

## CAA COMPETITION ASSESSMENT IN SCARCE CAPACITY HEARINGS

### Guidelines

1. During consultations on the last Statement of Policies on Route and Air Transport Licensing, it was suggested by some respondents that CAA should produce its own competition guidelines for use in scarce capacity cases, rather than rely on OFT's general competition guidelines. At the end of the consultation, CAA committed to give careful consideration to this proposal.
2. Having considered this point further, the CAA now proposes to adopt the OFT guidelines, rather than prepare any aviation-specific guidelines of its own. The CAA has reached this decision having considered the difficulties that would be inherent in producing specific guidelines that would be of use to parties without seeming to pre-judge any particular case.
3. In the light of these considerations, the CAA's view is that the OFT guidelines<sup>1</sup> are sufficiently comprehensive to be usefully applied in aviation scarce capacity cases. The CAA has also had regard to the fact that it is not a concurrent authority on competition matters concerning airlines or airports, and that it would therefore be unusual for a non-concurrent organisation to attempt to produce its own competition guidelines. The CAA remains committed to ensuring that its methodology in approaching scarce capacity cases is as comprehensive as possible. We believe that the procedures set out in the Statement of Policies, alongside the OFT's published guidelines on competition assessment, provide a transparent framework for the conduct of such hearings.

### Competition law changes

4. Since the CAA's publication of its proposed Statement of Policies in November 2001, the coming into force of the Enterprise Act has brought about changes to general competition law in the UK. Amongst other things, the Act inserts a new test based on the concept of "substantial lessening of competition". As a result, the CAA's current Statement of Policies, which linked to the EC merger test of "creating or strengthening a dominant position", is now out of date.
5. The task the CAA is charged with carrying out in scarce capacity cases has its closest parallels in merger hearings, as we are not dealing with any breach of competition law, but simply looking at the market before and after a particular change of circumstances and considering what competition concerns are raised. The CAA therefore proposes that, in order to maintain consistency with current UK merger policy, the Statement of Policies should be changed so that the existing wording of "creating or strengthening a dominant position" is replaced with the more appropriate concept of "impact on competition or rivalry".
6. The CAA's current [Statement of Policies](#) (which took effect from June 2002) says:

"Where bilateral restrictions prevent British airlines from operating all of the services they plan to provide, the CAA will allocate scarce capacity

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<sup>1</sup> OFT 403, Competition Act 1998 Guidelines "Market Definition". Also OFT publication in May 2003 on "Mergers – Substantive assessment guidance".

between competing British airlines .....CAA's overarching objective will be to maximise economic efficiency."

7. It goes on to say that the CAA will do this by "conducting a full economic analysis of the costs and benefits that would accrue to airlines and users, with capacity being awarded to the airline that provides the highest level of net benefit."

8. The following paragraph introduces the competition element of the analysis:

"The CAA will take into account the effect on competition of the proposed services **and the possibility that a dominant position would be created or strengthened** as a result of which effective competition would be significantly impeded. The CAA will therefore perform a standard competition assessment **in order to establish whether an award of scarce capacity would, or would be likely to, create or strengthen a dominant position**. In the event of such a finding, the CAA will weigh any resulting detriments to competition against the benefits which would arise from awarding the scarce capacity to the dominant carrier."

9. The way the CAA approaches this is made clearer in the detailed paper "CAA Guidance on the economic framework for considering cases relating to the allocation of scarce bilateral capacity" ([Annex 8 of the Official Record Series 1](#)). This paper sets out the mechanism the CAA will use when estimating customer benefits flowing from airline proposals for the use of scarce capacity, and which will form a major part of any CAA decision in such cases.

10. The current Statement of Policies attaches to the concept of creating or strengthening a dominant position, an approach to merger analysis that has now been explicitly rejected in the UK (and in the US) in favour of a test based on the concept of "substantial lessening of competition" or "SLC".

11. As the CAA intends to use the OFT's competition guidelines when taking decisions on the competition elements of options for allocation of scarce capacity, it would be inconsistent to continue to have language in the Statement of Policies that reflects an alternative approach to the conceptual framework for merger analysis in the UK.

12. In terms of general UK competition law, the rationale for moving (via the Enterprise Act) to a merger test based on the concept of SLC is that this best catches whether or not a merger will create a situation in a market that reduces competition between firms to the detriment of consumers. Asking whether a merger creates or strengthens a dominant position is not so conducive to a review of the economic consequences of a case.

13. However, whilst this provides a sound basis for merger analysis, it is not clear that it completely fits with the process the CAA undertakes when coming to a decision about the allocation of scarce capacity. The OFT is asking itself whether the market post-merger is substantially less competitive than the market absent the merger. Essentially, if it decides this is so, the merger will be referred to the Competition Commission for further consideration and could be blocked.

14. The CAA's job is different. The scarce capacity needs to be given to someone. The CAA must decide which of the (usually two, but it could be more) players should be given rights to operate services on a particular route. In taking such a decision, the CAA may often face the situation where supply is so tightly constrained that the relevant market is already largely controlled by a small number

of airlines. In which case, the answer to the question of whether an award of scarce capacity rights to the incumbent airline would substantially lessen competition may be “no”, even though the effect on customers may be negative.

15. Seeking to adopt wholesale the SLC methodology as it stands does not, therefore, provide the best tools for the CAA in scarce capacity cases, although it is still possible to employ the underlying concepts. Equally, sticking with the dominance wording in the existing Statement of Policies does not reflect current UK competition policy. Before explaining the CAA’s proposals for change it is worth considering briefly the purpose of competition analysis in these cases.

### **Competition analysis in scarce capacity cases**

16. The CAA is mainly interested in using competition analysis as a means of establishing whether the effect on competition, or rivalry between firms (and therefore consumer welfare) of awarding scarce capacity to one player rather than another will be comparatively more or less positive, more or less negative, or neutral. This assessment would need to be carried out in relation to all the relevant markets identified through the market definition process (which could extend from city-pair, through to country-pair, regional, and international). In each case, the CAA’s view should be influenced by the extent to which the allocation of scarce capacity would affect rivalry in those markets. If it were considered that the award of rights would confer market power upon a particular airline, and if it were considered that the airline could then act independently of competitors to increase prices, reduce quality etc to the detriment of consumers, then this would weigh particularly heavily in the final assessment.

17. Of course, the starting point for any competition analysis has to be market definition. In this respect, in scarce capacity cases, the CAA proposes to adopt the OFT’s published guidelines on market definition ([Competition Act 1998 Guidelines “Market Definition” OFT 403](#)) and will also have regard to the section on market definition in the OFT’s new SLC guidance within their [“Mergers – Substantive assessment guidance”](#) (published in May 2003).

18. The first stage of any CAA scarce capacity case would be to come to a conclusion about the relevant market by applying the standard principles set out in the OFT guidance. The CAA would then look at the impact of any possible award of rights on rivalry in that market or markets. Wherever possible (and there may be cases where this is not possible, for example where the market is defined as a city-pair market and that route may only be viably operated by a single airline), our decision on allocation of scarce capacity would seek to protect, create or boost rivalry and ensure that markets remain contestable, thereby diluting any pre-existing market power and constraining the ability of any one player to exploit the scarce capacity to the detriment of consumers.

19. In practice, the CAA would assess the impact of the different proposals on market power in the market or markets as defined. The fact that one airline may emerge as the “winner” on this competition assessment could of course be outweighed by countervailing benefits to consumers (calculated along the lines of our published statement on the economic framework we will adopt in estimating benefits to users of competing proposals).

### **Proposed changes to Statement of Policies**

20. The CAA therefore proposes to reword the sentences that refer to dominance in paragraph 5 of the current Statement of Policies on Route and Air Transport Licensing and replace them with a reference to the effect on rivalry. Paragraph 6 would be unchanged. This would mean that paragraph 5 would be revised to read:

“Where bilateral restrictions prevent British airlines from operating all of the services they plan to provide, the CAA will allocate scarce capacity between competing British airlines. In such cases, the CAA’s overarching objective will be to maximise economic efficiency. The most comprehensive approach would be to conduct a full economic analysis of the costs and benefits that would accrue to airlines and users, with capacity being awarded to the airline that provided the highest level of net benefit. In conducting this analysis, the CAA will take into account the effect on competition of the proposed services. ***This will include considering to what extent an award of scarce capacity would affect rivalry in all the relevant markets, using standard competition analysis and having regard to the OFT’s relevant published guidance and guidelines. Any detrimental impact on competition will then be weighed against the benefits which would arise from awarding the scarce capacity to the relevant carrier.***”

21. The CAA believes that this change will bring these procedures into line with UK competition law and, aligned with the OFT guidance material, provide a sensible framework to make decisions on scarce capacity cases.

22. Comments are invited on any of the issues raised in this paper, but in particular on this proposed change of language for the Statement of Policies. Comments should be received no later than 30 September 2003.

CAA  
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