

Gatwick Airport's comments on the Charles River Associates report to the CAA on two-sided market analysis in the context of the CAA's market power assessments

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Introduction

In December 2013 the CAA published a report that it had commissioned from Charles River Associates (CRA) on two-sided market analysis in the context of the CAA's market power assessments (the Report). We are concerned that this Report has been published at such a late point in the CAA's market power assessment process, without any notification being given to us that the Report had been commissioned, or that it had been delivered, or that it had been published. It is also not clear how the CAA proposes to interpret the findings of the Report or whether it will feature in the CAA's analysis in its Market Power Determination. We have already expressed similar concerns in relation to the York Aviation/ CTAIRA Report for the CAA.

In this paper we provide some initial comments on the Report. Our main observations are as follows.

While the Report provides a valuable analysis of the general issues around how a competition analysis should take account of multi-sided platform markets, it fails to provide sufficient analysis and, most particularly, evidence to reach a reasoned view in respect of airports. In particular, we find the material in the first part of the Report (up to part 2.5) of substantial analytical value. This provides a comprehensive summary of the academic and practical material on multi-sided platforms. There would have been substantial merit in the CAA providing such insight much earlier in the process, for example in advance of its Initial Views consultation in February 2012, or even in advance of its 'minded to' consultations in April 2013. It is unfortunate that this material has been made available to stakeholders only a matter of weeks before the CAA publishes its Market Power Determinations.

We consider that the late publication of this Report could be prejudicial to Gatwick's position, depending on how the CAA treats the material in its Market Power Determination. In particular, we are concerned about the latter part of the Report which appears to assert, without justification, that airports are not multi-sided platform markets and therefore, that the CAA's analytical approach in its 'minded to' consultation is appropriate. We set out our observations on this, and other matters, in more detail below.

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The Report provides a good summary of multi-sided platform market literature and practice

Sections 2.1 to 2.4 (inclusive) of the Report provide a comprehensive summary of the academic and practical material on multi-sided platforms, and add to material previously developed, including a submission from Gatwick to the CAA in August 2010.¹ In doing so, the Report recognises that multi-sided platform markets are a relatively recent phenomenon in the economic literature, with the seminal paper being Rochet and Tirole's 2003 paper "Platform competition in two-sided markets".

These parts of the Report are particularly useful in seeking to provide, in the context of continuing debate around the subject, a clear and concise definition of multi-sided platform markets. The Report provides such a definition in paragraphs 26 and 27, identifying three key conditions, these being:

- There are two distinct groups of consumers;²
- Indirect externalities exist across groups of consumers; and
- The price structure is non-neutral.

This definition, together with the preceding discussion in the Report, leads, in our opinion, to a clear conclusion that airports are multi-sided platform markets as they exhibit all of these conditions – see below. As a consequence, the CAA's market power analytical framework needs to take this fact into account.

The Report asserts airports are not multi-sided platform markets

The Report appears to acknowledge that the first and third of the key conditions above are present at airports, but concludes that there is no evidence to suggest a significant feedback effect at airports, such that there would be indirect externalities across user groups. The Report instead considers the price interactions to be a result only of complementarities, rather than indirect externalities.

We do not understand how the report can properly reach such a conclusion. In our view, it is clear that such indirect externalities exist at airports, in addition to complementarities. For example, if the price of aeronautical services to airlines were to increase, this would reduce demand from airlines, with a resultant loss of routes, frequency and airline variety (and such effects have been clearly observed at Stansted over recent years). This in turn would reduce demand from passengers (whether or not the increase in aeronautical charges was passed through to passengers by the airlines) in response to the resultant reduction in routes, frequency and choice

¹ *Two-sided platforms and airports*, Gatwick Airport, August 2010, <http://www.caa.co.uk/docs/5/ergdocs/Gatwick2SidedPlatforms.pdf>

² Although we note that this is more accurately that "there are **at least** two distinct groups of consumers".

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of airlines that emerge. This in turn, through the multiplier effect, would reduce demand from airlines and so on.

Similarly, if charges by the airport operator to, for example retailers, were to increase, this would reduce demand from retailers reducing the number and variety of retail outlets. This might make the airport less attractive to passengers, some of whom will choose a different airport to travel from instead. This reduction in passengers will reduce the viability of routes to airlines, with resultant service reductions. Again, due to the multiplier effect, this will feed back into passenger demand and so on.

Further, passengers also generally have to pay a surface access cost to access the airport. Many of these costs are not within the control of the airport, such as train fares or local buses. However, the airport does have control over some car park fees (although there are competing non-airport providers of long term-car parks) and charges to parking services providers. If the airport increases its charges for car park fees this will reduce the volume of passengers using this form of access, with some passengers deciding not to use the airport at all (perhaps switching to another substitute airport or deciding not to use air travel at all). This reduction in passengers will have similar impacts as noted above: there will be less demand for retail outlets and less demand from airlines, with the resultant feedback loop due to the multiplier effect.

In considering these issues, the Report tends to focus on the effects of changes in price whereas passenger demand to travel from an airport will also be affected by the range and quality of services offered whether by the airport directly (for example security queues), airlines (route and airline variety) or retailers and other third party providers. The ability of the airport to attract more passengers will depend inter alia on the nature of the airline offering and/or the quality and range of ancillary services – and, once attracted, they provide the base for further development of airline and retail offerings. Indeed, the feedback loop may be even more direct than this with, in particular, long haul flights providing both the potential for further retail development and being difficult to attract in its absence. The airport platform has to co-ordinate the offerings.

A case study

Recent experience at Gatwick shows clearly the presence of indirect network effects, both in terms of impact, but also in terms of the behaviour of the airport management. As the CAA is aware, Gatwick since the change of ownership has put substantial effort into:

- Increasing the diversity of its airlines and routes;
- Growing its passenger numbers and diversifying into different passenger segments, including business passengers;
- Transforming its retail and food & beverage offer in the departure lounges; and
- Making substantial improvements to surface access to the airport, from re-tendering the Gatwick taxi contract through to investing in the rail infrastructure at the airport.

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While an attempt could be made to explain each of these developments in isolation, they are better considered as a co-ordinated approach which takes account of each one on the other(s). The indisputable presence of indirect externalities and associated feedback effects are a key driver in making all of these changes. A particular example is the focus placed by Far East airlines on the retail offer at an airport, as this is an important part of the journey experience for Far East airlines' passengers. These requirements have been an important part of Gatwick's transformation of its retail offer at the airport.

Further light can be thrown on this issue by comparing and contrasting different airports' services. For example, Heathrow airport is considered to have a leading retail and food & beverage offering to passengers, in particular at Terminal 5, with many 'high end' luxury stores. This is no coincidence, given the large numbers of passengers using the airport and the variety of routes and frequency out of Terminal 5. This contrasts with, for example Luton airport, which has many fewer passengers choosing that airport and a much narrower variety of routes, frequency and airlines. Its retail offer is correspondingly narrower and much less attractive.

Conclusion

Given the above, we do not understand how a conclusion can be validly drawn that there are no significant indirect network effects at airports and that pricing interactions can be understood solely on the basis of a consideration of complementarities.

The Report fails to satisfactorily critique the CAA's approach

We consider that the Report would have provided greater insight if it had adequately critiqued the CAA's approach. In particular, the Report provides no view on whether the approach set out in the CAA's Competition Guidelines, which considered airports to be multi-sided platform markets,³ is appropriate or not. Neither does the Report provide a view on whether the CAA's interpretation of network externalities in its 'minded to' consultation, which refers to airline network effects, is in any way relevant to the consideration of indirect network effects that would be present in a multi-sided platform market.

The Report fails to critique the approach of other authorities

The Report highlights three specific cases of previous UK regulatory practice where the issue of multi-sided platform markets has arisen.⁴ However, the Report provides no indication as to whether the approaches adopted by each of the authorities were appropriate or not. In particular, we note that the issues in Aberdeen Journals were considered prior to the introduction of the concept of two-sided markets to the economic literature. If such a case were to be considered today, a different, more appropriate approach could be taken.

³ *Guidance on the assessment of airport market power*, CAA, April 2011, from paragraph 3.20.

⁴ Section 2.4.4: Aberdeen Journals (OFT /CAT, 2003), Classified Directory Advertising Services (CC, 2006), and NCCN 500 (Ofcom, 2008).

The discussion of the CAA's December 2000 consultation and of the Australian Productivity Commission's approach appears nugatory

The Report attempts to illuminate the issue further through a discussion of the CAA's December 2000 consultation on whether to continue with a single till approach to airport regulation, and the Australian Productivity Commission's (APC) 2002 study of airport regulation in Australia. The Report highlights arguments that have been made in support of a single till approach to regulation though these are not necessarily the CAA's or APC's views.⁵

In terms of the arguments reported in the CAA consultation, the Report highlights Argument 3 – that the single till ensures that the price of the airport product is kept to competitive levels – as being inconsistent with the two-sided market view. However, we note that the CAA's 2000 consultation was considering the appropriate form of regulation, not whether an airport is a multi-sided platform market. To use arguments about the form of regulation as evidence as to the multi-sidedness of a market is putting the question the wrong way round. Moreover, the CAA's consultation was prior to the seminal 2003 paper on two-sided markets by Rochet and Tirole, so it is unsurprising that the CAA's consultation did not place its consideration of the form of regulation within the context of a multi-sided platform market.

In terms of the APC study, the Report highlights that the APC identified airport's commercial services as being complementary to an airport's aeronautical services (as the CAA's 2000 consultation did). The Report, correctly states that complementarity alone does not make a market two-sided. However, we note that the APC's consideration of these issues was also prior to the 2003 Rochet and Tirole paper, so again it is unsurprising that the study did not place this within the context of a multi-sided platform market.

The fact that aeronautical and non-aeronautical commercial services are undoubtedly complementary to each other does not mean that indirect network effects do not exist. Indeed, as set out above, it is clear that such indirect network effects are present at airports, and that airports meet all of the key conditions of multi-sided platform markets.

Way forward

It is not clear how the CAA will take the conclusions of the Report into account in its Market Power determinations. However, the Report falls well short of justifying a departure from the CAA's approach in its Competition Guidelines, which is justified by the evidence of the economics of airports and how airports operate in practice. The key issue for the CAA is to ensure that its market power analysis adequately estimates, and takes fully into account, the additional constraints present from the multi-sided nature of airport markets. The CAA's analysis has so far failed to do this.

⁵ We note that both the CAA consultation and the APC study highlight the argument that single till regulation could address market power in relation to non-aeronautical commercial activities. As far as we are aware neither the CAA nor the APC have argued that airports have such market power.