

BAA AIRPORTS MARKET INVESTIGATION

Notice of possible remedies under Rule 11 of the *Competition Commission Rules of Procedure*

Introduction

1. On 29 March 2007, the Office of Fair Trading (OFT) referred the supply of airport services by BAA in the UK to the Competition Commission (CC) for investigation. The reference was made under section 131 of the Enterprise Act 2002 (the Act).
2. In its provisional findings published on 20 August 2008, the CC has provisionally found that there are features of the markets for the supply of airport services by BAA, either alone or in combination with each other, that prevent, restrict or distort competition within the relevant markets. Hence, there is a provisional finding of an adverse effect on competition (AEC) within the meaning of section 134(2) of the Act. The provisional findings report identified those features that give rise to the AEC and the detrimental effects on customers that have resulted or may be expected to result from the AEC.
3. Where the CC finds that there is an AEC, it has a duty, under section 134(4) of the Act, to decide whether action should be taken by the CC, or recommended for others, to remedy, mitigate or prevent the AEC and any detrimental effects on customers resulting from it. The CC must also decide what action should be taken and what is to be remedied, mitigated or prevented. In deciding these questions, the CC has a duty to achieve as comprehensive a solution as is reasonable and practicable to the AEC and any detrimental effects, as set out in section 134(6) of the Act.
4. This notice invites comments on the actions that the CC considers might be taken by the CC, or recommended for implementation by others, for the purpose of remedying, mitigating or preventing the AEC concerned or any resulting detrimental effects on customers.

Criteria for consideration of remedies

5. The CC will consider the effectiveness of different possible remedies and their associated relevant costs and benefits and will have regard to the principle of proportionality. Between two remedies that the CC considers equally effective, it will choose that which imposes the least cost or restriction.
6. The CC will also have regard to the effects of any remedial action on any relevant customer benefits within the meaning of section 134(6) of the Act arising from a feature or features of the market giving rise to the AEC. Such benefits must comprise one or more of: lower prices, higher quality or greater choice of goods or services or greater innovation in relation to such goods or services.

Possible remedies on which views are sought

Divestiture

7. Common ownership of the BAA airports is identified in our provisional findings as a feature that may prevent, restrict or distort competition as it prevents rivalry between airports that could potentially compete with one another. We consider that divestiture will be an effective remedy for this feature as it replaces common ownership with separate ownership where each separate owner has incentives to compete to gain the business of customers. We note in our market investigation guidance¹ that a structural measure, such as divestiture, is likely to be advantageous compared with behavioural measures as it will 'address the competition concern directly and will require comparatively little, if any, monitoring or enforcement of compliance'.
8. We first set out some general considerations regarding divestiture before moving on to consider the possibilities for divestiture remedies in respect of the Scottish airports, the London airports and Southampton in turn and to invite views on each. We conclude this section on divestiture remedies by setting out and inviting views on aspects of the divestiture process.

General considerations regarding divestiture

9. To create effective rivalry, divestiture needs to dispose of a viable competitive business to a suitable purchaser through an effective divestiture process. An effective divestiture remedy is therefore based on three critical elements:
 - (a) *Competitive divestiture businesses.* In general, a divestiture remedy is more likely to be effective if the business to be divested comprises a stand-alone competitive business unit rather than a package of assets as this is likely to reduce the risk of inadequate scope of the divestiture and enables the divestiture to be completed with greater speed.
 - (b) *Suitable purchasers.* We consider that suitable purchasers should be independent of the divesting party (in this case BAA) and any related party and should have appropriate expertise and financial resources to operate and develop the divestiture business as an effective competitor. In addition, a suitable purchaser should not itself create further competition concerns as a result of acquisition.
 - (c) *Effective divestiture process.* An effective divestiture process should ensure that divestiture of an appropriate divestiture business to a suitable purchaser takes place within a reasonable time period. It should also ensure that the divestiture business does not degrade prior to divestiture.

Scottish airports

10. We have provisionally concluded that Edinburgh and Glasgow airports could compete with one another and that common ownership results in an AEC. It is currently our view that separate ownership of Edinburgh and Glasgow would effectively address this AEC.
11. In order to inform our decision on the scope of any divestiture, we seek views on:

¹CC3, *Market Investigation References; Competition Commission Guidelines*, paragraph 4.15.

- (a) which of Edinburgh or Glasgow would be the most effective divestiture business, including whether there are likely to be any significant obstacles in achieving divestiture of either to suitable purchasers; and
 - (b) in respect of each airport:
 - (i) what would need to be included in the divestiture business in order to ensure the divestiture of a viable business unit;
 - (ii) whether and what contractual links it may be necessary to preserve between the divested business and the businesses remaining in BAA ownership; and
 - (iii) for how long any such contractual links might be needed following divestiture.
- 12. Aberdeen's comparatively isolated geographical position relative to other centres of population, combined with other general factors that make it unattractive to service a catchment of Aberdeen's size with more than one airport, is a feature adversely affecting competition. We do not see scope for significant potential competitive constraint from either Glasgow or Edinburgh airports on Aberdeen Airport. We therefore currently consider that separating the ownership of Aberdeen from either Glasgow or Edinburgh through divestiture would not be an appropriate remedy and we are not currently minded to consider the divestiture of Aberdeen. We therefore invite views on whether other measures are appropriate to address the AEC at this airport. These might include behavioural undertakings or some degree of regulation as discussed in the 'Changes to regulation' section below.
- 13. We particularly welcome views from Scottish businesses, public bodies and consumers regarding remedial measures for BAA's Scottish airports.

London airports

- 14. We have provisionally concluded that Heathrow, Gatwick and Stansted could compete with one another and that common ownership results in an AEC. It is currently our view that divestiture of two of these airports to achieve separate ownership of each of Heathrow, Gatwick and Stansted would effectively address this AEC.
- 15. In order to inform our decision on the scope of any divestiture, we invite views on:
 - (a) which of Heathrow, Gatwick and Stansted would provide effective divestiture businesses including whether there are likely to be any significant obstacles in achieving divestiture to suitable purchasers. In choosing between divestiture businesses that are equally effective in addressing the AEC, the CC will choose those which impose the least cost or least restriction. On this basis the CC is unlikely to require the divestiture of Heathrow unless divestiture of Gatwick or Stansted is likely to be ineffective or impractical; and
 - (b) in respect of each airport, we are seeking views on:
 - (i) what would need to be included in the divestiture business in order to ensure the divestiture of a viable business unit;
 - (ii) whether and what contractual links it may be necessary to preserve between the divested businesses and the businesses remaining in BAA ownership; and
 - (iii) for how long any such contractual links might be needed following divestiture.

16. We noted in our provisional findings that the potential for competition between Heathrow, Gatwick and Stansted is likely to be constrained, at least in the short term, by limitations on capacity. We also noted that Heathrow's position as the only significant hub airport in the South-East and indeed the UK is itself a feature that may restrict competition between airports. It is therefore currently our view that divestiture of the London airports will need to be accompanied by continuing regulation. This is considered in the following section on 'Changes to regulation'.

Southampton Airport

17. We have provisionally concluded that the common ownership of Heathrow, Gatwick and Southampton results in an AEC at Southampton. This is shown, in particular, by the lack of responsiveness of BAA to developing Southampton to satisfy the requirements of its airline customers. It is currently our view that if Heathrow or Gatwick were under separate ownership from Southampton, this would effectively address the AEC resulting from their common ownership. We seek views on whether divestiture of Heathrow or Gatwick would be effective in addressing the AEC concerning Southampton.
18. For the avoidance of doubt, it is currently our view that the divestiture of Southampton would not create a significant competitive constraint on Heathrow or Gatwick. We are therefore not considering the possible divestiture of Southampton to address the AEC at Heathrow or Gatwick.

Divestiture process, suitable purchasers and costs

19. In order to provide a timely and effective divestiture process we invite views on the structure of the process. In particular, we welcome views on whether a divestiture trustee should be appointed from the outset of the process to secure effective divestiture within a specified period or whether BAA should be given an initial period in which to achieve effective divestiture, but subject to appointment of a divestiture trustee if BAA appears unlikely to achieve divestiture within the initial period. We also invite views on the appropriate length of periods for achieving divestiture by (1) BAA or (2) a divestiture trustee.
20. We are concerned that any divestiture businesses should not degrade in advance of divestiture or be otherwise altered in such a way as to undermine the effectiveness of the remedy. We therefore consider that we should put in place measures requiring BAA to maintain and hold the divestiture businesses separate from its remaining businesses pending divestiture. Such measures may include the appointment of monitoring trustees and/or hold-separate management. We welcome views on the nature and application of such measures including any involvement needed by the Civil Aviation Authority (CAA).
21. In order to ensure an effective remedy, any divestiture business would need to be sold to purchasers approved as suitable by the CC. We are seeking views on:
 - (a) whether there are any criteria (in addition to those set out in paragraph 9 above) that we should take into account in respect of any or all of these divestiture businesses set out above; and
 - (b) the identity of possible purchasers for any or all of the divestiture businesses set out above and any issues these purchasers may raise in respect of any of the criteria set out above.

22. In considering alternative divestiture options, we welcome views concerning the costs of divestiture. However, we note that in acquiring BAA, the Ferrovial consortium (ADI) took over a business subject to regulation without any commitments from the Government or the CAA regarding the acceptability of continuing common ownership of these airports. ADI also completed the acquisition after the OFT announced a market study of BAA in which continuing common ownership of BAA's regulated airports was flagged as an issue. In deciding to proceed with the acquisition of BAA, ADI took on the regulatory risk of potential divestiture and the CC is therefore not currently minded to place any significant weight on the one-off costs of divestiture of airports in deciding upon appropriate divestiture businesses. We seek views on this issue.

Changes to regulation

23. As we note in our provisional findings, the need for economic regulation results from lack of effective competition in a market. Although we consider that any form of regulation may introduce distortions or constraints, we have provisionally concluded that the current system of regulation of the designated airports (Heathrow, Gatwick and Stansted) is a feature that distorts competition. To address this feature, the CC will seek to develop recommendations on the future framework and process of regulation taking into account responses to this notice and the review of economic regulation of the UK airport system announced by the Secretary of State for Transport.

Scope of regulation

24. The potential for competition between the three BAA London airports is likely to be constrained, at least in the short term, by constraints on capacity even if these airports are in separate ownership. We therefore consider that regulation of Heathrow, Gatwick and Stansted may need to continue following divestiture until capacity is a less significant constraint on competition. In addition, as noted in paragraph 16, we consider that Heathrow's position as the only significant hub airport in the South-East and indeed the UK is itself a feature that may continue to restrict competition between airports and that regulation may therefore continue to be required for Heathrow for a prolonged period.
25. As noted in paragraph 12, Aberdeen Airport does not appear to be subject to any significant potential constraint from other airports and, as noted in our provisional findings, its local market position is a feature which adversely affects competition in its own right. Views are sought regarding the need for and form of measures to address the AEC. These measures may involve behavioural undertakings or, alternatively, some degree of regulation.
26. We welcome views concerning the future scope and duration of regulation required for BAA's airports and the means of changing the scope of regulation.

System of regulation

27. Sectoral regulation takes a variety of forms in the UK but most UK sectoral regulators have comprehensive duties including an overriding duty to protect the interests of consumers and an objective to promote competition and have flexible powers to impose licence conditions. They also generally have concurrent competition powers and their determinations are subject to appeal on their merits to a competent body. We currently consider that many of the detriments arising as a result of the existing regulatory system for airports could be addressed, at least in part, by adopting much

of the normal structure and process of regulation employed in other sectors. We consider, on this basis, that the effectiveness of regulation could be improved without becoming, in overall terms, more intrusive. We welcome views on whether there are particular characteristics of the airport industry that should lead to a different framework and process of regulation from that employed in other regulated sectors.

28. In announcing a review of economic regulation of the UK airport system to be conducted by the Department for Transport (DfT), the Secretary of State for Transport said that 'If legislation is required as a result of this work, it would be taken forward in a future legislative session. Therefore we will not make changes to the basis on which the current price caps at Heathrow and Gatwick airports are set. This also applies to the cap which will take effect at Stansted from 1 April 2009.'² Accordingly, the CC proposes to proceed on the basis that the Q5 price cap settlements for Heathrow, Gatwick and Stansted would not be reopened in contemplation of, or following, a divestiture.
29. In considering recommendations for changes in the current regulatory regime we welcome views regarding changes to:
- (a) the objectives of the CAA;
 - (b) the powers of the CAA; and
 - (c) the process of regulation.

The objectives of the CAA

30. Section 39 of the Airports Act 1986 imposes four objectives on the CAA in performing its duties in setting the maximum level of charges that can be imposed on airlines in designated airports, namely:
- (a) to further the reasonable interests of users of airports within the UK (users being defined, in section 82 of the Airports Act, to include airlines, passengers and other users of air transport services at the airport);
 - (b) to promote the efficient, economic and profitable operation of such airports;
 - (c) to encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports; and
 - (d) to impose the minimum restrictions that are consistent with the performance by the CAA of its functions.
31. We discuss the objectives of the CAA in our provisional findings. We currently consider that it is appropriate to continue to include airlines, passengers and other users of airport services in the definition of users to whose interests the CAA must have regard. We note that the CAA does not, at present, have any explicit objective with regard to the financial viability of operators. We consider that the CAA should have an objective to ensure that operators of designated airports can finance the efficient performance of their functions.

²DfT press release, 22 April 2008, which can be found at:
www.dft.gov.uk/press/speechesstatements/statements/stateeconomicregairport.

32. It is important that competition facilitated by divestiture remedies and other market developments is supported by the regulatory framework. We therefore consider that the CAA should have an objective to promote competition in the best interests of airport users.

The powers of the CAA

33. The powers and resources of the CAA need to be sufficient to enable it to perform its duties effectively and the exercise of these powers needs to be subject to appropriate accountability.
34. As discussed in our provisional findings, the CAA, unlike other sectoral regulators, is unable to impose significant obligations on airport operators as conditions of an economic licence. We consider that the ability to impose or remove conditions on licensed airports would give the CAA the flexibility to respond to changing circumstances and to vary the measures applied to airport operators. In common with arrangements in other regulated sectors, it would be appropriate to permit a right of appeal for the airport operator against any proposal to apply or modify licence conditions. This appeal function could be provided by the CC or other competent bodies.
35. In common with practices in other regulated sectors, we consider that licence conditions set by the CAA could address detriments that we have identified by including requirements on airport operators such as standards of service, financial adequacy, ring-fencing and accounting separation, change of control provisions and conditions for revoking the licence and appointing a special administrator.
36. We note in our provisional findings that the CAA has limited formal ability to act between quinquennial reviews. We consider that the CAA should have appropriate powers of review and intervention between quinquennial reviews in order to improve the timeliness and effectiveness of regulatory response.
37. We currently consider that it may be advantageous for the CAA to be granted concurrent competition powers as in the case of other sectoral regulators. This would permit the CAA to place appropriate weight on general (ex post) competition powers, notably the possibility of Competition Act investigations, alongside sector specific (ex ante) measures of economic regulation.

The process of regulation

38. We consider that the current regulatory process in which designated airports are automatically referred to the CC prior to the CAA arriving at its quinquennial determination is cumbersome and blurs responsibility for regulatory outcomes. We concur with Sir Joseph Pilling's strategic review of the CAA which recommended a similar process to that employed in other regulated sectors. This would require the CAA to determine the outcome of the quinquennial review without prior reference to the CC but the CC would consider appeals on the merits of the CAA decisions. We welcome views on the appropriate form of this process and, in particular, whether airlines and other airport users should, individually or collectively, be granted rights of appeal as well as airport operators.
39. Many of the criticisms of the current regulatory process, as discussed in our provisional findings, relate to the planning and agreement of capital investment. Some of these criticisms are inherent in regulatory asset base (RAB) regulation which incentivizes BAA to invest in order to achieve an allowed return rather than

providing what users necessarily want. The introduction of competition through separate ownership may itself provide scope for alternative approaches to regulation at certain airports. Views are sought regarding the alternative approaches to RAB-based regulation and the appropriate circumstances of their use.

40. Within the current RAB regulation regime we consider, as discussed in our provisional findings, that there is greater scope than employed at present for the CAA to facilitate agreement between BAA and the airlines on service, investment and other issues by providing an appropriate framework for consultation and arbitrating within the process where necessary. We consider that airlines will require more adequate information, including airport business plans, provided on a timely basis in order to participate on a constructive basis in the consultation. Views are sought on measures that will facilitate consultation and agreement within the regulatory process.

Behavioural remedies pending regulatory change

41. To overcome potential delay due to the likely need for legislation in implementing certain measures of regulatory reform, such as licence conditions, the CC is considering whether to require implementation of such measures through undertakings or orders pending formal amendment to the regulatory framework. Our intention is that such undertakings would be cancelled once the requisite legislation was in operation. We consider that such measures may need to apply to Aberdeen as well as to the London airports. We welcome views on appropriate measures to be included in such interim action and the implementation of this approach.

Recommendations on government policy

42. We consider, in our provisional findings, that limited airport capacity in the South-East of England constrains competition, at least in the short term, and appears to result from the features of planning restrictions, government policy and BAA's approach to the planning system conditioned by its common ownership of the major London airports.
43. We would expect that introducing separate ownership through divestiture would provide significant incentives for owners of the London airports to pursue a more proactive and less sequential approach to capacity expansion and investment. The Government has already taken steps to reform the planning system, with particular regard to major infrastructure projects, to improve the speed, access and transparency of the planning process. We therefore make no recommendation in respect of the planning system.
44. We consider that the 2003 White Paper has provided a policy framework for planning airport expansion projects that is widely regarded as being necessary and useful to facilitate and encourage airport investment. However, by setting out the preferred location, order and timing of major airport developments in the South-East, the White Paper has the potential to affect competition and certain development prospects adversely. We are therefore minded to recommend that the Government should take the opportunity to review the White Paper in the light of market developments, particularly proposed separate ownership of London airports, and give explicit consideration to the impact of their stated policies on competition between airports. We welcome views on this issue.

Separate development and ownership of airport terminals

45. The possibility of separate ownership and operation of terminal facilities has been raised in the context of the Stansted regulatory inquiry by easyJet. We consider that this is more appropriately dealt with in the context of remedies on this inquiry. The proposal requires that terms of a tender for terminal facilities and other infrastructure should be drawn up by the CAA in consultation with the airport operator, users and other relevant parties. The proposal envisages that the terminal provider would have a fixed-term lease contract with BAA and price-cap regulation would continue to be needed for airport access infrastructure such as runways and common areas.
46. We consider that separate development and ownership of terminals may address some of the detriments we have noted in our provisional findings (such as responsiveness of capital programmes and service levels in part of an airport facility) in certain circumstances. However, such a proposal would need to deal with several issues including:
- (a) *Regulatory involvement.* The proposal requires a large amount of input from the CAA in setting up the tender for the facilities and associated rules of operation and this could artificially bias the market outcomes. Ongoing involvement may also be required regarding the interface between the terminal and the rest of the airport operations.
 - (b) *Potential for exclusionary behaviour.* Safeguards would be needed to ensure that new entrant airlines were not excluded from terminal facilities by incumbent airlines.
 - (c) *Operational interface.* Unlike overseas examples of separate ownership of terminals where core airport infrastructure is generally publicly owned, the proposal would involve a terminal competing with the remaining privately owned and integrated operations and terminals provided by BAA. There is therefore the potential for the operation of the private terminal to be disadvantaged by a number of 'soft biases' by BAA in favour of its own terminal clients.
 - (d) *Operational flexibility.* The separate ownership of the terminal has the potential to increase the complexity and reduce the flexibility of airport operations.
 - (e) *Legal issues.* It appears that the CAA may not have the powers to require BAA to undertake the proposal or regulate the results adequately under the Airports Act.
47. We welcome further views regarding the possible scope, operation and likely effectiveness of separately owned terminal facilities and how these would address the detriments that we have identified in our provisional findings.

Other possible remedies

48. The CC is willing to consider any practical alternatives to the possible remedies outlined above that the parties to the inquiry or other persons would like to propose, which they consider would appropriately address the AEC or resulting detrimental effects identified in the provisional findings.

Relevant customer benefits

49. The CC will also have regard to the effects of any remedial action on any relevant customer benefits within the meaning of section 134(8) of the Act arising from the

feature or features of the market concerned. Such benefits must comprise one or more of: lower prices, higher quality or greater choice of goods or services or greater innovation in relation to such goods or services. To be regarded as relevant customer benefits, the benefits must accrue as a result of the feature or features concerned and should be unlikely to accrue in the absence of the feature or features.

50. The CC welcomes views on the nature, scale and likelihood of any relevant customer benefits within the meaning of the Act. It also welcomes views on the impact of possible remedies on any such benefits.

Next steps

51. A copy of this notice will be posted on the CC website. The parties to this inquiry and any other interested persons are requested to provide any views in writing, including any additional or alternative remedies they wish the CC to consider, by 17 September 2008 (see note below). If necessary, the CC may publish a supplementary notice requesting views on particular issues on remedies that emerge from consultation.

(signed) Christopher Clarke
Group Chairman
20 August 2008

Note: This Notice of possible actions to remedy the AEC and any resulting detrimental effects is given having regard to the CC's provisional findings published on 20 August 2008. The parties to the inquiry or other interested persons have until 17 September 2008 to respond to those provisional findings. In the light of any responses by the parties or by other interested persons, the CC's findings may change and the CC may consider other possible remedies, if appropriate.