A report by Cambridge Economic Policy Associates (CEPA) for the Department for Transport

The extent to which airlines' interests are aligned with those of passengers

Note

This work carried out by CEPA for the Department for Transport was commissioned in March 2010 and this report was completed in June 2010. Therefore, any policy references contained herein are those of the previous Government and do not necessarily reflect current Government policy.

THE EXTENT TO WHICH AIRLINES' INTERESTS ARE ALIGNED WITH THOSE OF PASSENGERS

1. SUMMARY

This paper sets out a framework for considering whether the interests of airlines and passengers are likely to be aligned, and then reviews practical examples, to consider to what extent this corresponds with the framework for considering the interests of airlines, passengers and airports.

This working paper takes it as broadly agreed that airlines are best placed to understand the interests of their passengers, but distinguishes the *understanding* of the interests of passengers from the *alignment* with the interests of passengers.

1.1. Key conclusions

Overall **the interests of passengers and airlines are likely to be relatively well aligned where airlines are operating in a well functioning competitive market**. Developments in the European aviation sector over the last ten to fifteen years bear out this view. However, the overall fiduciary duty for airlines to maximise the future stream of their profits overrides passengers' price, quality and convenience preferences and means that **there can be no automatic presumption that in all circumstances airlines' and passengers' interests will be aligned**.

Amongst the key circumstances in which there may be a misalignment of interests are when:

- Airlines have market power.
- Developments that may increase the degree of competition are being contemplated.
- Airports being used by airlines are subject to economic regulation.

Statutory processes such as economic regulation and planning, as a minimum, may change the incentives for airlines and make it more difficult to be confident about the alignment between airline and passenger interests. The regulator has to interpret the views of airlines as distinct from the outcomes of a commercial negotiation.

1.2. Objectives and incentives of airlines, passengers and airports

It is important to recognise that airlines and passengers have different overall objectives. The Directors of airlines have a fiduciary duty to their shareholders to maximise the future stream of profits of the company. Therefore, airlines will need to consider all of their actions and decisions in the context of this overall fiduciary duty. The airline sector within the UK and Europe is now regarded as a generally very competitive market. Where there are limitations on competition it tends to arise for a few reasons, including the strong market positions of the main London airports and the presence of bilateral air service agreements that limit the number of flights between the UK and some other countries.

Passengers are seeking a combination of price, quality and convenience that best meets their needs. Different passengers will take different views about the balance of these factors that best represent their interests. For example, a student undertaking a backpacking trip around the world is likely to prioritise lower prices over quality and convenience, whereas a business traveller may prioritise quality and convenience relatively more than price.

Airports will have similar profit maximising incentives to airlines, given that most airports in the UK are privately owned, and those owned by local councils are generally operated on a commercial basis. There has been a substantial expansion in the volume of commercial passenger traffic using the regional airports in recent years following on from the liberalisation of the European airline sector. Therefore, with the exception of the designated airports where concerns about the presence of substantial market power remain, there is convincing evidence from the CAA and the Competition Commission of competition between a number of regional airports.

1.3. Key propositions regarding the alignment of airline and passenger interests

Building on the consideration of the different objectives and incentives of airlines and passengers, some key conclusions can be drawn, which are:

- **In a well functioning competitive market the interests of airlines and passengers are likely to be relatively well aligned** – This is because if airlines do not offer price and service combinations that are attractive to customers then rivals will step in to make such offers, and attract passengers.
- **Where airlines have market power, there will be a misalignment of interests because airlines' profit maximising strategy will involve restricting supply and raising prices** – This concern is reflected in the presence of general competition law.
- **Incumbent airlines may not re-allocate capacity (or support capacity development) if such a change would increase competition unless they perceive that the benefits they receive in return outweigh the costs (through reduced profits) from new entry into markets in which they are already established, whereas for passengers more competition is in their interests** – In this case the alignment of airline and passenger interests has to be considered on a case by case basis..
- **The presence of economic regulation or other statutory processes such as planning enquiries makes it more difficult to be confident about the alignment between airline and passenger interests** – In particular, unlike in a competitive market, a statutory process leads the airlines to focus on

persuading the regulator or other statutory body, rather than seeking to establish a commercial deal.

Finally, it is also important to recognise that airlines and airports can at times be in competition, which will affect whether their views reflect those of passengers. In particular, airlines and airports compete for the custom of passengers with regard to shopping purchases and purchases of refreshments. Therefore, airlines' views of what passengers would like with regards to the provision of airport shopping outlets may not represent those of passengers because of the profit maximising incentives for airlines.

1.4. Practical examples to test the propositions

There is good evidence that the interests of passengers and airlines are likely to be relatively well aligned where airlines are operating in a well functioning competitive market, and competitive markets have increasingly characterised the airline sector in recent years. Developments in the European aviation sector over the last ten to fifteen years bear out this view.

The presence of competition law means that it is generally accepted in the economy that companies with market power have the potential to act against the interests of their consumers. In the airline sector there have been recent cases in the UK and in Europe where airlines have been found to have breached competition law.

Developments that may lead to more competition are an area where the interests of airlines and passengers may or may not align. Airlines will make a case by case judgement about the trade-off between more profit opportunities from growth and lost profit from more competition. This can be seen in the airlines reaction to decisions to remove or relax bilateral air service agreements, which generally reflect their particular view of the likely gains or losses from each development.

The CAA has developed a worked example[1] that illustrates the potential for economic regulation to compound concerns about the mis-alignment of interests between airlines and passengers for capacity expansion that may promote more competition. The uniform level of airport charges at the designated airports is another example of where regulatory requirements can lead to a mis-alignment of interests between airlines and passengers that may not occur when airports and airlines operate in more competitive markets.

The remainder of the report discusses these issues further.

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[1] CAA (2008) "CAA price control proposals for Stansted Airport, Supporting paper 1: Illustration of airport and airline incentives", accessed at http://www.caa.co.uk/docs/5/ergdocs/081212SPIncentives.pdf

2. INTRODUCTION

This working paper reviews the evidence about whether, when and how the interests of passengers using airports and airlines, are aligned with the interests of those airlines.

2.1. Why this is an important issue?

This has been an important issue in the development of regulatory policy in the UK aviation sector in recent years, in a number of specific contexts, including:

- Consideration of the appropriate focus and formulation of the proposed new primary objective for the CAA's economic regulation functions, and in particular the degree of alignment between the interests of passengers and airlines;[2] and
- How the CAA takes account of the views of airlines with regard to the expenditure and development proposals of the designated airports when setting price caps.[3]

The CAA currently has four non-hierarchical statutory duties that guide its decision making, including for the setting of price caps at designated airports. One of these duties relates to taking account of the reasonable interests of airport users, which includes passengers and airlines, with no indication that the interests of any particular group of users should be prioritised. The DfT's proposals for a new framework for the economic regulation of UK airports includes a proposal to give the CAA a primary statutory duty to further the interests of passengers of airports, thereby giving their interests a clear pre-eminence over the interests of airlines and other airport users.

During the review of the framework for economic regulation there was much discussion amongst stakeholders about the appropriate primary duty for the CAA. Airlines generally argued that their interests should be specifically recognised in the primary duty of the CAA given that they, rather than passengers, are the direct customer of the airport. Airports, the CAA and a range of passenger representatives generally argued that the primary duty should clearly prioritise the interests of passengers. The CC agreed, but recommended that there should be an ancillary duty to consult and pay due regard to the views of airlines.

The most recent price control reviews for Heathrow, Gatwick and Stansted airports included a new approach by the CAA to gathering evidence for establishing some of the inputs to the decision about the price caps to put in place. This process was

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[2] See the various documents at http://www.dft.gov.uk/pgr/aviation/regulatoryreform/

[3] See the various documents at http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=67

called “Constructive Engagement” and involved the airport subject to the price cap and the airlines using the airport engaging in discussions about the future expenditure requirements for the airport. The CAA could then take account of the conclusions of this engagement when setting the price caps, including documented areas of disagreement. The process led to useful inputs for the price cap decisions for Heathrow and Gatwick airports, but the process was terminated by the CAA for Stansted airport. The use of Constructive Engagement in the price cap process recognised that airlines using airports are often large and relatively well informed and resourced customers of the airport, who can provide an important perspective on the expenditure proposals of the airport. However, the CAA explicitly reserved the right not to adopt any agreements reached, where these agreements did not adequately reflect the interests of consumers and future airport users, reflecting the CAA’s concern that airport-airline agreement might not adequately reflect the interests of these groups.

The DfT’s review of the framework for the economic regulation of UK airports and the most recent price control reviews of the designated airports has highlighted the issue of whether the interests of airlines and passengers are aligned. There has been a clear division of opinion on this issue amongst stakeholders.

2.2. Scope of this working paper

This working paper has been developed in the context of the DfT’s review of the framework for the economic regulation of UK airports. Therefore, the focus of the conclusions of the paper is to consider the degree of alignment between airlines and passengers in circumstances where airports are subject to economic regulation. However, to fully consider the issue of whether the interests of airlines and passengers are aligned, and the potential circumstances when they are not, this paper initially considers the degree of alignment in circumstances where airports are operating in broadly well functioning competitive markets and not subject to economic regulation. This can then be compared to circumstances where they are subject to price control regulation. This working paper does not seek to reach a view on the most appropriate way to undertake economic regulation, including the setting of price caps, given the conclusions reached about whether, when and how the interests of airlines and passengers are aligned. This is a matter for the CAA when setting price caps.

It is important for the purposes of this working paper to distinguish between whether airlines interests are aligned with passengers, and how well they understand the interests of their passengers. From reviewing the views of stakeholders, we believe that it is broadly accepted that airlines are better placed than any other organisation to understand the interests of their passengers. In particular, the Competition Commission in its final report for its Market Investigation of BAA’s airports, and the CAA in a number of documents, have accepted that airlines are better placed than either of them (as the current regulators[4] of designated airports in the UK) to understand the interests of their passengers. However, understanding the interests of passengers does not necessarily mean that airlines will also act to meet or further those interests, as we discuss in this working paper. In particular, the degree of competition between airlines will be an important factor in determining the likely degree of alignment between the interests of passengers and airlines. At designated airports the link between airline and passenger interests can be further complicated by the presence of economic regulation, which can change the incentives and approach of airlines to maximising profits.

This working paper sets out a framework for considering whether, when and how the interests of passengers and airlines are aligned, and then considers the views of key stakeholders and practical evidence to understand how well the framework corresponds to reality. The focus of the working paper is on the UK aviation sector, but we also discuss examples from other countries where they may be helpful in illustrating the potential alignment or non-alignment between passengers and airlines views.

Although the focus of the working paper is on the alignment of interests between airlines and passengers, given their role in the aviation sector we also discuss the incentives of airports to aid the discussion and for completeness. This includes some discussion of the economic regulation of designated airports in the context of the impact of such regulation on the decisions made by airlines. However, we are not seeking to reach detailed conclusions on whether and when the interests of airports align with those of airlines and passengers.

2.3. Structure of this working paper

The remainder of the working paper has the following sections:

- Section 3 sets out a framework for considering whether, when and how the interests of passengers and airlines may be aligned. In particular, it considers the objectives and incentives of airlines, passengers and airports.
- Section 4 discusses how the presence of economic regulation, and other statutory processes such as planning, may affect the interaction between, and incentives of airlines, passengers and airports.
- Section 5 draws together the analysis in Sections 3 and 4 to set out a number of propositions regarding whether, when and how the interests of passengers and airlines may be aligned.
- Section 6 seeks to test these propositions using a range of practical examples about the interaction between the interests of passengers and airlines.

[4] Although the CAA is the independent economic regulator of UK airports, the Competition Commission is required to undertake a review and provide advice to the CAA prior to the setting of a price cap for a designated airport.

- Section 7 draws together the analysis in the previous sections to reach overall conclusions.

Annex A summarises the views of key stakeholders on these issues.

3. THE OBJECTIVES AND INCENTIVES FOR AIRLINES, PASSENGERS AND AIRPORTS

3.1. Introduction

This section sets out a framework that considers the interests and objectives of airlines, passengers and airports.

3.2. Airlines

Most of the airlines with significant operations in the UK are privately owned, and therefore either listed on the stock market or owned by private individuals or investors. The Directors of privately owned companies (called public limited companies (plcs)) have a fiduciary duty with regard to the interests of their owners/ shareholders, which requires them to seek to maximise the value of the company, which is effectively the expected value of the future stream of profits. A short hand way of describing the objectives of these privately owned airlines is to say that they are profit maximisers. For the purposes of this working paper, we have made an assumption that airlines are generally seeking to maximise the value of the future stream of profits. Although we recognise that there are a range of airlines operating in the UK that are owned by foreign Governments (or in which foreign Governments have a significant ownership stake), who might not have the same profit maximising objective as privately owned airlines.[5]

Almost all companies in all markets have some degree of pricing power[6] at least from time to time. In other words no market corresponds to the definition of a perfectly competitive market in the economics literature. However, some companies can have market power in the sense that they have the ability to raise prices consistently and profitably above competitive levels. In these circumstances the company (including an airline) may be able to maximise profits by reducing supply and/ or quality compared to the levels it would offer in a relatively well functioning competitive market, thereby decreasing the overall welfare of passengers (the consumer surplus).

The airline sector in Europe has changed markedly in the last ten to fifteen years with the liberalisation of the EU market. The market has been characterised by strong growth from Low Cost Carriers (LCCs) and quite significant entry and exit of

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[5] An airline that is wholly or substantially owned by a Government may have other objectives, such as maintaining a certain level of employment.

[6] The term market power is commonly used by competition authorities to mean the ability to raise prices consistently and profitably above competitive levels. However, the term can also be used to mean an ability to price above short run marginal cost, which is sometimes measured by variable cost. Companies, such as airlines, with fixed or common costs may have such power even if they do not have the ability to raise prices consistently and profitably above competitive levels. In this paper, we use the term market power to mean only the ability to raise prices consistently and profitably above competitive levels.

airlines.[7] The entry and exit has been prevalent amongst new entrants and LCCs, although there has been some exit and consolidation amongst national flag carriers, such as Olympic, Alitalia, Swissair and the range of US airlines that have been in Chapter 11 bankruptcy protection. The recently signed agreement between British Airways and Iberia is an example of consolidation.[8] The relatively well functioning competitive market means that airlines are continually under pressure to seek a competitive advantage compared to competitors.

The increased competition in the European airline sector has seen both a greater diversity of airline business models and some blurring between previously distinct business models. Historically, there was a difference between full service airlines – that included the costs of refreshments and baggage in their prices and provided a designated seat – and LCC's that provided no designated seat and charged separately for baggage and refreshments. However, some previously full service airlines are adopting aspects of the LCC model, such as separate charges for baggage or reduced meal services. Different charter airlines operate a mix of these two models, and sell seats both as part of package holidays and on a seat-only basis.

While the market for intra-European airlines is very liberalised, the market for longer haul routes is still characterised by some constraints on entry through bilateral air service agreements that limit the frequency of certain routes and the airlines that can fly on the routes. However, these restrictions are gradually being phased out. In a way these limitations affect all airports, as bilateral air service agreements often prevent airlines other than those designated to operate the service. However, in practice, given the nature of the long haul routes that are generally now covered by these agreements, the main London airports and larger regional airports[9] (such as Manchester) are the most likely to be affected, as they would benefit from any additional flights.

Another limitation to competition that applies particularly at Heathrow airport, but also to some degree at Gatwick and Stansted airports, is slot availability. In order for an airline to operate a service at an airport it requires a slot to land and take-off at the airport, and a matching pair of slots at the destination. At many regional airports there are a range of slots available across most of the day, although a number of regional airports have limited slot availability for peak periods such as early in the morning.[10] Slots at regional airports are generally allocated on a first come first served basis. A limited number of airports in the UK have been designated as

[7] FlyGlobespan is the most recent airline to have exited the market through severe financial difficulties.

[8] http://www.bashares.com/phoenix.zhtml?c=69499&p=irol-rns0804

[9] For the purposes of this working paper we use the term regional airports as a catch-all term to cover all airports in the UK other than the main London airports of Heathrow, Gatwick and Stansted.

[10] LCC's business model is generally based on getting each plane into the air for the first flight of the day very early, so they value early morning slots.

requiring slot co-ordination, which is done by Airport Co-ordination Limited (ACL).[11] This is because the demand for slots at these airports either exceeds supply at all times of the day or at many times of the day. Therefore, ACL seeks to balance the supply and demand for scarce airport capacity to avoid unnecessary congestion and delays.[12] Where airports are slot co-ordinated airlines are entitled to keep their slots on an ongoing basis providing they use any given slot 80% of the time. Where slots become available for allocation, priority is given to new entrant airlines for 50% of the newly available capacity, to the extent that demand from such airlines exists. Following the EC decision on slot trading, it is now generally accepted that slots can be traded between airlines in a secondary market, and there is particularly prevalent trading of slots at Heathrow.[13]

It is notable that the approach to slot allocation at slot co-ordinated airports means that once an Airport Coordination Committee has declared/ accepted that a certain amount of capacity is available, it is effectively the airlines rather than the airport that ultimately "own" the right to use the infrastructure of the airport to provide services at a specific time, and it is the airlines that can realise any scarcity value associated with these rights (although airlines may have been allocated rather than paid for the slot initially).

Given the largely competitive nature of the European airlines market, the behaviour of airlines is generally subject to regulation only through competition and consumer law. In the UK, there is no *ex ante* regulation of the price or service quality offered by airlines, following widespread liberalisation of aviation markets, but a number of relatively restrictive bilateral agreements remain in place, such as between the UK and Japan. Airlines are covered by general consumer protection legislation, and sector specific consumer protection legislation, which imposes some restrictions and requirements with regard to areas such as advertising and the treatment of vulnerable passengers. We discuss this further in a later section of the working paper.

3.3. Passengers

The demand for air travel is essentially a derived demand, in that few people choose to travel merely for the experience of travelling, but instead travel to help fulfil another purpose or objective, such as going on holiday or attending a business meeting. Therefore, passengers are seeking air travel options that help them fulfil these objectives at the least cost, with the most convenience (including frequency) and at an appropriate level of quality. Passengers will have different preferences with regard to the trade off between price, quality and convenience. For example, a

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[11] In the UK, Gatwick, Heathrow, Manchester and Stansted airports are slot co-ordinated by ACL.

[12] While the allocation of the overall number of slots is undertaken consistent with the provisions of relevant EC Directives, ACL will seek to manage the allocation of slots over the day to smooth usage as far as possible to minimise delays.

[13] The legal position was previously somewhat unclear, with the UK courts recognising the legality of slot trading but with the EC adopting a policy position that such trading might not be legal.

student undertaking a backpacking trip around the world is likely to prioritise lower prices over quality and convenience, whereas a business traveller may prioritise quality and convenience relatively more than price. It is important to note that passengers' preferences are very heterogeneous. This also applies to the nature of their requirements at airports. The rapid expansion of LCCs and commercial passenger airports has also increased the breadth of quality options available to passengers, particularly for short haul flights. Furthermore, the separation of charges for many items such as luggage and refreshments, has allowed passengers to tailor their experiences much more to suit their own needs.

The internet has allowed passengers to compare the prices, quality and convenience of air travel options more actively and vigorously than was previously the case, when they relied largely on travel agents to do this. This has helped to improve the information available to customers, although there are still limitations in this regard, for example, airlines do not generally publish quality of service (such as delay) information, although the CAA does. The greater ability for passengers to find and compare prices should allow them to enjoy better deals, and encourage airlines to offer more competitive prices, given the ease with which passengers can compare their price and convenience with that of other airlines.

3.4. Airports

Airports have very similar overall incentives to airlines with regard to profit maximisation. However, while in the UK most airports are privately owned, airport ownership tends to be by Governments in significant, but not all, parts of continental Europe. Airports are often ultimately owned by the national or local Government, but operated under a concession by a private company. Where airports are not privately owned in the UK, they tend to be owned by local Councils rather than central Government, and are generally seen to be operated on a commercial basis, e.g. Manchester airport.

Substantially driven by the growth and expansion of the airline market in the UK, the airport sector has undertaken substantial change and growth over the last ten to fifteen years. In particular, a number of regional airports have expanded their operations in commercial passenger aviation markets. The Competition Commission's (CC's) market review of BAA's airports found substantial evidence of inter-airport competition amongst a range of groups of airports that it considered.[14]

There are only three airports within the UK – Heathrow, Gatwick and Stansted – that are currently subject to *ex ante* price cap regulation by the CAA. Although the need for price cap regulation is not automatically reviewed for each airport before a new five year price cap is set, an airport that believed it no longer met the criteria for designation (which includes consideration of its level of market power) could ask for

[14] http://www.competition-commission.org.uk/rep_pub/reports/2009/fulltext/545_3_3.pdf

a review of its designated status.[15] The requirement for *ex ante* price cap regulation reflects a view that without such regulation the airports concerned would be able to restrict supply or reduce quality in a way that would not occur in a well functioning competitive market.

However, there are reasons why in the future there may be significant changes to the degree of competition between the currently designated airports. The CC's report required BAA to dispose of Gatwick and Stansted airports (and one of Edinburgh or Glasgow Airports) in order to remedy the adverse effects on competition arising from common ownership During the course of the CC market inquiry, BAA announced its intention to sell Gatwick airport and the sale was completed in December 2009. Following a successful appeal by BAA, the Competition Appeal Tribunal made an Order quashing the decisions in the CC's report that relate to common ownership of airports and remitted those matters to the CC for reconsideration. The CC has been granted permission to appeal the Tribunal's findings to the Court of Appeal and any remittal will take place only after this appeal has been determined.

Although airlines and airports provide many services that are complementary, it is important to note that to some degree they compete for the provision of some services, such as shopping and refreshments. This is particularly the case with airlines that do not provide refreshments within the price of a ticket, as in these cases passengers have a number of choices with regard to where to purchase refreshments. This includes a choice between using retail outlets at the airport and on the aeroplane. This is therefore, an important example where airlines' interests with regard to the provision of services at airports are unlikely to be well aligned with those of customers. While it may be in the interests of airlines for any airport to have a minimum level of refreshments available (if this is necessary to attract passengers' to use the airport in the first place), they may not consider a wide variety of good quality refreshment facilities to be in passengers' interests if it significantly reduces the revenue from serving refreshments on the aeroplane. This may be the case even if the effect on airline profits is only short term (as would be expected if airline competition ultimately resulted in changes in short term catering revenue being offset by changes in ticket prices).

[15] The DfT decided in 2008 that Stansted airport should continue to be designated for the purposes of setting price cap regulation following a request by the CAA for its status to be reviewed.

4. THE INTERACTION OF AIRPORTS, AIRLINES AND PASSENGERS IN REGULATORY AND OTHER STATUTORY PROCESSES (SUCH AS PLANNING)

The discussion about the objectives and incentives of airlines, passengers and airports in the previous section is primarily premised around interactions between airlines and passengers within the competitive market environment. Within the aviation sector, airlines are also involved in a range of regulatory and other statutory processes, including economic regulation, planning and decisions about air service agreements. Within these processes many of the same considerations as are set out above, will apply. For example, an airline operating in a competitive market would support improvements to an airport subject to economic regulation if it believed that this was likely to enhance customer demand in a way that improves profitability, but it will take account of not just the absolute impact on customers' experience, but also whether it gains a competitive advantage.[16] For processes such as planning considerations for new developments, airlines will weigh up the benefits from more growth opportunities against the potential reduction in profits due to more competition.

The main distinction between a regulated airport (an airport subject to a price cap) and one that is not, is that the airlines do not undertake a purely commercial negotiation with the airport about the price, service quality, etc, but instead there is a regulator (the CAA in the UK on price issues, and currently the CC on service quality issues) who is empowered to make decisions about many of these parameters. The need for regulation recognises the substantial market power of the airports. Therefore, while airlines will discuss some aspects of the price and service quality with regulated airports (a price cap does not stop an airport agreeing to a lower price with an airline), they will also have regard to the potential outcome if the matter is left to the regulator to determine. In other words the potential decision of the regulator creates an envelope within which any commercial negotiation will fit.

In a commercial negotiation in a competitive market environment there is no need for any outside party to interpret whether an airport or airlines' views are aligned with passengers' interests because market forces provide the necessary disciplines. In particular, if the price-quality combination offered by an airline does not meet passengers' needs, they can switch to the services offered by the airline's competitors leaving the first airline with lower demand and therefore a likely drop in profits. However, with economic regulation, the operation of market forces are (deliberately) muted. This can improve overall welfare by limiting the behaviour of an airport with monopoly power but it may also change the incentives for airlines within that market. In this case, the impact of airlines' decisions on passenger welfare is

[16] For example, a full service airline may believe that it would attract some additional business customers from an LCC rival operating at another airport even if there was no overall increase in demand for air travel if an airport provided improved lounge facilities.

less obvious and hence third-party interpretation may be necessary where non-market processes, such as economic regulation, are in operation.

By way of an example, if an airport proposes to the regulator that it should be allowed expenditure to convert an existing passenger seating area to become a retail outlet, in a competitive market the airlines will judge the impact on passenger demand (which could in theory be positive or negative) and demand for in flight retail sales. Where an airport is subject to economic regulation, the regulator will also need to consider to what extent the airlines' views are affected by any perceived competitive advantage they may gain or lose given that at an airport subject to economic regulation all airlines will pay the same per passenger cost for the expenditure.

There is no automatic reason why the considerations in the previous section about the objectives and incentives of airlines and passengers should not apply in a situation where economic regulation applies to the airport. For example, there is likely to be strong alignment between the interests of airlines and passengers with regard to minimising the cost of maintaining existing facilities at airports, assuming no change in quality, whether the airport is subject to economic regulation or not. Airlines will still seek to maximise profits, but they will now do this through engaging with the non-market process. It is beyond the scope of this paper to evaluate how different forms of economic regulation will affect the alignment of interests between airlines and passengers. However, as an example, if an airline is aware that the regulator intends to apply a form of Regulated Asset Base (RAB) regulation then it will consider how best to influence the decisions of the regulator, and the proposals put forward by the airport to the regulator, to maximise its profits in this context. We discuss in Section 6 an example developed by the CAA to illustrate this potential concern.

As a minimum the presence of economic regulation complicates the relationships compared to a purely commercial negotiation meaning that it is more difficult to be confident that the incentives of airlines may not be somewhat distorted because they have to make a judgement about how to get the best outcome from the combined process of discussions with the airlines and interaction with the regulator. This is not a criticism of the airlines directly, but recognition that a regulatory process may affect the alignment of interests. The CAA's use of Constructive Engagement for the last price control reviews of Heathrow, Gatwick and Stansted airports also illustrates that it recognises that the presence of regulation does not mean that valuable information cannot be obtained from airlines.

Within the context of airport regulation it may be possible to distinguish between the costs of maintaining current facilities and expanding capacity or improving existing facilities. The interests of airlines and passengers are almost always likely to be aligned with regard to minimising the costs of current facilities (assuming no reduction in quality). Reducing such costs could flow through to lower fares for passengers and potentially higher demand and more profits for airlines. There is strong evidence from the regulatory processes that airlines and passenger representatives have had broadly aligned interests with regard to the costs of maintaining current facilities. Where improvements in quality or capacity expansion are being considered within the context of economic regulation issues arise about different airline business models, and the trade-off between expansion that facilitates growth and additional profits compared to more competition and lower profits. In this context the interests of airlines and passengers may not be aligned, and airlines may seek to argue against such expenditure which could be in the interests of passengers if it promotes more competition in the future.

The planning process is another example of an administrative process which replaces a potential commercial negotiation about the best way to expand capacity or improve quality at an airport. Again, the airlines will have regard not just to discussions with the airport about their views on how best to expand capacity or improve quality, but also the potential outcome of any planning process or enquiry. The potential outcome will again form the backdrop or envelope within which any commercial negotiation about expansion or improvements, would take place.

At airports with substantial market power, passengers have very little ability to affect materially the level of delay that is tolerated by the airlines. If passengers have no effective means to signal their willingness to pay and a lack of alternative airports for the services then a level of congestion may be tolerated by the airlines that would not arise in a well functioning competitive market.

The presence of economic regulation or other statutory processes such as planning enquiries, as a minimum, makes it more difficult to be confident about the alignment between airline and passenger interests. In particular, unlike in a competitive market, a statutory process leads the airlines to focus on persuading the regulator or other statutory body, as much as seeking to establish a commercial deal. However, the concern is more important where improvements in quality or capacity expansion are being considered, than when the costs of maintaining existing facilities is being considered. This is not a criticism of airlines directly, but a recognition of the potential impact of regulation or other statutory processes.

5. PROPOSITIONS ABOUT THE ALIGNMENT OF AIRLINE AND PASSENGER INTERESTS

When we draw together the discussion in the previous two sections it is possible to reach a number of main conclusions. The first three conclusions relate to situations where whether and to what extent there is alignment of airline and passenger interests is affected by the degree of competition. The final conclusion discusses situations where processes such as economic regulation and planning, which can broadly be described as non-market processes, operate, and how these can affect whether and to what extent there is alignment between airline and passenger interests.

First, **where the airline sector is characterised by well functioning competition then the interests of airlines should be relatively well aligned with those of passengers** because unless airlines offer passengers attractive price, quality and convenience then rivals will enter to make offers that better meet passengers' needs. So in a well functioning competitive market airlines are likely to maximise profits by looking to serve passengers' needs.

It is important to note that no market is perfectly competitive (as defined in the economics literature), so even in a well functioning competitive market there are likely to be examples where the actions of airlines are not obviously in the interests of passengers. For example, advertising in ways that may be considered misleading. This can reflect the point discussed earlier that even in a well functioning competitive market airlines may have a degree of pricing power, and influence over the information provided to customers could be an example of this.[17] It is also important to recognise that a variety of offers from airlines can be in the interests of customers, including offers that reduce quality if they correspond to a reduction in price.

It is important to recognise that airlines and passengers do not each have a single common interest. Airlines offer a range of services with different standards of service and different product offerings. Therefore, each airline will have a different view about what constitutes the interests of its passengers given the types of services it runs. For example, LCC's do not generally use air bridges whereas full service airlines do. As discussed above, passengers have a wide variety of preferences, and therefore, it is not generally possible to provide an overall or single description of the passenger interest. There may also be a temporal dimension to passengers' interests, meaning that current passengers may have different preferences to passengers in the future, particularly with regard to how much they value capacity expansion. The heterogeneous interests of airlines are only likely to be a problem if they have market power that allows them to raise rivals' costs by influencing the nature of equipment installed by airports. Heterogeneous interests

[17] Intermediaries in markets, such as price comparison websites or travel agents can help to overcome this.

amongst airlines may also make it more difficult for a regulator to assess how well the views' of airlines reflect those of their passengers.

Second, **where an airline has a degree of market power, and there are material barriers to entry, then there may be scope to reduce the services and quality to customers, thereby raising price, as a profit maximising strategy.** A possible example of where an airline may have market power of this type could be where it operates service on a route covered by a bilateral air service agreement[18], which one or both Governments are not prepared to change.

One case where this might happen is with a dominant airline at a hub airport. The hub-and-spoke configuration of airline operations developed following liberalisation. It can provide competitive advantages to an airline allowing the airline to charge a hub premium. In general hubs can increase the flight options available to passengers travelling to/ from that hub. Operating cost economies can also arise from the increased density of operations. The frequency of flights and number of destinations available to a hub airline can also give the airline a demand advantage compared to its competitors (at the same or other airports) on routes out of the hub.[19]

Third, **incumbent airlines may not re-allocate capacity (or support capacity development) if such a change would increase competition unless they perceive that the benefits they receive in return outweigh the costs (through reduced profits) from new entry into markets in which they are already established**. However, passengers will benefit from increased competition, and there is no trade-off for passengers to make. Again, an obvious manifestation of this would be the removal of bilateral air service agreements where new airlines gain the right to run services in competition with the incumbent.

Another possible example of where incumbent airlines might resist a development leading to more competition is in the secondary slot trading market. If incumbent airlines at an airport allow slot trades that lead to more competition then passengers will be better off. However, the one off bonus of a slot trade may be outweighed by the erosion of profits on competing routes over time. The trade-off for incumbent airlines will be between one-off opportunities to grow profits compared to increased opportunities for rivals to enter and undermine existing profits. Airlines will evaluate each situation on its own merits within this framework but may not make a decision that is in the interests of passengers if they have market power.

Fourth, when **non-market processes such as economic regulation or planning operate to decide outcomes they can act to change the interests of airlines**

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[18] Bilateral air service agreements are between two Governments and can determine a range of factors regarding air services between the two countries, including frequency, price, etc. Such agreements are likely to be result in the services offered between the two countries being different from those that would be offered if such an agreement was not in place.

[19] See Borenstein, S. and N. Rose (2007) "How airline markets work…or do they? Regulatory Reform in the Airline Industry", accesed at http://www.nber.org/books_in_progress/econ-reg/borenstein-rose10-3-07.pdf

and therefore their potential alignment with passenger interests. The presence of economic regulation or other statutory processes such as planning enquiries or decisions about air service agreements, as a minimum, makes it more difficult to be confident about the alignment between airline and passenger interests. In particular, unlike in a competitive market, a statutory process leads the airlines to focus on persuading the regulator or other statutory body, as much as seeking to establish a commercial deal. This is not a criticism of airlines directly, but a recognition of the potential impact of regulation or other statutory processes.

The framework suggests that we can be reasonably confident that there will be a good (although not perfect) alignment of passengers' and airlines' interests where airlines operate in a well functioning competitive market. This is because the profit maximising incentive for airlines is generally best met by serving as well as possible the needs of passengers, because otherwise other airlines would enter to offer the passengers' a service that better met their needs. Concerns about a significant mis-alignment of interests arise where an airline has market power or developments that would materially increase the degree of competition in the market are being contemplated. Where an airline has market power there is a clear mis-alignment because the profit maximising incentive of the airline will be best met by withholding supply to increase prices. Where developments such as the removal of bilateral air service agreements are being contemplated, airlines interests may align with passengers, but airlines will consider whether the development furthers their profit maximising objective or not, rather than whether it best meets passengers' interests. The operation of non-market processes, such as economic regulation and planning, as a minimum complicates the understanding of the alignment of airline and passenger interests as the airlines will focus on profit maximising within the context of influencing the regulator, who will need to interpret the commercial perspective that underpins their views.

Although not a major focus for this working paper, it is important to note that there could be a mis-alignment between the interests of airlines, airports and passengers related to differences in time preferences. Similar issues can arise in other sectors where there is competition between providers that relies on access to assets with long useful economic lives. It is likely that airlines, operating in relatively competitive markets with limited long life assets, will have a higher cost of capital, than airports, which have longer lived assets. If this mismatch between the relative cost of capital of airlines and airports was significant then it would imply that airlines would place greater weight on profits in the shorter term than airports. The alignment of interests with passengers would then further depend on their relative time preference of money. Another way of expressing this overall point is that airports are likely to be more concerned about passengers' possible preferences in the longer term, whereas airlines will have more of a focus on the short to medium term. This can mean that, for example, a regulator, may need to consider evidence other than the views' of airlines to be confident it was making a decision that reflected passengers' interests for assets with a long useful economic life.

In the next section we consider the practical examples to test whether the four propositions set out above appear to occur in practice. To summarise the four propositions are:

- In a well functioning competitive market the interests of airlines and passengers are likely to be relatively well aligned.
- Where airlines have market power, there will be a mis-alignment of interests because airlines' profit maximising strategy will involve restricting supply and raising prices.
- Incumbent airlines may not re-allocate capacity (or support capacity development) if such a change would increase competition unless they perceive that the benefits they receive in return are so pervasive that they outweigh the costs (through reduced profits) from new entry into markets in which they are already established.
- Where non-market processes such as economic regulation or planning operate to decide outcomes they can act to change the interests of airlines and therefore their potential alignment with passenger interests.

6. PRACTICAL EXAMPLES

This section seeks to draw on a range of evidence about how the aviation sector, operating in practice illustrates the degree of alignment between the interests of airlines and passengers. We set out our examples in line with the conclusions drawn in Section 5.

6.1. Conclusion 1: In a well functioning competitive market the interests of airlines and passengers are likely to be relatively well aligned

As noted previously in this working paper, the airline sector in the EU, and more generally, has seen substantial liberalisation over the last twenty years. This has allowed more airlines to operate routes, and to open additional routes. It has also allowed airlines to compete for passengers through price, quality and convenience. Although the financial crisis and subsequent economic downturn have reduced to some degree the routes offered by airlines, the range of prices, quality and choice offered by the airline sector in the EU is much greater than twenty years ago. The Competition Commission in its Market Investigation of BAA's airports highlighted two studies by IATA and the DTI that suggested the liberalisation had led to a material reduction in airlines' operating costs and the prices charged to passengers.

In particular, the CC noted figures published by IATA showing a 3 per cent a year decline in EU network airlines adjusted costs per airline seat kilometre (ASK) from 1997 to 2005 (adjusted, inter alia, by inflation), and slightly lower decline in adjusted revenue per ASK.[20] The CC also commented on a study by the then DTI on passenger flights in Europe which found evidence of price reductions, of some 66% (in nominal terms) for 1992–2002 in lowest non-sale fares.[21] The backdrop for the DTI study was the progressive liberalisation of the EU air transport market. By 1997, all domestic markets were open to competition, meaning that any airline which had an Operating License from any member state could operate any route within the EU. Results demonstrate that this increase in competition was beneficial to consumers by better aligning the interests of airlines and passengers. Box 6.1 contains some more detail on the results of the study.

[20] Competition Commission (2009) "BAA airports market investigation: A report on the supply of airport services by BAA in the UK", p. 151, accessed at http://www.competition-commission.org.uk/rep_pub/reports/2009/fulltext/545.pdf

[21] Competition Commission (2009) "BAA airports market investigation: A report on the supply of airport services by BAA in the UK", p. 151, accessed at http://www.competition-commission.org.uk/rep_pub/reports/2009/fulltext/545.pdf

Box 6.1: Case Study: Competition between airlines in Europe and outcomes for consumers

Choice:

- **Consumer interest:** An increase in the number of carriers operating on a given route should benefit consumers as competition increases.
- **Outcome:** By 2003, low-cost airlines had entered all of the sample routes. The average number of competitors increased over the period from an average of 3 in 1992 to 4 in 1997 and 2003.

Airfares:

- **Consumer interest:** Consumers benefit from having the services they demand offered at lower prices, at least where quality is not compromised.
- **Outcome:** Competition between airlines has been able to offer lower prices to customers.
  - For BA, the average lowest non-sale fare fell by 10% between 1992 (the base year) and 1997. By 2002, a fall of 66% had occurred.
  - Across all carriers, the price of the lowest-priced carrier had fallen by 36% in 1997 and 66% by 2002.
  - In relation to the lowest business and flexible fares, the change is less pronounced. BA's prices increased over the periods to 1997 and 2002. However, adjusting for inflation, the average business fare has increased very little and the average fully flexible fare actually fell in real terms.
  - The lowest priced carrier's average business and flexible fares both decreased initially but then increased between 1997 and 2003. In real terms they decreased over the entire period.
  - On domestic routes BA and other carrier's average lowest non-sale fares had fallen by 75% in nominal terms.

Flight frequency:

- **Consumer interest:** More frequent flights on a given route improve the quality of service for consumers as they have a greater choice of travel times and are more likely to find a flight that is convenient.
- **Outcome:** Over the period from 1992 to 2003, flight frequency, measured as services per weekday, increased by 78%. In 1992, there were 223 daily flights none of which were operated by low cost carriers. By 2003, there were approximately 397 flights per weekday and 38% of these flights were provided by low cost carriers.

Source: Based on DTI (2004) "The Benefits from Competition: some illustrative UK cases", accessed at http://www.bis.gov.uk/files/file13299.pdf

The CAA reviewed regional air services in the UK in 2007, and while a lot has happened in the aviation sector and the wider economy in the intervening three years, much of the evidence and analysis produced by the CAA remains relevant to this working paper.[22] Amongst the key conclusions of the CAA's analysis was that, "...competition amongst airlines remains fierce, with airlines using the "no frills" model continuing to gain ground." The report also noted that regional airports are continuing to have to compete vigorously to attract airlines and passengers.

Over the six years leading up to the date of the study traffic at regional airports had grown more quickly than at the main London airports, and accounted for 42% of total

[22] http://www.caa.co.uk CAP775

UK air traffic. International scheduled traffic was a key growth area, with charter flights showing a decline. In 2006 fifteen regional airports offered daily scheduled flights to five or more international destinations. There were about 400 international airport pairs served from UK regional airports in 2006 compared to about 100 in 1990. The report also noted that the increasing competition between airlines was blurring the distinction between full service, charter and no-frills airlines. This is illustrated on short haul flights through the number of no-frills airlines offering a menu of additional, optional services, such as lounge access, early boarding, and a general unbundling of services such as the carriage of hold baggage.

The CAA's analysis of the impacts of competition between airlines and regional airports was further supported by the analysis of the CC for the BAA Market Investigation. The CC looked at pairs or groups of regional airports that due to geographic proximity may be expected to compete with each other. These studies found examples of relatively strong competition to the benefit of passengers.

The increased service differentiation following liberalisation has meant that it is now difficult to say that there is anything approximating a single airline interest, with airlines having very different views about the requirements for airport facilities and other provisions based on a view about their competitive advantage and the needs of their passengers. Similarly passengers have different requirements and it is unlikely that these interests could be covered in a homogeneous way.

Recent studies looking at passenger perceptions and the reasons for choosing a particular airline indicate this divergence. For example, a recent survey of both incumbent airlines and low-cost carriers found that, as expected, the incumbent airlines surveyed carried a greater proportion of business traffic, with meetings being a significant motivator for the trip. However, almost 29% of the Ryanair passengers surveyed were also travelling on business. This was seen as being significant because Ryanair was operating a secondary airport which added time and inconvenience for business travellers. Looking further into these statistics, it was found that a high proportion of self-employed people choose to use low-cost carriers. These travellers were attracted by the low fare and were not necessarily interested in the full service products.[23] This indicates that passenger's interests are diverse and cannot be neatly categorised between those who favour full-service airlines and those that choose to use low-cost carriers. This diversity of interests may mean that airlines could seek to persuade statutory bodies in non-market processes to undertake developments that are in their interests, but not those of competitors.

The CAA has noted that the presence of general consumer protection laws that cover airlines as they do other parts of the economy, suggest that policy-makers have no automatic presumption that the interests of airlines and passengers are

[23] O'Connell, O.F. and G. Williams (2005) "Passengers' perceptions of low cost airlines and full service carriers
- A case study involving Ryanair, Aer Lingus, Air Asia and Malaysia Airlines", p.8 , accessed at http://web.nkhc.edu.tw/t0259/abt/LCC.pdf

aligned. There are a range of examples of airlines having been found to have breached requirements regarding standards of advertising, including the clarity of the prices advertised. The CAA's website also sets out the range of provisions that specifically relate to air passengers in the UK and Europe, which particularly cover denied boarding and passengers with reduced mobility.[24]

These provisions indicate that policy-makers take a view that the operation of a competitive market may not always align with the interests of passengers. For example, the provisions regarding passengers with reduced mobility suggest that policy-makers have taken a view that airlines operating in a competitive market would not make adequate provision for such passengers. A review of the first year of operation of these rules earlier this year by the CAA found that airlines and airports implementation of the regulations had varied significantly.[25] The regulations relating to denied boarding provide some additional protection for passengers against situations where airlines over book flights or could seek not to operate a flight that was not full.

These examples illustrate that policy-makers have taken a view that even within a relatively competitive market there can be circumstances where airlines derive a competitive advantage or improve profitability by undertaking actions that do not best serve the interests of passengers. Policy-makers have further taken the view that any initiatives that the market would take are not sufficient to meet passengers' interests. For example, concerns about pricing accuracy might be addressed through price comparison websites.

The practical evidence suggests that airlines operating in a well functioning competitive market have strong incentives to meet the needs of passengers, to maximise profits. Therefore, there is likely to be a good alignment of interests between airlines and passengers on many issues in these situations. It is also important to note that well functioning competitive markets are an increasing part of the aviation sector given the liberalisation of air travel. The presence of consumer protection legislation also suggests that policy-makers have concerns that even in a competitive market airlines would not serve some groups of passengers in a way that was considered socially acceptable.

6.2. Conclusion 2: Where airlines have market power, there will be a mis-alignment of interests because airlines' profit maximising strategy will involve restricting supply and raising prices.

We consider it almost without controversy that where an airline has market power there is a risk of significant misalignment with passengers' interests. However, we present some of the evidence to support this proposition.

[24] http://www.caa.co.uk/default.aspx?catid=125&pagetype=90

[25] http://www.caa.co.uk/default.aspx?catid=125&pagetype=90&pageid=8224

The particular issue we look at is the existence of a hub premium, where airlines that are dominant at a particular airport leverage that dominance to extract higher prices. A study in the US in 2005 concluded that hub premiums were in existence, despite a substantial decline over the ten-year period of the analysis.[26] Borenstein examined the 50 busiest US airports and found that at the 10 most expensive of these airports prices exceeded the overall national levels by an average of 33% in 1995.[27] In 2004, the premium was still there but had fallen to 24%. In particular, Borenstein commented on a group of four airports which are noted for their lack of large scale entry by low-cost carriers and calculated that passengers had "paid millions of dollars per year more than they would have if they had paid prices equal to the national average for the distances they were flying".[28]

Similar studies have been carried out for European air carrier markets. Results again suggest that where an airline has a dominant position, this can lead to higher fares.[29] A study looking particularly at hub premiums found that in 2000, the premium for Air France and Swissair was approximately 14 percent, while for Lufthansa it was slightly higher at 15 percent.[30] A recent OECD paper also cited evidence from a number of sources about a hub premium.[31]

The existence of a hub premium does not in itself imply a competitive problem, and may instead reflect network effects through customers being prepared to pay for the convenience of easier inter-connection. However, if hubs were characterised by significant barriers to entry, such as a hoarding of slots then the hub premium may be indicative of a competitive problem.

There have also been particular cases of abuse of a dominant position by airlines. For example, British Airways was found to have abused its dominant position in the UK market for air travel agency services. In this case, a complaint was lodged by Virgin Atlantic about agreements between British Airways and travel agents relating to commissions and financial incentives for selling British Airways tickets. This was investigated and found to be an abuse by the Commission of the European Communities. British Airways subsequently appealed the decision but this action was dismissed by the Court of First Instance and the Court of Justice.[32]

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[26] Borenstein S. (2005) "U.S. Domestic Airline Pricing, 1995-2004", accessed at http://129.3.20.41/eps/io/papers/0504/0504016.pdf

[27] All but one of these airports served as a hub for at least one carrier.

[28] Borenstein S. (2005) "U.S. Domestic Airline Pricing, 1995-2004", p.3, accessed at http://129.3.20.41/eps/io/papers/0504/0504016.pdf

[29] Piga C. and Bachis E. (2007) "Hub premium, airport dominance and market power in the European Airline Industry", WP 2007-11 at p.22, accessed at http://www.lboro.ac.uk/departments/ec/RePEc/lbo/lbowps/WP_Piga_Bachis_RPE_article.pdf

[30] Lijesen M., P. Rietvald and P. Nijkamp (2000) "Do European carriers dominate their hubs?" TI 2000-071/3 Tinbergen Institute Discussion Paper, accessed at http://www.tinbergen.nl/discussionpapers/00071.pdf

[31] "Competitive Interaction between Airports, Airlines and High Speed Rail", OECD.

[32] Court of Justice (2007) "The Court of Justice dismisses British Airway's Appeal", accessed at http://curia.europa.eu/jcms/upload/docs/application/pdf/2009-02/cp070023en.pdf

In addition to exercising market power, a number of cases considered by the Office of Fair Trading (OFT) and the European Commission indicate that airlines may also at times engage in anti-competitive or misleading behaviour that is not in the interests of passengers. Some examples include:

- In April 2009, the European Commission began a formal investigation into the cooperation of British Airways, American Airlines and Iberia on passenger transport routes between Europe and North America. The Commission was concerned that the agreement may breach EU rules on anti-competitive business practices and sent a Statement of Objections to the parties in September 2009. The airlines responded by offering a set of commitments to alleviate the Commission's concerns and the Commission is currently inviting comments from interested parties about the proposed commitments.[33]

- The OFT conducted a price fixing investigation which resulted in British Airways admitting that between August 2004 and January 2006 it colluded with Virgin Atlantic in relation to surcharges added to ticket prices to cover rising oil prices. Over the relevant period the surcharge increased from £5 per ticket to £60 per ticket for an average British Airways or Virgin Atlantic long-haul return flight.[34] A criminal case in relation to this issue has recently been dropped.

- In 2007, a wide-ranging investigation began, including both the European Commission and the US Department for Justice, into a conspiracy between a number of airlines to fix prices for international cargo shipments. Several airlines were found to be guilty, including Japan Airlines International, Qantas, British Airways and Korean Air Lines.[35]

- In 2007, the OFT took action against 13 airlines that had not included all fixed non-optional costs, such as taxes, in prices on their websites. The OFT wanted to ensure that consumers were not mislead "by advertised prices that bear little relation to actual prices".[36]

Overall, the examples suggest that there is evidence that airlines have breached competition law, and therefore acted contrary to the interests of passengers.

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[33] European Commission (2010) "Antitrust: Commission market tests commitments proposed by BA, AA and Iberia concerning transatlantic co-operation", accessed at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/256&format=HTML&aged=0&language=EN&guiLanguage=en

[34] OFT (2007) "British Airways to pay record £121.5m penalty in price fixing investigation", accessed at http://www.oft.gov.uk/news/press/2007/113-07

[35] US Department of Justice (2008) "Former Qantas airline executive agrees to plead guilty to participating in price-fixing conspiracy on air cargo shipments", accessed at http://www.justice.gov/atr/public/press_releases/2008/232954.htm

[36] OFT (2007) "OFT takes action against 13 airlines over misleading holiday pricing", accessed at http://www.oft.gov.uk/news/press/2007/118-07

6.3. Conclusion 3: Incumbent airlines may not re-allocate capacity (or support capacity development) if such a change would increase competition unless they perceive that the benefits they receive in return outweigh the costs (through reduced profits) from new entry into markets in which they are already established

To consider this proposition we discuss two potential examples where competition between airlines could be increased and we consider the response of airlines. The first is changes in capacity allocation and the second is the removal or amendment of bilateral air service agreements. It is important to note that in some of these examples, the role of airlines in these decisions will generally be to influence rather than make decisions. The example of bilateral air services agreements is a statutory process through decisions by Governments, although airlines can seek to influence decisions about whether and when to review such agreements.

Changes in capacity allocation

In general the UK's designated airports are operating at or close to capacity[37] and the available slots for airlines to land and take-off are allocated through a system of administrative rules, which largely favour incumbent airlines. However, these slot allocations are not fixed and slots can be traded between airlines on a one-for-one basis, with accompanying monetary consideration.[38] In a competitive market, the existence of secondary trading should mean that slots are allocated to their most economically efficient route, where passengers value the route most and are therefore willing to pay the most for it. The CAA and OFT examined the issue of slot trading in 2006 as a result of European-led discussion on the potential for introducing market mechanisms for allocating slots.[39]

In that paper, the CAA and OFT noted that if airlines were able to buy, sell and lease slots this would provide airlines with greater incentives to use their capacity allocation more efficiently. According to the paper, the outcome would be a less rigid system with increased opportunities to obtain slots and therefore a greater ability for new airlines to launch downstream services. This was expected to provide a challenge to incumbent airlines and benefits to consumers. However, the CAA/ OFT paper also envisaged the possibility that a dominant airline at an airport may use the secondary slot market to purchase more slots and increase market power so that the

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[37] Heathrow is broadly at full capacity, while there are some limited slots available at Gatwick and more slots available at Stansted.

[38] There was some uncertainty about whether slot trades could be accompanied by monetary consideration but this was clarified by the European Commission in a statement in 2008. See European Commission (2008) "Airport Slot Allocation: The Commission Clarifies the Existing Rules", accessed at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/672&type=HTML

[39] CAA/OFT (2006) " Competition issues associated with the trading of airport slots
A paper prepared for DG TREN by the UK Office of Fair Trading and Civil Aviation Authority", accessed at http://www.caa.co.uk/docs/589/oft832.pdf

ability of other airlines to compete in downstream markets is restricted. The CAA/ OFT considered that such behaviour would be to the detriment of air passengers.[40] In this case, the airline would be deciding that the benefits of selling an available slot may be outweighed by the increased competition on remaining routes and may lead to lower profits overall.

The potential for airlines to trade slots in a way that is harmful to consumers, and therefore not in their interests, is demonstrated in the recent case of Delta and US Airways. Under the proposed trade, Delta was planning to transfer 42 pairs of slot interests to US Airways at Ronald Reagan Washington National Airport while US Airways would transfer 125 pairs of slot interests to Delta at LaGuardia Airport (plus leasing an additional 15 pairs of slot interests).[41] In examining the slot exchange for approval, the Federal Aviation Administration (FAA) was concerned that the trade would mean that US Airways and Delta could increase the number of markets they served on a monopoly or dominant basis and that consumers might be harmed by "the loss of nonstop service, the loss of a nonstop competitor, or the transfer of nonstop monopoly service to a more dominant carrier".[42] The FAA further concluded that the transaction might result in higher fares for consumers as the airlines relied on their dominance and that these higher fares might be sustainable due to the increased market power at both airports. The FAA therefore only approved the exchange if certain conditions for release of slots were met.

The slot allocation rules and the incentives they create for airlines may also lead to a misalignment between passenger and airline interests when new capacity is created. In particular, the current slot allocation rules would mean that priority would be given to new entrants for 50% of new slots, where there is sufficient demand. In some circumstances, this may provide incentives for incumbent airlines to resist capacity expansion because the provision of slots for new entrants may increase competition, leading to an erosion of their profits, although they will trade off the potential for increased profits from growth in the number and range of services offered. However, it is important to note that airlines have often supported significant capacity expansion, including for example, the broad airline support for the development of a third runway at Heathrow airport. This suggests that airlines consider there are greater opportunities to profit from growth than risks associated with lost profits. In the case of Heathrow the greater opportunities for growth could, for example, arise from seeking to serve longer haul routes such as China and India which are increasing in economic importance.

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[40] CAA/OFT (2006) " Competition issues associated with the trading of airport slots
A paper prepared for DG TREN by the UK Office of Fair Trading and Civil Aviation Authority", accessed at http://www.caa.co.uk/docs/589/oft832.pdf at p. 2

[41] Federal Aviation Administration (2010) "Notice on Petition for Waiver of the Terms of the Order Limiting Scheduled Operations at LaGuardia Airport", accessed at http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480aeb0a5

[42] Federal Aviation Administration (2010) "Notice on Petition for Waiver of the Terms of the Order Limiting Scheduled Operations at LaGuardia Airport", accessed at http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480aeb0a5

There has been a lot of discussion about the issues regarding SG1 and 2 at Stansted airport with regard to the reasons why airlines at the airport had concerns about the plans of BAA. These issues have been extensively considered by the CAA and the CC, and involve consideration of a range of issues including the motivations of different parties and the impact of regulation on incentives.

The development proposed by BAA for Stansted would have led to a large increase in the Regulated Asset Base (RAB) for the airport, thereby substantially increasing airport charges for all airlines.[43] For LCC's this could have a particularly detrimental effect on the profitability and attractiveness of a range of existing routes, and growth opportunities. The airlines may not have made much use of the new runway, but would still pay the increased airport charges. In this context it is notable that both Ryanair (the largest user of Stansted airport) and easyJet (a smaller user of Stansted airport) were largely both opposed to BAA's plans.

The examples of Heathrow and Stansted indicate that airlines will consider the case for expansion on a case by case basis recognising the impact on their profitability, including the impact of decisions in the context of economic regulation on their profitability.

Bilateral air service agreements

It is important to note that the remaining restrictions on competition between airlines, which are primarily residual bilateral air services agreements governing international scheduled services, and limitations on slot availability, mainly affect the three designated airports in the UK (Heathrow, Gatwick and Stansted), so concerns about the alignment of interests between airlines and passengers may be somewhat greater at these airports than airports less affected by these limitations on competition.

The vast majority of the UK's international scheduled passenger services are provided under liberal aviation agreements, for instance multilateral agreements made at EU level, such as the European Common Aviation Area and the EU-US Air Transport Agreement, but also bilateral agreements made between the UK and countries such as Australia, New Zealand, etc. Under these agreements, there are no restrictions on the capacity that airlines can provide (certainly as far as 3rd / 4th and 5th freedom frequencies are concerned). The UK also has agreements with countries such as India and Brazil which, although not fully liberal in terms of traffic rights, do not constrain in practice the capacity that airlines wish to provide (since there is sufficient 'headroom' between the services being operated and the capacity cap). There are, however, a number of bilateral agreements between the UK and countries such as South Africa, Ukraine, Egypt and Russia, where the capacity cap is already 'biting' on airlines' operations (in that these airlines are providing less

[43] See presentation by Chris Hemsley, CAA, entitled, "Regulating alongside competition – issues raised in the UK airports market", Centre for Competition and Regulatory Policy Workshop.

capacity than they would otherwise choose to). The restrictions in a bilateral air services agreement can reduce the level of competition on a given route and can therefore increase prices for customers. The way in which rights to operate services between the countries are allocated does not fundamentally affect the fact that a bilateral air services agreement results in a level of service different from that which would be offered in a competitive market.

The CAA published a paper on the liberalisation of air services between the UK and India which illustrates the potential negative effects of bilateral service agreements and also that airlines might not be in favour of liberalisation where this affects their market share. As a result of liberalisation, between October 2004 and October 2006, the number of direct services between India and the UK rose from 34 to 112 services per week. This increase in services was brought about by a combination of existing carriers and the entry of new carriers. The CAA has said that "competition in the UK-India market is now amongst the most intense of any long-haul market".[44] There was also said to be evidence of a significant reduction in the fares for travel between the UK and India. In fact, the CAA's estimate of the net impact of liberalisation on consumers suggests that UK passengers have benefited by approximately £39 million a year due to lower average fares and times savings resulting from the liberalisation.[45] In the CAA's discussion about why liberalisation had not happened earlier it was noted that the constraints on air traffic were seen as protecting the airlines in both countries from competition.[46] In 2004, when liberalisation was agreed, the CAA noted that "the negotiators' focus had moved away from a narrow concern for the interests of particular airlines" and was considering other factors such as the "broader interests of consumers".[47]

The examples of capacity expansion and bilateral air service agreements illustrate that airlines and passengers' interests are not necessarily aligned in cases where a development could lead to more competition amongst airlines. In these cases, airlines will consider the implications for their profits on a case by case basis.

6.4. Conclusion 4: Non-market processes such as economic regulation or planning operate to decide outcomes they can act to change the interests of airlines and therefore their potential alignment with passenger interests

The examples discussed above begin to illustrate how the presence of non-statutory processes can compound the potential for airlines and passengers' interests to be

[44] CAA (2006) "UK-India Air Services: A Case Study in Liberalisation", para. V, accessed at http://www.caa.co.uk/docs/589/ERG_EPIA_India_Liberalisation.pdf
[45] CAA (2006) "UK-India Air Services: A Case Study in Liberalisation", para. X, accessed at http://www.caa.co.uk/docs/589/ERG_EPIA_India_Liberalisation.pdf
[46] CAA (2006) "UK-India Air Services: A Case Study in Liberalisation", para. 12, accessed at http://www.caa.co.uk/docs/589/ERG_EPIA_India_Liberalisation.pdf
[47] CAA (2006) "UK-India Air Services: A Case Study in Liberalisation", para. 14, accessed at http://www.caa.co.uk/docs/589/ERG_EPIA_India_Liberalisation.pdf

mis-aligned, where developments that promote more competition are being considered. In December 2008 the CAA developed a worked example that considered whether incumbent and new entrant airlines face incentives that are aligned with those of passengers, and whether incumbent airlines face incentives that are aligned with those of new entrant airlines.[48] The CAA found that:

- incumbent airlines incentives do not necessarily align with those of new entrants;
- airlines might not support an economic and efficient project that the airport would find profitable and was commercially justified; and
- airlines, and particularly incumbent airlines, might not support a project that delivers incremental benefits using the airlines' cost of capital, due to the impact of the building block or RAB based price control.

A worked example of this type is obviously dependent on the assumptions that are made, but as a minimum illustrates that the presence of economic regulation may compound the risk of a mis-alignment of airline and passenger interests, particularly when developments that may increase competition are being considered.

There is an important issue to note at designated airports which can distort the incentives of airlines with regard to the preferences of passengers. At an airport that has more than one terminal, which are not identical, airlines (and by extension their passengers) are likely to experience different levels of service, but because the structure of airport charges is such that all airlines pay the same charge at the same airport, the different levels of service are not reflected in a different level of charges. Therefore, if an airline perceives that a rival is gaining a better service through improvements to its terminal that are not being reciprocated, it may oppose the changes because if risks worsening its competitive position, but the improvements in service levels may be in customers overall interests. The mis-alignment of airline and passenger interests due to a lack of differentiated charges would not necessarily occur with differentiated charges that allowed airlines and passengers to signal preferences for different levels of service.

While not exactly related, there are also issues about the resources available to airlines to adequately represent the interests of passengers. In particular, the CC noted in its final report on BAA's airports that it had received concerns about the Heathrow East Terminal (HET) project.[49] This project is described as being critical to achieving competitive equivalence between BA and the Star Alliance airlines at

[48] "CAA price control proposals for Stansted Airport, Supporting paper I, Illustration of airport and airline incentives", CAA. December 2008.

[49] CC (2009) "BAA Airports, Final Report, Appendix 7.2: Further Evidence on Capital Expenditure at the Designated airports", accessed at http://www.competition-commission.org.uk/rep_pub/reports/2009/fulltext/545_7_2.pdf

Heathrow. All airlines pay the same airport charges irrespective of the facilities used with the consequence that non-BA airlines have effectively contributed to the construction of T5 without the benefit of being able to use the terminal (which is exclusively for BA). Airlines that will not use the respective terminals have had input into decisions relating to these terminals, which may again affect incentives

This implies that some passengers would be paying for T5 as pass-through costs in their airfares while not being able to use the terminal. In this case, airlines are not able to adequately represent the interests of all users. The CC was of the view that in comparison with BAA's more successful collaboration with BA on the design and development of T5, concerns expressed by the airlines about the development of the Heathrow East Terminal demonstrated the particular difficulty of airlines other than BA in constructively engaging with BAA given the fewer resources available to them. The disparity between the levels of resources of various airlines suggests that some airlines may have more bargaining power and therefore could better represent the interests of their passengers, at the expense of other passengers.

While it is difficult to draw firm conclusions from any single event, the development of the second terminal at Dublin Airport has led to somewhat different reactions from the two major airlines at the airport. Ryanair has been very concerned about the cost and scoping of the project, while Aer Lingus has generally seen greater benefits from the project, although still been keen to minimise the costs of the project. Differences in the business models of the two airlines are likely to be at least part of the explanation for why they take a different view of the relative merits of the project. Box 6.2 below provides more detail about the different views of the two airlines.

Box 6.2: Ryanair and Aer Lingus' views on Terminal 2 at Dublin Airport

Ryanair's views

- Ryanair points to recent independent capacity analysis indicating that the passenger capacity of Terminal 1 has risen to approximately 30 million passengers per annum. Ryanair suggests that these figures indicate that Terminal 2 is significantly oversized and is not required until after 2014 and that the project should be "mothballed".
- Ryanair is also of the view that Terminal 2 does not meet the reasonable requirements of the overwhelming majority of users and its completion should await annual traffic growth.
- Ryanair felt that the terminal should not be opened given that it will more than double the operating costs of Dublin Airport and that these costs will be borne by users who could have been accommodated in the existing terminal.

Aer Lingus

- Aer Lingus is generally supportive of the development of Terminal 2.
- However, Aer Lingus stresses that only the efficient operating costs arising from Terminal 2 should be passed through.
- Aer Lingus also expresses the view that Terminal 2 is over-sized and expresses the concern that operating costs will be higher than the efficient level. Aer Lingus was therefore in favour of benchmark costs not actual costs for the terminal.

Source: Ryanair (2009) "Response to airport charges draft decision paper CP3/2009", accessed at http://www.aviationreg.ie/_fileupload/2009-08-07_Ryanair_Part1_response_DD.pdf and Aer Lingus (2009) "Submission by Aer Lingus in Response to CP3/2009 – Draft Determination on Maximum

Levels of Airport Charges at Dublin Airport", accessed at http://www.aviationreg.ie/_fileupload/2009-08-07_AerLingus_Response_DD.pdf

The Commission for Aviation Regulation (CAR) made its final determination on airport charges at Dublin Airport on 4 December 2009. Ryanair subsequently appealed the decision to the Aviation Appeals Panel (the Panel). In particular, Ryanair maintained the position that a low cost terminal was critical for present and future airport users and that this issue had not been addressed. Interestingly, the Aviation Appeals Panel felt that there was merit in Ryanair's submission for differential pricing, acknowledging Ryanair's particular approach as a low-cost airline. The Panel therefore referred the issue back to CAR for consideration of the best way to initiate differential pricing.[50]

There is a range of evidence to support the view that airlines' and passengers' cannot be described as having single common interests, but instead the interests of each airline and different groups of passengers will reflect their specific business models and preferences.

6.5. Summary

The evidence considered in this section suggests that the alignment between airlines and passengers' interests has increased over the last ten to fifteen years, primarily because of the liberalisation of the airline sector, which has meant that airlines have had to respond better to the demand of customers. Passengers have seen price, choice and convenience improve significantly, and the variety of service offerings has expanded substantially, which allows passengers to choose options that much better meet their needs.

Where airlines have a significant degree of market power or are considering potential developments that might promote further competition, it is not clear that their response will always align with passengers' interests, although it is important to note that airlines have often been very supportive of proposals to expand airport capacity, such as the development of the third runway at Heathrow. This issue can be further compounded by statutory processes, such as economic regulation that can affect the incentives of airlines and the way airlines seek to further their objective of maximising their profits.

[50] Aviation Appeals Panel (2010) "Appeal of Ryanair against determination of the Commission for Aviation Regulation CP4/2009"

7. CONCLUSIONS

We developed four main propositions about the alignment of the interests of airlines and passengers, which were:

- In a well functioning competitive market the interests of airlines and passengers are likely to be relatively well aligned.
- Where airlines have market power, there will be a mis-alignment of interests because airlines' profit maximising strategy will involve restricting supply and raising prices.
- Incumbent airlines may not re-allocate capacity (or support capacity development) if such a change would increase competition unless they perceive that the benefits they receive in return outweigh the costs (through reduced profits) from new entry into markets in which they are already established.
- Non-market processes such as economic regulation or planning operate to decide outcomes they can act to change the interests of airlines and therefore their potential alignment with passenger interests.

There is very strong evidence that the interests of passengers and airlines are likely to be relatively well aligned where airlines are operating in a well functioning competitive market, and competitive markets have increasingly characterised the airline sector in recent years. Developments in the European aviation sector over the last ten to fifteen years bear out this view.

The imposition of competition law means that it is generally accepted in the economy that companies with market power have the potential to act against the interests of their consumers. In the airline sector there have been recent cases in the UK and in Europe where airlines have been found to have breached competition law.

Developments that may lead to more competition are an area where the interests of airlines and passengers may or may not align. Airlines will make a case by case judgement about the trade-off between more profit opportunities from growth and lost profit from more competition. This can be seen in the airlines reaction to expansion or quality improvement plans by airports and decisions to remove or relax bilateral air service agreements, which generally their particular view of the likely gains or losses from each development.

The presence of economic regulation or other statutory processes such as planning enquiries makes it more difficult to be confident about the alignment between airline and passenger interests. In particular, unlike in a competitive market, a statutory process leads the airlines to focus on persuading the regulator or other statutory body, as seeking to establish a commercial deal. This is not a criticism of airlines directly, but a recognition of the potential impact of regulation or other statutory processes.

For the purposes of this working paper we are not seeking to draw specific conclusions about the detailed implications for economic regulation of the degree of alignment between airlines and passengers, but instead to note that while alignment is often good where competition is vigorous, there are circumstances where alignment may be weaker, particularly where airlines have market power or developments that promote more competition are being considered.

ANNEX A - STAKEHOLDERS' VIEWS

In this section we summarise the views of a range of stakeholders on the degree of alignment between the interests of airlines and passengers. We have sought to draw the material from a range of public sources, and primarily responses to the DfT's consultations on the review of the airport regulatory framework, submissions to the Competition Commission's Market Investigation of BAA, and responses to various consultations held by the CAA. Given the range of material that has been produced regarding airport regulation and the interaction between airlines and passengers' interests, it is not possible to be confident that we have reviewed every relevant piece of information, but we have sought to summarise based on the publicly available information the most recently expressed views of the key stakeholders.

Regulators

CAA's views

As part of the DfT's review of the framework for the economic regulation of the UK's airports, the CAA was asked, amongst other things, for its views on how well the airlines' interests matched those of passengers. The CAA's response noted that airlines will "represent well the interests of passengers where this suits their commercial interests".[51] In the CAA's view this is most likely to be the case where there is effective airport and airline competition and economic regulation does not introduce distorting behaviour.

However, the CAA noted that where these circumstances do not apply there is the potential for divergences between the interests of airlines and passengers. The CAA went on to note that the existence of general competition and consumer protection legislation demonstrates that there is no general presumption that commercial entities will always be acting in the best interests of the consumer.

The CAA outlined a number of circumstances in the UK where airlines were found to have acted contrary to the interests of consumers. These examples included:

- where airlines had broken European competition law;
- OFT investigations of the way airlines had displayed their charges, requiring amendments to the online booking process and the promotion of airfares; and
- cases brought by the Advertising Standards Agency against misleading or otherwise inappropriate advertising by airlines.

The CAA was also of the view that there would be some disagreement between airlines themselves about what is in the interests of passengers and the type of

[51] CAA (2008) "CAA's response to DfT's September 2008 request for views" at p.20, accessed at http://www.caa.co.uk/docs/5/ergdocs/081107CAAResponseDfTSeptemberSubmission.pdf

services required at an airport. This can arise because airlines offer differentiated services that appeal to different market segments and hence the views of airlines will not always coincide. The CAA gave the example of the low cost carrier model which involves lowering the average ticket price by removing non-essential services and that was contrasted to the traditional service airlines who derive profits from offering a superior service.

The issue of airline and passenger interests was also considered by the CAA as part of the development of the constructive engagement process. In May 2005, the CAA published a paper on airport regulation and the process for constructive engagement which examined this issue.[52] The CAA noted that some of the responses received on the future of airport regulation did raise concerns about how the interests of passengers (and of small new entrant or future airlines) would be safeguarded in negotiations between airports and airlines.[53]

There was some concern that a regulatory process encouraging negotiation between airlines and airports would mean that larger airlines, with more resources, would be in a position to exert the most influence on negotiated agreements. The CAA noted the possibility of an agreement being concluded between dominant airlines and the airport which furthers the interests of those airlines but not necessarily the wider interests of users. A particular example suggested was restricting capacity. As a result, the CAA stated that it would adopt agreements reached between the airport and airlines if these agreements were consistent with its statutory duties.

In mitigation of this concern, the CAA noted that airlines' future revenues and profitability are dependent on the services provided to passengers and that passenger choice about which airline to use incentivises airlines to provide what passengers want. As evidence, the CAA noted the observed airline sensitivity to increases in airport charges which is in line with passenger interests. The CAA also noted that airlines have tended to be supportive of capacity enhancements.

Based on these and other factors, the CAA concluded that transparency and the level of shared interests between users would mitigate much of the risk that the airport/ airline negotiation would not represent the interests of all users. However, the CAA acknowledged that there was a risk that such outcomes could happen, for example through restriction of the pace of airport capacity growth. This would be a barrier to entry for non-incumbent airlines and therefore might subject passengers to fare increases. The CAA noted that the potential for such behaviour required the CAA to require further information where agreements were made. For example, the CAA would expect clear reasons and evidence where viable major capacity enhancement options were dismissed.

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[52] CAA(2005) "Airport Regulation: the process for constructive engagement", accessed at http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_airportregulation_may05.pdf

[53] CAA(2005) "Airport Regulation: the process for constructive engagement" at p.43, accessed at http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_airportregulation_may05.pdf

The CC's views

The Competition Commission summarised its views in its final report on the Market Investigation of BAA's airports. The CC stated that, "...for most purposes, competition between airlines is likely to imply a commonality of interests between airlines and final consumers...".[54] It subsequently stated that, "...on some issues relating to airport regulation, airlines' interests are likely to diverge from those of final consumers...".[55] Building on this point, the CC also noted that, "...the extent to which airport facilities are appropriate to meet the often divergent requirements of airlines, can therefore significantly affect the competitive position of the airlines."[56], which recognised that there is unlikely to be a single airline interest on any issue.

However, the CC did not think it necessary to go so far as to impose on the regulator a substantive duty to further the interests of airlines in the primary obligation. The CC recommended to the DfT that the primary objective of the regulator should be to promote the interests of existing and future consumers of passengers and freight services at UK airports, wherever appropriate by promoting effective competition, but with an ancillary duty to consult and pay due regard to the views of airlines, while also being required to consult appropriate designated passenger groups and airport operators.[57]

The CC was concerned that the CAA appeared to give insufficient weight to the airline users, tending to differentiate between their interests and those of passengers. Particularly in connection with Stansted airport, the CC noted that the CAA appeared not to regard Ryanair and easyJet, both successful and profitable airlines and main future users of the airport, as proxies for their customers.[58]

The CC discussed quite extensively whether the CAA was in a good position compared to airlines to assess the interests of passengers. While this is potentially an important question when considering how best to regulate designated airports or airports with a Tier 1 licence under the proposed new regulatory regime, it is not directly relevant to the issues being considered in this working paper.

Airlines

British Airways response to the CC's Provisional Findings of its Market Investigation into BAA's airports[59] argued that the statutory duties of the CAA should include reference to airlines' interests alongside those of passengers. It argued that this was appropriate because airlines' understood the needs of their passengers better than

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[54] *BAA airports market investigation – A report on the supply of airport services by BAA in the UK (*CC report), paragraph 6.38(a).

[55] CC report, paragraphs 6.51 and 6.53. the CC gave the treatment of assets in the course of construction as an example.

[56] CC report, paragraph 6.56.

[57] CC report summary, paragraph 35

[58] CC report, paragraph 6.51.

[59] http://www.competition-commission.org.uk/inquiries/ref2007/airports/pdf/response_pf_ba_a1.pdf

the CAA. It also argued that the CAA was mistaken to argue that there could be a misalignment between the interests of airlines and future passengers with regard to capacity expansion, not least because airlines had consistently supported capacity expansion.

Virgin Atlantic made similar arguments and suggested that highly competitive airlines were the best proxy for the interests of passengers because the presence of competition meant that there was a commonality between the interests of airlines and passengers.[60] The responses to the DfT's consultation on proposals to reform the airport regulatory framework included many responses expressing similar views.[61]

Airports

Airports were generally supportive of the establishment of a primary duty in relation to passengers and users of freight services. There was only limited comment on the particular issue of the potential divergence between airline and passenger views. For example, in responding to the CC's provisional remedies for BAA airports, BAA noted that regulation should consider the views of airlines given their important role as key stakeholders. However, BAA acknowledged that airlines may not always share the same interests as passengers.[62]

Airports generally thought that the CAA's primary duty should be to regulate airports in a way that promotes the consumers' interests because this would replicate the outcomes of a competitive market environment. It was noted that where airline competition is not fully effective, there may be differences in the interests of consumers and airlines.

Passenger representatives

In its response to the DfT's consultation on the regulation of UK airports, the Air Transport Users Council (AUC) was in favour of a primary duty to end consumers. This was said to be consistent with the primary purpose of economic regulation, which was described as the promotion of consumer interests. The AUC acknowledged that passenger interests were often closely aligned with airline interests and therefore suggested a role for airlines but reserved the primary duty for end consumers.[63]

Other stakeholders

[60] http://www.competition-commission.org.uk/inquiries/ref2007/airports/pdf/response_pf_virgin_atlantic.pdf

[61] http://www.dft.gov.uk/consultations/closed/ukairports/responsesummary.pdf

[62] BAA (2009) "Response for BAA Limited: BAA response to the Provisional Decision on Remedies", accessed at http://www.competition-commission.org.uk/Inquiries/ref2007/airports/pdf/response_pdr_baa.pdf

[63] http://www.auc.org.uk/docs/306/AUCEconRegResponseChapters%206-9.pdf

The House of Commons Transport Committee (the Committee) examined the passengers' experience of air travel in 2007.[64] In considering the passengers' interest, the Committee noted that the CAA had made the point that the airline and the passenger interest might not always coincide, although in general they would due to the commercial constraints in a service-orientated industry. In evidence to the Committee, Dr Harry Bush noted that gaps might emerge between airline and passenger interests. An example given was the case of security where the airline might focus on keeping costs down but the passenger would like to have a shorter security queue. The Committee acknowledged the CAA's recognition that the passenger and airline interest are not always the same and in the context of a duty to consumers, including end consumers and airlines, suggested that in the case of a conflict between the airline and the passenger interest, the presumption should be that the CAA will come down on the side of the passenger.[65]

In response to the DfT's review of airport regulation, some stakeholders did not comment on the issue of whether airlines were a good proxy for end consumers, rather they raised questions about whether the primary duty should in fact include other factors, such as the environment. For example, the 2M Group of Councils felt that the environment should be placed on an equal footing with the duty to consumers and the Local Authorities' Aircraft Noise Council agreed with this. The Local Authorities Coordinators of Regulatory Services suggested a rewording of the primary duty so that the interests of consumers would be promoted in a manner consistent with Government commitments to reduce greenhouse gas emissions and meet European and international air quality and noise standards. The Campaign to Protect Rural England felt that both the environmental and financing duty should be given equal weight to the interests of passengers and further that the interests of those who did not fly should be taken into account.[66]

Summary

There is a level of agreement amongst all stakeholders that there is likely to be a relatively good alignment of interests between airlines and passengers when airlines are operating in a vigorously competitive market. There is also a level of agreement that there are circumstances in which the interests of airlines and passengers will diverge, although airlines would not necessarily agree with this statement. Nevertheless, there are clearly differences of emphasis on this issue. The CAA is more concerned that there will be occasions where airlines' views influenced by their commercial interests are divergent from passengers' interests, notwithstanding the

64 House of Commons Transport Committee (2007) "Passengers' Experiences of Air Travel", accessed at http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtran/435/435i.pdf

65 This comment needs to be considered in the context of the existing duty to 'consumers' which does not distinguish between end consumers and airlines. House of Commons Transport Committee (2007) "Passengers' Experiences of Air Travel", at para. 69, accessed at http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtran/435/435i.pdf

66 http://www.dft.gov.uk/consultations/closed/ukairports/responsesummary.pdf

role that airlines have been given in the regulatory process through Constructive Engagement. The CC agreed that the regulator's primary objective should focus on the consumer interests, but put somewhat more emphasis on airlines' input into the regulatory process.

Overall, stakeholders appear to broadly agree that there will be good alignment of interests were airlines operate in strongly competitive markets, but disagree to some degree about how strong the mis-alignment of interests will be in other circumstances.