

DECISION ON THE REGULATORY STATUS OF STANSTED AIRPORT

This document sets out the Secretary of State for Transport's (Secretary of State/ Department for Transport — DfT) decision about whether Stansted airport should continue to be designated under Section 40 of the Airports Act 1986. In reaching her decision, the Secretary of State has carefully considered the advice she has received from the Civil Aviation Authority (CAA) as well as responses from interested parties that were provided to her through the consultation process. This has been considered in the context of the designation and de-designation criteria published in May 2007. On the basis of the evidence, she has decided that Stansted airport should remain designated because all three of the criteria for designation are met.

The Secretary of State has also noted that the Competition Commission is currently reviewing the market for airport services in the South East of England and East Anglia, and is mindful that this review could lead to changes to the structure of the market that would affect the assessment of whether the criteria are met. Therefore, she reserves the right to revisit her decision in the light of any information or findings that emerges from the Competition Commission's inquiry later this year (as she is entitled to do when taking into account all other relevant matters).

The Secretary of State's decision to continue to designate Stansted airport will mean that the CAA will be required to set a new price cap for Stansted airport to commence in April 2009. Before setting the new price cap the CAA is required to make a reference to the Competition Commission to seek its views on the appropriate form of price cap. The DfT understands that the CAA will shortly issue a consultation about the terms of its reference to the Competition Commission and that it expects to make its reference in March or April.

In making her decision, the Secretary of State is aware of the comments made by a number of the respondents on the costs of the current approach to price controls at Stansted airport. The structure of price controls is a matter for the regulator but my decision is not intended to constrain the CAA from adopting other approaches which meet their statutory duties while avoiding some of the costs of the current system that respondents have identified.

This decision document has the following sections:

- A description of the current regulatory framework.
- A summary of how the criteria for considering the designation and de-designation of airports were developed.

- A description of the request for advice from the CAA on whether the criteria are met for Stansted airport.
- A summary of the conclusions of the CAA's advice as to whether Stansted airport meets the criteria.
- A summary of the responses to the consultation process about whether Stansted airport should remain price designated or not and our process for considering the responses.
- Analysis of the key issues that arose through the consultation process.
- The Secretary of State's decision.
- An explanation of the next steps and timetable.
- Annex 1 provides a more detailed summary of the responses received by the DfT in relation to Stansted airport's regulatory status.

Current regulatory framework and recent developments

Currently, Heathrow, Gatwick, Stansted and Manchester airports are designated by the Secretary of State under Section 40(10) of the Airports Act 1986. Such designation places an obligation on the CAA to impose the following conditions on these airports:

- (i) price controls that limit the maximum revenue that they can recover from airport charges over a five year period;
- (ii) an accounts condition that obliges the airport to publish certain accounting information; and
- (iii) any public interest conditions required to remedy certain types of conduct identified by the Competition Commission.

The CAA makes its price cap decisions after taking account of advice from the Competition Commission. Prior to putting in place a price cap, there is a mandatory reference to the Competition Commission. The Competition Commission has recently

reported on the proposed price caps for Heathrow and Gatwick airports¹, and the CAA has issued its proposed price caps for these airports.²

The Competition Commission is also separately considering wider issues associated with the UK airport market through its evaluation of whether the airport services offered by BAA at UK airports, including Heathrow, Gatwick and Stansted airports, prevent, restrict or distort competition in the UK. This inquiry was referred to the Competition Commission by the Office of Fair Trading in March 2007 and a decision will be made by March 2009.

The criteria for assessing designation and de-designation

Following advice from the CAA, the Office of Fair Trading (OFT) and the Transport Select Committee, and in keeping with the principles of better regulation, the DfT reviewed the criteria for assessing whether airports should be designated or de-designated. The then Secretary of State consulted on new criteria and following consideration of responses to the consultation, the new criteria were confirmed by the then Secretary of State on 31 May 2007.³

The final criteria adopted by the Secretary of State are set out below:

‘Designation of an airport is appropriate if, in the view of the Secretary of State:

- 1. the airport, either alone or together with any other airport(s) in common ownership or control, has or is likely to acquire, substantial market power; and*
- 2. domestic and EC competition law may not be sufficient to address the risk that, absent regulation, the airport would increase and sustain prices profitably above the competitive level or restrict output or quality below the competitive level; and*
- 3. designation under Section 40 of the Airports Act 1986 would, taking account of the magnitude of the risk identified in (2) and its detrimental effects were it to materialise, deliver additional benefits (i.e. over and above competition law) which exceed the costs and potential adverse effects of such designation (i.e. the incremental benefits are positive).*

De-designation is appropriate if, in the view of the Secretary of State, any of these factors would cease to apply were the airport to be de-designated.

¹ “Competition Commission report: BAA Ltd – A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd)”, Competition Commission, September 2007.

² “Heathrow and Gatwick Airports, CAA price control proposals”, CAA, November 2007.

³ The decision document was subsequently amended, on 27 June 2007, to rectify two minor typographical errors.

In reaching any decision to designate or de-designate, the Secretary of State will take into account all other relevant matters, including international obligations.'

The decision document stated the Secretary of State's intention to consult on whether there should be a change in the designated status of Manchester and/or Stansted airports. This consultation process included written submissions from interested parties, a stakeholder meeting in September 2007 as well as correspondence and bilateral meetings with certain respondents to follow up on particular issues.

Request for advice from the CAA

Having confirmed the criteria to be used, Gillian Merron MP, the then Parliamentary Under Secretary of State at the DfT asked the CAA, under Section 16 of the Civil Aviation Act, for its advice about how these criteria applied to Manchester and Stansted airports, and therefore, whether the CAA considered that – against these criteria – the status of either or both airports should change. She stressed the importance of the CAA seeking to provide as much evidence as possible to support its views, and taking account of comments received in respect of its previous consultations on market analysis for Manchester and Stansted airports

CAA's advice on whether Stansted Airport meets the criteria

We briefly summarise below the conclusions of the advice provided by the CAA, which is available in full from their website⁴. It covered Manchester and Stansted airports. However, those sections relating to Stansted airport specifically, can be found by reading the summary, chapters 1 to 4, 8 to 10, and annexes A and B.

Summary of the CAA's conclusions

The CAA advised the Secretary of State that Stansted airport does not meet any of the three criteria established by the Secretary of State for an airport to be designated. Accordingly, the CAA advised the Secretary of State that Stansted airport should be de-designated.

In relation to each of the criteria, the CAA concluded that:

- *Criterion one* – On balance, the CAA considered that Stansted airport does not hold a position of substantial market power at present and that the balance of probability is that it is unlikely to do so for the foreseeable future. The CAA

⁴ CAA 2007, De-designation of Manchester and Stansted airports for price control regulation: the CAA's advice to the Secretary of State, http://www.caa.co.uk/docs/5/ergdocs/de-designation_advice.pdf (accessed 10 November 2007).

noted that overall there are good reasons to believe that there are competitive constraints from other airports (in its immediate market and elsewhere), and from passengers and airlines. The tightening supply- demand balance is likely to lead to the airport having more pricing power than it has had in the past, but this could be a reasonable consequence of the fundamental balance between supply and demand in the market, which encourages investment in additional capacity.

- *Criterion two* – The CAA considered that competition law was sufficient to address the risk that, absent regulation, the airport would increase and sustain prices profitably above the competitive level or restrict output or quality below the competitive level. The CAA particularly noted the large amount of information available to inform an allegation of excessive pricing and the high concentration of airline users who have previously been willing to take private enforcement action.
- *Criterion three* – The CAA concluded that, in the case of Stansted airport, designation would not deliver additional benefits (i.e. over and above competition law) that exceed the costs and potential adverse effects of such designation (i.e. the incremental benefits are negative). The CAA therefore recommended that the Secretary of State conclude that Stansted airport did not meet the third criterion.

The CAA recognised that it is possible to take an alternative view of the extent of the market power that the airport might enjoy in future, and therefore, of the balance of evidence on the first criterion. However, it considered that there was strong evidence in respect of the remaining criteria that provided considerable assurance that the airport should be de-designated.

Responses and the process to consider responses

The DfT received feedback from 8 stakeholders about the regulatory status of Stansted airport. These comprised 2 airports, 1 individual, 1 airline representative body, 3 airlines and 1 MP. We have summarized below the key views of respondents and the issues raised. A summary of responses is provided as an annex together with a full list of respondents.

BAA and David Starkie broadly agree with the CAA's advice to the Secretary of State that Stansted Airport did not meet the Secretary of State's criteria for a designated airport, and therefore, should be de-designated. London Luton Airport Operations Limited (LLAOL) also supported de-designation subject to receiving certain assurances

from the CAA. BA, Easyjet⁵, Oliver Heald MP, Ryanair, Stop Stansted Expansion (SSE) and Stansted Airport Consultative Committee (ACC) disagree with the CAA's advice to the Secretary of State for varying reasons, and believe that Stansted Airport met the criteria to be a designated airport, and should remain designated.

The Secretary of State has carefully reviewed the CAA's advice and responses to the consultation and then considered whether the responses provide any reasons to materially question the CAA's advice. The Secretary of State has also obtained professional advice to inform her considerations. The Secretary of State welcomed the CAA's advice as a substantial piece of evidence based analysis on whether Stansted airport meets her criteria. When considering the responses of interested parties, she put most weight on those views that were supported by evidence and analysis.

A number of respondents provided new evidence or analysis that raised questions regarding the robustness of the CAA's conclusions. To ensure it fully understood the evidence and analysis presented, the DfT met with easyJet and Ryanair. The DfT also sought the comments of the CAA on some of the evidence and analysis presented in the responses. Following receipt of this information, the Secretary of State has carefully considered the comments of all respondents, and whether any of the issues raised by respondents were such that it would not be appropriate to follow the advice of the CAA as to whether the criteria for designation/ de-designation for Stansted airport are met.

Analysis of the First Criterion

The analysis for this criterion is separated into four main parts. First, market definition is considered. Second, whether Stansted airport alone currently has substantial market power is assessed. Third, whether Stansted airport alone is likely to acquire substantial market power in the future is considered. Finally, whether Stansted airport, together with other airports in the ownership or control of BAA, has or is likely to acquire substantial market power is considered. Some of the analysis and evidence informs more than one of the sections. However, the analysis has been set out under the heading under which it has the greatest relevance, even if it is relevant for more than one part.

⁵ In addition to submitting its response, Easyjet also commissioned analysis and a report by Frontier Economics. Frontier Economics were provided with data about Easyjet's passengers to consider why passengers choose airline services at particular airports. As Frontier Economics' report is available on their website (<http://www.frontier-economics.com/europe/en/publications/150/>), we have only summarised the main elements of the report below. We would encourage those parties interested in understanding the analysis carried out by Frontier Economics in more detail to read the report on the website.

Market definition

CAA's advice

The CAA stated that analysis of the propensity of passengers to travel to Stansted airport and the strength of the interactions between the airport, other London airports and regional airports suggests that the relevant geographic market is relatively broad. In addition, it stated that emerging evidence from airlines suggested that they are seeking to switch growth plans between airports over a very broad area. Therefore, the CAA concluded that the analysis of Stansted airport should be undertaken against a background of a geographic market that not only included London and the East Anglian regions, but extended to include the catchment areas for Birmingham and East Midlands airports. It noted the relatively large capacity availability at East Midlands airport in the foreseeable future. In addition, it concluded that there appeared to be a reasonable basis for finding that airports within this market also faced significant competitive pressures from outside of this geographic area through a chain of 'substitution' between airports (where local airports compete with one another, creating a 'chain' of competition for those further away as well). A further discipline would be alternative capital market opportunities for investment.

Respondents' views

BAA broadly agreed with the CAA's conclusions about market definition and noted analysis by NERA that supported the CAA's views and also consistency between the views of the CAA and the OFT regarding market definition.

The airlines were concerned that the CAA had not defined the product market correctly by failing to consider the market for airport services to airlines, and instead had focused on the market for airline passengers. The airlines considered that as they were the prime contracting party with passengers, it was their behaviour that was most relevant to considering the appropriate market definition. The airlines were also concerned that the CAA had not taken account of Stansted airport's ability (although not necessarily its current intention) to price discriminate between airlines, e.g. overnight parking charges could allow higher charges to be levied on based aircraft, and had only considered the ability of airports to price discriminate with regard to passengers.

While airlines considered that the focus of the CAA's analysis should be about airline behaviour, they recognised the relevance of passenger behaviour to considering market definition. Airlines argued that the CAA's analysis did not consider the strength of passenger's preferences to use airports that have the shortest travel times from their house or business. easyJet provided analysis of booking records for a selection of easyJet routes served at London airports and East Midlands airport, which sought to show that

passengers had very strong preferences to use their local airport when the same destination was offered at more than one airport. They also sought to show that if a route was switched from Stansted to East Midlands airport, there was no fall in price that could simultaneously attract enough customers to use East Midlands airport and ensure that the flight at that airport was profitable. In general, the airlines were sceptical about the weight that the CAA had attached to its passenger survey information regarding the propensity for passengers to use airports other than Stansted or Luton airports, such as East Midlands or Birmingham airports.

While the airlines had some concerns about the CAA's use of catchment area analysis, and in particular viewed them as a somewhat arbitrary classification of passengers' propensities to travel to particular airports, Ryanair presented a range of analysis about average drive times for passengers using Stansted airport. This sought to show that particularly for routes offered at a range of competing airports, most passengers travelled for relatively short distances to the airport, and that Stansted airport had a relatively small catchment area based around London and the South East.

The airlines strongly disputed the validity of the CAA's "critical loss" analysis, which sought to calculate how many passengers BAA at Stansted airport would need to lose, before a 10% increase in the airport charge would be unprofitable, and how likely it was that they would lose this many passengers. Ryanair argued that evidence of actual behaviour following increases in charges at Stansted airport earlier this year showed that the number of passengers lost, taking account of airline decisions to reduce capacity, would be substantially less than the 1.8m suggested by the CAA required to make the increase in prices unprofitable. Ryanair also argued that the level of price elasticity necessary to achieve the CAA's figure was much larger than accepted estimates by the DfT and other commentators.

Analysis

Although not immediately apparent from the responses, there is a significant amount of agreement about the appropriate market definition between the CAA, BAA and the airlines, even if there are differences about the appropriate approach to reach the conclusion. All the parties broadly agree that there is a geographic market that at least includes London, East Anglia, and to an extent the broader South East of England, within which Stansted airport falls.

There is some dispute about whether the product market should be defined precisely as airport services to airlines or whether it should be defined to incorporate passengers. It is not clear in practice that this is a substantive point that materially affects the conclusions that would be reached. The prime contractual relationship for airport services is between the airport and airlines, but the demand of airlines for airport services derives from the

demand of passengers for air travel, and passengers have some direct relationships with the airport when using commercial services, such as car parking. Therefore, it appears appropriate to consider the airline and passenger behaviour when developing the market definition.

The main issue is whether the geographic market is wider than just London and the South East. The CAA argued that as a minimum it would be appropriate to include catchment areas covering East Midlands and Birmingham airports, and that wider chains of substitution might exist. The CAA supported this with evidence of the geographic overlap of airport catchment areas, and argued that airports could not discriminate in their charges towards passengers living further away, so passengers at the “margin” influence airport behaviour. The airlines argued that in practice while some passengers might travel from outside London and the South East, there was no evidence that passengers were prepared to travel in the opposite direction in significant numbers or that airlines moved routes from London airports to regional airports in response to price changes. Where the same route was run at a London and non-London airport, it reflected an attempt to serve different geographic markets.

It would be possible in theory to robustly define the market if we were able to do a fully robust SSNIP or HMT test.⁶ In reality, it is not clear that the information exists to perform these tests in this way, not least because there is very limited empirical evidence about passenger and airline responses to price increases at Stansted airport (the increases earlier this year are the first for some time). Therefore, the OFT’s guidance on defining markets suggests that the key issues are the strength of the competitive constraint as evidenced by supply and demand side substitution possibilities. There is substantial spare capacity at East Midlands and (to a lesser extent) Birmingham airports so there is a strong potential supply side substitutability. Therefore, the key issue is the strength of the demand side substitutability. The evidence available is mixed and it is difficult to draw a strong conclusion.

Some passengers are clearly prepared to travel significant distances to Stansted airport, particularly where routes are not served from their local airport. The CAA’s passenger surveys also show a willingness amongst passengers using Stansted airport to consider alternative airports. As airports have limited ability to price discriminate, a relatively

⁶ The SSNIP test seeks to identify the smallest relevant market within which a hypothetical monopolist or could impose a profitable significant increase in price. It asks whether such a monopolist could profit from a price increase of 5% or 10% for at least one year (assuming that "the terms of sale of all other products are held constant"). If sufficient numbers of buyers are likely to switch to alternative products and the lost sales would make such price increases unprofitable, then the hypothetical market should not be considered a relevant market. Another, larger basket of products is proposed for a hypothetical monopolist to control and the SSNIP test is performed on that relevant market.

small number of passengers being prepared to change behaviour at the “margin” can discipline an airport’s behaviour. Frontier Economics’ modeling for easyJet also shows a fairly substantial passenger sensitivity to price changes for the choices modeled.

While there are some limitations to the Frontier Economics’ modeling for easyJet (including a failure to consider preferences between airlines and decisions not to travel), it does support in general the view that passengers have a relatively strong preference to minimise the distance they travel to airports, particularly where more than one route is offered at each airport, and even allowing for material differences in price between the available choices. The geographic origin of passengers using Birmingham and East Midlands’ airports, also suggests that relatively few passengers currently travel from the South East and London to use these airports.

The DfT has used its own modeling of the air travel and airport markets to understand how passengers, airlines and airports might react to price increases at Stansted airport, proxied by reducing available capacity at Stansted airport. It ran a variety of scenarios through its NAPALM model to examine which airports passengers choose to travel from if capacity is reduced at Stansted airport.⁷ In broad terms, this analysis suggests that passengers have a relatively strong preference for local airports in London and the South East, but will consider using East Midlands when the London airports are capacity constrained. Therefore, while this modeling to some degree supports the conclusions of Frontier Economics’ modeling for easyJet, regarding the strong preference for passengers to use their local airport, it also provides some support for the CAA’s view that airports outside London and the South East can act as a competitive constraint on Stansted airport.

There is broad consensus that as a minimum Stansted airport is within a geographic market that includes London, East Anglia and part of the broader South East. It has been much more difficult to reach a clear view as to whether the geographic market is wider than this, because the evidence about the strength of competitive constraints provided by other airports is mixed. As explained further below, it has not been necessary to reach a definitive view on the geographic market to determine whether the first criterion is met. However, the additional evidence from the consultation following the CAA’s advice, provided by the airlines and DfT modelling suggests that the competitive constraint provided by airports outside of London and the South East might not be as strong as the CAA argued. It is explained above why the precise approach to defining the product market is unlikely to materially alter the conclusions that are reached.

⁷ “UK Air Passenger Demand and CO2 Forecasts”, Department for Transport, November 2007.

Current market power

CAA's advice

The CAA considered that, on balance, the available evidence supported the view that Stansted airport does not currently hold substantial market power. The CAA noted that the airport continues to charge below the maximum level permitted by the price control and their analysis suggested that the current level of airport charges is somewhat below the level that might represent efficient new entry costs or a level that might be expected to remunerate an efficiently incurred major expansion at the airport.

The CAA noted that airlines had provided evidence to it that highlighted that there are a number of practical barriers to airlines moving aircraft away from the airport. However, it noted that there is emerging evidence that airlines are considering moving capacity and are changing their growth plans away from Stansted airport in response to recent price increases. Taken together with the practical barriers that limit efforts by airports to identify and price discriminate between groups of services, it is reasonable to conclude that the threat of airline switching (together with the additional competitive constraints resulting from passenger switching) limits the market power of the airport.

Respondents' views

Ryanair argued that there were co-ownership benefits for BAA as the owner of Stansted airport as a result of its ownership of Heathrow and Gatwick airports. Ryanair argued that as a result of this joint ownership, BAA had substantial market power in London and the South East. It considered that this particularly affected investment decisions by BAA, by creating an incentive to focus investment on those airports where it perceived the greatest financial return, which might not be Stansted airport.

The airlines, and Ryanair in particular, argued that the pricing by Stansted airport below the price cap over the current price control period should not be interpreted as meaning that the airport did not have substantial market power. Ryanair/ York Aviation presented analysis to argue that a robust price cap for Stansted airport would have been set at about £4 per passenger, as compared to the £5.65 set by the CAA. Amongst other things, its revised calculation removed unspent capex during the current price control period. The airlines argued that the CAA's analysis of the incremental costs of new investment were based on too high a specification investment, and provided alternative lower calculations of incremental costs. Ryanair also argued that recent increases in the profits of Stansted airport showed that it was exploiting market power.

easyJet argued that Stansted airport had substantial market power due to the high switching costs incurred by airlines when moving routes. It argued that the switching

costs included initial losses on newly established routes. However, no quantitative analysis was provided to support these views. Ryanair verbally stated that switching costs were generally low, particularly if the switched aircraft only accounted for a small proportion of total aircraft at an airport (costs for moving a base would be substantially higher).

The airlines, and easyJet in particular, argued that the absolute size of the airlines at Stansted airport was not the key determinant of the relative power between the airlines and the airport in negotiations, but rather it was the available capacity. They argued that there was no spare capacity for basing aircraft at Stansted and Luton airports, and therefore other available slots were less valuable because the first flight of the day was particularly important for profitability. No quantitative analysis was provided to support this view.

The airlines considered that examples of poor quality of service at Stansted airport and difficulties associated with agreeing new investment plans between the airport and the airlines were also signals that the airport had substantial market power. Ryanair was particularly concerned that BAA had not shared sufficient information with it to allow informed discussions about appropriate future investments.

Analysis

There is emerging evidence that the competitive balance between the airport and the airlines is beginning to change at Stansted airport. Up until recently, the pricing behaviour at the airport (pricing below the cap) was strong evidence in itself about the limited market power held by the airport. However, this is beginning to change as prices increase, albeit they are still below the maximum that BAA could charge under the price cap (allowing for under recovery in previous years).

It is also important to note that without some increases in prices as the supply demand balance begins to tighten, there would be very limited incentives for airports to make further investments. David Starkie described this as “scarcity rent” as distinct from “monopoly rent”. Frontier Economics’ report for easyJet also noted that it would be expected that as capacity became scarce, airport charges would rise, as compared to a position of plentiful capacity when prices might be little more than short run avoidable costs. Although capacity availability is reducing in the South East, there is still some spare capacity at Luton and Stansted airports, albeit that airlines might require other bases for aircraft using the slots. The CAA also noted that incremental costs of investment might be an appropriate measure to consider the potential market power of the airport, and considered that Stansted airport’s current price levels were substantially below incremental costs.

The airlines arguments regarding switching costs appear to be relatively weak. There is clearly some cost associated with switching aircraft, but for low cost carriers it is not clear that the costs of moving aircraft rather than closing a whole base are particularly significant. Therefore, the threat of switching aircraft if spare capacity exists, provides a more credible discipline on airport behaviour.

Although the competitive balance of the airport is changing, on balance, it is probably the case that Stansted airport alone does not currently have substantial market power. This conclusion is reached particularly by noting that Stansted airport is currently pricing below the maximum allowed price under its cap, there is some available capacity at Stansted and Luton airports, and switching costs for the main airlines using and likely to use Stansted airport are low where they already have a base.

Future market power

CAA's advice

The CAA agreed that the absence of additional investment in capacity in the relevant market would tend to increase the degree of market power held by the airport. However, it considered that in assessing the impact of the balance between the demand for and supply of available airport capacity and inter-airport competition, care needed to be taken. In particular, it noted that a tightening of the supply- demand balance in a competitive market can be expected to put upward pressure on prices and would do so in an airport market, as in other markets.

The CAA noted that there were a number of plans for capacity expansion in the relevant market, including at Stansted airport, and that the incentives for other airport operators to invest would be increased if Stansted airport failed to invest in a timely manner. While it was not possible to quantify the likelihood of any particular investment plan being completed, it considered that the likelihood was that, in a tightening market for capacity, there would be an investment response from airports. Therefore, on balance, the CAA considered that the most likely outcome was that Stansted airport would not acquire a position of substantial market power for the foreseeable future.

Respondents' views

The airlines considered that Stansted airport's market power would only increase in the future for the following reasons:

- demand growth is predicted to be strong;
- there is little or no increase in capacity in the near future; and

- longer term capacity increases subject to risks associated with planning processes.

easyJet argued that there were strong reasons to believe that de-designated airports would have limited incentives to expand capacity because it would be more profitable for them to defer additional investment. They also noted the relatively high barriers to entry and expansion at airports. However, the CAA and Ryanair noted in their responses that there was limited evidence in practice that non-designated airports failed to invest.

The airlines were concerned about BAA's approach to considering additional investment at Stansted airport, and in particular, BAA's support for a configuration of the second runway that lacked support from the major airlines using the airport.

Analysis

There seems to be agreement amongst most parties that the direction of movement is towards the market power of Stansted airport alone increasing in the future. Although the CAA considered that, on balance, Stansted airport was not likely to acquire substantial market power in the future, it accepted that other analysts might conclude, to the contrary, that it was likely to acquire substantial market power when reviewing the same evidence. In other words, it was a relatively finely balanced judgement that it reached. The key issue is about how quickly Stansted airport's market power will increase.

This can broadly be seen as a judgement about the incentives for airports in the South East to build additional capacity and how quickly that capacity will be developed given the lumpiness of many airport investments and the timescales involved in planning and building processes. Given the DfT's demand forecasts, there appears to be a risk that Stansted airport alone will have a position of substantial market power that it is able to exploit if there is no increase in capacity at South East airports, and particularly Stansted or Luton airport, in the next 5 to 10 years. Using the DfT's modeling for the air travel, airline and airport markets, there is evidence that Stansted airport would have the ability to materially increase its charges without capacity expansion within the next 5 to 10 years.

However, Stansted airport is currently participating in a planning inquiry to increase the maximum passenger throughput for the airport, and BAA has developed plans for a second runway at Stansted airport, which have been identified as necessary by the DfT. Luton airport is currently reviewing its masterplan, having recently decided not to proceed with a project to lengthen its current runway. Nevertheless, there is some uncertainty as to whether these plans will be realised on the proposed timescales. Alternatively, there is spare capacity at some airports outside of the London airports, which might provide some competitive constraints to Stansted airport, including East Midlands and Birmingham. As discussed above in the market definition analysis, the

evidence is mixed regarding the strength of the competitive constraints provided by these airports, but the additional evidence casts material doubt on the CAA's conclusions about the strength of competitive constraints likely to be provided by these airports in the future.

On balance, the evidence suggests that it is more likely than not that Stansted airport alone will acquire substantial market power in the future, although this conclusion is finely balanced. This would be sufficient to conclude that the first criterion had been met.

Stansted airport's market power by virtue of BAA's joint ownership of other airports

In addition to an assessment of Stansted airport alone, the first criterion requires the DfT to assess whether Stansted airport together with any other airports in the common ownership or control of BAA (i.e. together with other relevant airports owned by BAA), has or is likely to acquire substantial market power. Given the market definition that has been established, this question particularly relates to the common ownership with Heathrow and Gatwick airports. When providing its advice, the CAA advised that the first criterion should be interpreted such that consideration of other airports in common ownership or control should focus on the incentives faced by Stansted airport as a result of common ownership. The CAA considered whether regulatory and other constraints on the behaviour of BAA at Heathrow and Gatwick airports affected the assessment of any market power held by Stansted airport as a result of common ownership. The CAA concluded that the existence of continuing price regulation at Heathrow and Gatwick airports meant that Stansted airport does not have, and is not likely to acquire substantial market power, even when considered in conjunction with Heathrow and Gatwick airports.

In considering whether Stansted airport has or is likely to acquire substantial market power as a consequence of the common ownership by BAA of Heathrow and Gatwick airports, the DfT has had regard to comments from respondents and to the OFT's reference of BAA to the Competition Commission in April 2007. In that decision, the OFT concluded that BAA holds substantial and persistent market power in the South East of England. Where the position of Stansted is considered together with that of airports in common ownership (i.e. where the assessment pertains to BAA as the relevant economic entity), then this is relevant to the assessment of market power. The distinct conclusion reached in this part is justified in these circumstances (as reflected below). Whilst the DfT acknowledges that continuing price regulation at Heathrow and Gatwick airports will affect the ability of BAA to exploit any substantial market power, on the basis of all the available evidence, including the CAA's advice, and the OFT's analysis and

conclusions in its reference decision, the DfT considers that Stansted airport, in common ownership with Heathrow and Gatwick airports has substantial market power.

The conclusion that Stansted airport through its common ownership by BAA with Heathrow and Gatwick airports has substantial market power also means that the first criterion is met.

As noted in the above discussion regarding current market power, it is necessary to consider whether Stansted airport is likely to acquire future market power by virtue of its common ownership as part of BAA of Heathrow and Gatwick airports. This is particularly difficult to do because it is likely to be dependent on the conclusions reached by the Competition Commission in its market review of the airport market in the South East of England. Without any change in ownership structure, and given the DfT's forecasts about future supply and demand for air travel in the South East of England, BAA is likely to continue to have substantial market power, as supported by the OFT's view that it had substantial and persistent market power.

Conclusions

The first criterion is met by both the conclusion that on balance Stansted airport alone is likely to acquire substantial market power in the future and that, by virtue of BAA's common ownership of Heathrow and Gatwick airports, Stansted airport currently has substantial market power.

Analysis of the Second Criterion

CAA's advice

The CAA has concluded, in relation to Stansted airport, that the second criterion is not met and that competition law provides sufficient safeguards against the risks identified in the second criterion. The CAA bases its conclusion on a number of factors, including (in summary):

- the distinction between *ex-ante* regulation and *ex-post* enforcement is exaggerated;
- the second criterion should be assessed with reference to the question of whether competition law would effectively address behaviour that is currently constrained by the price cap provided by regulation under section 40 of the Airports Act 1986;

- exploitation by airports in the form of excessive pricing is the most obvious risk which needs to be constrained by competition law. There have been a number of cases where competition legislation has been applied to airport behaviour - including excessive pricing - and a number of successful excessive pricing cases in other sectors;
- there is evidence of airlines exercising their rights to take action directly to UK courts and prompting actions by European competition authorities;
- there are no particular constraints on the information available to users of Stansted airport. Indeed the fact that airports are subject to regulation means that there may well be greater availability of information;
- the concentration of users at Stansted airport is sufficiently high to indicate that the largest operators would have the means and motivation to pursue legal actions; and
- that competition law operates across many areas of the UK economy to control successfully any abusive use of market power without the need for *ex-ante* price regulation. It is supplemented in relation to regulated airports by the CAA's powers under Section 41 of the Airports Act 1986.

Respondents' views

A number of respondents, including easyJet, Ryanair and Stansted ACC disagreed with the CAA's advice on the second criterion and with its conclusion that competition law is sufficient to control increases in prices above, or restrictions in output or quality below, the competitive level absent regulation by section 40 of the Airports Act 1986 in circumstances where Stansted airport has market power. Detailed arguments are contained in the responses of easyJet and Ryanair in particular. The nature of these arguments can be summarised as follows:

- that any case of excessive pricing is especially difficult to prove for both a competition authority and a private litigant and that the competition law regime is ill suited to address issues of under investment and poor service standards;
- that an Airports Act 1986 investigation by the CAA under section 41 has procedural uncertainties and shortcomings;
- that the *ex-post* operation of competition law, absent regulation, is ill suited to the prevention of excessive pricing by airports;

- that there can be no certainty that the OFT would investigate or reach an infringement decision under general competition law in response to a complaint by an airline about the behaviour of a de-designated airport;
- that national competition authorities are reluctant to become involved in excessive pricing complaints and are particularly reluctant to act as price regulators;
- that a complainant has little course of redress if the OFT decides not to pursue a complaint and that the recourse of judicial review is unlikely to succeed;
- that a private litigant, such as an airline, would face cost and information obstacles which reduce the prospect of private action to curb allegedly excessive prices being commenced. This is exacerbated by a private litigant and the court being less expert in excessive pricing cases than competition authorities;
- that the CAA's assumptions as to the willingness and ability of airlines such as Ryanair and easyJet to litigate are erroneous and in any event irrelevant to the assessment of whether the second criterion is met;
- that the availability and effectiveness of interim measures/relief under competition law rules is over-stated; and
- that the competition law regime is ill suited to addressing issues arising solely as a result of under-investment or reduced service levels.

Analysis

The second criterion requires the Secretary of State to consider and decide whether competition law may not be sufficient to address the risk that, absent regulation, the designated airport engages in the specific behaviours specified in the second criterion. For her to decide that Criterion 2 is not met, she would have to be satisfied that competition law is sufficient, absent designation, to address the risk of a de-designated airport engaging in the specific behaviour referred to in criterion 2:

- increasing and sustaining prices above the competitive level;
- restricting output below the competitive level; or
- restricting quality below the competitive level.

The CAA's advice argues strongly that competition law would be able to control the risk of a de-designated Stansted airport engaging in this behaviour, as it does at non designated airports and in other sectors of the economy.

However, the arguments against the CAA's conclusions also raised concerns that the Secretary of State was required to consider and address. To decide that Stansted should be de-designated on the basis that the second criterion is not met, the Secretary of State must be satisfied on the balance of evidence before her that competition law would effectively address the specific behaviour referred to in the second criterion. It should be noted that, in making this decision, the Secretary of State is not forming any view on the general efficacy of competition law as a means of controlling behaviour in markets generally. Rather, she is confined to deciding on the narrow question of whether available evidence supports the conclusion that competition law can be relied on in particular circumstances to address the risk that Stansted as a de-designated airport might engage in specific behaviour referred to in the second criterion.

In both the CAA's advice and the submissions of respondents to consultation, there was a large measure of agreement as to the sources of competition law that needed to be considered in addressing this question.

There was agreement that "competition law" comprises the Chapter I and Chapter II prohibitions of the Competition Act 1998, Articles 81 and 82 of the EC Treaty, the remaining provisions of Part IV of the Airports Act 1986 and the market investigation provisions of the Enterprise Act 2002.

Excessive pricing

In relation to excessive pricing, the CAA and a number of respondents agreed that excessive pricing cases are amongst the most complex and difficult to establish. The CAA, however, argued that despite the difficulties in establishing excessive pricing, there are no barriers or hurdles to public or private enforcement that lead to a conclusion that the remaining regime would not be sufficient to address the risk that a de-designated Stansted might engage in this behaviour.

The question the Secretary of State has considered, in the light of responses received, is whether the CAA is correct in this respect or whether some of the difficulties identified by the CAA and respondents cannot be wholly and satisfactorily addressed.

Based on available evidence, the Secretary of State is less confident than the CAA that competition law would address the risk of a de-designated Stansted airport engaging in excessive pricing. The Secretary of State considers, in summary, that:

- the limited resources of the authorities coupled with their current, stated priorities and reluctance to act as price regulators or arbitrate narrow commercial disputes, means that there can be no certainty that they would address an excessive pricing complaint;
- private litigants seeking to bring private action to address excessive pricing would bear a significant cost and evidential burden. In particular, private litigants would face the challenge of obtaining information required to show excessive pricing. It cannot be assumed that airlines, for example, would have sufficient incentives to litigate if faced with excessive prices (particularly where the ability to pass on prices may exist);
- recent case law on the issue of excessive pricing appears to impose a significantly higher evidential burden on private litigants or competition authorities seeking to establish an infringement. Whilst the impact of recent case law is applicable across all markets, it is in the Secretary of State’s view, likely to have particular impact in certain markets where it may be particularly difficult to discern “excessive prices” and distinguish these from legitimate prices. The airport services markets have particular characteristics which may give rise to general difficulties in successfully establishing excessive pricing. These include the capital intensity of airport activities; the lack of competitive pricing benchmarks; the durability of assets; the uncertainty of future demand; and the lumpiness of investment⁸; and
- all of these factors support a view that competition law may not be sufficient to deter a de-designated Stansted airport from increasing and sustaining prices above the competitive level.

Restricted output

There appears to be general agreement that existing price cap regulation is not a perfect tool to address restriction of output below competitive levels (i.e. under-investment).

There also appears to be general agreement that a reduction in output is a difficult issue to address via competition law. Respondents such as BA have even suggested that it would be almost impossible to prove an (alleged) infringement consisting of a decision to delay investment in new capacity. It is noted that only one case of this type has been referred to

⁸ The Secretary of State notes that the CAA in its advice addresses these issues in relation to airports in general and Stansted in particular and concludes these factors are not sufficient to treat airports generally, or Stansted in particular, differently from any other sector that is subject to competition law. Nevertheless, it is the Secretary of State’s view that the existence of these characteristics in the airport services sector are relevant in assessing whether competition law may not be sufficient to address the risk that a de-designated Stansted would engage in the specific behaviour referred to in Criterion 2.

by either the CAA or respondents. The CAA suggests that reduced output or under-investment could be dealt with in the context of consideration of a more obvious category of abusive behaviour (e.g. excessive pricing). However, as noted above the Secretary of State considers that competition law may not be sufficient to address the risk that a de-designated Stansted airport would engage in excessive pricing.

Having considered the limited evidence provided and the advice and comments of the CAA and respondents, the Secretary of State agrees with the CAA that Chapter II/ Article 82 are capable of being used for abuse consisting solely of restricted output or underinvestment. She also agrees with the CAA that in relation to Stansted airport, an instance of this type is more likely to be framed as an excessive pricing case (upon which she has commented above). She does not consider that the remaining provisions of the Airports Act 1986 can be relied upon to provide a remedy for this type of abuse. She also does not consider that, in accordance with OFT Guidance, this type of behaviour is likely to be a candidate for reference under the Enterprise Act 2002 provisions, nor that any reference or the risk of it, would be likely to provide a timely remedy and/or have a sufficient deterrent effect.

As with excessive pricing, where a complaint does relate solely to a reduction in output, the Secretary of State is, however, less confident than the CAA about the practical effectiveness and deterrent effect of the laws in relation to this type of behaviour, and is concerned that there are likely to be practical issues which would affect the enforcement of these rules. The lack of cases in this area, the likely evidential difficulties in proving a claim, the administrative priorities and limited resources of the public enforcement agencies, all suggest that private and public enforcement remedies may not be sufficient to control and deter a de-designated Stansted airport in a timely manner in relation to an abuse that consists purely of restricted output or under-investment.

Restricted quality

The Secretary of State notes that the primary source of current control of service levels at designated airports is through the public interest test which the Competition Commission is required to consider as part of its quinquennial review. She further notes that de-designation of Stansted airport would remove this control. The CAA's advice and the submissions of respondents do not contain significant evidence on the extent to which competition law is capable of addressing the risk that a de-designated Stansted airport would restrict service levels to below the competitive level. In particular, the Secretary of State has not received evidence that service level issues, in either the airports sector or generally, have been effectively controlled through the Chapter II/ Article 82 prohibitions and she does not consider that the prohibitions are likely to be sufficient to constrain an abuse that consists solely of restricted service levels. In this regard the practical issues and concerns referred to in the sections above are also of relevance in reaching her

conclusions on the likely enforcement of the prohibitions and the likely deterrent effect in relation to this type of behaviour.

The Secretary of State has considered the controlling and deterrent effect of the Enterprise Act 2002 provisions in relation to the risk of service levels falling below the competitive level. For similar reasons to those outlined in the sections above, she is of the opinion that these provisions are unlikely to provide a timely remedy or have a significant deterrent effect.

The Secretary of State does recognise and agree with the CAA that some control of service levels would be possible through the CAA's powers under the Airports Act 1986 to impose discretionary conditions. She notes, however, that the discretionary powers require the CAA to demonstrate that the behaviour constitutes unfair exploitation prior to the CAA asking the Competition Commission to consider whether the behaviour operates against the public interest. It is the Secretary of State's view that the additional requirement to demonstrate unfair exploitation may be a significant one and leads her to conclude that the discretionary regime provides weaker protection than is available under the designated regime and protection which may not be sufficient to control or deter the behaviour in a timely manner.

Conclusion

The Secretary of State notes the strong arguments advanced by the CAA in its view that competition law would address the risk that a de-designated Stansted airport would engage in the behaviour referred to in Criterion 2. However, the Secretary of State also recognises the contrary arguments put forward in submissions by respondents to consultation.

The Secretary of State is required to consider all evidence before her in reaching a decision on whether the second criterion is met. The second criterion is met if, based on the evidence before her, the Secretary of State considers that competition law may not be sufficient to address the specific behaviour referred to in the second criterion. On the basis of available evidence, the Secretary of State is not satisfied that the competition law regime will be sufficient to control the identified risks at a Stansted airport with market power. On the basis of available evidence, the Secretary of State has concluded that competition law, absent regulation provided by Section 40 of the Airports Act 1986, may not be sufficient to:

- control sustained increases in the price of services provided by Stansted airport to above the competitive level;

- control restrictions/reductions in the quality of services provided by Stansted airport to below the competitive level; and
- control restrictions/reductions in output of services provided by Stansted airport to below the competitive level.

The Secretary of State has therefore concluded that the second criterion is met in relation to Stansted airport.

Analysis of the Third Criterion

CAA's advice

The CAA considered that there appeared to be very limited incremental benefits over and above the benefits that might flow from competition and the application of general competition law. However, the costs and potential adverse effects of *ex ante* price control regulation appeared to be significant, particularly regarding incentives for new investment. Therefore, it followed that designation under Section 40 of the Airports Act 1996 would not deliver additional benefits, over and above competition law, which exceed the costs and potential adverse effects of such designation.

The CAA did not attempt a quantitative analysis of the potential costs and benefits of regulation to inform consideration of whether the third criterion was met, nor did it consider that it could be undertaken.

Respondents' views

The airlines broadly agreed with the CAA that it was very difficult to develop a quantitative assessment of the potential costs and benefits, and no airline provided such a quantitative analysis. The only quantitative analysis that was provided was a high level calculation by Ryanair of the costs if 1 million passengers were displaced from Stansted to East Midlands' airport as a result of airline decisions to reduce flights at Stansted airport in response to future price increases by BAA.

The airlines agreed with the CAA that the current system of Regulatory Asset Base (RAB)⁹ based regulation was not working very effectively, particularly as it related to new investment. However, as the airlines opposed de-designation of Stansted airport, their position was broadly that they would prefer RAB based regulation to a situation of

⁹ The regulatory asset base or RAB can be used by regulators when setting price controls. It is a value estimated by a regulator to reflect a value of the business to which it is applying a price control, and on which the business needs to be appropriately remunerated within the price control to finance its activities.

no regulation at all. While the airlines discussed the desire to develop alternative forms of regulation, they provided limited detail as to what such alternative forms of regulation might consist of. To the extent that a proposal for any alternative form of regulation was reasonably well developed, it was an outline proposal from Ryanair for a default price cap relating to additional assets and services, with a requirement for additional investment to be agreed between the airlines and the airport operator, with the CAA acting as the arbitrator.

While having concerns about the way RAB based regulation worked for new investment, the airlines, and Ryanair in particular, considered that the current price cap had been set too high by the CAA, and that outturn costs had shown that it had been set too high. Ryanair pointed out that RAB based regulation can lead to the regulated airport “gaming” the system by inflating capital investment requirements going into a review as recognized by the Office of Fair Trading. In particular, actual capital expenditure had been much lower than the amount forecast when the price control was set. Ryanair also noted that the CAA had set a higher price cap than was recommended by the Competition Commission.

The airlines considered that examples of poor quality of service at Stansted airport and the difficulties between the airlines and the airport in agreeing new investment plans were examples of why *ex ante* regulation was required and would provide benefits.

The airlines agreed with the CAA that the direct costs of regulation (CAA, Competition Commission, BAA and airline costs) were small compared to potential indirect costs or benefits from regulation.

SSE and Oliver Heald MP proposed that if Stansted airport was de-designated, the Government should seek to obtain a fiscal gain from BAA in return for the benefits that would accrue to BAA from de-designation.

Analysis

The assessment of the third criterion requires consideration of the incremental benefits of price cap regulation through designation above those provided by competition law, compared to the costs of regulation. Therefore, to assess whether this criterion is met it is necessary to consider the conclusions regarding criteria 1 and 2. If it is concluded that Stansted airport alone has substantial market power then there may be anti-competitive behaviour that needs to be addressed through either competition law or a price cap. If it is concluded that competition law may not be effective in addressing this potential anti-competitive behaviour then there may be benefits from setting a price cap to address some or all of the potential anti-competitive behaviour. Therefore, the assessment of

whether this criterion is met is heavily influenced by the conclusion for the first criterion that on balance it is likely that Stansted airport alone will acquire substantial market power, and the conclusion for the second criterion that competition law may not be sufficient to address the risks of anti-competitive behaviour.

The CAA and respondents to the consultation agreed that it was very difficult to quantify the potential costs and benefits of regulation for assessing whether this criterion is met. To recognize this difficulty the DfT has sought to consider both the qualitative and quantitative assessment of whether the third criterion is met. However, recognising that any quantification is difficult and there is a significant range of uncertainty for many of the numbers (so they are indicative), conclusions have only been reached when the qualitative arguments appear to be robust.

For the assessment it is broadly assumed that the CAA applies RAB based regulation because it represents the current approach. Although alternative forms of price cap regulation have been considered, none have been fully developed. However, it is notable that the types of alternatives that have been considered, including a default price cap or a market based price cap, might be anticipated to create less distortion for new investment than a RAB based price cap.

If Stansted airport alone does not have, and is not likely to acquire, substantial market power, then there are unlikely to be incremental benefits of regulation over and above those provided by competition law. Further, there are likely to be incremental costs. In addition to the direct costs of regulation, the simple act of regulation changes the 'rules of the game' and creates distortions that harm investment and efficiency outcomes. In particular, there may be negative indirect impacts on the cost of capital, price flexibility and speed of responses to events in the market. These types of costs are difficult to quantify in any meaningful manner even though they are likely to be important. The conclusion that it is better to have no regulation where there is no substantial market power is generally accepted for most markets within the economy.

In relation to BAA's common ownership of other airports in addition to Stansted airport, the exercise of market power at Heathrow and Gatwick airports is separately addressed through the CAA setting price caps for these two airports. Therefore, if the CAA sets a price control for Stansted airport when it does not have substantial market power alone, then the costs of regulation outweigh any benefits or, at least, the risk that costs are caused by regulation outweigh any potential benefits.

Further, it seems that different costs will occur depending on what level the CAA sets the price control. If the CAA sets the price cap at the 'correct' level or too high, no benefits are realised that would not be achieved in a competitive market and the direct costs of regulation are incurred in addition to the indirect costs mentioned above. This conclusion

favours de-designation. However, the net CBA will favour de-designation even more if the CAA sets a price control at a level that is too low because it risks distorting outcomes in addition to the other costs of regulation. In particular, it creates the possibility of under investment at Stansted airport or other rival airports, which is to the detriment of customers.

The scenario where Stansted airport alone has, or is likely to acquire, substantial market power, needs a separate assessment of the incremental benefits and costs. Given the nature of the conclusions about the protection afforded by competition law under the second criterion, this assessment needs to proceed from the assumption that there is a risk that the protection afforded by competition law may not be sufficient to avoid detrimental effects where an entity with market substantial market power chooses to take advantage of this market power. If substantial market power is held, there is a material risk that there is the opportunity for abusive behaviour occurring in this way leading to detrimental effects harmful to consumers, and which are not adequately addressed by competition law. Whether abusive behaviour leading to detrimental effects occurs will depend on the decisions of the airport owner.

Where the CAA sets a price control because Stansted airport alone has, or is likely to acquire, substantial market power, we need to make assumptions about the appropriateness of the price cap set by CAA. It could be assumed that the CAA sets a “perfect” price control, which prevents all potential detrimental effects arising from the holding of substantial market power and does not create any distortions. Under this assumption, and given the conclusion that there is a risk that competition law does not provide that much protection against abuse, we would conclude that the criterion is met, and it is appropriate to designate the airport.

In practice, it is probably not realistic to assume that the CAA sets a “perfect” price control. Other possibilities are that it sets a price control that is either “too high” or “too low”, which were also discussed above. On balance, it might be reasonable to argue that the CAA is more likely to set a price control too high than too low. This outcome principally reflects its duty to promote investment, which suggests that the CAA would err on the side of setting a price control that is higher rather than lower. However, it is important to note that a price control can appear adequate when it is set, but turn out to be too low if market conditions change during the price control period, for example, NATS following the downturn in air travel after 9/11.

Table 1 below considers the conclusions that can be drawn under the various scenarios discussed above. The counter factual is determined by reference to the degree of market power that has been assumed.

Table 1: Matrix of outcomes for various market power and price control scenarios

		Market power	
		Yes	No
Price control	Yes	<p>1) CAA sets the price control at the correct level. Benefits of protection against potential abuse through ‘excessive’ prices, which may manifest itself as higher prices, reduced investment and / or lower quality service compared to outcomes expected in a competitive market. There are no costs or distortions from regulation, except direct costs. Benefits exceed low direct costs of regulation. C3 is met.</p> <p>2) CAA sets a price control that is too high. Allows some potential abuse that would not be addressed through competition law, including through prices being too high, quality of service being too low or inappropriate investment decisions. However, it protects against further abuse that competition law would not correct. Nevertheless, there is also some potential distortion of investment decisions through the RAB approach, although arguably these are not likely to be significant and might be already partly accounted for by the potential abuse that is allowed. Direct and indirect costs of regulation are incurred. Further analysis needed to reach a conclusion. One approach might be empirical evaluation.</p> <p>3) CAA sets a price control that is too low. Inappropriate investment is decisions (including at rival airports) and the direct plus indirect costs of regulation are incurred. The benefit is that consumers pay lower prices. Further analysis needed to reach a</p>	<p>4) CAA sets the price control at the correct level. Regulation has no benefits but direct costs are incurred. C3 is not met.</p> <p>5) (Same as 2) CAA sets a price control that is too high. There is no benefit from regulation since competitive forces ensure that prices are lower than the cap. However, direct and indirect costs are still incurred. C3 is not met.</p> <p>6) (Same as 3) CAA sets a price control that is too low. Consumers pay lower prices but these lower payments do not represent avoiding potential market power abuse. Hence, there are inappropriate investment decisions (including at rival airports) while the direct and indirect costs of regulation are</p>
	No		

		conclusion. One approach might be empirical evaluation.	incurred. C3 is not met.
	No	7) There is the opportunity for abuse through excessive prices. The direct costs of regulation are avoided and the costs of setting a price control discussed above are also avoided but, given the conclusion about competition law, customers are exposed to a significant risk of potential abuse. C3 is met.	8) No abuse. C3 is not met.

The table begins to indicate that if you consider that Stansted airport alone does not have, and is not likely to acquire, substantial market power, the appropriate approach is likely to be to de-designate, whereas it points towards designation if you consider that Stansted airport alone has or is likely to acquire substantial market power, which is the conclusion reached, on balance, for the first criterion.

Furthermore, building on the conclusion reached for the second criterion, it appears reasonable to assume that there might be significant incremental benefits from price cap regulation that would not be addressed through competition law if Stansted airport has substantial market power on its own. This could cover excessive pricing, reduced quality and/ or reduced output. The precise magnitude of these impacts, the extent of passthrough to passengers and the period over which it would be sustained is again open to question, as higher prices would provide further incentives for new investment, including at alternative airports. Also, not all price increases, reductions in quality or output by Stansted airport in the future would necessarily be abusive behaviour causing detrimental effects, and indeed as discussed when analyzing the second criterion, the likely appropriate benchmarks are evolving with Court decisions. However, sustained and material increases above reasonable benchmarks for excessive prices could be. Pricing, quality of service and investment decisions would be made by the airport owner.

Indicative values for the potential benefits of price cap regulation through avoiding potential detrimental effects in the form of excessive pricing have been considered, which assume that Stansted airport is, on balance, likely to acquire substantial market power and that competition law may not be sufficient to protect against detrimental effects from abusive behaviour. The values range from relatively small values per passenger (up to £0.5) to larger values (£3-4) per passenger, which generates an indicative range of £55m to £350m. The smaller values are informed by some views presented in response to the consultation, while the larger values are informed by some analysis from DfT's airport modeling about the extent to which Stansted airport might have the capacity to increase

prices in the future. The values also seem a reasonable range of indicative values given the conclusions for the first and second criterion, and recognising the difficulty of establishing a precise benchmark.

It should also be noted that any market power abuse leading to detrimental effects may take the form of lower quality of service or insufficient or delayed investment. The potential range of impacts for quality of service are difficult to estimate without information about a combination of customer willingness to pay for quality and costs of improving quality. The percentage values used by the Competition Commission in its recommendations for quality of service incentives for Heathrow and Gatwick airport of up to 10% of revenue could be used as a proxy to generate indicative values for Stansted airport, which might fall within the range generated for potential abuse through excessive pricing, but at the lower end.

Taking the values for excessive pricing and quality of service together, but without attaching any specific values to reduced outputs, we generate an indicative range of £55m to £350m. The lower end of the range would be consistent with either a small amount of detrimental effects from potential abuse over a material period of time or relatively significant detrimental effects from potential abuse over a short period of time, while the higher end of the range would be consistent with sustained and material detrimental effects from potential abuse over a material period of time with large passthrough to passengers. The indicative benefit of regulation would be lower the higher the price cap that was set.

To confirm whether the appropriate approach is to de-designate given the conclusion that Stansted airport on its own is, on balance, likely to acquire substantial market power, it is necessary to consider the potential scale of any distortion arising from regulation. The CAA and the airlines agreed that RAB based regulation created distortions particularly for new investments. The CAA argued that this could be particularly material given that in the foreseeable future there is expected to be significant new investments at Stansted airport, including a new runway. However, it is very difficult to quantify the potential effect of any distortion and to identify which parts of any distortions arise from regulation rather than other factors that will affect investment decisions, such as the planning process. The DfT considered whether any of its airport models could provide helpful results to inform this type of analysis, but it was difficult to obtain useful results.

Given the difficulties of estimating indicative values for potential investment distortions, the size of the distortions and the risk of them occurring, we have tried to evaluate the scale and likelihood necessary to outweigh the range of potential benefits from regulation that we have identified. The overall cost of regulation is likely to be largest when the airport operator does not possess market power, and so there are few benefits from

regulation to counter-balance the potential distortions, with other scenarios potentially generating greater distortions.

Our analysis suggests that while it cannot be ruled out that the costs of distortions could outweigh the benefits of regulation, the balance of risks suggests that the distortions attributable solely to regulation would have to be very large, even given the scale of investments being considered, to outweigh the range of indicative benefits for regulation. The finding is particularly supported by our conclusions for the first and second criteria. Furthermore, while there might be material distortions, there may be options for the CAA to address some of the risks of distortions through different approaches to price regulation than RAB based.

The type of benefit from de-designation suggested by SSE and Oliver Heald MP is not one that forms part of the criteria, which seeks only to de-designate when an airport is operating in a broadly competitive market or there are other constraints such as competition law are sufficient to discipline its behaviour. Hence de-designation would not in itself be expected to generate this type of a windfall gain for Exchequer from the airport.

Conclusion

The third criterion is met because on balance while there is likely to be a material distortion, there may be options for the CAA to address some of the risks of distortions through different approaches to price regulation. Furthermore, given the conclusions regarding the first and second criteria, the potential benefits of regulation given the risks and potential detrimental effects would appear to outweigh any costs associated with the distortions.

Decision

The Secretary of State has decided that Stansted airport should remain designated because each of the criteria for designation is met.

In making her decision, the Secretary of State is aware of the comments made by a number of the respondents on the costs of the current approach to price controls at Stansted airport. The structure of price controls is a matter for the regulator but my decision is not intended to constrain the CAA from adopting other approaches which meet their statutory duties while avoiding some of the costs of the current system that respondents have identified.

In making her decision about the status of Stansted airport under Section 40 of the Airports Act 1986, the Secretary of State took account of the principles for better regulation set out by the Better Regulation Executive, which is part of the Department for Business, Enterprise and Regulatory Reform. More information about these principles and the work of the Better Regulation Executive is available at www.cabinetoffice.gov.uk/REGULATION. Her decision was also made with regard to the Government's overall policy for the aviation sector as set out in its December 2003 White Paper entitled, "The Future of Air Transport", which is available on the DfT's website at www.dft.gov.uk.

As the Secretary of State's decision does not change Government policy it is not necessary to prepare a formal Impact Assessment.

Next steps

The Secretary of State's decision to continue to designate Stansted airport will mean that the CAA will be required to set a new price cap for Stansted airport to commence in April 2009. Before setting the new price cap the CAA is required to make a reference to the Competition Commission to seek its views on the appropriate form of price cap. The DfT understands that the CAA will shortly issue a consultation about the terms of its reference to the Competition Commission and that it expects to make its reference in March or April.

ANNEX 1 – SUMMARY OF RESPONSES TO THE DfT CONSULTATION ON THE REGULATORY STATUS OF STANSTED AIRPORT

This Annex summarises, as appropriate, specific arguments made by respondents to DfT's consultation on the regulatory status of Stansted airport. It does not seek to replicate these arguments exactly as made or reflect all of the arguments by respondents that were considered by the Secretary of State in reaching her decision. As explained above, the decision is based on careful review and consideration of all evidence submitted, including evidence that is not referred to or summarised in this Annex.

Some of the comments that the respondents have made apply to more than one question. Where this is the case, we have noted the response under the most relevant question, instead of repeating it under each one. We have separately noted at the end of the summary any views expressed that did not specifically relate to the questions in the DfT's consultation.

Respondents' views

- *Question 1* – Do respondents agree with the CAA's proposed approach to assessing whether airports have substantial market power? If not, which elements of the CAA's approach do respondents disagree with and what alternative analytical approaches do respondents believe should be adopted?

BA considered that the CAA had “jumped the gun” by concluding that Stansted airport did not have substantial market power before the specialist competition authority (the Competition Commission) had concluded its enquiry, given that the Office of Fair Trading (OFT) had recommended the inquiry after concluding that BAA's three London airports might have substantial market power.

BA considered that the joint ownership of Heathrow, Gatwick and Stansted airports by BAA was relevant to consideration of whether Stansted airport had substantial market power. It provided an example noting that if as a consequence of exercising market power to increase prices, an airport displaces capacity to another airport in the same ownership group, it would benefit from the price increase.

BAA agreed with the approach adopted by the CAA, and noted that it was consistent with the OFT guidelines for assessing market power, and well established approaches by other competition authorities. BAA also stated that it considered that the CAA had given appropriate consideration to the various components of market definition, including the product and geographic dimensions, and demand and supply side substitution. BAA

believed that the CAA's interpretation of "substantial market power" as, "the ability and incentive to raise prices for an extended or non-transitory period to levels that are substantially in excess of those likely to be observed in a reasonably competitive market", is the minimum criterion for the test of substantial market power.

Easyjet believed that it is necessary to understand airline economics to assess whether an airport has market power. Airlines' choice of airports to operate from depends on the value of the passenger markets they can access and the cost of operating from the airport. Easyjet noted that the CAA has noted in previous reports on regional airports the increasingly localised nature of passenger traffic, and that Frontier Economics had shown that the distance airlines have to travel to airports is very important for customers' choices. It also noted that yields for airlines are not uniform across the day, and that early morning and evening peak flights have the highest yields, which makes the ability to base planes at airports particularly important. It also said that once a flight had been scheduled the airline was a price taker because it suffered a significant revenue penalty for empty seats.

Ryanair considered that the CAA had focused incorrectly on the passenger market rather than the airline market for airport services serving London and the South East of England. While noting that the CAA had stated that it was following the OFT's approach to assessing market power, including market definition, Ryanair considered that the CAA's approach did not reflect the approach advocated by the OFT. In particular, Ryanair considered that the CAA had placed too much reliance on market shares assessments based on passenger catchment areas for airports, and had not sufficiently considered the wider factors affecting the assessment of market power that the OFT identified.

Stansted ACC believed that the CAA had failed to focus correctly on the market power which Stansted airport holds over its airline customers and their inability to switch to other markets serving the key London passenger market. It considered that the CAA had wrongly focused on the potential market power that the airport might have over the passengers using the airport. Stansted airport's market power arose from the absence of spare capacity at London airports and was reinforced by the joint BAA ownership of Heathrow, Gatwick and Stansted airports.

- *Question 2* – Do respondents agree with the CAA's conclusions about the general factors relevant to the assessment of substantial market power at airports?

BA considered that the CAA's analysis of whether substantial market power exists is perfunctory and incomplete. In particular, it did not consider that the fact that Stansted airport had been pricing below its cap was necessarily indicative of an absence of substantial market power, as it could be due to the cap being set too high. It considered

that the recent increase in prices suggested that BAA was exercising substantial market power at Stansted airport. BA considered that CAA had not provided any evidence about the impact of a 10% increase in airport charges, including whether they would lead to price increases for passengers and therefore switching by passengers.

BA was also concerned that the CAA had inappropriately considered whether Stansted airport would abuse any market power it had in terms of the opportunity or incentive to price discriminate between different users of the airport. It considered that the only factor relevant for considering whether the first criterion was met was whether the airport had substantial market power.

BAA agreed with the CAA's conclusions, noting in particular that the CAA correctly stated that market definition merely provides a framework for the analysis of market power, constraints are provided by competitors to Stansted airport, joint ownership by BAA of Heathrow, Gatwick and Stansted airports does not give Stansted airport different pricing incentives than if it was separately owned because of the capacity constraints at Heathrow and Gatwick airports, and the buyer power exercised by Ryanair and Easyjet limits Stansted airport's pricing power.

David Starkie noted that all point-of-service activities set in spatial (geographic) markets potentially have some market power as a result of the costs of overcoming geographical separation between customers and the point-of-service. However, the ability to exercise market power is limited by the ability to price discriminate between customers faced with different degrees of convenience in reaching the point-of-service. The inability, or at best limited ability, for airports to price discriminate in a way that distinguishes sub-markets has important implications because it is passengers at the margin who set prices, and these are the passengers who have effective options to use other airports (whether they are in the same geographical market or not). David Starkie believed this inability to discriminate was reflected in the relatively low margins achieved by unregulated UK airports compared to other service sector activities.

David Starkie considered that the substantial revenues airports generate from non-aeronautical charges provided a significant incentive not to exploit any market power they have and even set aeronautical charges below the level that covers the costs of providing aeronautical services.

Frontier Economics considered that that CAA's approach to defining the geographic market was based on limited empirical analysis, and concentrated on the overlap of arbitrarily defined catchment areas and the results of passenger surveys which indicate that passengers occasionally alter the airport from which they fly. It noted that the CAA had not provided any evidence to demonstrate how significant the distance to the airport is in determining passenger choices between airline services. This would be necessary to

justify treating airports as if they are in the same economic market. Frontier Economics believed that the CAA had failed to understand that airlines operated multiple bases because they serve different economic markets.

Ryanair considered that the CAA's erroneous conclusions derived in large part from considering information relating to the possibility that passengers might switch between airports without considering the extent to which the airport is cushioned from this possible effect by the business model of airlines operating at Stansted airport. In particular, it noted that the airlines operating at Stansted had a business model based on maximising load factors, so would always strive to maximise the number of passengers, with the consequent advantages for the airport of commercial revenues remaining high.

Building on its concerns about the CAA's focus on the airlines market power over passengers, Stansted ACC was concerned that the CAA had failed to take into account the impact of the airlines' load factor maximising business models in cushioning the effect of increases in charges on the airport. It also considered that switching costs were not the key issue, as without spare capacity at London airports the cost of switching was irrelevant.

- *Question 3* – Do interested parties agree with the CAA's analysis that the competition law framework is capable of tackling effectively the risk of excessive pricing and/ or under-investment by an airport with substantial market power in terms of its application and enforcement?

BA considered that competition law is widely recognised as not being able to control excessive prices as not only is it difficult to determine that prices are "excessive", but that competition authorities are not suited to being price regulators. It also considered that it was virtually impossible to address unsatisfactory service standards under competition law.

BAA agreed with the CAA's assessment that competition law was likely to provide adequate protection to users in the context of airport markets. It noted that in addition to competition law, a non-designated airport would face the possibility of action by the CAA under Section 41 of the Airports Act 1986 and the threat of re-designation at some point in the future, which would discipline their behaviour. BAA noted three reasons why it considered that the *ex post* application of competition law does not reduce its efficacy – the severity of the penalties that can be applied, having a dominant position is not unlawful in itself so competition law is regarded as a proportionate approach to address dominance in a range of sectors and the injunctive relief available, which has been granted in competition law cases where abuse of dominance is threatened. BAA also noted that OFT, CAA, the Competition Commission and the Competition Appeals Tribunal could not be regarded as non-expert in considering competition law issues in

airport markets. BAA cited two cases to support its view that the efficacy of competition law is further boosted by the ability of parties to launch private actions and can be effectively used in the airport sector – a current case involving Easyjet and Liverpool John Lennon Airport, and a previous case involving BAA and Ryanair regarding fuel charges at Stansted airport.

Easyjet noted that it believed that the CAA's advice about this criterion was not airport specific, and therefore it was unclear whether the CAA believed that competition law would successfully address the risk of any airport abusing its market power, or if its success is specific to certain airports.

Frontier Economics stated that competition law could not rectify the risk of under-investment. It argued that if competition law is used too vigorously to control airports in the short run, when capacity is constrained, the effect may actually be to reduce further the incentive for airports to invest.

Ryanair believed that competition law was an inherently unsuitable tool to deal with a difficult form of pricing abuse, such as excessive pricing, on a forward looking basis and considered that the CAA has materially overstated the ability of competition law to address anticompetitive behaviour by airports. It considered that reliance on competition law would create a real risk that abuses on the part of airport operators could go unchecked. Ryanair was also very concerned that competition law was very unlikely to be an effective means to address concerns about poor quality of service and/ or under or inappropriate investment. It stated that the criteria for de-designation cannot be met if there is a real chance that competitive law would not adequately constrain airport behaviour.

Stansted ACC considered that the CAA's analysis was fundamentally misconceived because it had mis-interpreted the Secretary of State's criterion. It considered that a correct interpretation was that the criterion was not met for de-designation if there is a real chance that competition law would prove inadequate. Like Ryanair, Stansted ACC also considered that the CAA had grossly exaggerated the effectiveness of competition law as a substitute for proper regulation. Amongst the reasons why it did not consider that competition law would be effective were the small number of complaints that the OFT acts upon each year, private enforcement is unlikely to be successful given costs and timescales and the Courts are not sufficiently expert to consider such matters.

- *Question 4* – If interested parties are concerned that the competition law framework may not be an adequate mechanism to protect customers from potential anti-competitive behaviour, please set out, with supporting evidence, the specific factors about the airports sector that support this view.

BAA did not believe that there were any factors specific to the airports sector that would render the competition law framework inadequate to prevent anti-competitive behaviour.

Easyjet noted that it had considered whether the second criterion was met in light of its view that Stansted airport had substantial market power and it would further abuse it. It believed that the lack of an agreed view about how to judge whether an airport's price was excessive underlined the need for an expert regulator to assess such issues rather than considering them through general competition law. It noted that Frontier Economics had explained that because of the long lived assets at airports it was not possible to assess whether a price was excessive at a particular point in time.

Ryanair emphasised four factors that it particularly considered made competition law an inadequate mechanism to protect customers from potential anti-competitive behaviour in the airport sector. These were that:

- the airport's sector does not feature on the list of administrative priorities identified by the OFT;
- costs of private enforcement action in the sector would be borne by a small number of parties (the airlines);
- the nature of the abuse that is likely to arise (excessive pricing) is acknowledged by many commentators and courts as particularly difficult to prove; and
- the airports sector has complex and unique pricing determinations that would present a particular challenge for the OFT or a non-specialist court and are more appropriately dealt with by a regulator with specific sectoral expertise.

Ryanair noted the evidence it has presented regarding price levels at Stansted airport to highlight the complex issues involved in airport pricing

Stansted ACC built on its previous concerns about the prospects of successful public or private enforcement action. It cited a number of statements by the OFT and the Competition Commission that argued that it was unlikely they would be keen to take a case of excessive pricing against an airport because of the substantial difficulties of proving such a case and their desire not to act as price regulators. Amongst the difficulties of private enforcement action, it noted that there was no clear legal test as to what constituted excessive pricing and cited *Attheraces Limited v British Horse Racing Board* [2007] as an example of such legal difficulties. Stansted ACC also noted the considerable delay between action and possible remedy associated with private enforcement actions.

- *Question 5* – Do respondents agree with the CAA’s proposed approach to assessing the costs and benefits of regulation, including that the analysis is necessarily a mix of quantitative and qualitative factors? If interested parties consider that it is possible to quantify more of the costs and benefits than the CAA has done, please explain why and where possible provide evidence to allow such quantification.

BAA agreed with the CAA’s general approach, and accepted that there were difficulties in estimating the indirect costs of regulation since the outcome under a different set of incentives cannot be determined with certainty. BAA estimated that the direct cost to BAA (including the opportunity cost of diverted management time) of regulating Heathrow, Gatwick and Stansted airports for the current five year period has been around £20m. While difficult to assess precisely, BAA believed that the de-designation of Stansted airport might be expected to save between 10 and 20 per cent of the costs. £1m a year would be £30m in present value terms at the Treasury’s discount rate of 3.5%.

Easyjet agreed that airports should only be regulated if it would have an economic benefit. It agreed with the CAA that the main judgement should be made by considering the costs and benefits of regulation, rather than the costs of implementing it. Easyjet noted that there was broad agreement about the shortcomings of RAB based regulation, particularly in situations where the capital base of an airport was expected to significantly increase. However, it did not consider that this was an argument that regulation could not be effective, but that new approaches to regulation needed to be considered.

LLAOL stated that its general view was that economic regulation should be minimised, and so it supported de-designation of airports on a philosophical basis. However, it acknowledged that particular circumstances might lead to a different conclusion.

Ryanair accepted that quantifying the costs and benefits of regulation, excluding the direct costs of regulation, is difficult and must necessarily include a range of quantitative and qualitative factors. Ryanair through York Aviation sought to quantify the potential costs to society as a whole of “excessive” pricing at Stansted airport. It estimated that the diversion of 1 million passengers from Stansted airport’s core catchment area to Birmingham or East Midlands’ airports would result in costs of around £31m, including for example, long journey times for passengers. Ryanair noted that this type of assessment was missing from CAA’s analysis.

Stansted ACC accepted that quantifying the costs and benefits of regulation, excluding the direct costs of regulation, is difficult, and therefore any assessment must be quantitative and qualitative. It considered that the CAA’s analysis failed to consider the loss of consumer benefits arising from excessive pricing at Stansted airport, as it has done

in 2007, leading to lower or no growth in traffic volumes. Such costs could arise if customers moved to use more distant airports.

- *Question 6* – Do interested parties agree that the CAA has correctly identified the three potential incremental benefits associated with *ex ante* regulation, over and above general competition law? If not, please explain.

BA identified a number of risks of de-designation that could be addressed through *ex ante* regulation. These included an increase in prices for some or all airport users, a decrease in service quality and the creation of incentives to create capacity constraints or invest in overly specific assets. BA also identified a number of potential benefits of regulation, even though it is a “second best” option where there is sufficient competition. Amongst the benefits identified were preventing anti-competitive behaviour, encouraging efficiency, increasing certainty, avoiding the costs of ex-post intervention, associated incentives for appropriate behaviour and providing a wider policy tool. BA was concerned that the extent to which the incremental costs and benefits of regulation are driven by the existing regulatory framework rather than the best available *ex ante* regulation had not been considered.

BAA considered that the three issues identified by the CAA were relevant considerations but felt that they did not provide a strong case for continued regulation. BAA argued that the distortions arising from the detailed regulatory rules outweigh any potential advantages from regulation.

Ryanair agreed that the CAA had identified the three main areas of benefit that would arise from a properly applied regulatory framework. It believed that the CAA had erroneously assessed these benefits because of its assumption that Stansted airport did not have substantial market power. Ryanair believed that the benefits would be considerably greater when considered against a case of an airport having substantial market power.

Ryanair believed there was an additional benefit from *ex ante* regulation through the avoidance of additional costs for users that would arise from excessive pricing. It considered that the increase in airport charges to Ryanair in summer 2007 was a prime example of such costs.

Stansted ACC considered that the CAA had correctly identified the three main areas of benefit from a properly applied regulatory framework. It identified an additional benefit from *ex ante* regulation, which was the avoidance of costs for customers from excessive pricing.

- *Question 7* – Do interested parties agree that the CAA has correctly identified the four potential costs of *ex ante* regulation? If not, please explain.

BA identified a number of costs of regulation, including the costs of the regulatory process, distorted investment incentives and regulatory gaming.

BAA agreed that the four factors identified by the CAA are significant costs of *ex ante* regulation. BAA believed that the current regulatory framework was not particularly well suited to supporting major investment in new airport capacity, and it noted that some of the airlines at Stansted airport were concerned about distortions created by the current framework. BAA was optimistic that the tensions between it and some of the airlines using Stansted airport could be reduced following de-designation, as a more commercial approach to the negotiations could be adopted.

With the exception of the direct costs of regulation, Ryanair and Stansted ACC considered that the CAA's four potential costs related to those of a poorly applied regulatory framework as is currently the case at Stansted airport. Accordingly, they suggested that the RAB based regulatory framework is not the appropriate basis for assessing this criterion for evaluating costs and benefits. Ryanair also noted that it considered that the CAA had failed to adequately regulate Stansted airport thereby generating substantial unnecessary costs from a failure to adequately regulate the airport and not the costs associated with regulation *per se*.

- *Question 8* – Do interested parties agree with the CAA's assessment of the relevant market for its analysis of the market power of Stansted airport (paragraph 8.110 of the CAA's advice)?

BA considered that the CAA's approach to market definition left a considerable amount to be desired. In particular, it was concerned that the CAA did not look at the weighting of where passengers come from, nor how many passengers at the margin may be prepared to switch and that there was no quantitative SSNIP analysis. It also considered that BAA's common ownership of Heathrow, Gatwick and Stansted airports should inform the analysis of the relevant markets.

BAA agreed that the CAA's geographic market was a useful starting point for framing the analysis but suggested that it did not capture all the competitive constraints. BAA noted a number of other things that it felt should be included in the analysis, such as the competitive constraints provided by Luton airport, including its opportunities to develop further capacity, the availability of other European airports for low fares carriers, including the range of bases used by Ryanair and Easyjet and the low switching costs between airports for low fares carriers demonstrated by Ryanair's recent withdrawal of routes at Stansted airport.

Frontier Economics presented the conclusions of a model it developed using booking information from Easyjet to assess how sensitive passenger's preferences are to their

distance from an airport. It found that when passengers are presented with a choice of airports, passenger's propensity to take a service from a given airport declines sharply as the distance from their home increases. It considered that this strength of preference was such that airports as distant as London and East Midlands can be shown to provide little or no competitive constraint on the pricing of airports in London. Therefore, the CAA is wrong to conclude that Stansted airport operates in a relatively broad geographic market and, in particular, a market that includes Birmingham and East Midlands' airports.

Frontier Economics also considered that the potential response of inbound passengers to an increase in airport charges at Stansted airport had not been effectively considered by the CAA when assessing the appropriate market definition.

Ryanair believed that on the basis of the potential for passenger switching between airports the CAA has taken as the relevant market too wide a geographic area. The relevant market is the provision of airport services to airlines wishing to serve London and the South East. Ryanair presented analysis about the concentration of leisure passengers using Stansted airport in London and the South East, and further considered where passengers using competed (offered at other airports) and uncompleted routes lived based on drive times to the airport. It noted that for competed routes 70% of passengers lived within 53 minutes of the airport and for uncompleted routes 70% of passengers lived within 73 minutes of the airport. Ryanair considered that rather than the CAA's definition of a market including East Midlands and Birmingham airports, the geographic concentration of passengers using Stansted airport meant that it was more likely that the appropriate market definition was even narrower than the whole of the London and the South East rather than wider.

Stansted ACC disagreed with the CAA's conclusions and considered that it had failed to credibly and consistently apply the SSNIP test. Although concerned about the CAA's approach of focusing on passenger behaviour, Stansted ACC was also concerned that in applying its approach the CAA had not sought to understand the reasons why passengers from the Midlands would choose Stansted airport in preference to nearer airports to understand whether they were a significant competitive constraint for Stansted Airport. Stansted ACC considered that the relevant market is the supply of airport services to airlines wishing to serve the market in London and the South East of England.

- *Question 9* – Do interested parties agree with the CAA's conclusion that on balance Stansted airport does not currently have substantial market power? Where interested parties disagree with all or some of the CAA's analysis or believe that issues have not been covered in the CAA's analysis, please explain and provide evidence.

BAA agreed with the CAA's conclusion that Stansted airport does not currently have a substantial degree of market power. BAA noted that it had reviewed the CAA's analysis of the relationship between Stansted airport's profitability and passenger volumes. It derived similar results using updated numbers, thereby showing that Stansted airport's profitability is highly sensitive to reductions in passenger numbers.

Easyjet noted that market power is the ability to profitably raise prices beyond a competitive level and/ or provide a sub-standard quality of service. Where the airport increases its prices, Easyjet considered that the airlines would have to absorb increases because flight schedules are fixed in the short term. Over the longer term, airlines could exit the market, move routes from Stansted airport to an alternative airport or stay at Stansted airport. It noted that Frontier Economics had estimated that airlines' exit costs are at least twice as high as a 10% increase in airport charges. Easyjet considered that there was no suitable capacity at the London airports, which are the only effective substitutes for Stansted airport, and that Frontier Economics had demonstrated that passengers were not willing to travel further for flights. Easyjet considered that staying at Stansted airport and absorbing the higher costs was likely to be the only option for most airlines, and could not find any examples of London based aircraft permanently leaving a London airport following an airport price increase

Easyjet considered that the CAA's analysis incorrectly assumed that increases in airport charges would be passed on to passengers, which means it is inappropriate to assess potential passenger responses to such price changes. Easyjet also considered that airlines faced higher levels of operational gearing than airports because the absolute cost to an airline of losing a passenger is much higher than for an airport. While considering that the CAA's analysis of the amount of passengers that Stansted airport would have to lose following a price increase for it not to be profitable was a helpful framework, it did not believe that the CAA's data supported a view that Stansted airport would lose up to 1.8m passengers. Easyjet believed that Stansted airport could profitably sustain a 10% price increase as airlines had limited, if any, options to switch capacity.

Easyjet considered that Stansted airport currently held market power. As evidence to support this view, it noted amongst other things that it had not seen any evidence to suggest that the airport's service quality had improved since the concerns expressed by the Competition Commission in 2002, the failure of the airport to properly consult its airlines about expansion plans and its current ability to earn returns substantially above those forecast by the CAA when the price cap was set despite not undertaking all the capital investment that was forecast.

Frontier Economics presented evidence that Stansted airport already enjoys market power with regard to based aircraft there because they need access to capacity constrained early

morning slots for their flights to be economic. Stansted airport can be considered to have market power in this regard because there is no capacity to base additional aircraft in London.

Ryanair disagreed with the CAA's conclusion and considered that there was evidence that Stansted airport was currently abusing substantial market power. Amongst the key factors Ryanair set out to support its view were the need for airlines to serve the important London and South East passenger market, the very limited available capacity at other airports in the South East, the barriers to airlines switching existing capacity or planned growth, the cushioning effect for the airport as regards passenger numbers from the low fares carriers' high load factor business model, the reduction in growth compared to forecast and trends in the previous year following the recent increases in airport charges at Stansted airport and BAA now choosing to price up to the cap at Stansted airport, which Ryanair considered to be above an appropriate price. Ryanair presented analysis by York Aviation to illustrate its view that based on actual operational and capital expenditure during the current price control period, an appropriate charge at Stansted airport would be about or below £4. Ryanair also presented analysis by York Aviation which suggested that the CAA's analysis of the critical loss of passengers for 5 and 10% increases in airport charges was unlikely to be correct without radically different higher price elasticities to changes in air fare.

LLAOL did not specifically consider the merits of the CAA's analysis of Stansted airport's market power, except to note the experience of the earlier 1990's when Ryanair moved its base from Luton to Stansted airport. It considered that Stansted airport's charges in recent years had been set at unsustainable levels and, in particular, returns had been substantially below those set by the CAA in the price cap. LLAOL believed that these returns had only been sustained because of financial support for Stansted airport from elsewhere within BAA.

Stansted ACC disagreed with the CAA that Stansted airport does not currently have substantial market power. It considered that the CAA had wrongly interpreted the recent doubling of airport charges to airlines at Stansted airport as not an abuse of a dominant position because while the charges were within the price cap they were above an appropriate assessment of a competitive price at Stansted airport taking into account actual investment undertaken. It also believed that the elimination of the growth in volumes at Stansted airport following the price increases indicated that a greater proportion of traffic is captive to Stansted airport than the CAA's assessment indicated.

SSE believed that Stansted airport was just now acquiring some market power as evidenced by its ability to increase airport charges up to the price cap this year. It

considered that it would be perverse to de-designate Stansted airport just at the time when it was beginning to acquire some market power.

- *Question 10* – The CAA’s analysis of the potential market power of Stansted airport comprises a number of different elements. While recognising that a decision about the regulatory status of the airport is an overall decision, the DfT would welcome comments on the CAA’s analysis of:
 - *a* – The level of charges at Stansted airport that would reflect efficient new entry costs or a level that might be expected to remunerate efficiently incurred expansion at the airport (paragraphs 8.46 to 8.54 of the CAA’s advice).

BAA’s own analysis confirmed that the range of values derived by the CAA is a reasonable approximation of long run incremental costs at Stansted airport.

David Starkie noted that if Stansted airport is “full”, it would be appropriate for charges to increase to allocate capacity to those airlines that value it the most, in a similar way to airlines pricing models. He did not consider that this increase in the level of prices in this way justified elaborate *ex ante* regulation. David Starkie considered that in addition to pricing behaviour, to investigate whether a firm had market power and was abusing its position, it was necessary to consider whether it was withholding capacity from the market, or when faced with steadily rising demand, whether it tried to increase the volume of capacity. He considered that as Stansted airport was seeking to increase capacity, any recent increases in prices were examples of scarcity rather than monopoly rent.

David Starkie noted that there might be a range of explanations for the recent increases in prices at Stansted airport, and that as it was only pricing up to the cap, it was not making an excessive return.

Ryanair considered that airport charges of around £4 per passenger would be appropriate to remunerate efficiently incurred expansion at the airport. Ryanair presented calculations based on a different specification for the runway and other expansion at Stansted airport than that used by the CAA, which yielded charges of about £4 per passenger depending on precisely which specifications are used.

Stansted ACC stated it believed that the price cap during the current period should have been set at £4 given the actual operational and capital costs incurred by BAA. It considered that this price was an upper estimate because it includes a return on a RAB based on historical investments that are not currently used or required by the airlines.

- *b* – Cargo operations at Stansted airport (paragraphs 8.57 to 8.63 of the CAA’s advice), and particularly information and views from parties with particular interests in cargo operations at Stansted and other airports.

BAA identified a number of safeguards for the interests of cargo operators at Stansted airport, including that Stansted airport competes against a range of UK and European airports to retain and attract cargo services, Stansted airport does not have substantial market power and cargo operators could use competition law to address any concerns about a potential abuse of a dominant position.

BA and Stansted ACC noted that current traffic distribution rules preclude freighter movements at Heathrow or Gatwick airports, driving a shift to Stansted airport for freighter operations. BAA’s masterplan for the airport envisaged it becoming the major freight airport in the South East. Stansted ACC noted that Manston is the closest alternative airport with a runway length that could cope with long haul cargo operations, but its facilities and security are inadequate, and its noise regulations are punitive. It argued that due to a lack of alternatives, freighter operators do not have a serious choice of airport if they wish to operate in the South East. BA considered that Stansted airport was the only realistic option for cargo in the South East.

- *c* – Switching costs faced by airlines at Stansted airport (paragraphs 8.73 to 8.81 of the CAA’s advice) and, in particular, any additional information that airlines can provide about their switching costs.

BA noted that switching costs will vary depending on the nature of airlines’ operations. For example, the costs for an airline based at a particular airport could be quite significant. It criticised the lack of a quantitative critical loss analysis of whether switching of airlines with low switching costs would make a price rise unprofitable for the airport.

While stating that airlines are best placed to respond, BAA considered that the evidence of low cost airlines routinely re-organising their portfolio of destinations and their growing number of bases in Europe, suggested that switching costs were relatively low.

Easyjet considered that moving flights would incur significant switching costs, and pointed to analysis in the Frontier Economics’ report, which suggested that the costs of foregone revenue when establishing a new route are as high or higher than a 5-10% increase in airport charges.

Ryanair did not consider that airline switching costs were particularly relevant to the analysis of Stansted airport’s market power as there are few, if any, alternatives for switching significant amounts of capacity to serve passengers in London and the South

East. Ryanair did not consider that the fact that airlines might switch capacity outside of the UK market altogether to be relevant, and in any event, this would have wider economic consequences by way of lost jobs and lost opportunities to travel to and from the South East of England.

Stansted ACC considered that the CAA had placed an inappropriate emphasis on switching costs because in the absence of options to switch capacity, the level of switching costs were not particularly relevant. Switching aircraft out of the London and the South East area would also reduce the quality of air services available to passengers and freighters.

- *Question 11* – Do interested parties agree with the CAA’s conclusion that on balance Stansted airport will not acquire substantial market power in the foreseeable future? If interested parties disagree with all or some of the CAA’s analysis, or believe that issues have not been covered in the CAA’s advice, please explain and provide evidence.

BA and SSE considered that Stansted airport would have market power in the future given the DfT’s own forecasts that there would be significant capacity shortages at the London and South East airports in the future, and the time required for further developments at the airports. Therefore, SSE considered that it would be premature to de-designate Stansted airport while it remained an integral part of a London airports “system” operated by BAA alongside Heathrow and Gatwick, and the DfT considers that there is a severe capacity shortage in London and the South East. BA also noted a range of other potential investments that had been delayed, which could have increased capacity, including a replacement runway at Luton airport and a new runway at Birmingham airport.

BAA agreed with the CAA’s conclusion and believed that the competitive constraints identified by it and the CAA could be expected to remain in the future. BAA stated that as demand rises it would be investing in further capacity and that prices at Stansted airport would need to rise to remunerate the investment. It also noted that, as the CAA stated, a tightening of the demand-capacity balance could be expected to put upward pressure on prices without being an abuse of market power.

Drawing on the arguments and evidence presented for why it believed that Stansted airport currently had market power, Easyjet believed that it was likely to continue to have market power in the future.

Frontier Economics believed that the CAA’s analysis was insufficient to draw conclusions about the extent or otherwise of Stansted airports market power on a forward-looking basis. It also believed that the CAA had not articulated a clear theory of

how airport prices are determined in an unregulated market and how these charges could be expected to evolve over time. Frontier Economics' theory stated that the key facts in determining the strength of inter-airport competition will be geographical proximity, the extent to which airport capacity is fixed in the short to medium term and the presence or otherwise of switching costs for airlines, that may create knock-on effects. It concludes that the most important factor in determining airport pricing is the extent to which capacity is developed in large lumpy increments and can only be extended relatively infrequently.

Given these factors, Frontier Economics believed that airport pricing is unlikely to conform to an efficient long-run level in any given year or price control period. Prices will approach short-run avoidable costs when capacity is plentiful and may well rise above long run incremental costs when capacity is constrained. Therefore, to remunerate its investments an airport needs to have periods when it enjoys market power. Frontier Economics goes on to argue that there is a material risk that airports will strategically restrict capacity so as to reduce the intensity of competition and raise prices in the long run because they and their rivals cannot readily increase capacity in the long run.

For the reasons summarised above, Ryanair considered that Stansted airport already had substantial market power and this was likely to increase not decrease until such time as there is alternative spare airport capacity provided to the same core market. Ryanair also emphasised the joint ownership of Heathrow, Gatwick and Stansted airports by BAA as a continuing factor conferring market power on Stansted airport.

Stansted ACC considered that in addition to already holding substantial market power for the reasons discussed above, there is substantial behavioural evidence that BAA at Stansted airport is abusing its market power from its refusal to meet the reasonable needs of users in developing its Generation 2 proposals, and more generally regarding consultation with users and quality of service.

- *Question 12* – On the day that the CAA submitted its advice to the Secretary of State, Luton airport announced that it no longer intended to pursue the development of a full length replacement runway.¹⁰ Do interested parties consider that this development should alter the conclusions reached by the CAA regarding Stansted airport's market power, and if so, why?

BAA did not consider that Luton airport's announcement materially altered the conclusions reached. It noted that Stansted airport faced other constraints on its behaviour and that Luton airport might still choose to develop further capacity in other ways.

¹⁰ Press release from Luton Airport of 6 July 2007, titled "London Luton Airport Development Proposals".

Easyjet noted that Luton airport's decision to scale back its expansion plans increased the ability of Stansted airport to potentially raise prices if the airport is de-designated.

Ryanair considered that Luton airport's decision not to progress with a step change in capacity in the short term only served to increase Stansted's market power as it diminished the prospects of Luton airport acting as a competitive constraint. Ryanair emphasised that it considered that Stansted airport had market power irrespective of developments at Luton airport.

Stansted ACC considered that Luton airport's decision not to develop a full length replacement runway did change the CAA's analysis as it meant that a potential increase in capacity would no longer be available, thereby materially lessening any competitive constraint on Stansted airport from Luton airport.

- *Question 13* – Do interested parties agree with the CAA's conclusion that Stansted airport does not meet criterion 1?

BAA agreed with the CAA's conclusions. BA, Easyjet, Ryanair and Stansted ACC disagreed with the CAA's conclusions.

- *Question 14* – Do interested parties agree with the CAA that users at Stansted airport do not appear to have less information available to inform any charge of alleged excessive pricing, compared with that available to users of other airports or indeed users of capital intensive infrastructure?

BAA agreed that users of Stansted airport would have adequate information to inform any charge of alleged excessive pricing. It noted that due to the legacy of regulation there is far greater transparency of costs and revenues at Stansted airport than would be the case for the majority of other airports or providers of capital infrastructure more generally. BAA also noted the CAA's power to impose additional accounting requirements for non-designated airports and the European Union's proposed airport charges directive, which might introduce further requirements.

LLAOL said it expected the CAA to fulfill its responsibilities to ensure that airports did not engage in predatory pricing. It stated that it would not be sympathetic if the CAA sought to argue that it did not have sufficient powers or information to address such concerns for a de-designated airport.

Ryanair considered this question to be irrelevant given the inadequacies of competition law, explained above. It could not comment on the information that is available to users of other airports or capital intensive infrastructure. Ryanair considered that there was insufficient disclosure of information by BAA for Stansted airport in relation to traffic

forecasts, capital expenditure, operational expenditure and commercial revenue to inform any potential claim of excessive pricing through private enforcement. Ryanair noted that BAA had failed to adhere to the information disclosure requirements as set out in Annex 4 of the CAA's decision document for the current Stansted airport price control, which Ryanair considered had been recognised by the Competition Commission in its recent report on the Heathrow and Gatwick airport price controls. Ryanair considered that even if the information that should have been disclosed to the airlines had been disclosed it would not remedy the significant practical disadvantages faced by airlines seeking to bring private enforcement actions.

Stansted ACC did not consider this to be the appropriate question. While airlines at Stansted airport might have no less information than airlines at other airports, it still considered that there was inadequate disclosure by BAA at Stansted airport of a range of information (traffic forecasts, capital expenditure, operational expenditure and commercial revenue) necessary to bring a case for excessive pricing. It also noted that information currently disclosed was insufficient to formulate a private claim in the courts for abuse of a dominant position.

- *Question 15* – Do respondents agree with the CAA that the concentration of airline users is sufficiently high, and the demonstrated willingness of the two major carriers to bring competition and breach of contract cases against airport suppliers and airline competitors, suggests strongly that there would be at least two airlines with the means and motivation to pursue legal actions against any allegations of excessive pricing?

BAA agreed with the CAA, and also noted that the concentration of the two main airlines at Stansted airport should diminish any concerns that the OFT would have insufficient resources to address the issues as the airlines could take private enforcement actions.

Ryanair considered that the fact that the two airlines that are the main users of Stansted airport had litigated in the past is an inadequate basis on which to conclude that they are sufficiently litigious to make competition law a real deterrent to anti-competitive behaviour by Stansted airport if it was de-designated.

Stansted ACC did not consider this to be the appropriate question. Instead, it considered the appropriate question to be whether such actions are likely to remedy the effects of excessive pricing. For the reasons previously set out, it did not consider that such actions were likely to effectively remedy the effects.

- *Question 16* – Do respondents agree with the CAA's conclusion that Stansted airport does not meet criterion 2?

BAA agreed with the CAA's conclusions in the light of its other remarks.

BA said that competition law is not sufficient to control the use of substantial market power where it is held by the owner of major infrastructure assets. It considered that *ex post* control is much less effective than *ex ante* control, which is why so many infrastructure assets are subject to *ex ante* regulation.

Easyjet did not agree with the CAA's conclusions, and noted that if there is likelihood that Stansted airport would abuse its market power, it seems to be more efficient to restrain this power *ex ante* through regulation.

Ryanair believed that given the market power held by Stansted airport and the substantial risk of abuse, competition did not provide an adequate remedy in terms of timeliness or effect.

Stansted ACC disagreed with the CAA's conclusions. It considered that absent regulation, Stansted airport would increase and sustain prices profitably above the competitive level. It also considered that any conclusion that Stansted airport met criterion 2 for de-designation would also imply that Heathrow and Gatwick airports should be de-designated.

- *Question 17* – Do respondents agree with the CAA that there appear to be very limited incremental benefits associated with designation, over and above the benefits that might flow from competition and the application of competition law?

BA considered that any assessment of the potential costs and benefits of *ex ante* regulation at Stansted airport needed to be considered on the basis of updating the regulatory framework. Such an updated framework would include imposing additional statutory duties on the owners/ operators of airports, introduce licences for the regulated airports and consider introducing financial ring-fencing provisions and appropriate incentives on quality and standards of service.

Building on its previous comments, BAA did not consider that there were any incremental benefits of regulation.

Easyjet noted that Frontier Economics had set out an option for a new regulatory framework based around the long run incremental costs of investment at Stansted airport. It considered that with the expertise available, it would be possible for a new framework to be developed that gave airports the right incentives to invest in capacity. Such a framework would be built around ensuring that both the airport and airlines are incentivised to agree on investment plans. It believed that this would involve increasing

the proportion of investment that is subject to commercial negotiation, so investment would only occur when commercial agreements had been reached.

Frontier Economics set out an alternative approach to regulating airports based on seeking to ensure that airports were reasonably able to recover the costs of investments over their lifetime, recognising that prices would be lower at times of plentiful capacity and higher when capacity was limited.

Ryanair and Stansted ACC considered that there were significant potential additional benefits arising from a properly applied *ex ante* regulatory framework through avoiding the costs and risks associated with excessive pricing. It considered that there were likely to be substantial and irrecoverable costs associated with leaving the matter of pricing to be addressed through competition law. Ryanair considered that a properly applied regulatory framework would prevent damage to the interests of both airlines and passengers from the effects of excessive pricing.

- *Question 18* – Do interested parties agree with the CAA that the potential costs and risks of regulation are significant, particularly for regulation to distort investment decisions?

BAA agreed with the CAA that the current regulatory framework is not well suited to supporting major new investments at Stansted airport. BAA noted in particular that the current regulatory framework fails to provide sufficient certainty for long term investments because of the potential for change between price control reviews.

Ryanair considered that the distortion of investment incentives arose primarily from the RAB-based form of regulation. Ryanair believed that a correctly specified market-based approach would provide the correct incentives to provide a balanced approach to investment in time to meet the needs of users. This would require a stronger engagement between the airport operator and its airline users, based around the central business plan envisaged in Annex 4 of the CAA's decision documents for the current price control.

Stansted ACC considered that the distortion of investment incentives derives primarily from the RAB based form of regulation. It believed that a correctly specified market-based approach would provide the correct incentives to provide a balanced approach to investment in time to meet the needs of users. It considered that this required stronger engagement between the airport operator and its airline users around a central business plan.

- *Question 19* – We would welcome any additional information or evidence that respondents can provide to consider the potential incremental costs and benefits of designation compared to de-designation.

Ryanair noted that in response to other questions and as part of its response more generally, it had provided specific evidence of the costs to it of the current failure to regulate Stansted airport properly. Ryanair considered that under a de-designated regime the burden of costs on customers of Stansted airport would only rise substantially as BAA exploited its market power.

- *Question 20* – Do respondents agree with the CAA’s conclusion that Stansted airport does not meet criterion 3?

BAA agreed with the CAA’s conclusions. BA, Easyjet, Ryanair and Stansted ACC did not agree with the CAA’s conclusions. Ryanair and Stansted ACC believed that the CAA had not correctly considered whether this criterion had been met because it had not considered whether it would be met if Stansted airport had market power and it had assessed the costs and benefits of *ex ante* regulation compared to the inappropriate RAB based form of regulation. Ryanair considered that the CAA should have assessed the costs and benefits compared to an appropriate form of *ex ante* regulation, which may or may not be a market led cap.

Other issues raised by respondents

BA noted that there was considerable concern about the highly leveraged financial structure of BAA under its ownership by Ferrovial. It noted that the Competition Commission intended to address this issue in its market enquiry. BA was concerned that de-designation at Stansted airport would allow BAA to raise additional revenues to service the debt and that it could choose to grant security over airport assets as part of financing arrangements.

LLAOL noted that, while not excluded, the interests of competing airports did not appear to be foremost in the consideration of the regulatory status of airports given the criteria adopted by the DfT. A number of the arguments LLAOL had previously made in favour of designation were not explicitly considered in the criteria.

If de-designation occurred, LLAOL wanted the CAA to:

- publish a stand alone WACC for Stansted airport to provide a benchmark for appropriate price levels;
- continue to monitor Stansted’s actions and collect information to allow prompt action to be taken if concerns about anti-competitive behaviour arose; and
- act promptly if LLAOL had concerns that it had been subject to unfair competition.

Ryanair, Stansted ACC and SSE considered that it would be inappropriate to de-designate Stansted airport before the Competition Commission had published the conclusions of its review into BAA's operation and ownership of airports in the South East of England.

Ryanair and Stansted ACC considered that it was misleading for the CAA to claim that the Transport Select Committee recommended that the de-designation of Stansted airport be investigated, when it was the CAA that made the initial suggestion in the evidence it provided to the select committee.

Ryanair was also concerned that the CAA's conclusions about the lack of substantial market power contradicted the OFT's view of the extent to which Stansted airport had market power, as expressed through its decision to refer the airport market in the South East of England and particularly the issue of BAA's joint ownership of Heathrow, Gatwick and Stansted airports to the Competition Commission.

SSE believed that the timing of the proposal to de-designate Stansted airport was driven by the DfT's desire to assist BAA in the development of a second runway as soon as possible, recognising that it was not possible for the runway to be funded on a commercially viable basis whilst the current form of price controls remained in place.

SSE noted that the prospectus that accompanied the privatisation of BAA did not make any reference to the possibility of Heathrow, Gatwick or Stansted airports being de-designated.

SSE and Oliver Heald MP argued that BAA would derive a substantial financial benefit from de-designation through its ability to increase charges, and that some or all of this benefit should accrue to the Treasury. SSE stated that it was important to set this principle for Stansted airport as the benefits of de-designation would be much larger for Heathrow and Gatwick airports.