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## Prospects for Greater Competition amongst European Community Airlines

by C. J. Redston, Aberystwyth\*

**The deregulation of civil aviation in the United States has led to customers being offered a wider choice of flights at lower fares, whereas deregulation within the European Community is still a distant prospect. Chris Redston examines the proposals of the European Commission for liberalization and assesses their chances of success.**

In recent years there has been a mounting tide of criticism of the high level of scheduled air fares within the European Community. Whilst no agreed solution to this problem has been found as yet, a variety of institutions including the European Parliament, consumer groups, the European Commission and some governments consider that a relaxation of current regulations to allow greater competition in passenger air transport is overdue. However, the structure of Europe's civil aviation industry makes the call for more competition an issue of some political sensitivity. National airlines in Europe are mostly state-owned or controlled and tend to be regarded as status symbols by their respective governments, rather than mundane passenger or cargo carriers subject to normal commercial pressures.

### **The Background to Europe's Civil Aviation System**

The background to the present system of civil aviation in Europe is to be found in the Chicago Convention of 1944 which established the basic international rules which govern air transport. The Chicago Convention makes it clear that each state has exclusive and complete sovereignty for the airspace over its territory and decides on rights for traffic originating in or destined for its territory, or even crossing it. The freedom to fly into foreign airspace and to land are routinely given between allies but the freedom for an airline to pick up passengers from its home country and land them in a foreign country, and to make a similar return trip, is a right jealously guarded by negotiating governments.

The market structure established for international civil aviation is one in which the forces of free competition are not allowed to operate. Typically, scheduled international flights between two European cities will be confined to services by just one airline from each of the countries concerned. The lack of competition does not extend only to the absence of freedom of entry. Air fares are regulated by a producers' cartel, the International Air Transport Association (IATA). The principal function of IATA is to coordinate tariffs, via a system of air traffic conferences which, in effect, sets international air fares at agreed levels. Its decisions are sanctioned by the governments of the participating countries. Competition is further limited (if not eliminated entirely) by capacity-sharing arrangements, by which two countries agree to share (usually on an equal basis) the capacity they offer on the air routes between them and the revenue earned from those routes. In this situation, neither carrier on any given route has a real incentive to attract more passengers, given that the benefits of such commercial activity will have to be shared with the other. The fact that Europe's scheduled airlines are mostly state-owned or controlled reinforces the lack of competition inherent in the IATA arrangements. Many of these national flag carriers enjoy financial support from their governments in addition to the monopolistic privileges granted by the protected market structure.

The typical outcome of this system has been that what competition does exist is concentrated on quality, in terms of either in-flight service or frequency of flights. The cost of this approach has helped to contribute to the high level of fares. The interests of business travellers in quality of service and availability have dominated those of non-business travellers in prices. Indeed, a secondary sector has developed to help meet the needs

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of non-business travellers, namely the charter or non-scheduled sector.

While charter travel is very rare in the United States and in 1983 accounted for only 9 per cent of all world air traffic, it is the normal means of air travel for European holiday-makers. In 1982, for example, 28.7 million passengers flew between the United Kingdom and continental Europe, and of these, 13.2 million used charter services.<sup>1</sup> The existence of the charter sector is of benefit to the private traveller but it does not offer any real defence to the scheduled airlines who have chosen to ignore this section of the market. Conditions of charter travel are restrictive, involving advanced booking, early payment, and fixed travel dates. The non-scheduled market has flourished despite the unpopularity of these restrictions because travellers are dissatisfied with the product offered by the scheduled airlines.

### Developments in the United States

Much of the pressure for greater liberalization of European air transport stems from a comparison with civil aviation in the United States. The airline deregulation act of 1978, introduced by President Carter, led to the abandonment of all official controls on American domestic air fares at the end of 1982. For the past two years, subject only to meeting the required safety standards, any airline has been able to fly anywhere in the United States as often as it wants and at whatever fare it wants. Although there have been adjustment problems, exacerbated by the fact that deregulation was swiftly followed by a doubling in the price of fuel and the worst recession for fifty years, the overall impact of deregulation has been to the benefit of consumers. In simple terms it has offered them a wider choice at lower fares. Some established airlines (e. g. Braniff and Pan American) have encountered severe difficulties but a number of smaller airlines and some of the major carriers have prospered. As in any competitive situation, the airlines which have been most successful are those which have cut their costs and priced their product to fit their chosen market. One indicator of the stimulus to efficiency provided by deregulation is the increase in productivity enjoyed by US airlines since 1978. Productivity, measured in terms of revenue passenger miles (the number of miles flown multiplied by the number of paying passengers) per employee has improved by 24 per cent in the six years since deregulation.<sup>2</sup>

The range of low fares available to US airline passengers is enormous. To quote just one example,

the recently available fare (on United Airlines and People Express) of \$ 119 for the 2,500 mile flight between New York and Los Angeles must be considered cheap by any standard. It is put fully into perspective when compared with the \$ 268 charged for the lowest unrestricted fare for the 900 miles from London to Rome. The low-cost, low-fare airlines which have developed since deregulation have not only taken business from established carriers (who have been forced to retaliate) but have generated new traffic. Deregulation has not led American airlines to compete on the basis of low fares alone. Other marketing techniques used to attract passengers include developing an attractive corporate image, offering discounts from the full fares for frequent travellers, improving reservation and ticketing services, and the introduction of more convenient route structures.

Developments in the United States are not confined to domestic American air travel. The United States has also sought to liberalize the conditions governing international flights by the renegotiation of bilateral agreements with foreign governments. The first of these was the Bermuda II agreement with the United Kingdom, concluded in July 1977, to be followed by agreements with Israel, Belgium, the Netherlands and West Germany. The latter agreements provided for as many airlines as possible on their routes (multiple designation), conditions and tariffs to be based on those of the country of origin, and the greatest possible degree of freedom for operators on tariffs, frequency and capacity (the open skies policy). The impact of these measures is to be seen in a substantial reduction in the real cost of air travel on North Atlantic routes. However, it is possible that these re-negotiated agreements are only the beginning. At present, the United States Civil Aeronautics Board (CAB) grants immunity from American anti-trust legislation to airlines negotiating fares in IATA tariff conferences. But the CAB ceased to exist at the end of 1984 (its main function, that of setting internal US fares, having disappeared) and the authority to grant anti-trust immunity passed to the US Justice Department. The Justice Department is already on record as stating that, "there is simply no commercial rationale for multilateral fare co-ordination. . . Our strong foreign policy interests lie in the establishment of free markets in international air transportation. Abolition of IATA fixing of rates and regulation of their components is an important step in that direction".<sup>3</sup>

<sup>2</sup> See The Economist, op. cit.

<sup>3</sup> Quoted in: The Economist, op. cit.

<sup>1</sup> Figures from U. K. Civil Aviation Authority, quoted in: The Economist, August 25, 1984.

<sup>4</sup> J. Erdmenger: The European Community Transport Policy, Gower 1983, p. 113.

Although none of these US developments has a direct impact on domestic air services within the EC, they inevitably create expectations of greater liberalization in a Community which is theoretically committed to internal free trade. Even so, many of those involved in European air transport argue that the American experience is not strictly relevant to the EC. For example, Dr. Jurgen Erdmenger, Director of the European Commission's Directorate-General for Transport has stated, "... (deregulation) would never be successful in the E.E.C. since its air transport sector is organised in quite a different way, compared with the United States."<sup>4</sup> On behalf of the airlines it is claimed that European air fares will inevitably be higher than those in the US for a whole variety of reasons. These include more expensive fuel, higher landing charges, a smaller market which gives less scope for economies of scale (e.g. larger aircraft), and the predominance of short routes which make for the less economical use of fuel. Whilst there is some validity in these claims, they do not provide sufficient reason for the size of the disparity between internal European and US fares.

### Relevance to the European Community

In its defence of the status quo, the airline lobby claims that deregulation would not be in the best interests of either the airlines or their passengers. It has been argued<sup>5</sup> that for deregulation to be in the public interest, the resulting market forces must work effectively, which it is said requires the economists' ideal of perfect competition. Whilst the US is believed to approach this ideal, having several airlines of comparable size, it is considered that on most European routes there would be very few operators. In this situation of oligopoly, it is feared that destructive price wars would end in mergers and the eventual elimination of competition. This line of argument is misleading in a number of respects. For one thing, the US market is far removed from the concept of perfect competition, which envisages a very large number of competitors selling a homogeneous product. Secondly, the situation in the US prior to deregulation was very similar to the current position in Europe, with very few operators on most routes. Many of the new American airlines have developed specifically in response to deregulation and the increased traffic generated by lower fares. There is good reason to believe that similar developments would occur in Europe, given the opportunity. Consideration of existing scheduled carriers only ignores the existence of the many highly cost-effective charter airlines which in

the appropriate environment would wish to offer scheduled services.

There is no doubt that the new air transport policy in the United States has created a great deal of interest in Europe. This interest is reflected in the fact that over the last three or four years the various institutions of the Community have put forward suggestions for improving the structure of civil aviation. Prior to this period, air transport received no particular consideration in the context of European integration. The European Court of Justice decided in 1974 that the general rules of the Treaty of Rome could apply to air transport, but it was not until the late 1970s that the Commission, the Parliament, the Economic and Social Committee and the Council of Ministers began to express an interest. It is evident that a political movement has developed in Europe with a powerful opinion in favour of more competition to benefit the airline passenger.

Any introduction by the Community of its own, more liberal, rules on civil aviation within the EC would create a new level of administration between national regulations and the international rules based on the Chicago Convention. There is nothing within the Convention to prevent the Community from introducing its own rules on air transport. Chapter XVI (Articles 77 to 79) allows states considerable freedom to combine with other states to operate their internal air services jointly. This makes it possible for civil aviation within the EC to be placed on a basis quite independent of the existing international system. Article 77 of the Chicago Convention specifically permits the establishment of joint air transport organizations by the contracting states, which implies that supranational bodies like the EC would be free to play a role in the administration of civil aviation.<sup>6</sup>

The European Commission's Memorandum of July 1979<sup>7</sup> was influential in developing the debate on air transport. Though rejecting deregulation (except in the very long term) it called for greater liberalization of route and tariff fixing. The Commission demonstrated that the present air transport system does not meet the requirements of all users, particularly passengers who wish to visit friends and relatives, holiday-makers who require a cheap flight without an accommodation package, and passengers in regions where the air network is not very developed. The Commission also established that economy-class air fares on flights between European countries are higher than fares on comparable flights anywhere else in the world.

<sup>5</sup> R. Watts: Cloudy outlook for civil aviation?, in: *Transport*, July/August 1982.

<sup>6</sup> See J. Erdmenger, op. cit., pp. 109-111.

<sup>7</sup> EC Bulletin Supplement 5/79.

The Memorandum suggests various measures designed to improve internal EC air transport. These can be put into various categories<sup>8</sup> but the most significant from the economic point of view are, firstly, measures designed to extend the application of existing Community rules to air transport. These include the progressive application of competition policy (Articles 85 to 90 of the Rome Treaty) to air transport and the application of the principle of the free right of establishment within the EC. Secondly, there are measures to extend the services provided, in particular by liberalizing the inclusive tour markets and by encouraging new links between regional centres in the Community. Thirdly, the Memorandum puts forward suggestions to increase flexibility and reduce fares on the main trunk routes. The main instruments envisaged by the Commission under this heading are, in the short term, requests to the airlines to introduce more flexible fare systems, including round-trip tickets, standby facilities, etc., incorporating appropriate discounts from the standard fares. These requests are backed by the threat that in the long term new entrants would be allowed to provide these facilities if the existing operators did not. The Commission sees a long-term framework which would permit new entrants to the market so long as the new provisions were demonstrated to be commercially viable, involve significant price reductions, promise to be stable, were not introduced too rapidly, and were not matched by existing operators. It has been suggested that this system approximates to a system of competitive tender for restrictive franchises, with preference given to existing operators.<sup>9</sup>

In effect, the 1979 Memorandum was an attempt to offer a compromise between the extremes of rigid protection and complete deregulation, the latter being politically impossible even if having economic merit in the long term. Reaction to the Memorandum was favourable from consumer interests but distinctly cool from leading airlines and most governments. There were fears that the development of new regional services would reduce the profitability of existing main routes and that more competition and a reduced role for national flag carriers within the EC might weaken their position on international routes. Furthermore, the initial impact of deregulation in the US, coinciding as it did with recession, gave the immediate impression that greater competition might not be an appropriate recipe for long-term stability.

<sup>8</sup> See K. M. Gwilliam: *The Future of the Common Transport Policy*, in: A. M. Al-Agraa (ed): *Britain Within the European Community*, London 1983.

<sup>9</sup> See K. M. Gwilliam, *op. cit.*

Discussions on the Commission's proposals have continued over a long period in the various institutions of the EC. However, it has proved impossible for the Council of Ministers to find agreement on the implementation of the various suggestions for liberalizing Europe's civil aviation. The majority of member states are unwilling to abandon the traditional policy of protection for their national flag carriers. More specific proposals introduced in 1981 for applying the competition rules (Articles 85 and 86) and for establishing a mechanism for fixing intra-Community scheduled air fares have met with a similar lack of success.

### Revised Commission Proposals

Faced with this situation, the Commission has recently put forward new suggestions for a limited form of liberalization of civil aviation.<sup>10</sup> The new proposals recognise, in effect, that in the current environment it is politically impossible to persuade the countries of the EC to adopt any far-reaching measures to increase competition in air transport. The proposals maintain the existing structure of bilateral agreements and arrangements between governments and cooperation between airlines but seek to find some scope for greater competition and flexibility within this framework.

The major modifications proposed to existing agreements concern, firstly, capacity sharing. The Commission considers that it should no longer be a rigid condition of bilateral agreements to insist on a 50/50 share of traffic services between one country and another. But in order to ensure that no airline is squeezed out, agreements may guarantee any one party 25 per cent of the market at least. Secondly, on tariff flexibility the Commission proposes that the concept of reference or bracket tariffs, used on routes between the United States and some EC countries should be adopted for intra-EEC air transport. This system offers a price range within which the airlines can establish their tariffs freely, without having to seek detailed government approval. The "bracket tariff" or price range would still have to be approved by both governments concerned in any bilateral agreement. The Commission proposes that any disputes would be settled by consultation but where this proved impossible, the country of origin would, in certain circumstances, be allowed to approve the fare unilaterally. Thirdly, the Commission proposes that revenue-sharing agreements between airlines should be subject to the scrutiny of Article 85 of the Rome Treaty. Capacity-sharing agreements usually contain

<sup>10</sup> COM (84) 72, 15 March 1984.

clauses granting the partners equal or almost equal shares of the revenue generated on the route in question. The Commission considers that by restricting competition, such agreements could be contrary to Article 85, unless they embody any grounds for exemption. Basically, it would be for the airlines to demonstrate that a revenue-sharing agreement in some way improves the air transport service offered to the public.

The Commission recognizes that if its proposals for increasing competition were introduced, in the context of Europe's (mostly) state-run major airlines, the result could be a subsidy race among governments. It proposes, therefore, that state aids to airlines should be brought within the scope of Articles 92 and 93 of the Treaty of Rome which cover aids to other economic sectors. In effect, subsidies would be permissible as part of a restructuring programme but not as a means of offsetting operating costs. In addition, the Commission calls for greater transparency of airline subsidies, with a view to avoiding unfair competition.

The Commission's 1984 proposals also contain ideas for promoting smaller airlines and for liberalizing non-scheduled services. It is suggested that consumers would benefit if it were easier for smaller airlines to run scheduled services on regional routes at present ignored by the major airlines because they are unprofitable. One possibility is the abandonment of all route and tariff restrictions on intra-Community services by Community operators in aircraft with 25 seats or less. On non-scheduled services, the Commission suggests that a percentage (perhaps 15 per cent) of the seats available should be for sale on a "seat-only" basis. This would enable holiday-makers to have access to cheap flights without the obligation to purchase an inclusive accommodation package. The result would be to strengthen somewhat the role of the charter operators in acting as a check on scheduled services and their fares while not posing any serious threat to the viability of the major airlines.

### **Prospects for the Future**

The latest package put forward by the Commission is a considerable retreat from its 1979 Memorandum which in itself advocated liberalization rather than deregulation. The Commission also does not expect its current proposals to be adopted without very lengthy negotiations. However, the pressure for change is still considerable and even though some governments are committed to the status quo, others are convinced of the need for change. The United Kingdom has already liberalized its domestic air services and favours a policy

of "dual designation" on international routes wherever possible. Furthermore, it is proceeding with "privatization" or denationalization of British Airways.

The most significant recent development in the EC is the agreement of 20th June 1984 between Britain and Holland. It allows British and Dutch airlines to decide for themselves the frequency and capacity of their services between the two countries and the fares for these services, subject only to the approval of the government of the country where the journey begins. Furthermore, the agreement gives the right to airlines from either country to pick up passengers in the other country and take them to a foreign country via the airline's home base. It also allows them to match each other's fares over the whole of their respective route networks. For example, KLM can pick up passengers in London, fly them to Amsterdam and then on to Singapore for the lowest price charged by British Airways for its flights from London to Singapore.

The Anglo-Dutch agreement has already resulted in a whole batch of low-cost return fares between the two countries. The impact of these low fares has been seen in a substantial amount of newly-generated traffic. A survey by British Airways<sup>11</sup> found that 31 per cent of people buying tickets would not have travelled at all if it were not for the cheap fare and a further 44 per cent would have gone by ferry. Furthermore, by allowing Britain's Virgin Atlantic airline to operate from London to Maastricht for a nominal fare, the Anglo-Dutch agreement gives the airline access to an entirely new source of passengers for its low-cost London to New York service.

The significance of the Anglo-Dutch agreement goes beyond the two countries concerned. The cheap fares between Amsterdam and London provide incentives for neighbouring French, Germans and Belgians to forsake their national carriers and travel by road or rail to Holland to take a flight to London. If sufficient numbers are persuaded to do this, then airlines in the countries mentioned will also have to cut their fares to London in order to compete.

While deregulation in the Community may still be a distant prospect, the liberalization measures introduced by some European countries, combined with steady pressure from the Commission, are helping to make the maintenance of the existing cartelized structure of European civil aviation much more difficult. The potential benefits for Europe's air travellers are enormous.

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<sup>11</sup> Reported in: *The Times*, 8 November 1984.