



Response to the Office of Fair Trading
UK Airports Market Study

Submission by BAA Limited

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Executive summary

- In its report of December 2006 (“the Market Study”), the Office of Fair Trading (“OFT”) sets out its proposal to refer the supply of airport services by BAA within the UK to the Competition Commission (“CC”) for a market investigation.
- BAA has fully cooperated with the OFT during this process and welcomes the opportunity to respond to the Market Study.
- The UK aviation sector has been growing over the last 30 years with a five fold increase in air travel and a 6 per cent growth in passenger volumes year on year. The UK has the most innovative and vibrant airline sector in Europe. BAA has fully contributed to this rapid growth through the provision of capacity at its airports.
- In relation to the South East the Market Study considers that there are three structural features which adversely affect competition¹:
 - The existence of development restrictions and capacity constraints;
 - The regulatory regime applied to BAA’s South East airports; and
 - The common ownership of Heathrow, Gatwick and Stansted.
- Two of these structural features, development/capacity issues and regulation, are effectively outside BAA’s control. Firstly, the existence of development issues and capacity constraints in the South East have had, and will continue to have, a determinative impact on BAA’s ability to deliver new capacity. The challenges posed by the planning system are not, however, created by BAA’s ownership of three South East airports. The BAA airports are operating under these constraints which make it more difficult to respond to new operational requirements.
- Secondly, the Market Study sets out wide ranging concerns as to the scope and implementation of the current regulatory model. BAA agrees that there is a pressing need to review the nature and scope of regulation at our South East airports. Such a review should take account of the experience of other regulators, expert parties such as the Better Regulation Task Force, as well as draw on best practice from around the world. BAA is prepared to fully participate in such a debate with all relevant stakeholders.
- In relation to the third structural feature - BAA’s common ownership of Heathrow, Gatwick and Stansted - BAA does not believe that the OFT has set out a compelling case for reference founded on a robust analysis of the market. BAA accepts that analysing the scope for competition in the

¹ paragraph 9.3, OFT UK Airports Market Study, OFT 882, December 2006.

South East is complex and recognises that the OFT is not required to undertake a conclusive analysis in order to make a reference. However, BAA considers that the material presented by the OFT contains some generalisations (for example paragraphs 27-28 below) and an unbalanced assessment of the facts (for example paragraphs 29-38). In addition, the OFT sets out some assertions and tentative conclusions using a weak evidential base (for example, paragraphs 35-42 and paragraph 83-85).

- In particular, the OFT cites airline criticisms of almost every aspect of BAA's record on investment in the South East even though many of the criticisms appear contradictory. The OFT cites capacity constraints as a key distortion, yet the main airline criticism at Stansted is that BAA is expanding capacity. It is said that BAA's service quality is too low, yet a key criticism at Heathrow relates to the redevelopment of the central terminal area that will substantially improve service quality. BAA responds to these criticisms in detail in the main text of this document.
- More broadly, the OFT does not place issues around BAA's high share of traffic in the context of the broader aviation market. To limit the focus of any reference to the issues around ownership of the airports without due consideration of the broader ramifications of structural change on the wide aviation sector will inevitably result in a partial analysis.
- The Market Study also argues that BAA's prices at Heathrow and Gatwick are too high, despite the fact that BAA has been subject to detailed regulation since privatisation: this does not appear to have been considered as relevant by the OFT. The OFT has presented no evidence that our prices are too high. Indeed in the Transport Research Laboratory ("TRL")² survey quoted by the OFT Heathrow and Gatwick are ranked at 19th and 43rd respectively out of the fifty airports covered. The facts simply reflect that BAA's prices at Heathrow and Gatwick are below those for peer airports.
- BAA understands that the proposed reference will include the provision of airport services at Southampton and Aberdeen. Since the Market Study does not set out the case that BAA ownership of these airports restricts, prevents or distorts competition in any way, BAA submits that the OFT has failed to set out adequate reasoning or evidence for referring either airport.
- The Market Study's assessment of BAA in Scotland offers a selective interpretation of the CAA's passenger survey data to claim that there is material scope for competition. In fact the propensity for BAA Scotland airports to compete is extremely limited due to their location. The OFT simplistically uses its provisional view that there is competition between the two Glasgow airports to support a claim that there is potential for significant competition between Glasgow and Edinburgh. The Market Study also raises concerns over the impact of development restrictions and the joint ownership of Edinburgh and Glasgow airports in lowland Scotland

² Transport Research Laboratory: Review of Airport Charges 2006.

- In conclusion, BAA accepts that the development and capacity issues identified by the OFT are a fundamental constraint in the South East. In terms of the genuine shortcomings of the current regulatory model, BAA also agrees with the Market study that there is a pressing need to review the nature and scope of regulation. BAA welcomes the opportunity to engage in this debate.
- However, despite the low threshold the OFT has to meet, BAA contends that the OFT has not made a compelling case for reference on the grounds that the current ownership structure of BAA's airports is the main barrier to effective competition now or in the future. BAA maintains that break up is not the solution to tackle the problems identified in this report.
- BAA has been invited to offer undertakings in lieu of a reference. Due to the reasons outlined above BAA does not consider it would be appropriate to offer undertakings in lieu of a reference.

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Introduction

1. In its report of December 2006 (“the Market Study”) the Office of Fair Trading (“OFT”) sets out its proposal to refer the supply of airport services by BAA within the UK to the Competition Commission (“CC”) for a market investigation.
2. BAA welcomes the opportunity to respond to the Market Study. BAA is not responding to each and every issue highlighted by the Market Study with which it disagrees but instead focuses on some of the more significant points with which we take issue.
3. The OFT’s discretion to make a reference arises under section 131 of the Enterprise Act 2002 (“EA02”) where it has reasonable grounds for suspecting that any feature or combination of features of a market in the UK prevents, restricts or distorts competition. This is a low threshold.
4. The referral of any market imposes a significant burden on public resources as well as all the affected parties in terms of cost and time. A full market investigation by the CC will take two years and will have a major impact on BAA’s (and others’) management time.
5. The OFT recognises this and in its Guidance, published in 2006³, sets out four criteria which need to be met before it will make a reference to the CC under section 131 EA02:
 - It would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT;
 - It would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference;
 - The scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it; and
 - There is a reasonable chance that appropriate remedies will be available.
6. As a result, the OFT should only refer where it has reasonable grounds to suspect that the adverse effects on competition of features of a market are *significant* (the third criterion) *and* that a reference is proportionate, taking account of the likely alternative remedies that may be available. BAA sets out below a number of concerns with the robustness of the Market Study.
7. The OFT accepts that “aviation is of great importance to the UK economy” both in terms of monetary value and wider productivity⁴. As the OFT observes, over 25 million foreign visitors a year

³ paragraph 5.11, OFT UK Airports Market Study, OFT 882, December 2006.

⁴ paragraph 4.2, OFT UK Airports Market Study, OFT 882, December 2006.

contribute to the tourist industry whilst one third of the UK's visible exports, by value, are transported by air.

8. Indeed the UK aviation sector has been a marked success story over the last 30 years with a five fold increase in air travel and a 6 per cent growth in passenger volumes year on year.
9. All parts of the value chain, whether airports, airlines, support services or public transport providers will play a crucial role in ensuring that this sector continues to thrive. The OFT has a duty to protect the interests of consumers, in this case passengers. For passengers, the provision of airport services will be one element in the overall cost and experience of undertaking a flight to or from a UK airport. Therefore, if a reference is made, it is incumbent on the OFT to set terms of reference which allows for the CC to consider and where possible address issues around airlines' market power both in the existing market structure as well as any alternative market structure posited.
10. Therefore, it is important that the market is looked at in the round. To build an analysis with too narrow a focus – the provision of airport services – runs the risk that insufficient account will be given to the possible impact of changes to structure of the airport industry on other levels of the value chain. For example, it would be an error to ignore the market position of airlines at Heathrow, which, unlike BAA, control slots at that airport, and the implications of this for potential competition between our South East airports.

The OFT's approach to market analysis

11. BAA questions whether the OFT's market analysis as set out in the Market Study is sufficiently robust to underpin a reference. BAA has consistently maintained its position that to understand whether two or more airports can be considered to be either actual or potential competitors is a complex question which requires careful and detailed empirical and conceptual analysis. The OFT does not appear to have undertaken such an analysis. Indeed the OFT itself accepts that, despite the setting out of some broad principles or analytical tools in the report:

“ultimately whether two airports act as a competitive constraint on each other depends on whether sufficient numbers of airlines and air passengers see the two as substitutes not simply on whether their catchment areas overlap”⁵

12. Despite this observation, the Market Study offers little by way of further analysis of the extent to which passengers and airlines do view different airports as substitutes. For example, in terms of airline switching, the OFT observes that *“in recent years very few airlines have switched between airports in the South East of England”⁶* but does not develop the analysis beyond two observations: the absence of switching may be due to common ownership or capacity constraints.

13. Instead the Market Study appears to build its case on a portfolio of criticisms of BAA's record rather than a coherent assessment of the scale of any perceived problem that arises from its ownership of seven UK airports. The OFT argues that taken together these issues provide a compelling case for reference⁷. However, the OFT's market analysis contains little evidence beyond the general point that BAA accounts for the large share of air traffic in the South East and Scotland. These issues are discussed in more detail in the sections below.

14. There are several recurring themes in the OFT's analytical approach that can be questioned:

- The OFT has not set out a strong case, based on a robust analysis of the market, to give rise to reasonable suspicions that the common ownership of BAA's airports significantly prevents, distorts or restricts competition within the market;
- The OFT often defaults to broad generalisations without having developed the evidential or analytical foundations to underpin these arguments;
- Some of the observations made in the Market Study appear unbalanced due to the selective use of evidence;

⁵ paragraph 5.47, OFT UK Airports Market Study, OFT 882, December 2006.

⁶ paragraph 5.50, OFT UK Airports Market Study, OFT 882, December 2006.

⁷ paragraph 1.6, OFT UK Airports Market Study, OFT 882, December 2006.

- The OFT sets out some assertions and tentative conclusions using a weak evidential base;
- More broadly, the OFT does not place issues around BAA's high share of traffic in the context of the broader aviation market. To limit the focus of any reference to the issues around ownership of the airports without due consideration of the broader ramifications of structural change on the wide aviation sector will, by definition, result in a partial analysis;
- The OFT places uncritical reliance on some of the views of airlines without questioning whether the interests of those airlines are aligned with the broader interests of the travelling public;
- The consideration of issues stemming from the heavy burden of regulation on BAA, such as BAA's record on investment, is diminished by what appear to be inaccurate or incomplete assessments of some aspects of that regulation. This could have been corrected by a better dialogue with the Civil Aviation Authority ("CAA");
- BAA considers that the material presented by the OFT contains some generalisations (for example paragraphs 27-28) and an unbalanced assessment of the facts (for example paragraphs 29-38). In addition the OFT sets out some assertions and tentative conclusions using a weak evidential base (for example paragraphs 35-42 and paragraph 83-85); and
- BAA considers that the issues raised above constitute significant shortcomings of the OFT's Market Study. BAA would expect the OFT to address these issues if it proposes to proceed in making a CC market reference.

BAA airports in the South East

Introduction

15. In relation to the South East, the Market Study alleges that there are three structural features which adversely affect competition⁸:

- The existence of development restrictions and capacity constraints;
- The regulatory regime applied to these BAA airports; and
- The common ownership of Heathrow, Gatwick and Stansted.

16. BAA owns three out of the four largest airports in the South East of England. The degree to which these airports are or could be substitutes is an empirical question which requires careful analysis. In theory, BAA's three airports could be substitutes for a proportion of passengers originating in population centres between or around the three airports, such as central London. However, the degree to which this is true, and how it might interact with the commercial incentives of airports, is not developed in any depth by the OFT. Moreover, there are a large number of factors ranging from choice of destinations, frequency of flight times, surface access time and cost to ticket price which could limit the extent to which individual passengers perceive one or more of these airports as substitutes, or not. This might limit the incentive of airlines to switch their operations from one airport to another. The OFT does not look at these matters in any detail.

17. BAA agrees with the OFT that the *"relevant market can depend on the specific competition concerns being analysed"*.⁹ Yet the OFT does not present a systematic appraisal of the relevant market in the light of any specific competition concerns that it thinks should be examined. For example, the OFT accepts that the particular circumstances of Heathrow may lead to the conclusion that it is a separate market¹⁰. But the OFT does not expand on what the implications of this might be for the competition concerns that allegedly arise. The OFT argues that the relevant market for an analysis of BAA airports could be *"wider than the South East or narrower"*¹¹ than its base definition of the South East and East Anglia. However, since the choice of relevant geographic market is not linked to any developed theories of harm, it is difficult to see what relevance the OFT intends this to have.

The importance of capacity constraints on the ability of BAA airports to compete

18. A key feature of the market in the South East is the existence of capacity constraints which the OFT argues may restrict, prevent or distort competition between airports.¹²

⁸ paragraph 9.3, OFT UK Airports Market Study, OFT 882, December 2006.

⁹ paragraph 5.64, OFT UK Airports Market Study, OFT 882, December 2006.

¹⁰ paragraph 6.41, OFT UK Airports Market Study, OFT 882, December 2006.

¹¹ paragraph 5.64, OFT UK Airports Market Study, OFT 882, December 2006.

¹² paragraph 6.74, OFT UK Airports Market Study, OFT 882, December 2006.

19. At present there is limited, if any, scope for competition between BAA airports in the South East of England due to the fact that Heathrow and Gatwick are substantially capacity constrained. The only prospect of significant inter-airport competition is therefore in respect of competition to install and operate additional capacity. In view of planning constraints, there is no real prospect of more, or more speedy, capacity installation than is presently occurring.
20. The OFT seems to accept that capacity constraints are a fundamental issue in assessing the extent to which airports can compete and states that “airports operating at capacity have little incentive to attempt to attract business from other airports”¹³. But the OFT’s analysis¹⁴ of the impact of current capacity constraints on the potential for competition between BAA airports is limited to three observations: that Gatwick and Stansted have some spare capacity outside of peak periods, that there might be spare capacity in the event of a demand shock, and that runway constraints are not absolute. BAA has already provided the OFT with data on capacity utilisation. However, if the OFT is still uncertain as to whether capacity constraints are binding at Heathrow and Gatwick then it should seek clarification from Airport Coordination Limited (“ACL”), the independent slot coordinator. Even if there was merit in these claims the OFT does not provide an appraisal as to whether this available capacity is of sufficient magnitude to facilitate material airport competition.
21. The Market Study does not consider in any detail other exogenous factors such as the control of slots or the existence of bilateral agreements between the UK and other countries on the ability of our South East airports to compete, irrespective of the ownership of those airports. The operation of the slot market in the South East - over which BAA has no control - has important implications for a full analysis of potential competition. The current structure of the slot market with both the existence of grandfather rights at all co-ordinated airports, and evidence of rents accruing to airlines from the control of slots at some airports (e.g. Heathrow) will have a significant impact on an airline’s incentives to relocate to another airport or to support proposed capacity expansions. Similarly bilateral treaties, which have nothing to do with BAA’s ownership structure, also create market rigidities. The OFT does not present an in depth appraisal of how these rigidities might affect the potential for competition between BAA’s South East airports.
22. Finally, the OFT argues that separate ownership and hence competition could “increase capacity”¹⁵ through better incentives. The OFT’s claims on this point are highly theoretical and do not, in BAA’s view, reflect a serious and balanced interrogation of the nature of the planning regime faced. The White Paper sets out an agenda for capacity expansion on a substantial scale, and BAA’s plans are to develop the capacity permitted. In BAA’s view, the OFT does not present sufficient argument or evidence on what the OFT itself claims to be a key issue. The OFT advances no basis for suggesting that within the current planning framework capacity would be increased any faster under separate ownership.

¹³ paragraph 6.12, OFT UK Airports Market Study, OFT 882, December 2006.

¹⁴ paragraph 6.38, OFT UK Airports Market Study, OFT 882, December 2006.

¹⁵ paragraph 6.49, OFT UK Airports Market Study, OFT 882, December 2006.

23. Therefore, even if analysis of passenger preferences did indicate that different airports are perceived as substitutes, the OFT analysis still seems to place little emphasis on the importance of capacity as a key factor in determining whether or not BAA's South East airports can compete under separate ownership.

Economic regulation

24. The OFT outlines a number of issues relating to the current regulatory model in the South East. In particular, concern has been expressed by airlines that the current regulatory model does not provide the correct incentives to BAA to deliver the type of investment required at each airport in a timely and cost effective manner.

25. BAA is fully prepared to engage in such a debate. BAA has itself expressed concern that some aspects of the current regulatory model could be improved to deliver better incentives to all parties. However, the OFT analysis of this issue relies primarily on complaints by airlines (whose commercial priorities cannot necessarily be assumed to be aligned with those of passengers) rather than an impartial and balanced assessment of some of these issues. This is particularly true in relation to BAA's record on investment as discussed below.

Investment

26. In the report, the OFT sets out a number of issues raised by airlines relating to the impact of the current regulatory model on investment. BAA submits that many of the issues or concerns raised are:

- A reflection of the commercial interest of airlines operating out of BAA airports and do not necessarily reflect the view of passengers using these airports;
- Often based on an inaccurate interpretation of the current regulatory model or not supported by the facts;
- Considered and addressed by the airlines' own consultants as part of the detailed regulatory scrutiny by the CAA and CC for each quinquennium; and/or
- Not developed beyond broad hypothesis and lack adequate analysis of how any problems, if they were demonstrated to exist, should best be remedied.

Airlines and passenger interests are not necessarily aligned in relation to investment

27. The generalisation in paragraph 1.12 of the Market Study that airline and passenger interest are aligned is an overly simplistic interpretation of the market. BAA would question whether it is in the interests of passengers to face delay in the delivery of new capacity or the modernisation of our airports.¹⁶ The CAA has recognised this on a number of occasions; for example in the CAA initial

¹⁶ paragraph 1.12, OFT UK Airports Market Study, OFT 882, December 2006.

proposals document, the CAA notes that “*In particular, it will not always be the case that airlines’ views represent the views of passengers*”.¹⁷

Excessive reliance on theoretical objections

28. The OFT’s main arguments rely heavily on theory without evidential support. For example in paragraphs 6.17 to 6.18, the OFT cites uncritically the theoretical problem that BAA is incentivised by “*guaranteed return*”¹⁸ to over invest at its designated airports “in facilities which from the viewpoint of airlines and/or passengers are higher quality than they want”¹⁹. This sweeping generalisation is not supported by evidence that in practice BAA has invested either inefficiently or in facilities that were not desired by users. BAA’s investments are not automatically added to the Regulatory Asset Base, and BAA’s returns are not guaranteed: all investment bears risk. In recent years, all BAA airports have had to withstand the significant adverse impact of terrorist activity both here and overseas. The risky nature of new investment is evidenced by the fact that until recently BAA has not been able to price to the regulatory cap at Stansted.

The wrong type of investment

29. The Market Study repeats uncritically a number of issues or criticisms relating to BAA’s incentives to make new investment at our designated airports. It is disturbing that the OFT appears to make highly selective use of material to lend some credence to these accusations.

30. The OFT repeats a number of criticisms in relation to BAA’s investment record ranging from the investment being:

- In wrong assets²⁰ (terminals and not runways, despite the fact that runways do not add to capacity unless they have terminals to support them);
- At the wrong location²¹ (Stansted and not Heathrow, despite the fact that the priority for investment is determined by Government policy and that expansion at both is planned subject to environmental conditions being met); and
- In the wrong time frame (BAA’s forecasts of demand are excessive, despite the fact that the Government evidently believes that early build at Stansted is desirable).²²

31. BAA is said to have an incentive to overspend on new capacity so as to artificially inflate its RAB - the so called “gold plating” argument. Finally, airlines are concerned that BAA has an incentive to cross subsidise investment at one airport from revenues at another airport.

¹⁷ paragraph 3.8, CAA, Airport Regulation, price control review - initial proposals for Heathrow, Gatwick and Stansted Airports, December 2006.

¹⁸ paragraphs 6.17,6.23,6.28, OFT UK Airports Market Study, OFT 882, December 2006.

¹⁹ paragraph 6.17, OFT UK Airports Market Study, OFT 882, December 2006.

²⁰ paragraph 6.23, OFT UK Airports Market Study, OFT 882, December 2006.

²¹ paragraph 6.57, OFT UK Airports Market Study, OFT 882, December 2006.

²² paragraph 6.17, OFT UK Airports Market Study, OFT 882, December 2006.

32. Whilst the OFT admits that it is “not however drawing judgements on individual investment decisions or their cost”²³ the fact that it relies uncritically on these comments to support its view that there is an “investment problem” is a questionable basis for a reference.
33. The OFT claims that some airlines based at Heathrow were concerned that a loss making investment at Stansted would be subsidised by airlines at Heathrow. But the current model for regulation applied by the CAA is on a stand alone basis so that such a cross subsidy is not possible. This shows a basic lack of understanding of the CAA’s current proposals. Neither has the OFT presented its deliberations on whether, were the regulatory authorities to reintroduce a regulatory model that did allow linkages between the airports, their decision might have sound economic reasons.
34. In terms of implementation of investment, the Market Study also makes reference to the airline perception survey commissioned by BAA in 2005.²⁴ This report outlines both positive and negative feedback for BAA. Nevertheless, despite BAA advising the OFT that the extracts taken from the report were selective, the OFT has simply published the negative statements without reference to the positive.
35. The Market Study cites allegations that BAA’s tendering process is “not always competitive”²⁵ or well managed. In addition, BAA is criticised in relation to the timing of spend on new investment. The OFT does not present any evidence to support these allegations and BAA does not accept them.
36. BAA finds it surprising that the OFT has not considered higher quality and more unbiased evidence on BAA’s investment efficiency available from the work led by the CAA in relation to the price control review.
37. For example, during 2005 and 2006 Scott Wilson, on behalf of the CAA, undertook a detailed assessment of BAA’s investment proposals at Stansted Airport; some relevant quotations are set out below²⁶

‘4.1.3 ... in terms of infrastructure provision, BAA’s BHR forecasts tend to fall well within and generally towards the lower end of the range we would consider reasonable.

4.1.4 This is largely as a result of BAA’s methodology, which uses empirical observations to deliver forecasts by process element. It is likely that the observed difference is as a result of the different methodologies adopted and we

²³ paragraph 6.54, OFT UK Airports Market Study, OFT 882, December 2006

²⁴ paragraph 6.66, OFT UK Airports Market Study, OFT 882, December 2006

²⁵ paragraph 6.7, OFT UK Airports Market Study, OFT 882, December 2006

²⁶ CAA’s initial price control proposals for Heathrow, Gatwick and Stansted airports, December 2006

Supporting paper X (Scott Wilson) Advice to CAA on BAA’s Capital Investment Plan at Stansted Airport, page 31

are satisfied that BAA's BHR forecasts are reasonable, especially given that they deliver pragmatic planning parameters.

4.1.5 In terms of the facility required to meet BHR demand (e.g. number of stands, check-in desks, area of arrivals concourse, etc) we find BAA's methodology for assessing facility requirements to be generally reasonable.

4.1.6 Overall we agree with BAA's proposed developments in the context of the range of forecast demand.

4.1.8 In summary, we find BAA's analysis of facility requirement to be in general reasonable.

38. In addition, during 2004 and 2005 Currie and Brown was appointed by the airline community to undertake a detailed review of BAA efficiency in delivering large scale capital projects. Currie and Brown's findings did not paint a picture of inappropriate or over-costed capital expenditure equivalent to that set out in the Market Study. Indeed a significant part of the Currie and Brown report did not find BAA was complacent in its approach to new investment, finding that significant improvement in BAA's approach to capital investment has been made since the last quinquennium. The following quotations from the report illustrate this.

'In general it is evident that a significant amount of change has taken place at BAA. This includes the introduction of the next generation of project processes and the injection of a greater degree of commercial rigour. Good examples of this are the Pier Facilities Strategy and the contract strategies for the Edinburgh Pier, T1 IDL and MSCP West.

In particular it seems that BAA have addressed many of the issues raised in the January 2004 report and responded positively, viz:

- The new Capex Delivery Model is simpler, easier to understand and has fewer key decision points.*
- The enhanced commercial process should drive better value from framework suppliers with the introduction of more competition and setting of robust fixed proceed targets.²⁷*

We consider that where benchmarks have been agreed they:

- Provide a transparent basis for cost targeting.*

²⁷ Currie and Brown, Heathrow Airport Capital Investment Programme Capex Efficiency Workstream – Facility Benchmarking, February 2006, Section 8.1, page 42.

- *Demonstrate, in some instances, a real measure of performance against the market, particularly multi storey car parks and pavement works.*
- *Are generally set at realistic levels for base costs, which should be a focus for continuous improvement over time.*
- *Represent a real improvement on recent past performance.*²⁸

39. The efficiency targets identified by the airlines' consultants and mentioned here have been included in the current capital expenditure plans.

The “gold plating” argument

40. The “gold plating” criticism of BAA is quoted in several places in the Market Study. This criticism is to the effect that if the rate of return allowed at least equals the company's cost of capital, then the company would have incentives to over invest in assets as long as the regulator was expected to allow those assets to be included in the RAB.

41. However, contrary to the OFT's assertions, the facts show that BAA has not “gold plated” any of its investments. The OFT has produced no evidence to the contrary. In fact, BAA has a good record of delivering large projects, such as Terminal 5 on time and on budget. The OFT's analysis largely ignores the checks and balances in the regulatory framework that work against the theoretical concerns.

42. Responses to this accusation include:

- Whilst the current regulatory model can in theory generate the “Averch Johnson” effect, in reality there are numerous checks and balances designed to ensure BAA's capital investment programme is efficient. For example, both the CAA and CC undertake extensive scrutiny of BAA's investment plans, often using expert consultants. Indeed the CAA has recently concluded that all of BAA's Q4 investment, following extensive consultation and scrutiny, should be included in the RAB when determining Q5 prices;
- Each year at its regulated airports, BAA publishes a proposed Capital Investment Programme (CIP) in order to facilitate consultation with airlines on its investment plans. The structure and content of the document is aligned to CAA recommendations²⁹ and enables airlines visibility of scope, cost and underlying rationale for major investments;

²⁸ Currie and Brown, Heathrow Airport Capital Investment Programme Capex Efficiency Workstream, Facility Benchmarking, February 2006, Section 8.2, page 43

²⁹ Economic Regulation of BAA London Airports (Heathrow, Gatwick and Stansted) 2003-2008 CAA Decision, February 2003, Annex 4

- Further to the publication of the CIP, the process of constructive engagement at the three airports has provided airlines with a broader mechanism to become actively engaged in BAA's capital investment programme;

“Pre-funding” of investment

43. One issue where the OFT appears to have reached a conclusion is in relation to the pre-funding of new investment. The OFT appears to argue that the use of pre funding is inherently problematic.³⁰

“we...question the view that any investment funding should be generated by higher charges to current users before the investment takes place. Investment projects are usually selected on their ability to generate new revenues, not in view of the scope to raise current prices to fund them.”³¹

44. BAA does not agree that pre-funding of investment is inherently objectionable. Indeed, BAA would suggest that the use of pre-funding (as opposed to allowing spikes in pricing) can deliver a pricing path than that which might be expected to occur in a competitive market. Further, BAA does not understand what counterfactual approach to pricing the OFT would deem a better approximation to the delivery of competitive prices. BAA is uncertain as to what conclusions the Market Study comes to on this issue. Is the OFT positing that only new users should meet the cost of new investment through higher charges, whilst an existing user would benefit from falling prices? In this situation, should a new airline launching a service at, say, Stansted pay a high airport charge, based on the relatively high incremental cost of new capacity whereas an incumbent airline pays a lower charge based on the existing cost base. This is an example of where failure to consider the broader implications of policy decisions can have perverse consequences in downstream markets. We discuss the implications of the OFT's approach in more detail below.

45. Determining whether an investment is desirable or not is an important question for both BAA and its customers to address. But once the decision to make the investment has been made, the relevant question is how best to fund it. For a number of reasons the use of pre-funding may be an efficient means of funding the investment: these reasons include lowering regulatory risk and a potentially more efficient financing of the investment.

Pre-funding and determining the desirability of an investment

46. The OFT seems to believe that pre-funding implies that new capacity will be built even if it is not desired by users. Without pre-funding, we presume the logic runs, the users of new capacity will be faced with its full costs, creating an essential discipline that ensures that new capacity will be built only if users value it.

47. BAA understands the general point being made. It is true that under a RAB approach to regulation incentives could be influenced by regulatory decisions to a significant extent. As discussed above,

³⁰ paragraph 6.2, OFT UK Airports Market Study, OFT 882, December 2006.

³¹ paragraph 6.21, OFT UK Airports Market Study, OFT 882, December 2006.

BAA recognises that this creates important challenges for the regulatory framework. But this is a general issue, and not one that is created specifically by pre-funding. Pre-funding is merely one means of lowering the regulatory risk that is also a general feature of price cap regulation.

Comparing future prices to current prices

48. Even if regulatory risk was not a consideration, BAA takes issue with the OFT's apparent view that the efficient profile of prices should not include higher prices to existing users. The notion that price increases are inefficient presumes that current prices correspond to some notion of an efficient level. But under RAB regulation this need not be the case. BAA's prices over time correspond to the historic average costs of providing the assets. These historic average costs reflect the depreciated investment spend of the past; they do not necessarily bear any relation to the incremental costs of accommodating additional traffic in the future, or the economic value of the capacity that already exists.

The price profile that would arise in a competitive market

49. BAA presumes that the OFT would agree that pricing that mimics the likely outcome of a competitive market should not be viewed as inherently objectionable. In a competitive market, we would expect a pattern of expansion to involve periods of capacity scarcity that are eventually relieved by lumpy capacity expansions.³² It would normally be expected that prices would be relatively high when capacity was scarce, and then relatively lower when new capacity became available.

50. The price profile implied by pre-funding implies a shift towards the competitive profile of pricing. Pre-funding relatively increases the prices to existing users (when capacity is scarce) and reduces the prices relatively to future users (when more capacity becomes available). In contrast, a price profile that did not involve pre-funding, would typically involve price reductions when capacity is scarce, and much sharper price increases when new capacity becomes available. BAA cannot see how this profile could be viewed as more consistent with a competitive outcome than pre-funding.

³² Presuming, for the sake of argument, that the expansions were possible under the prevailing planning arrangements.

Financing

51. A further advantage of pre-funding is that it increases the degree to which the investment can be financed through existing cash flows rather than through raising external finance.³³

Use of overseas comparators

52. The OFT appears to look at whether other capacity expansions at Toronto, Frankfurt Hahn, Singapore Changi and Marseille³⁴ have resulted in higher or lower airport charges. Although it finds “mixed evidence”³⁵ BAA has serious doubts as to whether observations on this should constitute “evidence” at all. The circumstances surrounding charges at different airports can vary for many different reasons³⁶ and BAA submits that comparisons of this type should, at a minimum, be accompanied by evidence that takes all of these differences into account. BAA has doubts whether such an exercise, even if it had been undertaken, would ultimately yield useful inferences for the issue concerned.

The claim that the environmental consequences of Heathrow expansion are overstated

53. Finally, not only is BAA deemed to be an inefficient investor at its airports but it is also apparently at fault for overstating the environmental constraints at Heathrow³⁷. This is at best risible. No informed observer of the environmental issues around Heathrow could seriously claim that the issues are not significant or that BAA can dictate that significance. It is clear from the White Paper that there are serious issues relating to noise, traffic congestion and air quality that will need to be addressed.³⁸

BAA’s record on pricing in the South East

54. The OFT suggests that overall yields at BAA’s airports in the South East are too high. BAA considers that the OFT’s conclusions lack any meaningful analytical or evidential foundation, and BAA rejects the OFT’s conclusion. BAA’s reasons are set out below:

- The OFT fails to present any meaningful analysis of what benchmarks should be used to judge whether charges at an airport are “high”. The OFT ignores candidate economic benchmarks that would tend to point to BAA’s charges being very low;
- The OFT’s comparisons of BAA’s charges and revenues with those of other airports is not fully reasoned and does not in any event support a conclusion that BAA’s charges are unduly high;

³³ For example, pecking order theory suggests that internal funds will be cheaper than external funds. Information asymmetry suggests that external capital providers will price risk more highly.

³⁴ paragraph 6.21, OFT UK Airports Market Study, OFT 882, December 2006.

³⁵ paragraph 6.21, OFT UK Airports Market Study, OFT 882, December 2006.

³⁶ Including, non-exhaustively, the degree to which the charges concerned are directly comparable, what the basis for oversight of charges is, what the costs were of the expansions compared to existing facilities, whether the expansions themselves were comparable, what the profile of charges would have been in the absence of the expansions, the exchange rate basis for comparison, the degree of capacity congestion prior to the new facilities being implemented, and a multitude of others.

³⁷ paragraph 6.72, OFT UK Airports Market Study, OFT 882, December 2006.

³⁸ paragraph 11.47-11.68, OFT UK Airports Market Study, OFT 882, December 2006.

- The OFT suggests, by implication, that the regulatory authorities have not used their extensive powers to ensure that BAA's charges are reasonable. Yet the OFT does not present any evidence of regulatory failure in this regard; and
- The OFT gives credence to allegations that BAA's corporate financing structure results in excessive returns, without any apparent theoretical or empirical foundation.

55. The OFT's principal evidence is a claim that BAA's charges and returns are high compared to other airports and to airlines. The OFT fails to present any meaningful discussion of what the appropriate basis for comparing prices and returns should be, and whether comparisons of this type are fit for purpose.

56. We discuss the complications of making direct comparisons below. Here we merely observe that the OFT has not discussed candidate benchmarks which include inter alia, market clearing prices³⁹, long run incremental cost⁴⁰ or the cost of capital⁴¹, for appraising BAA's charges and returns. In BAA's view, prices at Heathrow⁴² are below all meaningful economic benchmarks, and its returns on assets are the focus of intensive ongoing regulatory oversight. BAA considers that the OFT's disregard of these alternative means of examining Heathrow's charges renders the OFT's analysis one-sided and ill-founded.

57. The OFT notes claims from IATA that airline costs have declined while airport charges have increased. The OFT appears to be suggesting that airport charges should fall when airlines' other costs decline. However, the OFT does not present any analysis of why this connection or direct correlation should exist. BAA does not accept that this comparison is meaningful. The fact that airline costs may have declined in recent years does not constitute any coherent evidence on whether airport costs, prices or returns, should have risen, fallen or stayed the same.

58. The OFT says that it is "*cautious in the use of international comparisons given the difficulties in controlling for factors outside of an airport operators control*".⁴³ Nonetheless the OFT clearly does rely on the evidence to support its conclusion that overall yields may be too high.

59. The Market Study then discusses TRL data comparing airport charges, other revenues, profits and returns at Heathrow, Gatwick and a sample of other airports. The data itself does not provide strong support for the OFT's concerns in respect of charges. Firstly the data does not provide any

³⁹ Heathrow is heavily capacity constrained. At current charges there is large excess demand for use of the facilities. Where capacity is scarce, efficient price levels would clear the market (as would occur in a competitive market). These price levels would be much higher than current charges.

⁴⁰ Another candidate benchmark for comparison is the cost of providing additional capacity (assuming that planning permission is available). At the last regulatory review, the CAA concluded that the long run incremental costs of expansion at Heathrow were well above current charge levels.

⁴¹ Heathrow is regulated on the basis that it should expect to earn a return on assets that corresponds to its cost of capital. Comparing returns on assets with the relevant cost of capital is widely accepted as one basis for appraising prices and profits. BAA is regulated so the cost of capital used to set its charges has been subjected to detailed regulatory oversight. Despite the fact that this benchmark has been applied in practice with a high degree of oversight, the OFT does not even mention this benchmark.

⁴² In relation to Gatwick the OFT's data fails to present any indication at all that Gatwick's charges could be considered high.

⁴³ paragraph 6.84, OFT UK Airports Market Study, OFT 882, December 2006.

indication at all that Gatwick's charges are "high". On all of the indicators (save commercial revenues) Gatwick ranks in the middle of the sample. Secondly, Heathrow tends to rank higher, but Heathrow's ranking in respect of aeronautical charges - the key charge to airlines - is well below the top of the sample.

60. The OFT notes that Heathrow's revenue per passenger is high relative to some other airports in the TRL survey and that this is driven by high commercial revenues. But the OFT points out that:

"the extent to which high commercial revenues indicate consumer detriment is unclear".⁴⁴

61. The fact that commercial revenues are high simply reflects good performance on BAA's part in developing commercial activities that are highly valued by passengers.

62. Heathrow and Gatwick are both subject to detailed ongoing price cap regulation. The defining feature of the regulatory approach adopted by the CAA and CC is that the price caps are set to give Heathrow and Gatwick the expectation of earning a reasonable return on their assets. Moreover, the approach is based on the "single till" such that the cashflows associated with all activities at the airport are taken into account (not just aeronautical activities).

63. In BAA's view, this creates an extremely strong presumption that its charges and returns across all activities are reasonable. Against this presumption, in BAA's view the OFT's evidence falls well short of creating even *prima facie* concerns in respect of performance on prices and returns.

64. The OFT appears to give credence to claims by airlines that BAA's ability to offer £750 million to shareholders in defence of the Ferrovial takeover indicates that its returns are excessive⁴⁵. This confuses the issues of the financing structure that a company adopts and the returns that it generates; there is no reason to suppose that an ability to pay cash to shareholders means that the company is earning excessive returns. If the OFT does place any weight on this episode BAA submits that it should spell out its reasons for doing so. If not, it should not give implied credence to this evidence.

Service Quality

65. BAA agrees with the OFT that some of the comparative statistics used to compare different airports' records on service quality do not adequately take into account a variety of factors that might have an influence. As the OFT rightly observes, the different age, location, size and level of congestion at any airport will have a determinative impact on its ability to score highly in relative measures of quality of service. Nevertheless BAA is aware that its record on quality of service could be improved, especially in the South East, and is currently undertaking record investment to improve the passenger experience at its South East airports.

⁴⁴ paragraph 6.82, OFT UK Airports Market Study, OFT 882, December 2006.

⁴⁵ paragraph 6.29, OFT UK Airports Market Study, OFT 882, December 2006.

66. Given that the OFT accepts that age, congestion and size impact significantly on an airport's ability to deliver a high service offering then it is also true that service quality cannot be divorced from levels of investment. This is one reason why BAA is undertaking large scale investment in new facilities such as T5 and Heathrow East. This level of investment has implications for airport charges at our airports but BAA has to balance the interests of both passengers and airlines to ensure that our airports reflect all their needs.
67. It is also important to note that the OFT presents no evidence to support its conclusion that competition between airports can be linked to a higher ranking in terms of airport quality. Rather, the OFT asserts that BAA's overall quality rankings are symptomatic of the restriction, prevention or distortion of competition. Interestingly, some analysis would show that the top five airports in the same ASQ survey are all in effect monopolists within a 50 mile or 100 mile radius where there is no scope for competition. In reality the high scores at these airports will reflect a range of factors such as location, congestion or newness of build.⁴⁶ BAA considers that the OFT has not explored this issue in sufficient detail.
68. The OFT also fails to mention that Manchester Airport is ranked 42nd in the same ASQ survey. This is only marginally better than Stansted, ranked 43rd, and worse than Edinburgh ranked 38th. The OFT however omits this fact from its analysis of Manchester and expresses no concerns relating to quality at Manchester, despite its view that in the South East low quality is consistent with market failure. Of further interest is the recently published annual 2006 ASQ survey ranking which on overall airport satisfaction ranks Stansted 3 places higher than Manchester.

Intra airport competition

69. BAA has made extensive argumentation as to the infeasibility of breaking up airports to engender intra airport competition at our UK airports.⁴⁷ Both the CC and CAA have looked into this issue. BAA does not propose to reiterate these arguments here.

Southampton

70. We understand that the OFT proposes that any reference would not be limited to particular geographical areas in the UK and so would extend to Southampton airport. However, the OFT does not present any reasoned explanation as to why its market analysis supports a reference which would cover the supply of airport services at Southampton. The OFT states that "*we do not address whether Southampton airport should be included because the relatively small scale means that their inclusion or exclusion would not affect our later conclusions.*"⁴⁸ If the OFT has not considered Southampton then it would be inappropriate to frame the reference so widely that it is included.

⁴⁶ The top five airports by rank in the ASQ Q1 survey are Seoul - Incheon International, Hong Kong International, Singapore-Changi, Nagoya - Centrair International and Kuala Lumpur - KLIA International. None of these airports have significant competitors within a 100 mile radius. In addition most of these airports are relatively new.

⁴⁷ For example, see BAA response to question 40 of OFT information request.

⁴⁸ paragraph 5.28, OFT UK Airports Market Study, OFT 882, December 2006.

71. Therefore in summary:

- The OFT does not offer persuasive evidence to support its view that there is sufficient capacity to allow significant competition between BAA's airports;
- The OFT does not present an adequate appraisal of how bilateral treaties, the slot allocation system or other rigidities might affect the market;
- The OFT does not present persuasive evidence or argument that indicates that separate ownership would result in better performance on capacity;
- Excessive reliance is placed on objections by airlines whose interests may not be aligned with those of passengers;
- Excessive reliance is placed on a theoretical assertion of "gold plating", and not enough attention is given to whether this results in serious problems in practice. The OFT ignores CAA evidence that indicates that BAA has invested efficiently;
- The OFT's view that pre-funding is inherently objectionable is not adequately reasoned or supported. If anything, pre-funding provides for a price profile that is closer to that which would be expected under a competitive market;
- The claim that environmental externalities associated with expansion at Heathrow have been fabricated by BAA is risible;
- The OFT's comparisons of BAA's charges and revenues with those of other airports is not fully reasoned and does not in any event support a conclusion that BAA's charges are unduly high;
- BAA accepts that its record on service quality could and should be improved, but questions whether separate ownership would make a difference;
- BAA does not accept that there is a case for further consideration of inter-terminal competition, and the OFT has made no case; and
- BAA does not consider that the OFT has sufficiently justified the inclusion of Southampton in the proposed CC reference.

BAA airports in Lowland Scotland

Introduction

72. The OFT has undertaken a preliminary analysis of the market in Scotland. BAA does not believe the Market Study sets out a robust or coherent market analysis.

73. BAA understands that the OFT proposes that any reference would not be limited to particular geographical areas in the UK and that it would extend to Aberdeen airport. However, the OFT does not present any reasoned explanation as to why its market analysis supports a reference which would cover the supply of airport services at Aberdeen. The OFT states that *“the evidence suggests that BAA’s Aberdeen airport “operates in a separate relevant geographic market”⁴⁹*. If the evidence does suggest that Aberdeen is a separate market then is it not incumbent on the OFT not to draw the reference so widely so as to include services provided at Aberdeen airport?

74. For its analysis of the lowland markets, the Market Study relies on three pieces of evidence to underpin its market definition. Firstly, the CAA passenger survey shows that passengers originating from different regions of Scotland use all three of the lowland airports. Secondly, all three of the airports are situated within a 90 minute drive time isochrone of each other. Finally, the OFT presents some evidence of airline switching between Prestwick and Glasgow. Each of these pieces of evidence is discussed below.

Passenger demand side substitution

75. The Market Study’s assessment of passenger demand side substitution appears unbalanced and incomplete. The CAA passenger survey shows a marked delineation of passenger demand around each airport. For example the Lothian region accounts for 27% of all originating passengers in Scotland, 82% of whom use their local airport in Edinburgh. Similarly, 40% of all passengers originate in the Strathclyde region, 73% of whom use Glasgow as their primary airport. BAA is not surprised by this finding. Both Edinburgh and Glasgow airport primarily serve the cities in which they are located. Where passengers do travel to the other airport, in BAA’s view this will in many cases be because there are other reasons to go to that airport rather than because of a genuine view that these airports are substitutes (e.g. because of a differing availability of services).

76. BAA is also surprised by the absence of any analysis of substitutability for passengers travelling on UK domestic routes. A large part of both airports’ traffic is domestic.⁵⁰ BAA would question whether significant numbers of passengers would switch airports for domestic travel. In addition, the Market Study does not consider alternative forms of transport such as rail.

⁴⁹ paragraph 5.66 and repeated in paragraph 5.70, OFT UK Airports Market Study, OFT 882, December 2006.

⁵⁰ In 2006 72% of Edinburgh passenger volume was domestic compared to 52% of Glasgow passenger volume.

Geographic market definition

77. As has been discussed elsewhere and the OFT itself accepts,⁵¹ to undertake an assessment of the scope for and scale of competition between two or more airports requires a careful assessment of demand side substitution both by the airlines and passengers. The OFT's use of a ninety minute isochrone is one possible relevant catchment area. However, the OFT does not explain its rationale for using ninety minutes centred on each airport. It is not clear to BAA that this is necessarily the appropriate drive time. In addition, centering the isochrones on airports as opposed to relevant population centres may not be the most appropriate methodology to use in this case.⁵²

78. Even under the OFT's preferred isochrone analysis, Prestwick is only marginally outside the Edinburgh isochrone. Interestingly, BAA has generated a similar ninety minute isochrone centred on Prestwick which has Edinburgh in the "catchment area" (BAA is happy to supply this). It is also interesting to note that independent websites estimate the drivetime between Prestwick and Edinburgh to be less than 1 hour and 24 minutes⁵³. Therefore it is not clear to BAA that, assuming hypothetically that the OFT's methodological approach is valid, Prestwick is necessarily less relevant than Glasgow to an assessment as to which airports might constrain Edinburgh or not. Further, surface access to airports is not confined to car travel. The journey time to each airport for users of public transport is also relevant.

79. Therefore, the isochrones presented by the OFT provide only indicative information and the analysis is not complete.

Airline demand side substitution

80. The OFT cites two examples of switching by airlines between Glasgow and Prestwick. The OFT seems to argue not only is Prestwick an active competitor to Glasgow, but that it can be inferred from this that Glasgow and Edinburgh are potential competitors. BAA finds such an inference difficult to understand. Glasgow and Prestwick are both located outside Glasgow. Edinburgh is located outside Edinburgh. As far as BAA can see, the degree of possible competition between Glasgow and Prestwick does not provide any coherent basis for drawing conclusions as to the potential degree of competition between Glasgow and Edinburgh.⁵⁴ As the OFT rightly points out, whether or not two airports are actual or potential competitors will be governed by a number of factors, including their relative location.⁵⁵ There are two relevant but separate questions here. Firstly, is Prestwick an active competitor to Glasgow? Again this requires more analysis than the evidence provided in the Market Study. Whilst, in principle, two airports primarily serving one city or population centre, can be expected to be potential competitors, there still may be features of the

⁵¹ paragraph 5.47, OFT UK Airports Market Study, OFT 882, December 2006.

⁵² The OFT has sometimes relied on isochrones at the local level where there are a large number of overlaps centred on competing businesses, including those relating to supermarkets and cinemas, such as the completed acquisition by Terra Firma Investments (GP) 2 Ltd of United Cinemas International (UK) Limited and Cinema International Corporation (UK) Limited. This approach is generally adopted to deal with the large number of local overlaps which is less applicable here.

⁵³ www.theaa.com – 1hr 18 minutes, 71.6 miles. www.rac.co.uk – 1hr 24 minutes, 71.6 miles.

⁵⁴ Similarly BAA struggles to see how the CC's views on competition between two airports serving Belfast are relevant. If the OFT wishes to rely on these "precedents" for anything other than a proposition that there have been other cases where on the particular facts and circumstances of those cases airports compete, BAA suggests that a much fuller explanation of the OFT's reasoning is required.

⁵⁵ paragraph 5.47, OFT UK Airports Market Study, OFT 882, December 2006.

market which mean that they are not. Secondly, whether or not Edinburgh and Glasgow are potential competitors is a separate empirical question which needs a separate analysis.

OFT conclusions on relevant market in lowland Scotland

81. The Market Study appears to set out some tentative conclusions on what constitutes the relevant market in lowland Scotland. The Market Study seems to conclude that Prestwick competes with Glasgow, Glasgow can compete with Edinburgh, but Prestwick does not (and presumably cannot) compete with Edinburgh and that Newcastle cannot compete with Edinburgh. BAA does not believe that the Market Study sets out, in any detail, why Glasgow can compete with Edinburgh but Prestwick does not or cannot. Further the Market Study does not appear complete because it does not set out why Newcastle could not compete with one or more of Edinburgh, Glasgow or Prestwick. But most importantly, BAA considers that the study fails to present a well evidenced case that either of the Glasgow airports do or could compete with Edinburgh or vice-versa.

Evidence on pricing

82. The Market Study does not undertake a detailed analysis of the competitive interaction between the airports in lowland Scotland. However, it does argue or cite claims that:

- Yields at Edinburgh are higher than those at Glasgow which suggests that Prestwick has been exerting a competitive constraint on Glasgow;
- Charges are falling but from a high base⁵⁶; and
- BAA has been either bundling discounts across its Scottish airports or has been offering for an equivalent service more aggressive discounts at Glasgow relative to Edinburgh.

83. The argument that yields are lower at Glasgow due to the impact of Prestwick is an assertion. Given that the OFT has not by its own admission obtained data on airport charges from Prestwick it is difficult to understand how it could have undertaken a comprehensive or robust analysis to support this assertion.

84. In reality, the fact that average yields for BAA at Glasgow are lower than at Edinburgh is not about whether Prestwick is competing effectively with Glasgow or not. It cannot be assumed that variance in airport yields between these two airports is the result, in whole, in part, or at all, from the presence of Prestwick.⁵⁷

85. As discussed above, even if there was evidence of price competition between these two airports this is not a necessary or sufficient condition to infer that similar price competition could take place between Edinburgh and Glasgow.

⁵⁶ paragraph 7.16, OFT UK Airports Market Study, OFT 882, December 2006.

⁵⁷ As the OFT should be aware from its inspection of TRL data on airport charges and yields, charges vary considerably across different airports.

86. The OFT argues or cites the allegation that BAA has been either bundling discounts across its Scottish airports or has been offering for an equivalent service more aggressive discounts at Glasgow relative to Edinburgh. Because BAA is not privy to the detailed comments made to the OFT it is difficult to respond in full. However, as already explained to the OFT, BAA's policy on airport charges, as set out in its Conditions of Use,⁵⁸ is designed to promote traffic growth and international connectivity. Therefore the exact nature of discounts is a route specific question and it would be wrong to make sweeping generalisations based on yield analysis. It should also be noted that these claims have recently been rebutted in public by one of BAA's largest customers.⁵⁹

Investment

87. The OFT argues that in theory "joint ownership may delay or impede investment due to the lack of competition".⁶⁰ BAA would contend that there is no evidence of under/investment in Scotland. Indeed, both Edinburgh and Glasgow airports have undertaken extensive investment in recent years. It is not clear to BAA that the OFT has undertaken any significant analysis of its investment record in Scotland. Further the OFT cites no evidence, from airlines, that there is a problem with investment at our Scottish airports.

88. To establish whether break up of BAA in Scotland would actually create significantly different investment incentives requires careful analysis as to whether BAA's Scottish airports can significantly compete for airlines under separate ownership to grow the market in a way BAA is not currently doing. For the reasons outlined above, such an analysis has not yet been undertaken. Therefore the OFT has merely asked a theoretical question and presented no case on BAA's investment record in Scotland.

Service Quality

89. The OFT notes, but does not discuss, the fact that BAA's Scottish airports achieve relatively high scores in the ASQ surveys that are comparable to Manchester. Indeed Edinburgh ranked at 38th in the table is four places higher than Manchester which is ranked at 42nd. Glasgow ranked at 44th is only two places behind Manchester.

90. Further, the OFT implies that any difference in perceived service between Glasgow and Edinburgh airports is as a result of some incentive BAA has to raise quality of service at an airport which has more business orientated traffic. In reality, both airports have scored highly in BAA's internal service quality measures over many years, and BAA has invested heavily at both airports in order to ensure both capacity and service quality requirements are met. In particular, both terminals were significantly redesigned and expanded during the 1990s, and investment in recent years has continued. There are a variety of factors which can influence the ranking of airports in service quality surveys, some within and some beyond the airport operators control. As such, and

⁵⁸ See www.baa.com/cou.

⁵⁹ Scotsman 19th December: Easyjet.

⁶⁰ Paragraph 7.1, OFT UK Airports Market Study, OFT 882, December 2006.

considering the OFT does not present any evidence to suggest the situation would change under separate ownership, the conclusions drawn are speculative.

91. Therefore in summary:

- There is insufficient evidence to conclude that Edinburgh and Glasgow serve the same market, and in BAA's view they are not substitutes for most passengers;
- The degree to which Glasgow does (or does not) compete with Prestwick does not read-across to whether Glasgow would compete with Edinburgh;
- The fact that Glasgow's yields are lower than Edinburgh's does not provide any reliable indication of the degree of competition faced by Glasgow from Prestwick;
- The OFT does not offer an evidenced case that there is any concern regarding investment;
- The OFT largely ignores the relatively high service quality scores achieved by Glasgow and Edinburgh, though this contradicts the OFT's thesis (in the South East) that joint ownership is associated with service quality issues.
- BAA does not consider that the OFT has justified sufficiently the inclusion of Aberdeen in the proposed CC reference.

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Proposed decision on a reference

92. Before making a reference the OFT must be satisfied that it has the power to make a reference (reasonable grounds for suspecting that features of the market prevent, restrict or distort competition⁶¹) and that the making of the reference is an appropriate exercise of its discretion having regard in particular to its own guidelines.⁶²

93. As set out above, BAA believes that the Market Study:

- Fails to demonstrate to the necessary standard that the joint ownership of airports in the South East and Lowland Scotland distorts short run competition. The Market Study fails to adequately demonstrate that such airports could under separate ownership compete in the short run, particularly given other factors such as capacity constraints in the South East, the dearth of evidence of switching by airlines or indeed that sufficient numbers of passengers and airlines view the airports as substitutes. In Scotland, the reliance on assertions of competition between Prestwick and Glasgow provides no coherent basis for the assertion that there is scope for significant competition between Glasgow and Edinburgh. Indeed the Market Study accepts that it is difficult to assess what would occur absent common ownership,⁶³
- Fails to demonstrate any basis to extend the reference to the whole of the UK so as to cover the provision of airport services at Southampton and Aberdeen;
- Fails to adequately demonstrate that in the long run the timing and scale of investment under separate ownership would be different or preferable from the perspective of both airlines and passengers;
- Relies uncritically on the submissions of certain airlines;
- Fails to adequately demonstrate that BAA's prices are too high;
- Raises some valid questions regarding the adequacy of the current regulatory system to provide appropriate incentives; and
- Raises some valid questions regarding the effect of planning restrictions.

94. The OFT must therefore carefully consider whether it is appropriate to make a reference particularly on the basis of common ownership. It is telling that the Market Study seeks to rely⁶⁴ on the merger

⁶¹ Section 131 of the Enterprise Act.

⁶² OFT 511.

⁶³ paragraphs 9.5 and 9.8, OFT UK Airports Market Study, OFT 882, December 2006.

⁶⁴ paragraph 9.5, OFT UK Airports Market Study, OFT 882, December 2006.

provisions of the EA02 to support its position. This is irrelevant: the legal test is different (as the Market Study recognises) and the legal context is different.

95. Therefore in summary:

- BAA questions whether the OFT's Market Study provides a sufficient basis for referral on grounds of common ownership.

Undertakings in lieu

96. In paragraphs 9.21 and 9.22, the OFT invites BAA to offer undertakings in lieu of a reference to the CC. In the light of this response to the OFT Market Study BAA does not believe it is would be appropriate to offer undertakings in lieu.