

# **The Competition Commission's Emerging Thinking on BAA's Market Investigation**

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**Note: the text of this speech is substantially drawn from the Emerging Thinking report published on 22 April 2008. It highlights some of the background to the report; sets it in the context of the several other inquiries into the airports sector; summarises some of the key preliminary findings; and explains the next steps and timescale.**

## **Introduction**

Good morning!

I am addressing you at the end of a long morning which for some of us started over breakfast with the Secretary of State for the launch of London First's interesting report on Heathrow. I recognise that what you would now like me to tell you is what is going to happen to BAA. Unfortunately I can't do that for the simple reason that we have yet to reach our conclusions, even in provisional form. However, we plan to do so before the end of August.

Our current thinking was set out in what we called our Emerging Thinking report published on 22 April which received widespread publicity. You will find a copy of the whole report on our website. In terms of substance, it would be inappropriate for me to say more than is already in the public domain. Indeed, in a moment, when I refer to our 'current view', by that I mean our view when we published our Emerging Thinking and it does not reflect the further evidence and thinking since then.

What I will do, however, is to highlight some of the background to our report; set it in the context of the several other inquiries into the airport sector; remind you of some of our key preliminary findings, and tell you where we are going and in what timescale.

Our Emerging Thinking was precisely that and no more, even though we were more explicit than at the same stage in some of the Commission's other market investigations. This means that while we have set out in some detail the direction of our thinking, the underlying evidence and our assessment of it, we've not reached any conclusions. By publishing our thinking, however, we have provided BAA, the airlines, the CAA, government and other interested parties with the opportunity to assess what we have said and to respond to it. Many of you here today are part of that process and your constructive involvement is important to us in reaching our conclusions. That is now progressing well, through written submissions and oral hearings. This is part of our normal process of investigation which is open, transparent and non-adversarial. It provides all interested parties with the opportunity to have their views taken into account, provided of course that these

are supported with real data which can be subjected to rigorous examination.

Let me now set our BAA market investigation in the context of a number of other significant inquiries into the airports sector which have been, or are being, conducted in parallel, either by ourselves or others. They include:

- Our recommendations last September to the CAA on BAA's charges to the airlines at Heathrow and Gatwick for the five years from April 2008; and the CAA's subsequent final determination of them;
- Our current review of airport charges at Stansted on which we will publish our recommendations to the CAA before the end of October prior to their final determination by next April;
- The report on The Future of BAA by the House of Commons Transport Select Committee in March;
- The current independent review by Sir Joseph Pilling for the Secretary of State for Transport on the structure, scope and organization of the CAA; and
- The current review of airport regulation by the Department for Transport announced in April as part of which Professor Martin Cave has been appointed to chair an advisory panel.

And if that was not enough, there are several other important planning applications or consultations underway:

- At Stansted, BAA has applied to raise the planning limit of 25 million passengers per year to 35 million. A decision is now awaited from the Government. BAA has also recently made a second planning application to build a second runway and terminal there.
- At Heathrow, the Government is consulting on the introduction of mixed mode operation of the runways and also on a third runway and sixth terminal.

We are conducting our market investigation of BAA quite separately from these other inquiries. However, where they are relevant, we are taking them into account, not least in terms of the effect of regulation on BAA, both now, and to the extent it becomes relevant, in the future. Similarly, those responsible for those other inquiries may be expected to take account of *our* findings in due course.

Turning now to our investigation into BAA, let me remind you of what we are required to do. Briefly, following a reference from the

OFT in March last year, we are required to determine whether there are any features of the market which give rise to an adverse effect on competition. If we find any such features, we are obliged to remedy the problems we have found. I will return to what this means in practice a little later.

Let me also remind you, this is not *just* an investigation into *Heathrow*. BAA owns *seven* airports in the UK. Four are in the South East of England - Heathrow, Gatwick, Stansted and Southampton. The other three are in Scotland - Edinburgh, Glasgow and Aberdeen. BAA's ultimate parent company, Ferrovial, also currently owns Belfast City airport but that falls outside our terms of reference. 91 per cent of all air traffic arriving at, and departing from, the South East goes through BAA's airports, as does 84 per cent of traffic arriving at, and departing from, BAA's airports in Scotland.

That's enough by way of background. Let me now turn to the substance of our investigation. Essentially, we are addressing four key questions:

First, to what extent is there **potential for competition** between

BAA's airports?

Second, to what extent is there competition in BAA's two geographical markets, **Scotland** and the **South East**?

Third, to what extent is **capacity** being provided in a timely and efficient way?

And finally, what are the effects of the **planning** system, **government policy** and the system of **economic regulation**?

Turning to the first of these questions, the **potential for competition**, our starting point was that we found there is no competition between BAA's three London airports or between their two airports in lowland Scotland, although Glasgow does face competition from one non-BAA airport, namely Prestwick.

In contrast, the evidence we have received from airlines and airports confirms a significant degree of competition between some non-BAA airports in the UK, for instance between Birmingham and East Midlands. There was some competition between Luton and Stansted when Stansted's capacity was underutilised. We saw

evidence of airlines' use of bargaining power from their ability to bring new passengers to airports or take them away; declining yields from airport charges at regional airports; switching of passengers between pairs of regional airports and some switching by airlines, but also with competition between airports for new routes; and competition on service, for example to provide the facilities for the quick turnaround times required by the low-cost carriers. However, such competition was invariably between airports with spare capacity or capacity that could readily be expanded.

More specifically, in **Scotland**, the main concerns we received about the performance of the BAA Scottish airports, which we currently share, were of a slow development of routes at all three Scottish airports, at least until the Scottish Government introduced its Route Development Fund; and of a lack of ambition in the development of Aberdeen.

We found very little airline switching between Edinburgh and Glasgow although there is evidence of airline switching between Prestwick and Glasgow. Some of the evidence we received from BAA and third parties suggested the two airports served largely

distinct catchment areas. We did, however, find some overlap in the catchment areas of Glasgow and Edinburgh. A passenger survey indicated that Glasgow was the best alternative to Edinburgh; and Edinburgh, together with Prestwick, was the best alternative to Glasgow; otherwise there was no effective competition to BAA from other airports in Scotland.

Pricing and incentives are currently largely the same at both Glasgow and Edinburgh. BAA has previously had a poor record compared with Prestwick in attracting new routes. Given spare capacity at BAA's Scottish airports, and some airlines' ability to open new routes, under separate ownership there would be an incentive for the airports to compete against each other to secure such routes.

Our current view, therefore, is that common ownership adversely affects competition between Edinburgh and Glasgow and that under separate ownership there would be potential for competition between them. The evidence on Aberdeen is relatively weaker.

In regard to the **South East** airports in **England**, our present view is that BAA shows a lack of responsiveness to airlines and

passengers that we would not expect to see in a business competing in a well functioning market. This is evident in BAA's approach to planning capital expenditure, and in the levels, quality, scope, location and timing of investment. Although Constructive Engagement between BAA and the airlines, which was introduced by the CAA, has undoubtedly had some positive effects at Heathrow and Gatwick, it seems to us to be conducted in a way which excludes genuine two-way dialogue. Lack of BAA's responsiveness to users is also evidenced in the unwillingness to consider options of separate terminal development, co-investment or longer-term contracts; a failure to ensure operating excellence; and deficiencies in the level and quality of service.

Our current view is that BAA's London airports face very limited competition from non-BAA airports, although there is some evidence that Southampton faces competition from Bournemouth. But the evidence we have seen suggests considerable substitutability of passenger demand between the three London airports, with significant overlaps between their catchment areas, although to an extent that varies between different categories of passenger, and therefore the very real prospect of competition between them, subject to capacity constraints and regulation. We

also see the potential for some competition from the BAA London airports to Southampton.

On this basis, common ownership does therefore adversely affect competition between BAA's South East airports.

However, we recognise there are constraints on the ability and willingness of airlines to switch between the BAA airports, particularly in the London area due to capacity constraints and the unique position in the UK of Heathrow as a hub airport. BAA, and some airlines, have argued that planning restrictions combined with capacity constraints were a feature of the market that potentially adversely affected competition and that a lack of spare capacity would prevent competition between BAA's London airports until new runway capacity was available.

Our current view is that there is scope for a *degree* of competition between the London airports *despite* capacity constraints, for example between Stansted and Gatwick in off-peak periods.

Turning now to **capacity**, one of the main purposes of privatising BAA as a single entity was for investment in new capacity in the South East. In terms of runway capacity, this has not happened.

In contrast, we found that BAA's Scottish airports do not face capacity constraints. We have recently seen Prestwick expand rapidly but no evidence of possible entry or expansion by other airport operators in Scotland.

We acknowledge that to some extent BAA's actions can be attributed to government policy and the planning system. However, BAA's development of infrastructure over the long term has generally been too late to meet demand. BAA has also been too prepared to accept, or even offer to have, *constraints* placed on developments, such as at Heathrow in the T5 inquiry and at Gatwick. BAA may also have a tendency to undertake major developments sequentially. We are, therefore, currently inclined to the view that the way in which BAA has conducted its business in terms of its approach to planning, combined with its common ownership of the airports, may well have contributed to the shortage of capacity and be features which prevent, restrict or distort competition.

Lack of capacity, particularly runway capacity, at the South East airports also appears to be a reason for the current poor standards of *service* at its airports and lack of resilience at times of disruption. We have considered the extent to which that slow development of capacity can be attributed to restrictions under the planning system, government policy and/or the common ownership of the airports.

In regard to the **planning system**, we are of the view that lengthy planning processes inevitably affect airport competition, in particular by acting as a barrier to entry for new airports and expansion by existing airports. Planning restrictions are unavoidable given the environmental consequences of airport development, but we currently believe that the planning process is a feature which prevents, restricts or distorts competition.

Evidence shows that **Government** continues to play a significant role in any decision to invest in new runway capacity in the South East. But while Government policy may provide a framework within which airport infrastructure and operating companies can take commercial decisions, it may also restrict competition.

In terms of **economic regulation**, the three BAA London airports are currently designated for price regulation by the CAA. There are significant differences in the legal framework for the economic regulation of airports compared with that of other utilities. There are, for example, no statutory duties on BAA nor any economic licence; nor any requirement on BAA to 'ring fence' the designated airports. There is no annual review by the regulator of capital expenditure, operating expenditure, or service provision, nor is the regulator's consent required for asset disposals. The CAA's objectives also differ from those of other sectoral regulators.

The regulatory system may therefore facilitate, reinforce or exacerbate some of the other characteristics of the market. However, we are also of the view that *common ownership* exacerbates the inadequacies of the regulatory system, reducing the benefits of regulation and therefore affecting competition between airlines.

So, what are our next steps?

Once we have received and assessed the further evidence in response to our Emerging Thinking, we will reach and publish our Provisional Findings. If we find that there are features of the market which alone or in combination prevent, restrict or distort competition, there will be an adverse effect on competition in the market in which BAA operates. As will be clear from what I have said, we are focusing on potential features such as common ownership, planning, government policy and regulation, as well as their interaction. We are looking at them in terms of the structure of the market and in terms of conduct, that is to say how the various parties operate in their respective spheres of activity. In doing so, we are considering each of BAA's airports individually as well as in combination with others.

Were we to reach a provisional adverse finding in terms of competition, we would then be obliged to consider how best to remedy the adverse effects. Such remedies may be either structural or behavioural. Structural remedies might include the requirement for BAA to sell one or more of its airports.

In deciding whether remedies are needed, we would take into account any customer benefits of the market features we had found.

However, I must stress again, we are not there yet and there is still much to be done before we reach and publish our provisional findings in August. If we do find an adverse effect on competition, albeit provisionally, we will publish our consultation paper on possible remedies at, or about, the same time.

Thank you.