarly, the shares of revenues from specified activities⁸⁰ and from retail and car parking activities, as shares of total

⁷⁸ The current price controls apply a single till approach, meaning that all costs and revenues are taken into account when setting the price control for aeronautical regulated charges.

⁷⁹ Q5, from 1 April 2008 until 31 March 2014. It was extended by one year in 2011, to last for six instead of five years. The CAA's decision is available at <http://www.caa.co.uk/docs/5/ergdocs/PIConditionsExtensionDecision.pdf>.

⁸⁰ Specified activities are activities not captured by the price cap but for which the airport has to fulfil additional transparency and consultation conditions as these are also essential services to airlines and passengers. These include, among others, fixed electrical ground charge (for aircraft), check-in desk rental, utility costs or staff car parking.

revenues, have not changed over time: specified activities accounted for 9 per cent in 2010/11, and retail and car parking income accounted for 33 per cent in 2010/11.

Pricing structure

3.186 Under the price cap, the airport is free to determine the structure of charges for aeronautical services, which typically consist of landing charges, passenger charges and (aircraft) parking charges. Furthermore, the airport can freely set its charges for non-aeronautical and commercial services.

3.187 Gatwick's aeronautical charges are published annually on its website, and subject to consultation with its users prior to coming into effect. Its structure of aeronautical charges has broadly retained the same categories, although in 2011/12, in addition to its already existing peak pricing for the morning and evening peaks in the summer season, Gatwick introduced a new discount on landing charges for the winter season, with charges for the most commonly used aircraft types falling to £0.

3.188 The following summarises how Gatwick currently differentiates its aeronautical charges:

- Landing charges are differentiated by:
 - Aircraft weight and noise certification
 - Seasons
 - Time of day (only in the summer season)
- Passenger charges are differentiated by:
 - Destination: domestic, Republic of Ireland and other international
- Aircraft parking charges are differentiated by:
 - length of parking time;
 - weight of aircraft (however, the majority of aircraft using Gatwick would fall into the same category, so that there is no strong differentiation between, for example, a short-haul A320 and a long-haul A340; and
 - time of day (peak charge only for the morning peak in the summer season).

3.189 While these categories have remained the same, since 2010 there have been some marked shifts between landing, passenger and parking charges, with landing charges increasing sharply (by 62 per cent, in nominal terms, in 2010/11) while passenger and aircraft parking charges have remained (in nominal terms) unchanged. In 2011/12 Gatwick increased landing charges in the summer again sharply (by 62 per cent) but set landing charges in the winter season to £0, with passenger and aircraft parking charges again remaining unchanged. Gatwick has been arguing that this, in addition to the introduction of a discount on landing charges in the winter season, would incentivise better a more efficient use of Gatwick's scarce runway resources.

- 3.190 As discussed above, Gatwick told us that apart from a long-haul incentive programme to attract new long-haul traffic it charged all airlines the published tariff.
- 3.191 The way in which Gatwick has been developing its charging structure in recent years suggests that there is more scope to differentiate temporal markets than there is to differentiate different markets according to the destination, type of passenger or type of airline. Furthermore, it appears that if Gatwick holds market power its pricing power is likely to be strongest in the peak times in the morning and evening, and in the summer season.

Investment

- 3.192 After Gatwick was sold to its new owners Global Infrastructure Partners it undertook a comprehensive review of BAA's capital investment programme for the airport. This review identified major cost savings and led to more projects being delivered than had been planned by BAA.
- 3.193 Furthermore, Gatwick stated that it was working on a number of capacity enhancing initiatives:
- it is cooperating more closely with NATS regarding the management of Gatwick's runway movements;
 - it is exploring possibilities to develop A380 pier facilities;
 - it has opened a new check-in area in North Terminal in collaboration with BA; and
 - it is collaborating with Network Rail to secure an upgrade to the Gatwick rail station.
- 3.194 As discussed above, in addition to the change of ownership the presence of regulation complicates the interpretation of observed behaviour, and judgement is required whether the company would have behaved in the same way absent any regulation. For example, while a company with SMP absent regulation might have an incentive to under-invest, RAB-based regulation can serve to reverse these incentives and stimulate a degree of over-investment or inefficient investment. It is, therefore, difficult to place significant reliance on the new owner's investment performance in the assessment of SMP

Airport performance and behaviour – summary

- 3.195 It is certainly the case that the airport's conduct has changed and that – in a number of important ways – has delivered real improvements to airlines and passengers. However, while there is evidence that supports the view that the airport is competing for passengers and for airlines more than it once did, the airport might still have sufficient market power to require economic regulation.
- 3.196 It could also be argued that any change in conduct was driven by the change of owner attempting to maximise the return on its investment, rather than being driven by a step-change in the level of competition faced by the airport.

- 3.197 Furthermore, there is mixed evidence on the extent to which there has been a significant change in the airport's incentive to compete for airline business. In particular, whilst the airport emphasises its successes in attracting a number of airlines to the airport, including a mix of short and long-haul operators, the previous owner successfully attracted growth from easyJet, and a number of other carriers. There is, therefore, mixed evidence as to whether recent trends represent a clear break from the past.
- 3.198 Evidence on the airport's pricing structure suggests that there is clear scope for differentiated temporal markets, and that any market power held by Gatwick is likely to be strongest in the peak times in the morning and evening, and in the summer season.

Long term view

Traffic forecasts and capacity constraints

- 3.199 As we discussed, Gatwick has been operating at its runway capacity limit for some time. Gatwick's previous owner BAA gave a commitment to the local council not to build another runway before 2019, and the current Government policy does not support additional runway capacity at Heathrow, Gatwick and Stansted. Gatwick explained that it is working with NATS to expand the number of maximum hourly runway movements, but these changes would not lead to a step change in runway capacity. It is therefore unlikely that there will be a change in the capacity constraints currently faced by Gatwick, and similarly at two of its closest competitors, Heathrow and Stansted. However, other airports outside of London might consider expanding, particularly if London airports remain constrained.
- 3.200 The DfT regularly produces long term passenger forecasts for UK airports. Its latest forecasts published in August 2011 predict that absent any further runway expansion by 2030 Heathrow, Gatwick and Stansted will be operating at full capacity, suggesting there will be excess demand for these three airports.
- 3.201 Increasing capacity constraints at both Gatwick and its competitors could suggest higher switching barriers for passengers and airlines and therefore a higher level of market power: There would be less scope for airlines at Gatwick to switch to other airports, and excess demand suggests that switching would have limited effects on Gatwick as any vacated slots would be taken up by other airlines.
- 3.202 However, in response to tightening capacity at the three largest London airports other airports, including Luton and neighbouring regional airports might emerge as more credible competitors by developing their infrastructure and service offering further. Indeed, Birmingham was recently discussed in the press as a potentially viable alternative to the large London airports. In particular LCC might also find it more profitable to move any traffic growth increasingly to other geographic areas across Europe.
- 3.203 Furthermore, even under capacity constraints the London airports, in separate ownership, might still find it profitable to compete for marginal

users, for example by inducing airlines to use larger aircraft and passengers with higher retail spend to use their airport instead of their competitors.

- 3.204 In summary, increasing capacity constraints are unlikely to ease, in the foreseeable future, the current degree of market power held by Gatwick. It is not clear, however, whether they will lead to an increase in the level of market power held by Gatwick, given separate ownership.

Competitive interaction with Stansted

- 3.205 In addition to the capacity constraints discussed above, competitive constraints from nearby airports, in particular Stansted, might also change in the near future following a sale of Stansted by BAA. We discussed above that Gatwick's behaviour and performance noticeably changed following its separation from BAA. We consider that it would be reasonable to expect a similar development following the sale of Stansted.
- 3.206 We also discussed above that a number of airlines and passengers currently do not appear to regard Stansted as a viable substitute for Gatwick. Airlines regarded Gatwick's catchment and surface access facilities as superior to those of Stansted. However, on the face of it, Stansted's infrastructure, location, surface access facilities and core catchment (Greater London) are not dissimilar to Gatwick, which would suggest that Stansted could be a stronger competitive constraint to Gatwick than it currently is. To the extent that this relies on a lack of airline and passenger awareness a new owner might market Stansted more aggressively and position itself as a more direct competitor to Gatwick, not only for short-haul low cost traffic but also for long-haul and full service traffic. This could, even in the near future, impose higher competitive constraints onto Gatwick.

Summary – factors contributing to Gatwick's market position

- 3.207 This final section presents a summary of the factors that appear to contribute to Gatwick's overall market position. It considers evidence on market shares, airline switching, passenger switching and the airport's behaviour, before presenting an overall conclusion.

Market shares

- 3.208 Gatwick's passenger market appears to be focused on the South East region, where the airport has a relatively high share of traffic (44 per cent of passengers from this region use Gatwick, constituting 38 per cent of Gatwick's passengers) and evidence suggests a degree of reluctance by passengers to use some other airports.
- 3.209 On the other hand, the largest share of Gatwick's passengers comes from the Greater London area (41 per cent, constituting 25 per cent of passengers from this region). The Greater London area is generally more contested than the South East region, and Heathrow holds a significantly higher passenger share (45 per cent) than Gatwick.
- 3.210 In the market(s) for passenger airlines Gatwick's market shares depend on which airports airlines regard as suitable substitutes for Gatwick, as discussed above. Market shares are therefore of limited explanatory value in

the context of airport markets. It is likely that the relevant market for most airlines operating at Gatwick stretches beyond the London area, involving other airports across the UK and for some airlines possibly also across the EU. In the UK Gatwick is the second largest airport by quite a margin, with Heathrow remaining the largest airport with about 22 per cent of flight movements. However, as many airlines operating from Gatwick might not regard Heathrow as a viable substitute, when excluding Heathrow from the analysis, Gatwick is the largest UK airport, but only with 14 per cent of all flight movements.

- 3.211 Further, when we consider how passenger-facing and airline-facing aspects interact, it suggests that the airport might have a particularly strong market position in some market segments. For example, it has a relatively strong market position when competing for point-to-point (no frills and charter) services serving passengers in the South East of England, as well as outbound holiday passengers.

Airline switching

- 3.212 The evidence gathered in the course of our assessment suggests that airline switching costs can differ significantly for different airlines. At one extreme, a full service carrier providing premium services, long haul routes and a degree of network dependency that has based a large share of its business at Gatwick is likely to face significant switching costs that would include sunk investments (that would need to be replicated at another airport) and a loss of network effects/economies of scale. At the other extreme, a low cost carrier whose point-to-point short haul business is highly geared towards operational efficiency and flexibility might not face these types of switching costs, at least not to the same degree.
- 3.213 Further, a number of airlines stressed the higher yields earned at Gatwick, explaining that the reduction in yield experienced when switching away from Gatwick contributed to the airport's market position. To assess fully the likelihood of airlines switching away from Gatwick in response to a price increase, and therefore the degree of Gatwick's market power vis-à-vis airlines, we need to understand better the magnitude of yield losses caused by switching away from Gatwick. We will be engaging further with stakeholders on this specific issue following the publication of this assessment.
- 3.214 Linked to this, Gatwick argued that the current price controls keep its prices at the airport artificially low, inflate airlines' route profitability, and increase the apparent market power of the airport. In order to assess these arguments, it is necessary to take a view on whether the current price cap keeps prices significantly below the level that would be seen in a competitive market. Whilst Gatwick presented evidence that supports their view, it was not sufficiently compelling to allow the CAA to conclude that this was the case (but equally, this is an issue that would need to be looked at again in the context of any revised price caps that were to apply at Gatwick beyond April 2014).

Passenger switching

- 3.215 Most of Gatwick's passengers appear to have a real choice between different London airports, with 76 per cent of short haul routes served from Gatwick also being served from other London airports. However, there is a lower degree of overlap for long haul routes, with only about 40 per cent of Gatwick's long haul routes also being served from Heathrow. No other London airport currently serves more than one long haul route.⁸¹ This suggests that while passengers have, in principle, a reasonable choice of airports for short haul flights, passengers' options to use other airports are limited for long haul flights.
- 3.216 However, there is evidence to suggest that some passengers do not view Stansted airport as a particularly close alternative to operating at Gatwick, albeit that both airports have significant catchment overlaps. There are a number of possible explanations for this. The main reason cited by airlines is the inability to realise the same level of yields at Stansted as at Gatwick; with some regarding the two airports operating in distinct catchments.
- 3.217 Joint ownership of Stansted and Heathrow by BAA may have reduced Stansted's efforts to differentiate its service offering and to adopt innovative and aggressive strategies to raise passenger awareness of the airport and its relative strengths. Alternatively, the apparent unwillingness of passengers currently using Gatwick to travel to Stansted might reflect relative weaknesses in the surface access options offered to passengers, such as the congestion and cost associated with travelling to Stansted from South London, Kent and Sussex.

Airport behaviour and performance

- 3.218 Gatwick argues that its conduct since its sale by BAA is consistent with that of a competing airport, with improved service quality, greater efficiency and more competition to attract airlines to the airport.
- 3.219 It is certainly the case that the airport's conduct has changed and that – in a number of important ways – has delivered real improvements to airlines and passengers. Whilst not agreeing with every example of improvements, airlines generally accepted that these changes had been positive overall.
- 3.220 However, this is not sufficient to find that Gatwick no longer holds any SMP:
- First, whilst some of this evidence supports the view that the airport is competing for passengers and for airlines more than it once did, the airport might still have SMP and sufficient market power to require economic regulation.
 - Second, it could also be argued that any change in conduct was driven by the change of owner attempting to maximise the return on its investment, rather than being driven by a step-change in the level of competition faced by the airport. It is difficult to distinguish this from changes brought about by increased competition.

⁸¹ BA currently serves New York from LCY with a business-only aircraft, and EZY currently serves Tel Aviv, Sharm-el-Sheikh and Marrakech from Luton.

- Third, there is mixed evidence on the extent to which there has been a significant change in the airport's incentive to compete for airline business. In particular, whilst the airport emphasises its successes in attracting a number of airlines to the airport, including a mix of short and long-haul operators, the previous owner successfully attracted growth from easyJet, and a number of other carriers. A number of incumbent airlines based at the airport have also stressed that they have not been offered the discounts available to some new carriers. There is, therefore, mixed evidence as to whether recent trends represent a clear break from the past.

3.221 To the extent that ownership changes have affected the degree of competition faced by Gatwick, there is still a lack of sufficient evidence to support a clear, unambiguous decision on the airport's market power. The airport has been in separate ownership from Heathrow and Stansted for only a little more than two years, limiting the amount of information available about the airport's conduct.

The CAA's initial view on the degree of Gatwick's market power

3.222 On the basis of the evidence available to the CAA for this assessment, there is a reasonable prospect that Gatwick will hold overall substantial market power beyond the end of the current price control. Although the ownership change is benefitting passengers and airlines, the airport continues to have a strong market position that appears to derive, in particular, from its locational advantage, serving a large and wealthy catchment area and having good surface access infrastructure to London and within the South East of England. Its traffic has traditionally focused on outbound holiday passengers that still represent the largest passenger share, and Gatwick has (after Heathrow) the largest number of long-haul services in the UK. The higher yields airlines can achieve from this catchment means that airlines might face higher switching costs (loss of yield) when switching to other airports, therefore increasing Gatwick's market power over airlines.

3.223 On the other hand, however, there are clear competitive interactions;

- passengers have generally a wide choice between the London airports and neighbouring smaller airports;
- LCC and, to a lesser degree charter carriers – that together represent the majority of Gatwick's airline customers – tend to have lower switching costs. This is likely to allow them to switch airports more quickly than FSC, potentially increasing the competitive constraints on Gatwick; and
- FSC tend to have a clear preference for Gatwick's nearest competitor airport, Heathrow, where capacity at Heathrow can be secured.

3.224 Overall, while Gatwick appears to still hold SMP on the basis of the evidence currently available, we are not able to come to a definitive finding at this stage and there are a number of issues that we need to assess further, in particular:

- additional evidence on the switching costs faced by airlines at Gatwick, including the extent to which yields might fall when moving services away from the airport;
- whether there is evidence that the competitive pressure from Stansted represents a significant constraint on Gatwick's conduct; and
- the emerging evidence on the extent to which other UK airports can attract passengers and airlines away from Gatwick.

3.225 We would hope to be able to work with airlines and the airport to obtain better information to reach a firmer view on all of these factors.