

## Competition Commission Issues Adverse Provisional Findings on BAA Airports Market Investigation

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On August 20, 2008, the Competition Commission (“CC”) published the provisional findings report in respect of its investigation into the UK market for the supply of airport services by BAA Limited (“BAA”). The CC has provisionally concluded that significant competition problems exist as a result of varied market characteristics, each of which adversely affects the service received by both passengers and airlines. Given these conclusions, on the same date the CC also published a notice describing a series of potential remedies. These include proposals to require BAA to divest itself of a number of UK airports, possibly including one or both of Gatwick and Stansted airports.

The CC began its investigation of the provision of airport services by BAA in March 2007, and has consulted extensively with and collected substantial evidence from interested parties. While the CC has identified a number of market features that give rise to competition problems, including aspects of the current regulatory and planning systems, the principal cause of concern is the common ownership by BAA of all of the UK’s principal airports. BAA, a successor to the State-owned airports operator, controls seven major UK airports collectively accounting for some 60 per cent of total UK passenger traffic. Through the course of its market investigation, the CC established that competition between airports was possible, and evidence demonstrated that competition occurred in practice among certain regional, non-BAA airports. Such competition has delivered benefits in the form of lower airport service charges and higher quality services. While the CC’s analysis demonstrated that BAA’s neighbouring airports were potential demand substitutes, the CC also found that these airports did not compete meaningfully with one another. The CC concluded that under separate ownership these same airports would compete effectively. Moreover, the absence of effective competition to BAA and between BAA airports had adversely affected airport capacity planning and general airport service standards. In assessing market conditions, the CC was highly critical of BAA’s investments in airports and its long-term capital expenditure programmes, which had resulted in significant capacity shortages at BAA’s London airports.

In light of these issues, the CC has proposed an array of remedies, including that BAA divest itself of multiple UK airports. In south-east England, BAA will likely be

required to sell two Gatwick and Stansted airports. This marks the first occasion on which the CC has seriously contemplated structural remedies in the context of a market investigation case. More generally, the scope and severity of the remedies proposed by the CC has surprised many industry participants and commentators, with the CC, in effect, provisionally recommending the enforced break-up of BAA. That such rigorous and dramatic remedial action is proposed serves to emphasise both the powers available to the CC in the conduct of market investigations, and the willingness of the CC to employ those powers.

Interested parties, including market participants, are invited to submit comments to the CC in relation to its remedy proposals, and more generally in respect of its provisional findings, on or before September 17, 2008. Following receipt and consideration of all such comments, the CC should publish its final report no later than March 28, 2009.

## **I. BACKGROUND TO PROVISIONAL FINDINGS REPORT**

### **A. OFT Market Study And Market Investigation Reference**

In June 2006, the Office of Fair Trading (“OFT”) launched a market study in respect of UK airports. The OFT sought to assess whether the current market structure functioned well and to the benefit of consumers. The market study was initiated following extensive consultation with the sectoral regulator, the Civil Aviation Authority (“CAA”), the UK Government, and following complaints from both airlines and passenger groups concerning BAA’s management of its airport portfolio. In deciding to proceed with a market study, the OFT observed that UK airports are of significant importance to national productivity. The UK’s airports collectively achieved turnover of approximately £2.5 billion (roughly €3.3 billion) in 2005, while in the same period the wider UK aviation industry had turnover of some £13.6 billion (roughly €17 billion). More generally, effective air links are vital to the UK’s continued economic prosperity.

In March 2007, following the conclusion of its market study, the OFT made a market investigation reference to the CC pursuant to section 131 of the Enterprise Act 2002. The OFT may make a market investigation reference to the CC where it has reasonable grounds to suspect that any feature, or combination of features, of a market in the UK for goods or services prevents, restricts, or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK. Once a market investigation reference has been made, it is for the CC to determine whether competition is indeed prevented, restricted or distorted and, if so, what, if any, action should be taken to remedy the adverse effect on competition or consumer welfare.

The provisions of the Competition Act 1998 provide the OFT with means to take direct enforcement action against anti-competitive agreements or abuses of market dominance. Market investigation references are made in differing circumstances, typically to address competition problems arising from uncoordinated parallel conduct by several firms or industry-wide features of a market, in cases where the OFT does not

have reasonable grounds to suspect the existence of anti-competitive agreements or dominance.

**B. Scope Of The CC Market Investigation**

Under the terms of the OFT's reference decision, the CC was required to investigate and consider whether any feature, or combination of features, of the market for the supply of airport services in the UK by BAA prevents, restricts or distorts competition. It is notable that this reference decision was the first issued by the OFT to focus solely on the conduct of a single company within a market, rather than the market as a whole.

BAA is the successor to the State-operated British Airports Authority, which was privatised in 1987. BAA was acquired for a total consideration of £10.1 billion (roughly €2.6 billion) by a consortium led by Grupo Ferrovial SA in July 2006. At present, BAA operates all of the UK's principal airports. BAA owns and operates Heathrow, Gatwick, Stansted and Southampton airports, all of which are based in south-east England. The remaining BAA airports are situated in Scotland, at Edinburgh, Glasgow and Aberdeen. The BAA airports collectively account for over 60 per cent of all passengers using UK airports. More significantly, Heathrow, Gatwick, Stansted and Southampton airports account for approximately 90 per cent of airport passengers in south-east England. Similarly, Edinburgh, Glasgow and Aberdeen airports together account for some 84 per cent of all Scottish airport travellers.

Having regard to the activities of BAA, the CC concluded that a single market exists for the provision of aeronautical services by airports to airlines, their ground-handling agents and their passengers. Other methods of transport are not generally substitutable for air travel and were therefore excluded from investigation. Similarly, the CC declined any narrow segmentation of the aeronautical services market by reference to differing types of airport users, or the unique characteristics of differing airports. The CC instead found that such matters were more appropriately considered as part of its competitive analysis.

Having determined the appropriate analytical frame of reference, the CC determined that its investigation had to address certain key questions raised by the OFT. Principally, the CC had to determine: (1) whether competition currently exists between BAA airports and non-BAA airports; (2) whether there is scope for competition between BAA airports; (3) what constraints presently prevent the development of such competition; and (4) whether any defective aspects of BAA's performance in providing aeronautical services can be attributed to a lack of competition or, conversely, whether BAA's operational conduct has contributed to or otherwise exacerbated the absence of strong competition.

In identifying the primary areas for investigation, the CC also noted that other reviews were being conducted in parallel to its market investigation inquiry. For instance, the Airports Act 1986 requires that the CC provide periodic recommendations

to the CAA as to the maximum airport charges to be levied by BAA on airlines operating at Heathrow, Gatwick and Stansted airports. Recommendations had only recently been issued in relation to pricing at Heathrow and Gatwick airports, while CC advice in relation to pricing policies at Stansted are to be published in October 2008. Similarly, in April 2008, the UK Department of Transport launched a review of airport regulation, with the object of determining whether new legislation was required to reform the current regime, established at the time of BAA's privatisation in 1987. In establishing the ambit of its market investigation, the CC emphasised that its review would be conducted separately, although the CC would take account of relevant findings and conclusions resulting from other inquiries. Equally, the CC also stressed that the scope of its investigation was limited to consideration of competition matters. Accordingly, the CC would not consider non-competition issues, such as the significant environmental issues arising from the operation and development of airports.

## **II. PROVISIONAL FINDINGS**

Having commenced its market investigation in March 2007, the CC has spent the last sixteen months collecting evidence and consulting widely with interested parties, leading to the publication of a series of working papers, including an "Emerging Thinking" paper released in April 2008. On August 20, the CC issued its provisional findings reports, setting out the conclusions it is inclined to reach based on its analysis of the evidence. The CC's principal provisional conclusions are set out below.

### **A. Absence Of Competition Between BAA Airports**

Before assessing the competitive implications of BAA's position on the market, the CC first considered the extent to which competition for airport services is possible and exists. The CC concluded that demand for airport services is derived from and inextricably linked to demand for air transport. In assessing the dynamics of competition in relation to the provision of airport services, the CC first had to consider demand emanating from airline operators and, further downstream, from airline passengers.

The CC observed that one of the most important characteristics of an airport for passengers, and thus airlines, is its location relative to other airports. From a demand perspective, passengers will regard geographically proximate airports as potential substitutes. Although passengers will frequently use the closest available airport, they may switch to a neighbouring airport to take advantage of a greater choice of destinations, more conveniently timed or frequent flights, or lower fares.

While the ability of airlines to switch between neighbouring airports is more restricted owing to the costs associated with establishing new routes and the physical relocation of operations, the CC found that switching costs are not prohibitively high, with airlines able, in theory, to enter into long-term fixed price contracts to protect and recoup airport- and route-specific sunk costs. Moreover, competition between airports has occurred in the recent past, particularly in response to the entry to the market of low cost airline carriers with differing business models and a greater willingness to consider a

wide range of airports. The low cost carriers have frequently made use of available spare capacity at regional airports, and there have been instances of such carriers switching between airports in response to high airport service charges.

Taking into account these factors, the CC declined to define rigid geographic markets for airports, and instead had regard in its competitive assessment to two broad groups of neighbouring airports. First, the CC had regard to Scottish airports, including BAA's Aberdeen, Edinburgh and Glasgow airports. Second, it had regard to airports in south-east England, including BAA's Heathrow, Gatwick and Stansted airports.

Evidence presented to the CC indicated that there was generally scope for neighbouring airports to compete, with competition delivering benefits in the form of lower airport charges and improved quality of service. Focusing solely on the BAA airports, the CC found there was very limited evidence of substitution between these airports by airlines, with available evidence instead indicating that the airports under common ownership by BAA did not compete with one another for airline business.

In Scotland, the CC observed that the catchment areas of Glasgow and Edinburgh airports overlap. A passenger survey indicated that the airports are close demand-substitutes, particularly for leisure passengers. Aberdeen's comparatively isolated geographic position relative to the other Scottish population centres severely limits the scope for competition between Aberdeen and other Scottish airports. Accordingly, the CC had regard primarily to Glasgow and Edinburgh airports. It concluded that BAA's common ownership of the airports had led to each adopting very similar commercial, marketing and pricing strategies. Given the spare capacity existing at BAA's Scottish airports, CC concluded that separate ownership of Glasgow and Edinburgh airports would likely introduce a strong incentive for these airports to compete against each other in terms of price, service level and quality, capital investment and innovation.

In south-east England, the CC found that BAA's London airports face very limited competition from independent regional airports. The evidence collected by the CC demonstrated that the London BAA airports had overlapping catchment areas and were regarded as close potential substitutes by passengers and airlines (with a notable exception existing in relation to transfer customers and airlines offering connecting flight services, with Heathrow the only significant hub airport in the UK offering a range of connecting domestic and international routes). On these bases, the CC reached the provisional conclusion that the three BAA London airport were substitutes for one another, yet under common BAA ownership did not compete to any significant degree. In response, BAA submitted that the scope for material competition was limited in south-east England owing to airport capacity constraints. The CC considered this issue in considerable depth, and sought to understand whether capacity constraints impeded effective competition or were, instead, a product of ineffective competition in the market.

**B. Significance Of Capacity Constraints**

In identifying instances of actual competition between airports, the CC had examined cases where airline switching was possible due to the availability of spare capacity at rival airports, as is the case in Scotland and among certain regional airports in northern England. Significant capacity constraints exist at BAA's London airports, with substantial excess demand existing at all of these airports, most particularly at Heathrow.

In these circumstances, the CC concluded that lack of capacity, particularly runway capacity, diminishes the scope for potential competition between airports, and was, in addition, one of the main reasons for the current poor standards of airport service in London. While acknowledging that both Government airport policies and the broader planning system had contributed to existing capacity constraints, primary responsibility for inadequate airport capacity lay with BAA. The CC concluded that BAA's planning and investment in airport capacity and resources had generally been inadequate and conducted in response to short-term considerations. The absence of an effective long-term infrastructure strategy had contributed materially to the lack of capacity in south-east England. In this circumstance, BAA's common ownership of the principal London airports was a cause of the prevalent capacity problems, and therefore constituted a market feature restricting competition.

In reaching this conclusion, the CC scrutinised carefully BAA's approach to capital expenditure at its airports. The CC found that the BAA airports in south-east England displayed a singular lack of responsiveness to the interests of airlines and passengers. Such inattentive conduct in relation to customers' demands would not be expected from a business competing in a well-functioning market. The CC found that BAA's consultation with the airlines on future airport expenditure was ineffective, and characterised by a stark asymmetry of information that skewed the dialogue overwhelmingly in BAA's favour. BAA selected information for disclosure during consultation programmes, controlled the timing of any such disclosures, and was found to have the ability and incentive to exploit differing requirements of airlines, whether acting individually or in combination. Without attending closely to airline requirements, BAA's capacity planning was not aligned to future demand growth and had proven inadequate, leading to insufficient investment in runway capacity at London airports. Chronic under-investment had diminished the quality of airport services provided to both airlines and passengers, with passengers suffering increased queuing times and a greater likelihood of flight delays.

Considering the need to maintain or improve investment programmes at the London airports, the CC also observed that it was imperative for BAA to negotiate adequate refinancing measures, an activity that had been ongoing during the market investigation. Refinancing had proven difficult given the current conditions of the capital markets, resulting in increased costs of funding. In this regard, the CC raised additional concerns that the funding requirements of all seven BAA airports, accounting for two-thirds of total UK air traffic, relied on a single group parent company, Grupo

Ferrovial SA, which had a highly geared balance sheet. This circumstance exposed the airports to significant financial risk, and possibly further constrained available investment in facilities and services.

Reviewing these varied problems, the CC determined that while capacity shortages limited the degree and intensity of competition between BAA London airports in the short-term, there would be greater scope for competition if these same airports were owned separately. BAA had contributed significantly to current capacity problems, and the CC concluded that separate airport owners would have greater incentive to overcome capacity constraints, invest in additional capacity and airport resources, and thereby compete more intensively in the long-term. On these bases, BAA's common ownership of airports in south-east England was found to impede effective competition.

### **III. PROPOSED REMEDIES**

Having concluded that numerous features of the airport services market gave rise to adverse effects on competition, with the common ownership by BAA of the UK's principal airports the primary cause for concern, the CC is under a statutory duty to consider appropriate remedies. Accordingly, in conjunction with its provisional findings report, the CC published a notice of possible remedies setting out for consultation the remedial actions the CC considers appropriate in this case.

The CC has provisionally identified the common ownership of the BAA airports as a primary feature that precludes effective competition, preventing rivalry between airports that could potentially compete with one another. The CC has therefore proposed the compulsory divestiture by BAA of airports in both Scotland and south-east England. In Scotland, the CC is seeking views as to which of Edinburgh or Glasgow airports would be the most effective divestiture business, with the intention that one of these airports should be sold by BAA. In south-east England, the CC is of the view that Heathrow, Gatwick and Stansted could compete with one another under separate ownership. Accordingly, the CC is of the view that two of these three airports should be divested by BAA. Moreover, the CC has provisionally concluded that the divestment of either Heathrow or Gatwick airports would remedy the adverse effect on competition arising from the common ownership of these airports with Southampton airport (although divestment of Southampton airport would not be sufficient to remedy competition issues affecting Heathrow and Gatwick airports). In addition to seeking views on the appropriate airports for divestment, the CC has also invited comment on the optimal divestiture process and period.

To complement the envisaged divestment programme, the CC is also committed to developing recommendations for the improved future regulation of airports. In particular, the CC is of the view that Heathrow, Gatwick and Stansted all require continued regulation until present capacity constraints are solved. Inviting comment on the appropriate future regulatory framework for UK airports generally, the CC has specifically sought views on the future objectives and powers of the sectoral regulator, the CAA.

All comments on the CC's remedies proposals, and more generally the provisional findings report, are required on or before September 17, 2008. The CC is required to publish its final report no later than March 28, 2009.

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