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UK Airport Regulation

Prepare for a rough landing

The UK Civil Aviation Authority (CAA) is in the process of assessing whether the main London airports should be subject to continuing price controls under the new *Civil Aviation Act 2012* (Act). In this *Casenote* we look at how the CAA is applying this new regulatory framework.

The Three Tests

Under the Act the CAA is required to undertake a "market power assessment" to determine where an airport has "substantial market power" (SMP) and to examine whether *ex ante* regulatory intervention is warranted.

More specifically, under s.6 the CAA must satisfy three tests before imposing a licence with terms. Under "Test A" the CAA must determine whether the airport has SMP. This entails defining the relevant product and geographic markets. "Test B" requires the CAA to establish that competition law would not provide a "sufficient" remedy. And, finally, "Test C" requires the CAA to show that its proposed licence intervention generates net benefits to airport users. While other similar regulatory approaches use variants of Tests A and B, Test C is not common.

Test A – Substantial Market Power

The CAA has so far completed several rounds of its provisional market power assessments for Heathrow, Gatwick and Stansted airports. Its *Guidance on the Assessment of Airport Market Power (2011)* makes clear that the standard approach will be used, but that this may be fairly complex when applied to airports. Indeed, the various CAA consultation documents reveal that defining the services supplied by airports, characterising the relevant markets, and identifying the operative competitive constraints are not at all straightforward. Bizarrely in its latest preliminary findings (somewhat idiosyncratically called "minded to" positions), the CAA has swung from an Initial View of a expansive pan-European market in which London's airports operate, to one where they hardly compete with one another. This dramatic volte face is largely unexplained and in sharp conflict with findings of the OFT and Competition Commission.

The CCA's assessments reveal another serious problem – an almost casual approach to the evaluation of the evidence and stakeholders' submissions. The CAA rightly points out that it must exercise its judgement in interpreting the evidence and coming to a conclusion. But while it has a "margin of discretion", its decisions are fully reviewable by the UK Competition Appeal Tribunal (CAT). In particular, when its decisions are appealed, the CAA's factual assessment and analysis must satisfy the standard of proof set by the courts and not some internal procedure. This requires that the CAA "prove" the facts it relies on to a "high" balance of probabilities. In law a fact need not be a certainty, but its existence needs to be (much) more likely than not.

The CAT has been harsh on sectoral regulators who have not taken account of all the available evidence, have failed to test the evidence, and have engaged in poor analysis. This clearly exposes the CAA to a substantial threat. The experience of Ofcom (which is mounting a rear-guard action to abolish or restrict appeals to the CAT) and of the OFT has shown that too often they have failed to satisfy the standard of proof, set out counterfactuals which have in the CAT's judgment ascended the theoretical stratosphere, and revealed "confirmation bias".

The CAA is falling into this trap. So far it has not been rigorous in its analysis of evidence or balanced in its treatment of stakeholders' submissions. Frequently the unsupported claims of particularly aggressive stakeholders have been accepted uncritically. So far the CAA has built its case for regulation on the finding that some airports "may" now have SMP and are likely to gain SMP in the future. Hardly definitive findings. If the CAA is to avoid finding itself in serial litigation, it will have to tighten up considerably its factual analysis, and adopt forensic methods to deal with the expert and lay evidence submitted by stakeholders.

Test B – Insufficiency of Competition Law

The Act contains a preference for competition law remedies. It requires the CAA to establish "that

competition law does not provide sufficient protection against the risk" of an abuse of SMP. UK and European competition laws have been strengthened in recent years by more vigorous enforcement, higher penalties, and private rights to sue for damages including reforms to make class actions easier. The traditional criticisms of private actions are that they are expensive, take a long time, and offer weak remedies to claimants. While the former two are true, the same can often be said of regulatory solutions. A regulatory approach can also suffer from arbitrariness and lack of coherence, and be over-influenced by aggressive stakeholders gaming the system. They also take a long time, as is evident from the CAA's SMP assessments which have been in progress for 18 months with no end in sight.

The Act imposes on the CAA an express duty to undertake bottom-up analysis, and the burden of showing that a regulatory approach is better than competition law (see below further). How it satisfies this test – other than by assertion – is an open question.

The experience of EU communications regulation gives some clues. The EU communications directives require the national sectoral regulators to establish the inadequacy of competition law. They simply treat competition remedies as inferior to *ex ante* regulatory interventions. Yet there is a sting in the tail. The European Commission backed by the courts has brought actions against incumbent national telecom operators despite their compliance with regulatory price controls. In *Deutsche Telecom* the operator complied with wholesale and retail price controls set by the German telecoms regulator. The European Commission held that where an operator has discretion (such as adjusting prices within the basket of services which are price capped, or lowering prices), it could still be found to have infringed the competition rules. Thus all regulated entities are subject to the general competition laws, and regulatory compliance is not a defence. Indeed nearly all margin squeeze abuse cases are brought against regulated operators. For the airports this is double jeopardy; for disgruntled users a second chance in the courts.

The CAA has built this into its approach. It states: "the risk that the price cap is set too high could to some extent be mitigated by the presence of competition law". So how then is regulation superior to competition law, if the latter is left to deal with regulatory error? And, what if the price control is too tight?

Test C – Net Benefits from Licence Regulation

Test C requires the CAA to show "that for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects".

The CAA has interpreted Test C as a low threshold. While it accepts that the analysis must weigh the *incremental* benefits against adverse effects, albeit in more qualitative than quantitative terms, it asserts that its "assessment .... does not require the CAA to set out in detail how individual forms of regulation might operate but rather to consider whether key forms of licence regulation that might be applicable ... may have net benefits". Whether this is a legitimate statutory interpretation is something to be tested in courts. In the meantime, it certainly is not regulatory best practice to base regulation on abstract speculation over the effects of hypothetical licence terms. This is especially so when the key licence term – price controls – will remain in place under other regulatory requirements. This implies the incremental competitive gains may be low from a licence arrangement. Further, how the CAA's assessment meets the standard of proof required by the courts is another contentious issue

Conclusion

The new Act places the burden on the CAA to developed reasoned regulation which is superior to competition rules and generates net benefits. Unfortunately the way the CAA has analysed the mass of evidence and submissions, and interpreted its statutory duties have been far from satisfactory, and may well soon be tested in the CAT.

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