



CONFIDENTIAL

Response for BAA Limited

Response to Working paper on the
potential for competition between BAA's
south-east airports

BAA/CC2008/948

BAA Limited
June 2008

1. Summary

- 1.1. This paper is BAA's response to the Commission's working paper on the Potential for Competition between BAA's South East Airports.
- 1.2. The working paper does not address the key issues in the South East, namely capacity constraints and price caps, but rather discusses some indicators of the degree of demand side substitutability between the airports. However, in BAA's view the paper gives a general impression that appraisal of these indicators are closely connected with the scope for competition under separate ownership, and in some instances it is suggested without qualification that the indicators do lead to scope for competition under separate ownership. For example:
 - Emerging Thinking, paragraphs. 166-167: in the subsection titled "Current assessment of demand substitutability between the south-east airports" the Commission states its current view that "taking into account all of the above evidence and analysis, our current view is that there should be significant potential for competition between BAA's south-east airports, [...]"
 - The Commission's decision to entitle this working paper "Potential for competition between BAA's south-east airports" when it explicitly only deals with demand substitutability.
 - The Commission's inference that catchment overlaps implies the potential for competition throughout the working paper (e.g. paragraph. 38).¹
 - The Commission's statement at paragraph. 12 of the working paper that it is undertaking "various pieces of analysis that yield information on the extent of competitive interaction that would exist absent joint ownership between BAA's airports"
- 1.3. BAA recognises that the Commission refers to restrictions on airports' ability and incentive to compete (such as price caps or capacity constraints) as potential caveats to the implications of its analyses and provides some commentary on these points elsewhere in its Emerging Thinking. However, BAA is concerned that the Commission's approach creates the – clearly incorrect – impression that the primary requirement for airport competition in the South East is demand substitutability while the other constraints are in some sense secondary.
- 1.4. In fact, however, all three factors – a sufficient degree of substitutability between airports, sufficient incentive to compete, and sufficient ability to compete – constitute equally

¹ The Commission does state numerous caveats that may affect the reliability of catchment overlaps as an indicator. – BAA's concern here, however, is related to a different issue. Even if it was found that the caveats did not invalidate the use of catchment overlaps as indicators, they would still be indicators for demand substitutability and not for the potential for competition.

necessary conditions that have to be fulfilled in order for the view that significant competitive interaction may emerge under a different ownership structure to be plausible. Therefore, any findings that relate to the consideration of a subset of these conditions in isolation cannot be meaningful indicators for the present scope for airport competition in the South East.

- 1.5. Consequently, the Commission's analysis of demand substitutability in this working paper is of no value on its own as an indicator for the scope for competition between BAA's South East airports.² The Commission sent a draft second working paper assessing the scope for competition in the South East to BAA on 24th June which does address the key issue of capacity constraints - that paper, however, takes as its premise an absence of regulatory price caps, thereby rendering it similarly lacking as an appraisal of the scope for competition in circumstances where price caps continue to apply. BAA will respond to that working paper in due course.
- 1.6. Further, since capacity constraints and price caps are ignored in the analysis in this working paper, there is no attempt at an appraisal of how the various aspects of airport differentiation that the Commission discusses might impact on the scope for competition in the context of the capacity constraints and price caps that apply.
- 1.7. The considerations above imply that - as has been emphasised by BAA several times - any comprehensive assessment of the market environment of its South East airports has to take full account of the constraints imposed by capacity limits and regulation which undeniably have strong implications for airports' incentive and ability to compete.
- 1.8. In the face of the capacity constraints and price caps that apply there is no scope for material competition between any of BAA's South East airports. That would be the case even if the airports were viewed as very close substitutes by their users and the fact that they are significantly differentiated serves to reduce the scope for competition even further. It is in that context that views on substitutability need to be appraised.
- 1.9. Accordingly, the Commission's working paper does not provide the necessary foundation for drawing a conclusion that there is even a *prima facie* likelihood that BAA's South East airports would compete under separate ownership. It simply has not addressed the issues that are relevant to that question.
- 1.10. The remainder of BAA's response follows the Commission's working paper by focussing on issues of demand substitutability to a large extent. Many issues have been addressed at a high level in BAA's response to Emerging Thinking, and this paper does not attempt to restate all of the points that were previously made. In summary, BAA considers that the

² At paragraph. 11, the Commission appears partially to recognise this point by stating that assessing demand substitutability is a "starting point" in the analysis of the scope for competition in the context of price constraints.

Commission's analysis of demand substitutability in the South East has failed to sufficiently address the following points (see BAA's response to Emerging Thinking, Chapter 5):

- Geographic differentiation. BAA agrees that there are significant overlaps between the catchments of the London airports and that a substantial number of passengers in the South East are likely to view two or more of them as relatively close substitutes. However, this does not imply that there is no geographic differentiation between them or that the ultimate effect of this differentiation on the scope for competition can be ignored.
- Airport differentiation. Equally, the high degree of differentiation between BAA's London airports – such as Heathrow's unique hub status and several important differences in the characteristics of Gatwick and Stansted – is a factor that is likely to reduce any scope for competition – irrespective of whether capacity and price constraints are taken into account.
- Southampton. The Commission relies heavily on a catchment overlap analysis to reach a view on the degree of substitutability between Southampton and the London airports. An indicative analysis of this type is not sufficient to draw reliable conclusions on this issue and, in addition, BAA has several concerns in relation to the methodology adopted and the interpretation of results.

1.11. This response provides:

- A brief summary of BAA's position in relation to airport differentiation in the South East. BAA believes that it is important to give appropriate weight to a substantial amount of evidence that suggests that the London airports are materially differentiated from each other – both in terms of location and other characteristics.
- Some further points in relation to the Commission's assessment of the market environment of Southampton which suggest that the associated evidence is by no means sufficient to identify potential for competition with the London airports.
- Some point-by-point remarks on various Commission statements in the working paper

1.12. Finally, BAA notes the Commission's statement that the working paper represents work in progress and that further sensitivities and potential extensions are planned. BAA requests that the Commission provide this further analysis to BAA to enable it to develop a comprehensive view on the associated conclusions, the potential parallels and differentiating factors relative to the Commission's analyses in the working paper and to satisfy itself that analysis refinements in one area did not give rise to new caveats in others. BAA would be grateful for clarification of when the Commission expects to have completed this further work and when it may be able to provide the corresponding materials.

2. Airport differentiation

- 2.1. In BAA's view its London airports are significantly differentiated (even if capacity constraints are ignored). Heathrow is clearly a very different proposition to Gatwick and Stansted given its position as an international hub and the associated network, its proximity to the centre of London, its international profile and its strength in the business segment. Gatwick and Stansted are also differentiated. Although their catchment areas overlap to a degree, Gatwick has a strong position south of London. Gatwick's user base includes significant long haul and charter traffic, whereas at Stansted two low frills carriers pre-dominate. Luton is Stansted's closest actual competitor, and that would likely remain the case even if Gatwick had no capacity constraints and even if it was separately owned.
- 2.2. This is consistent with the general picture arising from the airline views on substitutability as collected by the Commission which indicate substantial differentiation of Heathrow – as most airlines view the other London airports as not substitutable or at least not as good substitutes³ – as well as of significantly differentiation between BAA's other airports.
- 2.3. Some airlines explicitly mention that Stansted and Gatwick appear to be substitutable to a degree⁴ but it is notable that BA, Delta and Virgin do not even mention Stansted when discussing potential substitutes for Gatwick or Heathrow (substitutability, or lack thereof, with Gatwick is discussed in these instances, indicating that those airlines clearly view Gatwick and Stansted as differentiated).
- 2.4. Further, BAA accepts that some airlines appear to have taken actual slot constraints into account in their responses but considers that this is not sufficient to infer that the degree of substitutability is generally understated by the reported responses – in particular by the views on substitutability that do not mention any capacity constraints.
- 2.5. Overall, these views and evidence support BAA's position on airport differentiation as set out in its response to Emerging Thinking at 5.8-5.18: BAA does not believe that this differentiation in terms of location and other characteristics alone precludes competition between its London airports but that the scope for competition – even in the absence of any capacity constraints – would be limited and that the Commission has not given sufficient consideration to these issues and not attached adequate weight to substantial evidence from airlines that effectively suggests a relatively high degree of differentiation between all South East airports.

³ Air Canada, bmi, SAS, SWISS, TAP, United and Virgin as well as one excised airline considered that the other London airports were no substitutes, no realistic substitutes or no substitutes of equal standing for Heathrow. BA, American Airlines and GB Airways as well as one excised airline identified limited substitutability. However, several airlines viewed Heathrow as a good substitute for Gatwick.

⁴ See e.g. Ryanair's response: *"Should slots become available at one or some of the London airports, it would be possible to move some aircraft out of Stansted. However, there still remains a significant local catchment area for each of the London airports, according to CAA data."* (Commission working paper, p. 82)

3. Southampton

- 3.1. BAA considers that the Commission's analysis of the market environment of Southampton does not address several important issues:
- Given capacity constraints at Heathrow and Gatwick, there is no scope for material competition between Southampton and those airports even if airlines and passengers regard them as potential substitutes;
 - Few airlines will regard setting up operations at Southampton as a substitute for operations at Heathrow and Gatwick (or vice-versa). As explained in BAA's comments on the March 2008 hearing (BAA/CC2008/650 from paragraph. 87), Southampton's current infrastructure cannot accommodate many larger types of aircraft and a potential extension to the runway would be complicated substantially, if not made entirely unfeasible, by the combination of physical constraints and a s106 legal agreement.
 - Southampton and Bournemouth compete for route location, but route overlaps are unsurprisingly relatively low (given the limited scale of the south coast market and flybe's greater emphasis on business orientated services than the routes currently operated by Ryanair from Bournemouth). This explains why airlines at Southampton/Bournemouth do not regard airlines at the other airport as being close competitors on a route (since the other airport will not tend to operate the route). There are however, indications that this may be changing. Ryanair have previously employed an advertising vehicle to drive around Southampton airport whilst advertising Bournemouth airport. This was responded to by flybe appointing an agency to provide a vehicle providing advertising to counter this.
 - The Commission does not appear to have given adequate weight to evidence in the form of several airline statements that indicate competition for new services between Southampton and Bournemouth.
 - The Commission's catchment overlap analysis in relation to Southampton cannot be considered reliable for numerous reasons and, therefore, is by no means sufficient evidence to support the Commission's preliminary conclusions in Emerging Thinking (as outlined at paragraphs. 5.20 and 5.22-5.23 of BAA's response to Emerging Thinking).
 - Southampton's principal target markets have many geographically distant alternatives to expanding at Southampton.
- 3.2. BAA notes that the Commission's "closest competitor" analysis (Commission working paper from paragraph. 69) indicates that airlines at Heathrow and Gatwick are viewed as closer competitors by airlines at Southampton than are airlines at Bournemouth. This does not imply that Bournemouth is not Southampton's closest competitor at the airport level, however, since it does not take into account airport competition for new routes. In general, there is unlikely to be sufficient demand for both Southampton and Bournemouth to serve

the same route in many instances. Rather, competition between them will take the form of competing to attract the routes. It is quite possible that competition could coexist with very low levels of route overlap. Accordingly, the closest competitors of services at one of the airports would not be found at the other airport.⁵

3.3. This issue seems to be particularly relevant in relation to Southampton and Bournemouth where limited route overlaps may have distorted the “closest competitor” scores. The Table below shows route overlaps between Southampton and other airports in the South East. As can be seen, Southampton has substantially greater route overlaps with Gatwick and Heathrow (in both instances accounting for around 80% of Southampton’s passengers) than it does with Bournemouth. Accordingly it is not surprising that airlines operating at Southampton consider airlines at Heathrow and Gatwick as closer competitors than those operating at Bournemouth.

	Total scheduled routes	Overlap scheduled routes (Southampton offers 43 scheduled routes)	% of Southampton scheduled passengers on overlap routes
Bournemouth	30	11	32%
London City	39	17	67%
Gatwick	189	27	79%
Heathrow	195	23	80%
Luton	81	20	55%
Stansted	175	23	72%

Source: CAA airport data 2007

3.4. The relatively low route overlap between Southampton and Bournemouth does not indicate that these airports do not compete. There is competition to establish routes between Southampton and Bournemouth. This view is supported by evidence as presented (BAA/CC/2007/191 which include statements by Air Berlin and Thomsonfly) and by a Ryanair statement in its hearing with the Commission (hearing summary, paragraph. 27).

- Air Berlin released the following press statement related to the switch of a route from Southampton to Bournemouth in 2005 that mentions airport charges as a factor in its decision which suggests competitive interaction: *“Air Berlin is actually starting a new replacement service to south-central England: Paderborn to Bournemouth. Lured to Bournemouth from Southampton by its longer runway and cheaper landing fees, Air Berlin will offer a twice weekly Paderborn to Bournemouth roster ...”*

⁵ BAA notes that in principle, the same issue arises in relation to the Commission’s closest competitor analysis for Scotland. There, however, this shortcoming is resolved by the fact that there are very large route overlaps between Glasgow and Edinburgh while airlines, at the same time, do not perceive their closest competitors at the respective other airport.

- Thomsonfly made the following statement after switching five routes from Southampton to Bournemouth indicating that Bournemouth's characteristics render it an attractive alternative to Southampton: *"Bournemouth is one of the fastest growing towns in Europe making it a great choice for a new base. The number of low cost routes is very limited from Bournemouth so our flights will open this up dramatically and this is a real opportunity for Thomsonfly.com"*.
- In the Ryanair hearing summary it is stated at paragraph. 27 that: *"When Ryanair had been unable to secure a low-cost arrangement at Southampton it had developed an arrangement with Bournemouth. Operations there had grown and recently Bournemouth had become a base airport for Ryanair. It did not believe that Southampton or Bournemouth could ever be an alternative for London."*
- In recent conversations with carriers wishing to commencement on new routes from this region, BAA Southampton was told that Bournemouth (and indeed Bristol) were considered as alternatives.
- The Isles of Scilly Skybus operated from both Southampton and Bournemouth before concluding that operations from one airport, Southampton, rather a joint operation was more viable.

3.5. As indicated above, BAA strongly disagrees that the catchment overlaps between Southampton and its London airports as identified by the Commission are, by themselves, sufficient to support the view that there may be scope for competition between these airports.

3.6. First, the catchment analysis for Southampton is based on data for all routes and is therefore (despite the substantial route overlaps of Southampton with Heathrow and Gatwick pointed out above) likely to indicate a significant number of passengers as marginal that actually would not be likely to switch airports in response to movements in relative airfares due to route availability or different service frequencies. For example, Heathrow and Gatwick offer a much higher average frequency of destinations served when compared to Southampton. Data shows that short haul services are operated an average of over 90 times at Heathrow, compared to around 50 at Gatwick and 20 at Southampton.⁶ It is equally plausible that passengers from overlap regions, whose destination is available at Southampton, have a strong preference for that airport (although many may still prefer to fly from London given the superior frequency available at those airports) while those who cannot reach their desired destination from Southampton travel via one of the London airports – in this case neither of the passenger groups should be considered marginal.

3.7. Further, the Commission's analysis does not include Bournemouth, which, in BAA's view, is Southampton's closest competitor – this view is supported by the statements of several

⁶ This analysis is based on the top 20 short haul destinations served (in terms of movements) for one week in June 2008.

airlines as set out above. Therefore, the analysis cannot be considered to be a comprehensive assessment of the market environment of Southampton. BAA recognises that the Commission does not seem to have access to passenger data for Bournemouth but submits that a more substantive analysis of the competitive interaction between these airports is nevertheless required.

- 3.8. Finally, BAA is not convinced that the origin data for Southampton passengers that the Commission has obtained from Flybe (online booking data from 2001 to 2007) is sufficiently representative for Southampton's current passengers to allow for reliable conclusions. BAA notes that, in the cleaning process, more than 15% of Southampton passengers were dropped while the corresponding figure for the London airports is around 1% (excluding transfer passengers), which might indicate persistent issues with the reliability of the final Southampton dataset – e.g. it seems plausible that the billing or delivery addresses reported by passengers during the online booking process are not identical to their journey's surface origin; while the Commission may have removed the clearly implausible origins caused by this in the cleaning process, the remaining dataset would still be affected.

4. BAA's point-by-point comments

- 4.1. At paragraph 9, the Commission notes that it expects further input from BAA on South East substitutability. BAA answered the Commission's questions regarding catchments in the market questionnaire issued last summer, however, following this, BAA is unclear what input the Commission is referring to and seeks clarification from the Commission on this matter.
- 4.2. At paragraph 10, the Commission mentions suggestions that common ownership of the London airports has prevented competition and resulted in higher prices and/or lower service quality. It is not clear to BAA at all what impact ownership structure could be considered to have on prices in the context of price cap regulation and the associated availability of instruments to the regulators to prevent airports from imposing charges that are considered inappropriate. In addition, regulation entails significant incentive mechanisms in relation to service quality and is consequently highly relevant for this issue as well.
- 4.3. The Commission then discusses the conditions that would have to be fulfilled in order for the hypotheses implied by the suggestions mentioned above to hold. The necessary condition of sufficient demand substitutability is mentioned explicitly but BAA considers that the remaining necessary conditions that are related to airports' incentive and ability to compete are not stated with sufficient clarity. These conditions are: availability of spare capacity, absence of binding price caps, absence of other distortions and restrictions (e.g. policy, planning).

- 4.4. At paragraph 11 the Commission mentions the binding price caps at Heathrow and Gatwick and states that demand substitutability is relevant to an assessment of the scope for competition subject to these constraints. However, neither this working paper nor the Commission's second South East working paper provide any details on its theory of how competition would operate in the context of price caps and what distortions may be expected to arise. BAA considers that this issue requires further analysis.
- 4.5. At paragraph 12 the Commission dismisses the SSNIP framework without explaining why. BAA presumes that the Commission relies on the arguments advanced its working paper on Market Definition to justify this. However, as stated in BAA's response to the market definition working paper, BAA considers that the Commission should have given detailed consideration to the feasibility of applying the SSNIP test and provided a much more comprehensive explanation of why it considers the adopted approach to be capturing all relevant effects or whether it thinks that some shortcomings are likely to arise and what their implications for the results are expected to be.
- 4.6. BAA notes the Commission's acknowledgment that there is no established threshold in relation to the analysis of catchment overlaps⁷ and that "overlap benchmarking" as conducted in relation to Scotland is "one piece of analysis" that could provide information on what an appropriate threshold might be at paragraph 20. The Commission uses Birmingham and East Midlands as a benchmark for addressing in this in the case of Scotland, a comparison that BAA has commented upon in its response to the Commission's working paper on Scotland. In relation to the South East it is, in BAA's view, clear from the outset that the values for Birmingham and East Midlands are not meaningful comparators in any way due to vast differences in market environments and airport characteristics of Birmingham and East Midlands.
- 4.7. At paragraph 55 the Commission notes that its overlap results are based on observed passenger behaviour and that it will need to consider the extent to which overlaps are affected by the current ownership structure, capacity constraints and price caps. In relation to the apparent focus on the impact of joint ownership, BAA would ask the Commission to set out its thinking in detail as to why this is seemingly considered to be a significant determinant of passenger preferences. Further, BAA notes that an analysis of substitutability aimed at informing the question of whether there is scope for competition cannot rely on the speculation that, if there was competition, the findings on substitutability may have been different – this would clearly invalidate the conclusions of the analysis and effectively reduce them to the uninformative inference that there is scope for competition if scope for competition is assumed to exist.

⁷ As discussed earlier, values exceeding any such threshold would not be sufficient to conclude on the scope for competition. However, due to the fact that all conditions for competition are necessary, values below the threshold would be sufficient to infer that there is no material scope for competition.

- 4.8. The Commission have removed multiple bookers from the dataset, BAA questions the Commission's methodology in this regard. At Southampton, passengers fly on average 6 times in one year as many users are business or visiting friends or family. On this basis, the Commission this will have reduced the 'close in' density of the catchment, a bias that would not exist with CAA data.
- 4.9. At paragraph 75 the Commission summarises the results of its airline "closest competitor" analysis that there appears be material competition from airlines at other airports at all four BAA South East airports which is relatively most important at Stansted and Southampton and least important at Heathrow. Further, the Commission states that "*in all cases the main competition comes from other BAA airports.*" This is not correct. At Heathrow and Gatwick the main competition is shown to be airlines operating at the same airport.
- 4.10. Further, BAA accepts that there is clearly some competitive interaction on some routes between airlines at its South East airports. However, it is not clear how strong and comprehensive this interaction actually is and due to the caveats identified by the Commission at paragraph 74 the "closest competitor" analysis seems unlikely to enable insights in relation to this issue. In particular, because its focus lies on the relative ranking of competitive constraints and not their absolute strength.
- 4.11. At paragraph 77 the Commission provides a summary of airline views it received and mentions airline data that seemed to show that passenger growth on some Southampton routes coincided with reductions in growth at Heathrow and Gatwick. BAA would be interested in additional details related to this statement, the Commission's analysis of the data and its view as well as the underlying data itself if the Commission is able to provide it.