

The need for the divestiture of two BAA London airports

Introduction

1. We have found that BAA's common ownership of Heathrow, Gatwick and Stansted is a feature of the market which prevents competition between them. We have noted that the benefits of competition between them would come mainly from competing airports seeking to leapfrog each other through innovation and capacity development. We expect that the process of competition will improve capacity delivery and in so doing will overcome existing capacity constraints and the consequent need for price control regulation at Gatwick and Stansted and that it will deliver customer benefits.
2. In our Remedies Notice, we put forward the view that divestiture of two of the London airports would effectively address the AEC identified, freeing BAA's London airports to compete with one another and creating comparators against which the regulator could benchmark airport performance. We noted that current capacity constraints would limit the intensity of price competition in the period following divestiture and that this implied that price control regulation in some form might need to continue at Gatwick and Stansted until the prospect of capacity expansion had an impact upon competition. In the case of Heathrow, we also noted that its hub status might limit the degree to which it could be constrained by rival airports. This suggested that Heathrow might warrant longer-term regulation.
3. In our Remedies Notice, we stated that, in choosing between divestiture businesses that are equally effective in addressing the AEC, the CC would choose those which imposed the least cost or restriction. On this basis we said, in selecting the two airports to be divested, that we were unlikely to require the divestiture of Heathrow unless divestiture of Gatwick or Stansted was likely to be ineffective or impracticable.
4. Following our Remedies Notice, BAA submitted that our proposal to remedy the AEC associated with common ownership by divesting two of its London airports was not supported by a proper analysis of potential remedies. It argued that it was incumbent upon us to consider whether the divestiture of one airport would be sufficient to address our concerns and, moreover, to assess whether regulatory/behavioural remedies might be an alternative to divestiture (or could be employed in conjunction with a single divestiture).
5. According to BAA, the reasoning set out in our provisional findings¹ should have led us to conclude that the sale of one airport would address the AEC of common ownership. Given BAA's announcement in September 2008 concerning its intention to sell Gatwick, its arguments focused on demonstrating that Gatwick would address the AEC of common ownership and that the continued common ownership of Heathrow and Stansted would not have given rise to an AEC at all, or certainly not one requiring compulsory divestiture of a second airport.² However, BAA also submitted that, as part of the justification for the sale of two airports in the South-East, it was incumbent upon the CC to demonstrate why the sale of Stansted alone would not address the AEC and to consider what the case would be to require the sale of Gatwick in

¹BAA did not accept our reasoning. BAA's comments in its response to the remedies document were based, without prejudice, on the general premise that our AEC finding and the reasons for it were well founded (this did not, however, extend to the competition between Heathrow and Stansted discussed in paragraph 7).

²BAA told us that its intention to sell Gatwick meant that it did not anticipate a future scenario in which Stansted was the only airport that was divested. BAA/CC2008/1268, Alternative Remedies, paragraph 28.

addition to Stansted. BAA argued that, for reasons broadly similar to those it advanced in relation to the sale of Gatwick, the sale of Stansted alone would be equally effective in addressing the AEC related to common ownership. The reasons BAA advanced to demonstrate that the sale of Gatwick on its own would address the AEC are summarized in paragraphs 6 to 9 below.

6. BAA argued that the divestiture of Gatwick would achieve:
 - the anticipated scope for competition between Gatwick and Stansted in off-peak periods;
 - the anticipated scope for competition to attract more passengers per ATM between Heathrow and Gatwick through the adoption of different aeronautical pricing structures;
 - the anticipated incentive for Gatwick to overcome the constraints on expanding runway capacity and the anticipated competitive pressures to provide customer-led timing, delivery and specification of new capacity; and
 - the anticipated regulatory benefits arising from more comparators because it would provide the most appropriate comparator among BAA's airports for both Heathrow and Stansted as well as the anticipated benefits from the introduction of new management strategies.
7. BAA stated that the only benefit that the divestiture of Gatwick would not achieve was that of static³ competition between Heathrow and Stansted once the new runway capacity supported by the White Paper was developed at those two airports. It submitted, however, that there was no basis on which to rely on competition of this nature to justify divestiture. In particular, the company claimed that our provisional findings did not contain any analysis to support a conclusion that new runways at Heathrow and Stansted would give rise to a situation where any airport other than Stansted had material spare runway capacity available.
8. BAA reinforced its argument by drawing attention to reasons why it saw the scope for competition between Heathrow and Stansted to be marginal (or, put another way, that any restriction of competition resulting from common ownership of both airports could not be considered material or certain enough to amount to an AEC).⁴ It submitted that Heathrow and Stansted were poor substitutes for: the majority of airlines serving Heathrow; the majority of transfer passengers that used Heathrow; and a large proportion of non-transfer passengers that used Heathrow. This was because of the differences in Heathrow's location, network and flight frequency. Even if non-transfer passengers did consider Heathrow and Stansted as close or effective substitutes,⁵ BAA argued that there was little that an airport operator could do to influence the choice that such passengers made when choosing between airlines operating out of Heathrow and Stansted; and hence that their behaviour would not discipline airport operators. It also noted that the degree of excess demand at Heathrow was particularly large and that the likelihood of price control regulation being removed was less than at the other airports. This, it argued, implied that there were particularly strong reasons to doubt that there was any scope for static competition between Heathrow and the other airports. It also submitted that what affected dynamic competition at Heathrow were overseas hubs.

³For example, on price and service quality.

⁴[BAA response to the provisional remedies decision](#), paragraphs 1.18a and 2.2.

⁵BAA accepted that some airlines operating out of Heathrow actively compete for non-transfer passengers with airlines operating out of Stansted.

9. BAA also pointed to competitive influences operating on BAA's London airports, which, it suggested, implied that we should carefully consider whether the divestiture of Stansted in addition to Gatwick was necessary. It cited the following competitive constraints: competition from other European hubs in relation to a significant element of Heathrow traffic; competition from Luton and London City; competition from more widely dispersed airports (particularly those providing for LCCs); and airline buyer power.
10. We disagree with BAA's view that the sale of only one of its London airports would remedy the AEC we have identified. In our view, the evidence that we have collected in the course of our inquiry demonstrates that there is material scope for competition between each of BAA's London airports. We consider that the divestiture of only one London airport, regardless of the identity of that airport, would not comprehensively remedy the AEC we have identified because BAA would continue to own two airports that would substantively compete with each other in separate ownership. We do not believe that the outcomes of competition between these pairs of airports could be effectively replicated by behavioural remedies. Therefore in order to enable competition between Heathrow and Gatwick, Heathrow and Stansted and Gatwick and Stansted, it is necessary to divest two airports to two separate owners.
11. In relation to the identity of the two London airports to be divested, we have said that we were unlikely to require the divestiture of Heathrow unless divestiture of either Gatwick or Stansted was likely to be ineffective or impractical. We note in Section 10 that, having weighed the totality of the evidence before us, we do not consider that there is likely to be an obstacle to divesting either Gatwick or Stansted. In the remainder of this appendix we therefore focus our reasoning on the need to divest both Gatwick and Stansted to remedy the AEC associated with common ownership that we have identified. In doing so, we address the relevant points that BAA has made.
12. In January 2009, the Government confirmed its support for the construction of a third runway at Heathrow, but subject to an aggregate limit of 605,000 annual movements, with any increases above that being subject to review in 2020. In our view, this increases the likelihood of the next round of runway capacity increases being realized at Heathrow and Stansted, as envisaged by the White Paper, and hence that continuing common ownership of Heathrow and Stansted will prevent competition between them in the design, cost, timing and allocation of this particular form of capacity.

The framework for assessing the impact of divestitures

13. Prior to setting out our reasons for requiring the divestiture of both Gatwick and Stansted, we set out the analytical framework for assessing whether the divestiture of two airports is required. BAA has argued that we should employ the following framework:
 - (a) establish the impact on competition of the divestiture of one of BAA's London airports;
 - (b) establish whether continued common ownership of the remaining two airports would be a feature giving rise to an AEC and, if it would, whether divestiture would be a proportionate remedy to that AEC; and
 - (c) establish whether regulatory or behavioural remedies would be an effective remedy either in their own right or in combination with the divestiture of one airport.

14. We accept the framework proposed by BAA subject to the following caveat. In applying it, we must allow for the possibility that the impact on competition of the divestiture of one airport (eg Gatwick) may be affected by whether or not a second airport (eg Stansted) is also divested. This is because a second divestiture will change the behaviour of all the London airports with pro-competitive outcomes, not just that of the two airports whose structural link has been severed. For example, by increasing the competitive constraints on both Heathrow and Stansted, the structural separation of Heathrow and Stansted would also increase the competitive constraints faced by an independent Gatwick and therefore how aggressively it competes. In the case of the London airports, this effect is likely to be magnified by its knock-on effect on the need for regulation. If the divestiture of Stansted were to increase rivalry between all the airports (and we believe it would), then this would make it more likely that price control regulation could be removed at Gatwick, increasing the effectiveness of the Gatwick remedy. We take this into account when considering the impact of the divestiture of the second airport.
15. In evaluating whether, following the divestiture of one of BAA's London airports, common ownership of the remaining two airports would have an AEC, we must also recognize that the impact on competition may not be captured solely by the scope for actual or potential substitution between the two airports. For example, in determining whether common ownership of Heathrow and Stansted has an AEC, we also need to evaluate whether these two airports are indirectly exposed to the effects of each other's pricing, quality and/or capacity decisions as a result of Gatwick competing with each of them. If so, this implies that common ownership of Heathrow and Stansted could give rise to additional distortions in behaviour with anti-competitive outcomes.
16. In line with the way in which BAA has presented its arguments, we first explain why we do not think that the divestiture of Gatwick alone would be sufficient to remedy the AEC (or put another way, why continuing common ownership of Heathrow and Stansted would have an AEC).⁶ We then explain why we do not believe that the divestiture of Stansted alone would be sufficient to remedy the AEC identified (or put another way, why common ownership of Heathrow and Gatwick would have an AEC). Finally, we explain why we do not believe that regulatory or behavioural remedies would be an effective remedy either in their own right or in combination with the divestiture of one airport. The costs and benefits of requiring BAA to divest two London airports are considered in detail in Section 10.
17. Our assessment reflects our view that the main benefits from the divestitures of Gatwick and of Stansted will result from the dynamic aspects of competition. As we explain in Section 5, competition is a dynamic process which drives prices and costs down, and increases innovation and productivity so increasing the quality and, more generally, the diversity of choice available to customers. Markets that are competitive generate feedback from customers to firms which, in consequence, direct their resources to customers' priorities. In addition, firms are encouraged to meet the existing and future needs of customers as effectively and efficiently as possible. We consider that there is scope for competition to improve the way in which the London airports deliver capacity in terms of its design, cost-effectiveness, timeliness as well as its allocation to users. There may also be an opportunity for competition to limit distortions relating to the location of capacity. As we explain in paragraph 5.37, we do not believe that regulation will impede the transition towards a competitive market because there is significant scope to modify the system of price controls to facilitate

⁶Under this approach we look first at the effect of a divested Gatwick competing with Heathrow and Stansted. We then compare the effect of there also being competition between Heathrow and a divested Stansted with continued common ownership of those airports.

the emergence of competition. For both divestitures, we therefore focus upon the impact they would have on competition of these kinds.

18. It is important to recognize that whilst the outcomes of competition over capacity development and allocation may not manifest themselves for several years, the benefits to the processes of capacity development and allocation will accrue much sooner as decisions begin to reflect competitive pressures. For example, although decisions about the form and amount of significant additional capacity come into effect in the long term, the decisions themselves may take place in the short term and may be influenced by the pressures of rivalry following divestiture. Similarly, users may experience pricing and quality benefits in advance of capacity roll-out as airports, in anticipation of an increase in capacity, offer competitive contractual terms to attract new airlines or to prevent the loss of incumbent airlines.
19. We also believe that competition would in any case deliver quality and modest pricing benefits in the period immediately following divestiture, ie while capacity constraints and price control regulation persist. During this period, the divestitures of Gatwick and Stansted would also enable regulators to undertake comparative competition and in so doing to improve regulatory settlements and to spread best practice.

Why the divestiture of Stansted is required in addition to the divestiture of Gatwick

20. The divestiture of Gatwick would:
 - (a) sever the structural link between Gatwick and Stansted introducing competition between the two airports; and
 - (b) sever the structural link between Gatwick and Heathrow removing the distortions in behaviour resulting from common ownership of these two airports.

However, unless the divestiture of Gatwick was coupled with the divestiture of Stansted, Heathrow and Stansted would remain under common ownership, precluding competition between them. In paragraphs 21 to 34 below, we outline the benefits we would expect to result from the divestiture of Gatwick alone, and in paragraphs 35 to 53 we explain why continuing common ownership of Heathrow and Stansted would have an AEC.

21. We note in Section 3 that there is a significant degree of substitutability between Gatwick and Stansted. The results of our quantitative analysis, which largely relate to passenger behaviour, are summarized in Table 1 and demonstrate that Gatwick is the closest substitute for Stansted and that Stansted is the second-closest substitute for Gatwick, after Heathrow. In relation to airline behaviour, one airline told us that although its Gatwick route network (which was operated by non-based aircraft) might be moved, the most realistic substitutes were all BAA-owned airports. Another airline told us that, should slots become available at the other London airports, it would be possible to move some aircraft out of Stansted, although there remained a significant local catchment area for each airport. BAA's own analysis showed two examples of airlines switching routes from Stansted to Gatwick and it suggested that this might have been to achieve a higher fare.

TABLE 1 **Substitutability of Stansted for Gatwick, and Gatwick for Stansted**

<i>Extent to which Stansted is a substitute for Gatwick</i>	
Catchment analysis: % of Gatwick's total passengers [% of passengers travelling to common destinations] from Stansted's catchment at 20% threshold*	27% [27%]
CAA survey: % of Gatwick respondents saying Stansted was first choice if flights available from all airports (ranking of all airports apart from Gatwick)	4% (2 nd after Heathrow)
CAA survey: % of Gatwick respondents saying Stansted was first or second choice if flights available from all airports (ranking of all airports apart from Gatwick)	16% (2 nd after Heathrow)
BAA survey: % of Gatwick respondents saying best alternative airport was Stansted (ranking of all airports apart from Gatwick)	14% (2 nd)
Airport competitor analysis: score† out of 100 (ranking excluding Gatwick)	9 (2 nd)
<i>Extent to which Gatwick is a substitute for Stansted</i>	
Catchment analysis: % of Stansted's total passengers [% of passengers travelling to common destinations] from Gatwick's catchment at 20% threshold*	53% [44%]
CAA survey: % of Stansted respondents saying Gatwick was first choice if flights available from all airports (ranking of all airports apart from Stansted)	12% (2 nd after Heathrow)
CAA survey: % of Stansted respondents saying Gatwick was first or second choice if flights available from all airports (ranking of all airports apart from Stansted)	35% (1 st)
BAA survey: % of Stansted respondents saying Gatwick best alternative airport (ranking of all airports apart from Stansted)	26% (1 st)
Airport competitor analysis: score† out of 100 (ranking excluding Stansted)	27 (1 st)

Source: CAA, BAA, CC analysis.

*The figure provides an illustration of the results of the inter-airport exposure analysis which are set out in full in Section 3 and Appendix 3.5.

†The score is a summary measure of the extent to which airlines considered that their close route-by-route competitors were located at the airport specified (higher score indicates closer competitor). See Appendix 3.5, Annex 2.

22. We also note in Section 3 that there is a significant degree of substitutability between Gatwick and Heathrow. The results of our quantitative analysis in relation to Heathrow–Gatwick substitutability are summarized in Table 2 below and demonstrate that Heathrow is the closest substitute for Gatwick; and that Gatwick is the closest substitute for Heathrow’s non-transfer passengers (these currently make up two-thirds of all passengers). The evidence also suggested that, in the right circumstances, some point-to-point routes might be switched from Gatwick to Heathrow, and to a lesser extent from Heathrow to Gatwick.

TABLE 2 **Substitutability of Heathrow for Gatwick, and Gatwick for Heathrow**

<i>Extent to which Heathrow is a substitute for Gatwick</i>	
Catchment analysis: % of Gatwick's total passengers [% of passengers travelling to common destinations] from Heathrow's catchment at 20% threshold*	81% [50%]
CAA survey: % of Gatwick respondents saying Heathrow was first choice if flights available from all airports (ranking of all airports apart from Gatwick)	21% (1 st)
CAA survey: % of Gatwick respondents saying Heathrow was first or second choice if flights available from all airports (ranking of all airports apart from Gatwick)	51% (1 st)
BAA survey: % of Gatwick respondents saying best alternative airport was Heathrow (ranking of all airports apart from Gatwick)	33% (1 st)
Airport competitor analysis: score† out of 100 (ranking excluding Gatwick)	22 (1 st)
<i>Extent to which Gatwick is a substitute for Heathrow</i>	
Catchment analysis: % of Heathrow's total passengers [% of passengers travelling to common destinations] from Gatwick's catchment at 20% threshold*	64% [63%]
CAA survey: % of Heathrow respondents saying Gatwick was first choice if flights available from all airports (ranking of all airports apart from Heathrow)	11% (1 st)
CAA survey: % of Heathrow respondents saying Gatwick was first or second choice if flights available from all airports (ranking of all airports apart from Heathrow)	50% (1 st)
BAA survey: % of Heathrow respondents saying Gatwick best alternative airport (ranking of all airports apart from Heathrow)	36% (1 st)
Airport competitor analysis: score† out of 100 (ranking excluding Heathrow)	13 (1 st)

Source: CAA, BAA, CC analysis.

*The figure provides an illustration of the results of the inter-airport exposure analysis which are set out in full in Section 3 and Appendix 3.5.

†The score is a summary measure of the extent to which airlines considered that their close route-by-route competitors were located at the airport specified (higher score indicates closer competitor). See Appendix 3.5, Annex 2.

23. Taken together, the substitutability evidence indicates that in the absence of common ownership, or any other restrictions on competition, Gatwick would be competing intensely with both Heathrow and Stansted for users. However, as we explain in Section 4, Heathrow has excess demand for runway slots at all hours of the day, Gatwick has experienced excess demand through much of the day in summer, and at Stansted, demand has been at or very close to capacity at peak times of the day in summer (though Stansted demand has been declining for two years and initial indications for summer 2009 are that some runway capacity will be available throughout the day). This will naturally limit the extent of competition during the period when capacity constraints persist,⁷ as there are limited benefits from reducing prices to attract additional traffic when capacity is constrained. So long as price caps persist at levels the airports can price up to, it will be economic regulation that determines the average level of airport charges.
24. As a result of these constraints, we would expect price competition between Gatwick and Stansted to be modest at first and largely confined to competition to fill spare off-peak capacity.⁸ As we explain in Appendix 5.1, to the extent that competition between Gatwick and Stansted to fill off-peak capacity results in lower published off-peak charges, this seems likely to result in higher peak charges to restore average revenue per passenger to price-capped levels. However, such competition may result

⁷It will take time for existing capacity constraints to be relaxed: our latest estimates indicate that the earliest date that a new runway might be delivered at any of the London airports is 2017. However, relaxation of price control regulation may occur sooner if the prospect of runway developments influence pricing in advance of capacity roll-out.

⁸As noted in Section 4, both Gatwick and Stansted have spare off-peak runway capacity and both airports may be able to handle higher volumes of passenger throughput, even in peak hours of the day: Stansted currently processes around 23 mppa and has the capacity to handle 35 mppa, and Gatwick, which has capacity for 40–45 mppa, currently handles 35 mppa.

in a different distribution of off-peak vs peak charges and higher capacity utilization. Beyond this, competition between Gatwick and Stansted to fill spare off-peak capacity at each airport may enable airlines to secure more generous unpublished discounts. Since such unpublished discounts cannot be offset by an increase in peak prices whilst remaining within the limit of the price cap, this could lead to lower average prices at both airports and better runway utilization.

25. During this period, the divestiture of Gatwick might also result in modest price competition between Heathrow and Gatwick. The fact that Heathrow has excess demand for runway slots at all hours of the day implies that competition between Gatwick and Heathrow would not generate enhanced incentives to compete to fill spare capacity.⁹ However, as we explain in Appendix 5.1, the divestiture of Gatwick may enhance Heathrow's incentives to lower passenger charges (which would be offset by an increase in landing charges). This is because the impact on Gatwick would no longer be factored in to the profitability of doing so. If airlines are willing and able to react to these tariff changes, this could lead to lower passenger fares and increased runway utilization in terms of passengers per ATM.¹⁰ We may also observe a similar effect at Gatwick as a result of the divestiture.¹¹ Compared with Heathrow, Gatwick has fewer slots subject to excess demand and higher load factors, suggesting less scope for competition in this way. However, there is a higher proportion of small aircraft operating slots, which suggests more scope for this kind of competition.
26. It is difficult to identify all the other ways in which airports which have never competed before will compete. Nevertheless it seems likely that the operator of Gatwick would compete with both Stansted and Heathrow in this period to retain or win particularly valuable users such as airlines which convey higher numbers of passengers per ATM or passengers that contribute proportionately more to retail revenues.¹² This could take the form of tariff discounts or airline-specific improvements to quality. There may also be scope for separate ownership to stimulate improvements in the overall quality of service offered, even at price-capped capacity-constrained airports. As we have noted, airlines operating from different BAA London airports compete with each other and we would expect separately-owned airports to be more responsive to airline views than BAA, as a common owner, has been. We consider that good service quality is often a matter of good management and organization rather than the result of spending large amounts of money (this is relevant as even separately-owned price-capped airports do not necessarily have the incentives to spend on improving service quality, except to achieve SQR targets). Rivalry in the provision of service quality would supplement the effect of SQR targets, which are inevitably imperfect substitutes for competition. However, this rivalry would not replace SQRs, at least in the short term.
27. We note in Appendix 5.1 that the disincentive that exists under the current regulatory regime to compete to attract additional or commercially important users¹³ could be weaker at Gatwick and Stansted under separate ownership if there was an expectation that price control regulation would be relaxed. We have also noted that the effect

⁹Because Heathrow is unlikely to drop prices while excess demand persists, and Gatwick would have to reduce prices by an extremely large amount to have any effect on Heathrow's profitability.

¹⁰Although following the construction of T5, there should be significant spare terminal capacity, the redevelopment of the Central Terminal Area over the next few years may result in some terminal capacity constraints. However, these constraints have not yet proved to be an insurmountable barrier to entry for airlines.

¹¹Because it no longer factors into the profitability of this the impact upon Heathrow and Stansted.

¹²An airport operator would be reluctant to lose a particularly high-value user even if this would free up a slot that was subject to excess demand because the replacement user would be unlikely to generate the same level of revenues.

¹³Under the current regulatory system, short-term incentives to compete would become weaker towards the end of the quinquennium because the benefits of attracting additional passengers/valuable users disappear at the beginning of the next quinquennial review period.

of recession on airline traffic along with planning approval for the SG1 developments at Stansted means that there will be more spare capacity in the south-east airports than we anticipated at the time of our provisional findings. As spare capacity at Gatwick and Stansted increases, so do the incentives for the two airports to compete under separate ownership.

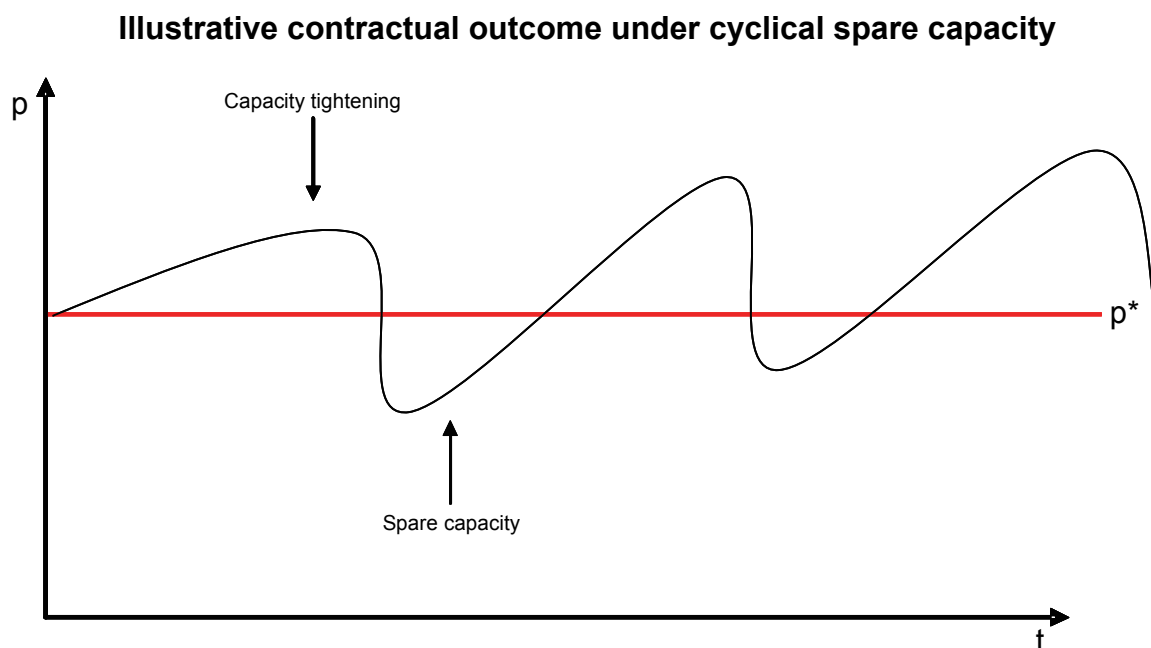
28. We also believe that the divestiture of Gatwick would enhance the ability of regulators to benchmark performance across airports and diffuse best practice. We discuss the role of inter-company comparisons in paragraphs 6.63 to 6.81 and conclude that common ownership reduces the quality of regulation by limiting the ability of the regulator to make cost and quality comparisons between independently-owned airports. As long as Gatwick remains under a full regime of economic regulation (that is, Tier 1 under the DfT's consultation proposals for reform of regulation), we consider that divestiture of Gatwick would improve regulation, in particular through different regulated management teams taking different approaches and revealing new information to the regulator—leading, for example, to gains from the identification and diffusion of best practice and more innovative activity. While other independently-managed airports are available as comparators, their value to the regulator is lower as they are not required to provide detailed information to the regulator. Furthermore, the circumstances of Gatwick are such that it is likely to be a particularly good comparator for both Heathrow and Stansted as it is subject to similar, if not always identical, regulation, labour market forces, noise, pollution and planning constraints. Gatwick and Heathrow are also similar in having a very high degree of runway utilization. We accept, however, that the value to the regulator of Gatwick as a comparator would become less when Gatwick ceases to be subject to the full regime of economic regulation.
29. Rivalry between Gatwick and both Heathrow and Stansted for users will also provide dynamic benefits. The divestiture of Gatwick would provide Gatwick with additional incentives to press for additional runway capacity and the possibility that it could be successful would provide an additional incentive to the owners of Heathrow and Stansted to secure planning permission and proceed with their own developments. The divestiture of Gatwick would also generate an important competitive constraint on the roll-out and allocation of the new capacity at Heathrow and Stansted. We expand on these points below.
30. As we explain in Section 5, we consider that there is considerable scope for competition between BAA's London airports to improve capacity delivery and in so doing to overcome existing capacity constraints and the consequent need for price control regulation at Gatwick and Stansted and to deliver customer benefits. BAA argued that current government policy as expressed in the White Paper precludes the possibility of competition over capacity delivery, as it dictates where and when airport operators should bring forward new investments. Whilst we accept that the Government has a significant role to play in determining the location of future capacity, the timing of delivery, scale and design of the capacity is not determined by the Government. We therefore see scope for airports to compete which we believe will drive improvements in:
 - (a) the decision-making process relating to the location of capacity;
 - (b) the scale, design and cost of facilities;
 - (c) the speed with which capacity is rolled out; and
 - (d) the terms that airlines obtain when taking up slots.

31. We would expect separate owners to display a greater appetite for runway capacity expansion than BAA has and to negotiate with the Government accordingly for the necessary policy framework to support such development, rather than lobby against it as BAA appears, at times, to have done. This has the potential to improve the decision-making process relating to the location of new runway capacity. In the case of Gatwick, we would expect a separate owner to seek to remove the section 52 agreement, because it will not be factoring the impact on profitability at Stansted and Heathrow into any analysis of the profitability of expansion at Gatwick.
32. For the future, we accept that government policy in relation to the next round of runway capacity expansion has already been developed and therefore that it may be too late for the divestiture of Gatwick to bring any benefits to the decision-making process in relation to the next tranche of runway capacity. Nevertheless, we believe that the divestiture of Gatwick would enhance the delivery of new capacity. This is because:
- (a) Under government policy as set out in the White Paper, a second runway at Gatwick is explicitly supported by the Government if a third runway at Heathrow cannot be built for environmental reasons. This threat gives an incentive to the owner of Heathrow to push forward with its planning application for a third runway as soon as possible.
 - (b) Similarly, if the development of a second runway at Stansted does not proceed, it is implicit in government policy that the operator of Gatwick would be best placed to build one of the two runways supported in the South-East (although it does not currently have explicit government support under this scenario). This threat gives an incentive to the operator of Stansted to pursue its planning application proactively.
 - (c) Even if both Stansted and Heathrow developed one runway each, there would remain the possibility for Gatwick to persuade the Government to support a second runway at Gatwick after 2019. The development of an aviation NPS would provide an opportunity to do so.
33. In the event of Gatwick itself not participating in the competition to roll out capacity, we still envisage that the divestiture of Gatwick would have a positive influence on the way in which BAA designed, rolled out and allocated new capacity at Heathrow and Stansted. For example, we would expect BAA to be more aggressive in approaching airlines that currently use Gatwick to fill the second runway at Stansted and perhaps even to fill the third runway at Heathrow than it would be if Gatwick remained part of BAA.¹⁴ Similarly, we would expect Gatwick to be more aggressive in retaliating in an effort to prevent the loss of these airlines than if it remained part of BAA. This process of rivalry to win and retain airlines would induce the airport operators to improve their offering in terms of facilities, and perhaps of pricing, to the benefit of airlines and customers.
34. Over time, as demand grows, we would expect spare capacity to diminish until the Government provides for a new round of capacity expansion (with airport operators lobbying for it to do so). As capacity at rival airports tightens, this confers on an airport greater negotiating power. However, an airport will tend to have strong incentives to price low in the immediate aftermath of a new capacity development (giving the airlines negotiating power). As competition develops, negotiating power may ebb and flow between airport and airlines, as capacity at rival airports tightens followed by

¹⁴Even with excess demand, Heathrow might try and poach high-value traffic from Gatwick.

new capacity coming on stream. The south-east airports might move towards the model we observe at regional airports whereby airports and airlines enter into long-term contracts. In this way, airlines and airports would trade off the differences in their negotiating strength and commercial positions to arrive at an overall arrangement which mitigates the negotiating power an airport can exercise. For example, they may be able to contract for a constant price over time (shown as p^* in Figure 1), rather than face the more volatile fluctuations in prices that the airport would charge if prices reflected the amount of spare capacity that was available at rival airports (see Figure 1).

FIGURE 1



Source: CAA original figure amended by CC.

35. We now turn to the question of whether, following the divestiture of Gatwick, the continuing ownership of Heathrow and Stansted by BAA would constitute an AEC. In doing so, we consider the impact of common ownership of Heathrow and Stansted on incentives to compete in the period during which capacity constraints and price control regulation still apply, on capacity development and on comparative competition.
36. BAA has argued that its ownership of Heathrow and Stansted is not a feature that amounts to an AEC because the scope for competition between the two airports is marginal and uncertain. There are two strands to BAA's argument that the scope for competition between the two airports is marginal: the first relates to substitutability whilst the second relates to the persistence of excess demand at Heathrow. (We turn to BAA's arguments in relation to uncertainty in paragraph 49 below.)
37. In relation to substitutability, BAA said in its response to our Remedies Notice that there was limited substitutability between Heathrow and Stansted airports because the majority of airlines and passengers would not consider them to be close or effective substitutes. It stated that:
 - (a) the majority of airlines serving Heathrow would not consider the other London airports to be close or effective substitutes, or even alternatives at all given Heathrow's unrivalled network of long-haul and short-haul connections;

- (b) the vast majority of Heathrow's transfer passengers would not consider Gatwick or Stansted as close or effective substitutes, or even alternatives for Heathrow at all; and
- (c) a large proportion of non-transfer passengers using Heathrow would not consider the other London airports to be close or effective substitutes given the significant differences in location, network coverage and frequency between these airports.
38. Although BAA accepts that some airlines operating out of Heathrow do actively compete for non-transfer passengers with airlines operating out of Stansted,¹⁵ it does not accept that the behaviour of non-transfer passengers would be capable of influencing the behaviour of the two airports, given that airlines would not substitute between them.¹⁶ This is because, whilst airlines can influence the choices passengers make with respect to which airport they fly from or to, BAA claimed that airports could not:
- But there is very little that an airport can do to influence that choice [of airport]. There is everything an airline can do to influence that choice and airlines do compete fiercely, visibly, for O&D, origin and destination, traffic evidently. But the influence of an airport is very small, and that is true if it is owned by a common owner or separate owners. There is simply nothing that Stansted can do to offset the network benefits that British Airways and other network airlines generate in Heathrow.
39. Second, according to BAA, continuing and significant excess demand at Heathrow would in any case preclude any material scope for competition between Heathrow and Stansted. BAA claimed that, even with a second runway at Stansted and a third runway at Heathrow, its forecasts showed that new runway capacity would be quickly taken up, and any period of excess capacity over demand would be short-lived.
40. In our view, the evidence does not support BAA's view on substitutability nor do we accept BAA's view that excess demand at Heathrow would preclude competition. On substitution by airlines, we agree that it is very difficult for airlines to switch existing services from Heathrow to other airports (see paragraph 3.117) and vice versa. However, on substitution by passengers, the survey results and analysis we have collated (summarized in Table 3 below) indicates that many non-transfer passengers view Heathrow and Stansted as substitutes. In particular, the catchment analysis, the competitor analysis and the survey data that was collected by BAA and the CAA indicates that for this group of passengers, Heathrow is the second-closest substitute to Stansted (after Gatwick) and Stansted is the second-closest substitute to Heathrow (after Gatwick).

¹⁵When asked whether it was his view that airlines at Heathrow do not compete with airlines at Stansted, even for non-transfer passengers, BAA's Chief Executive told us:

No, definitely not. If I purchase a ticket from London to Geneva, for instance, which is a destination served by several London places, then I definitely look at the prices and quite categorically, on chart whichever it was in my presentation, the top purchase criteria is price. Therefore, evidently, via whatever mechanism, web or whatever, passengers are comparing the price on the ticket from London to Geneva from, say, easyJet and British Airways. So, clearly, those two very different economic models which I described—one which is maximising asset utilisation, the other which is maximising network effects—they do compete for passengers. Those two economic models have been fighting, as it were, competing with each other, since the invention of the low cost model.

¹⁶In its response to the provisional remedies decision, BAA stated that:

Heathrow is a hub airport, and its airlines have business models that place significant value on the connectivity with other services that only Heathrow can provide. Airlines operating at Heathrow are therefore highly unlikely to regard Stansted as an effective substitute. Stansted serves point to point demand and its airlines have business models that place almost no value on connectivity, but instead attach significant value to the airport's ability to support quick aircraft turnarounds and low airport charges. Airlines operating at Stansted are therefore highly unlikely to regard Heathrow as an effective substitute. [Annex 1, A1.11.]

TABLE 3 **Substitutability of Heathrow for Stansted, and Stansted for Heathrow**

<i>Extent to which Heathrow is a substitute for Stansted</i>	
Catchment analysis: % of Stansted's total passengers [% of passengers travelling to common destinations] from Heathrow's catchment at 20% threshold*	73% [38%]
CAA survey: % of Stansted respondents saying Heathrow was first choice if flights available from all airports (ranking of all airports apart from Stansted)	13% (1 st)
CAA survey: % of Stansted respondents saying Heathrow was first or second choice if flights available from all airports (ranking of all airports apart from Stansted)	30% (2 nd after Gatwick)
BAA survey: % of Stansted respondents saying best alternative airport was Heathrow (ranking of all airports apart from Stansted)	17% (2 nd after Gatwick)
Airport competitor analysis: score† out of 100 (ranking excluding Stansted)	25 (2 nd after Gatwick)
<i>Extent to which Stansted is a substitute for Heathrow</i>	
Catchment analysis: % of Heathrow 's total passengers [% of passengers travelling to common destinations] from Stansted's catchment at 20% threshold*	24% [19%]
CAA survey: % of Heathrow respondents saying Stansted was first choice if flights available from all airports (ranking of all airports apart from Heathrow)	5% (2 nd after Gatwick)
CAA survey: % of Heathrow respondents saying Stansted was first or second choice if flights available from all airports (ranking of all airports apart from Heathrow)	12% (3 rd after Gatwick and Luton)
BAA survey: % of Heathrow respondents saying Stansted best alternative airport (ranking of all airports apart from Heathrow)	11% (2 nd after Gatwick)
Airport competitor analysis: score† out of 100 (ranking excluding Heathrow)	10 (2 nd after Gatwick)

Source: CAA, BAA, CC analysis.

*The figure provides an illustration of the results of the inter-airport exposure analysis which are set out in full in Section 3 and Appendix 3.5.

†The score is a summary measure of the extent to which airlines considered that their close route-by-route competitors were located at the airport specified (higher score indicates closer competitor). See Appendix 3.5, Annex 2.

41. Evidence from BA corroborates this view. It told us that competition from LCCs at Stansted has affected the profitability of a number of the short-haul routes that it operated from Heathrow, leading in one case to BA switching the route to Gatwick and ultimately discontinuing it.¹⁷ These sources of evidence are likely to underestimate the degree of substitutability we would observe under separate ownership in the future because BAA will have faced incentives to minimize competition between its airports and because it does not reflect how the airports will be operated once new runways are developed.
42. In contrast to BAA, we believe that substitution by non-transfer passengers would influence the decisions taken by the operators of Heathrow and Stansted. Most passengers using Heathrow and Stansted are non-transfer (ie flying point to point): at Heathrow, the figure is approximately two-thirds and at Stansted approximately 90 per cent. Although non-transfer and transfer passengers are distinct user groups, they travel on the same flights and both play a role in supporting the route network. If an airport has strong local (non-transfer) demand it can offer a wide range of destin-

¹⁷BA gave us a number of examples of competition at Stansted affecting its services from Heathrow. In one case, entry at Stansted by an LCC increased the overall market size of a particular route, but also increased price competition at Heathrow, with a reduction in yield of about one-third in economy class. BA moved its services to Gatwick, and then discontinued the route. Loss of passengers as a result of growing competition from LCCs at both Luton and Stansted more generally caused BA to change the commercial proposition for short-haul services, as a result of which it competed more effectively with the LCC sector.

ations and a high level of frequency, which in turn attracts transfer passengers. The presence of transfer passengers enables the airport to offer an even wider range of destinations and a higher level of frequency to non-transfer passengers. In other words, there are important complementarities between the two sources of demand that reinforce each other. The implication of this is that the effect of failing to retain local (non-transfer) passengers goes beyond the effect on that route: it can have an impact upon the viability of other flights in the network (eg long-haul). Conversely, increasing local demand could improve the profitability of other routes in the network.

43. Second, we do not accept BAA's view that airport operators cannot influence the choices that this group make. As we set out in Section 3, airport charges are a cost to airlines and therefore affect the fares paid by passengers.¹⁸ BAA itself accepts that airlines at Stansted attach significant value to low airport charges, presumably so that they can continue to offer the fares that enable them to compete for passengers with airlines at Heathrow and Gatwick. In addition, the quality and range of services provided by the airport affects both airline costs, and therefore fares, and potentially the quality of service that airlines can offer to their passengers. If an increase in airport charges results in airlines increasing fares, it is likely to cause some passengers to switch to other airports, to other methods of transport or not to travel at all. Passenger switching may also be caused by a reduction in service quality as a result of under-investment by the airport. We therefore believe that switching by non-transfer passengers between Heathrow and Stansted would influence their decisions in relation to the long-term development of their business.
44. Given that Heathrow is the closest substitute to Gatwick and that Gatwick is the closest substitute to Stansted, it seems likely that anything which induces switching from Gatwick to Heathrow will also have a knock-on effect on Stansted. In other words, even if there were no direct substitutability between Heathrow and Stansted, which we would dispute, user substitutability between Heathrow and Gatwick and between Gatwick and Stansted would, in principle, expose Heathrow and Stansted to each other's decisions in relation to capacity, price and service quality.
45. We also disagree with BAA's second point that excess demand at Heathrow precludes competition between Heathrow and Stansted from producing pro-competitive outcomes. The presence of excess demand does not preclude Heathrow from increasing service quality or restructuring prices (in the ways described in paragraphs 25 and 26) so that it could improve on its passenger number forecasts. We consider that Heathrow would have a stronger incentive to undertake this behaviour if Stansted were divested in addition to Gatwick. For example, the divestiture of Stansted may enhance Heathrow's incentives to lower passenger charges (which would be offset with an increase in landing charges) because the impact on Stansted would no longer be factored in to the profitability of doing so. Stansted would also be expected to compete with Heathrow to retain valuable users such as passengers that contribute proportionately more than others to retail revenues. Competition between Heathrow and Stansted may also deliver enhanced service quality outcomes.
46. BAA's view also ignores the dynamic element of rivalry and the anti-competitive distortions that common ownership would give rise to in this respect. This element is highly relevant given that only Stansted and Heathrow have government support for new runways. Specifically, in adopting this view BAA overlooks the constraint Heathrow could provide on Stansted (which is not currently nor expected to be

¹⁸Stansted's 2009/10 maximum airport charge of £6.53 represents about 14 per cent of the average short-haul fare to/from Stansted, while Gatwick's maximum airport charge of £7.38 represents about 11 per cent of the average short-haul fare to/from Gatwick, and Heathrow's maximum airport charge of £14.56 represents about 12 per cent of the average short-haul fare to/from Heathrow (average fares based on 2006 data from CAA survey adjusted for the increase in APD in February 2007).

subject to excess demand going forward). Our substitutability analysis indicates that competitive initiatives at Heathrow such as capacity expansions and/or improvements in service quality would have an effect upon passenger numbers, airline performance and ultimately airport performance at Stansted. This view is supported by BAA's own modelling which demonstrates that passenger numbers and profitability at Stansted would be reduced¹⁹ by prospective capacity expansion (mixed mode and a third runway) at Heathrow.²⁰ We would therefore expect Heathrow to have a greater incentive to expand capacity and invest in productive capital if Stansted were divested in addition to Gatwick.

47. In addition, BAA's view also overlooks the possibility that eventually, competition from Stansted on short-haul feeder flights, vital to the profitability of long-haul services, could over time erode Heathrow's position as a hub. This prospect provides a strategic incentive to Heathrow to offer better conditions (either in terms of price or service) to its passengers and airline customers in order to protect the profitability of such services.
48. Therefore, although Heathrow currently has substantial market power, there is also potential for competition between Heathrow and Stansted. We would expect the divestiture of Stansted to generate additional rivalry between Heathrow and Stansted which would manifest itself in improvements in the scale, cost and design of facilities, the speed with which capacity is rolled out, the terms that airlines obtain when taking up slots and the decision-making process relating to the location of further tranches of capacity. As noted in paragraph 5.34, users might experience pricing and quality benefits in advance of capacity roll-out if an expanding airport enters into long-term contracts to reduce volume uncertainty post-expansion (airlines might obtain lower prices in the short term in exchange for long-term volume commitments) or if a non-expanding airport seeks to pre-empt the loss of incumbent airlines.
49. BAA has suggested that the scope for competition between Heathrow and Stansted was uncertain and contingent on the relaxation of regulation at Stansted and/or Heathrow. Whilst we accept that the precise outcome of competition is uncertain, the evidence enables us to reach a clear expectation that competition will develop. Moreover, whilst we consider that regulation and certain aspects of government policy distort competition, we do not agree that the development of competition is contingent on changes to regulation or government policy. Current government policy generates scope for competition over the timing, design, delivery and allocation of new capacity between Heathrow, Stansted and (to a lesser extent) Gatwick. The relaxation of regulation is itself contingent on the development of competition (rather than the other way around) and is more likely to take place if both Gatwick and Stansted are divested.
50. Moreover, as with Gatwick, we consider that, as long as Stansted continues to be subject to the full regime of economic regulation, its divestiture would improve regulation, in particular through an increase in the number of regulated management teams taking different approaches and revealing new information to the regulator—leading, for example, to greater gains from the identification and diffusion of best practices and more innovative activity. The incremental benefit would be somewhat less than in the case of Gatwick (as the benefit of going from two to three independent comparators is not as great as from going from one to two, and because

¹⁹See paragraph 5.29 for details.

²⁰BAA told us that the fact that demand was higher at Stansted in scenarios where capacity was restricted at Heathrow showed that excess demand for Heathrow would 'spill' around the system: it was not evidence of competition between Heathrow and Stansted. We consider that BAA's decision to model 'spill-over' must reflect a view, however general, that passengers substitute between the airports.

Stansted would seem a less similar comparator for Heathrow than Gatwick), but are still significant in our view. However, as with Gatwick, we accept that the value to the regulator of Stansted as a comparator would become less once Stansted ceases to be subject to the full regime of economic regulation.

51. We therefore believe divestiture of Stansted will inject significant additional rivalry into the market as, in separate ownership, Heathrow and Stansted would impose a constraint on one another which is removed by common ownership. To assert that the divestiture of Stansted would not add any significant rivalry to the market implicitly assumes that competitive pressure from Gatwick, Luton, overseas hubs and other airports will be sufficiently strong to prevent a common owner of Stansted and Heathrow from exploiting any reduction in rivalry resulting from the loss of this competitive constraint. This seems unlikely for a number of reasons. In relation to competition for non-transfer traffic, survey evidence indicates that there is a significant group of passengers which views Heathrow as the closest substitute for Stansted and, to a lesser degree, vice versa. Non-BAA airports in this regard, including Luton and London City, are generally weaker substitutes for both Stansted and Heathrow than the BAA airports. In part, this reflects their size: today Luton and London City's share of London runway capacity (ATMs) is 9 and 10 per cent respectively (though of course London City's share of passengers is much lower). In the foreseeable future it seems unlikely that their shares of runway capacity will increase. Following the building of a third runway at Heathrow and a second runway at Stansted, the DfT forecasts suggest that the runway capacity share of Luton and London City by 2030 would be about 8 per cent and 7 per cent respectively (though as London City can only accommodate small aircraft, its effective share of passenger capacity would be lower). Gatwick, which is a close substitute for both Heathrow and Stansted, is predicted to have a 15 per cent share of London runway capacity while BAA would hold 70 per cent of London runway capacity if it continued to own both Heathrow and Stansted.
52. In relation to competition for transfer-traffic, we have noted in paragraph 3.129 that, although airlines operating from alternative hubs compete with Heathrow airlines for transfer passengers, any constraint imposed by such competition on Heathrow is weak. We do not therefore consider that competition from overseas hubs would be strong enough to remove any benefit from divesting Stansted.
53. It is possible that the divestiture of Gatwick alone may not be sufficient to guarantee the relaxation of regulation. If this is the case, imperfect regulation and its associated detriments will remain which would tend to minimize the dynamic benefits which divestiture of Gatwick will bring (because incentives to bring forward new capacity will depend on regulatory factors as well as competition). Therefore, the divestiture of Stansted, as well as yielding its own benefits in terms of competition with Heathrow, also increases the likelihood that price control regulation can be relaxed at Gatwick and Stansted.

Why the divestiture of Gatwick is required in addition to the divestiture of Stansted

54. For similar reasons, it is our view that the divestiture of Stansted alone would not effectively address the AEC arising from common ownership of BAA's London airports. Just as the divestiture of Gatwick would sever the structural link between Gatwick and Stansted enabling these two airports to compete with one another in the manner described above, so would the divestiture of Stansted: they are equivalent in this regard. The divestiture of Stansted would also sever the structural link between Stansted and Heathrow and in doing so deliver the benefits we describe in para-

graphs 45 to 47 above. However, it would not remedy the adverse effects arising from common ownership of Heathrow and Gatwick.²¹

55. Our substitutability analysis (summarized in Section 3 and in Table 2 and its associated text above) indicated that Heathrow is the closest competitor to Gatwick, and that, for non-transfer passengers, Gatwick is the closest competitor to Heathrow. For similar reasons to those set out in paragraphs 42 and 43, we believe that substitution by these passengers between Heathrow and Gatwick would influence the strategic decisions taken by the airport operators eg in relation to capacity, quality and pricing. The evidence also suggested that airlines might be willing to switch some point-to-point routes between Heathrow and Gatwick.
56. For the reasons set out in paragraph 45, we disagree with BAA's view that excess demand at Heathrow would preclude competition between it and Gatwick since it overlooks the dynamic element of rivalry. First, we would expect Heathrow to face greater incentives to increase service quality or restructure prices so it could outperform its passenger number forecasts if Gatwick were also divested. This would also be expected to have a pro-competitive impact upon the terms offered by Gatwick. Second and more important, as in the case of Stansted we would expect Heathrow to have a greater incentive to expand capacity and invest in productive capital if Gatwick were divested in addition to Stansted.
57. As noted in paragraph 32, under current government policy, a second runway at Gatwick is explicitly supported if a third runway at Heathrow cannot be built for environmental reasons. Similarly, if the development of a second runway at Stansted does not proceed, it is implicit in government policy that the operator of Gatwick would be best placed to build one of the two runways supported in the South-East. The divestiture of Gatwick would provide an additional incentive to the owners of Heathrow and Stansted to secure planning permission. There is also the possibility that, even if both Stansted and Heathrow developed one runway each, Gatwick could negotiate with the Government for a second runway at Gatwick after 2019. The development of an aviation NPS could provide an opportunity to do so.²²
58. We therefore consider that the divestiture of Gatwick, in addition to the divestiture of Stansted, is required to address the AEC we have identified.

The effectiveness of regulatory remedies in remedying the AEC

59. BAA has argued that it is incumbent upon us to consider whether regulatory or behavioural remedies would be an effective remedy, either in their own right or in combination with the divestiture of one airport. In what follows, we set out the remedies that BAA has proposed in this regard and explain why we do not consider that they would, either in isolation or in conjunction with the divestiture of one airport, effectively remedy the AEC resulting from common ownership.
60. BAA has argued that peak pricing could be used as an alternative to divestiture of either Gatwick or Stansted to address the scope it claimed we identified for encouraging greater use of capacity in off-peak periods. This, BAA argued, could be implemented either by way of regulatory requirement or by increasing the incentives for airports to attract airlines to use spare capacity. We disagree. We do not view peak pricing as an end in itself. Nor do we view making maximum use of runway capacity

²¹Nor would the divestiture of Stansted alone remedy the AEC arising from BAA's common ownership of Southampton with Heathrow and Gatwick.

²²See our recommendations to the DfT in paragraphs 10.374 to 10.376.

as a stand-alone objective, particularly if it results in poor service quality. Rather, we view competition over spare runway capacity as a mechanism to deliver benefits to users. As we have set out above, separate ownership could give rise to lower charges for some users and increased utilization if it led to more aggressive discounting targeted at individual airlines because of an improvement in their relative bargaining position. This improvement in airline bargaining position relies on the airlines having a choice of where to operate off-peak flights, which is only possible under separate ownership.

61. BAA has suggested that instead of divestiture, the benefits from rebalancing tariffs could be achieved by ensuring that airports rebalance charges either through a requirement within the regulatory system or by increasing the incentives for airports to accommodate additional passenger growth. Again, we disagree. Currently incentives are being distorted by common ownership (even if the effect is small). We believe that it is more effective to correct the distortion than to provide stronger financial incentives to compensate for the distortion. In relation to BAA's proposed regulatory solution, it seems unreasonable to expect that a regulator should be able effectively to mimic the market by setting the appropriate balance of charges. In contrast, divestiture would effectively address the absence of competition in this regard.
62. BAA has suggested that the benefits we have identified resulting from the proposed divestitures on investment in new capacity could be achieved by a stable regulatory framework that provided increased incentives for airports to invest in such projects. For example, it suggested that the regulator could set returns on incremental outputs delivered by new runways at a higher level than for existing outputs. Alternatively, if this was not fully effective, trigger mechanisms could be introduced to provide greater assurance over the delivery of new capacity.
63. We recognize that, under common ownership, there is a role to play for the regulatory system in encouraging capacity development. However, we consider that it is better to rely on the process of competition between airports to bring forward new capacity rather than on a regulatory system which will always be an imperfect and therefore ineffective mimic of the market. BAA itself recognized in proposing this alternative remedy that it would require the regulator to take a substantive view of the appropriate basis for expansion with user perspectives properly accommodated in this process through enhanced consultation arrangements. We have documented extensively how challenging this process can be and, in cases where competition is unlikely to develop, we recognize that regulation and consultation arrangements have a role to play. But in cases where competition can be expected to generate the levels and configurations of airport expansion that we would expect to observe in a well-functioning market, we consider that divestiture will be a more effective means than enhancing regulation.
64. For all these reasons we do not believe that regulatory or behavioural solutions applied instead of any divestiture, or in conjunction with the divestiture of one London airport, would be effective in replicating the benefits that we foresee competition between all three of BAA's London airports delivering.