

**CAA AIR FARES POLICY:
REMOVING REGULATION**

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**Civil Aviation Authority
Economic Regulation Group
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CAA AIR FARES POLICY: REMOVING REGULATION

Summary

Having considered the responses to the CAA's formal consultation in August 2006 about the regulation of excessive air fares, **the CAA has decided to remove any remaining fares regulation**. This will be achieved in two stages. The first stage will remove regulation from all routes other than UK/US with effect from 1 December 2006. The second stage, covering UK/US routes, will be deferred until other pricing restrictions are removed, most likely when the UK/US market is liberalised.

The CAA's fares policy is expressed in its Statement of Policies on Route and Air Transport Licensing, which relates only to UK-licensed airlines and routes outside the European single aviation market. The CAA's long-standing preference is for airlines to set fares with a minimum of regulatory intervention. Its policy has therefore been, wherever possible, not to intervene in fares or to dictate what level they should be, except in the few cases where competition is insufficient and it has seen a need to protect "captive" passengers that are at risk of being overcharged. Over time, the extent of the CAA's regulation has gradually reduced, and currently it affects only a small part of the market, specifically fares that meet all of the following criteria:

- flexible economy fares;
- offered by UK-licensed airlines;
- between the UK and points outside the single European aviation market;
- in relatively dense scheduled markets; and
- where competition is constrained by government-imposed restrictions.

Continuing liberalisation of global airline markets has reduced the number of markets where regulation can or should operate, as greater competition has led to a wider choice for the passenger, in particular from airlines offering indirect travel via a change of aircraft at their hub, and the internet has made it much easier for the consumer to identify those choices. Having carried out a review of its policy and the market, the CAA has concluded that these changes in the way the airline market functions mean that regulatory intervention in fares is no longer appropriate or necessary. This would be more consistent with the principles of good regulation, in particular that regulation is appropriate only where the benefits clearly outweigh the costs imposed.

UK/US routes are regarded differently because in its analysis of the wider choices now available to the consumer – choices which are considered to remove the need for regulation – the CAA attaches some weight to the availability of lower fares on indirect services that involve a change of aircraft en route. This analysis does not hold for UK/US markets, where the ability for indirect airlines to offer lower fares is severely constrained. The constraint is caused by pricing restrictions which the UK Department for Transport asks the CAA to apply on behalf of UK airlines denied access to the US domestic market. These restrictions (commonly known as the "sum-of-sector" policy) would be lifted upon liberalisation of the UK/US market.

The CAA will now proceed with making the appropriate changes to its Statement of Policies on Route and Air Transport Licensing and to UK-licensed airlines' Route Licences and Air Transport Licences.

Introduction

1. The CAA has concluded that its regulation of excessive air fares is no longer necessary or appropriate.
2. This document gives some background to the CAA's regulation of air fares, how its policy has developed and what form the policy has taken most recently. It goes on to explain the changes that have occurred in the market in the last few years that have led the CAA, when reviewing its fares policy in line with good regulatory practice and against its statutory duties, to conclude that it no longer remains appropriate. The CAA consulted the industry, user representatives and others about the results of this review and has taken into account the responses it received, which were generally supportive of removing regulation. A summary of the responses is included in Annex 1 to this document.
3. The removal of fares regulation will be achieved in two stages, because of impediments to free pricing that remain in the UK/US market. The first stage will remove the regulation from all routes other than UK/US with effect from 1 December 2006. The second stage, covering UK/US routes, will be deferred until other pricing restrictions are removed, most likely when the UK/US market is liberalised.

How and why fares have been regulated until now

4. The CAA's general objectives are set out in Section 4(1) of the Civil Aviation Act 1982. In economic terms, the CAA is required to secure that British airlines satisfy all substantial categories of demand at the lowest charges consistent with an adequate economic return and the sound development of the industry, and to further the reasonable interests of users. It achieves this by way of the route licensing mechanism for UK airlines under Section 69A, which also includes a duty to impose the minimum of restrictions on the industry.
5. These duties are reflected in the CAA's Statement of Policies on Route and Air Transport Licensing¹, which relates only to UK-licensed airlines and routes outside the European single aviation market². The Statement makes clear the CAA's view that the interests of users will be best served if airlines are free to operate air services in competition with one another according to their commercial judgement, subject only to the application of normal competition policy. It also includes two paragraphs specifically referring to air fares. At present, these state that it may sometimes be necessary for the CAA to safeguard users against any abuse of market power in markets where competition remains restricted because of government-imposed constraints under a bilateral Air Services Agreement. In other words, if an airline is protected from competition because all or most of the frequencies on a route that are

¹ www.caa.co.uk/docs/589/Statement_of_Policies_Dec2003.pdf

² Fares within the single market are governed by [Council Regulation \(EEC\) 2409/92 of 23 July 1992 on fares and rates for air services](#), which allows airlines to price freely subject to the safeguard in Article 6 (which has never been used) against excessive fares or a "downward spiral" of fares. See also [The Air Fares Regulations 1992 \(as amended\)](#) which implement the UK's obligations under the Council Regulation. Outside the single market, the fares of foreign airlines are governed by the relevant bilateral Air Services Agreement.

permitted by the bilateral agreement are already being used, and effective new entry or expansion is therefore impossible, then the CAA has been prepared to regulate fares to protect passengers.

6. The CAA has never sought to apply this fares policy to foreign airlines, although it does exercise some control over their fares at the request of the DfT where UK airlines are perceived to be affected by potentially unfair competition. The most significant routine intervention concerns fares for indirect travel between the UK and the US, which are subject to “sum of sector” policy. Although policy on intervention in the fares of foreign airlines is essentially a matter for DfT, the CAA does need to take into account the effect on the market of such intervention when considering its own fares policy.

Changes in the CAA’s perspective of the need for regulation

7. The CAA’s fares policy has evolved over many years, and the extent of the CAA’s intervention has reduced considerably in that time. For example, some 15–30 years ago, the CAA, in common with other aviation authorities, required all tariff changes on scheduled services to be filed in advance for prior approval. These tariffs were scrutinised in some detail by a dedicated department that had expertise in airline tariffs and economics, and which, in cooperation with airlines, developed tariff regulation policies including a methodology for analysing tariff proposals using data on airline costs, revenues and traffic. This scrutiny ranged from the shortest domestic route to long-haul routes, and extended to foreign as well as UK airlines, with UK airlines being given the opportunity to comment upon proposals filed by their competitors. The filed tariffs did not just cover fare levels, but all the associated fare conditions, baggage allowances and excess charges, fare construction principles, agency commissions as well as all the tariffs associated with the carriage of cargo.
8. As the aviation market matured, the CAA was able to relax regulation in stages and focus solely on those areas where users were open to potential exploitation. For example, the regulation of UK domestic fares had largely been removed by 1990; fares within the EU were substantially deregulated by European legislation that created the single aviation market in 1993; the regulation of cargo tariffs was dropped in 1996; and in 1999 the CAA relaxed regulation in non-EU markets that were (or subsequently became) free from restrictions on market entry in Air Services Agreements. This has left the CAA potentially regulating certain fares only in markets where airlines are unable to begin or expand air services because of restrictions imposed by governments. The policy that encompassed this residual fares regulation is explained in more detail below.

The “regulated” fare

9. The focus of regulation in recent years has been on a very small subset of fares on a shrinking number of mainly long-haul routes. These are fares paid by what the CAA perceived to be “captive” passengers – those who must travel by air and were not prepared to pay for a premium product, but who may have had no option but to pay what was on offer by airlines that were effectively protected from competition by government restrictions. Such passengers might need to travel at short notice on specified flights with a minimum journey time, and to retain some flexibility to change reservations etc without an onerous penalty.
10. Past experience, coupled with anecdotal evidence, suggested that typical examples of such passengers might be those working for a small business or

travelling because of some emergency. Hence the development of the CAA's policy aimed at ensuring that in market conditions where competition was significantly constrained, such passengers still had access to a flexible fare in the economy cabin that allowed last-minute travel from A to B without onerous conditions and at a level that was reasonably related to cost. Although the means of regulation limited the CAA to freezing such fares where appropriate so that they were eroded by inflation over time, rather than forcing a reduction, regulation did ensure that passengers in this segment of the market shared in the efficiencies from new technology and from airlines driving down costs. The number of tickets sold at such fares in the UK market has been relatively small, in the region of 3% on UK airlines' long-haul routes on average – far fewer than flexible business class fares, for example – and appears to have reduced in recent years.

11. The CAA's policy has, for some time, been not to intervene in any other circumstances, including in fares:

- in markets generally free from government-imposed restrictions;
- aimed at the holiday market, where sufficient competition exists to hold prices down, and the market is relatively broad (in that destinations will be potential substitutes for one another);
- on relatively "thin" routes where it can be difficult for airlines to operate profitably, even where there is little or no competition; and
- in First Class, Business or Premium Economy cabins, where passengers are deliberately choosing to pay extra for a premium product.

The impact of the policy

12. The CAA's regulation over a long period has kept many flexible economy fares from rising higher than they are today. Instances of such fares *decreasing* in nominal terms as a result of normal market forces have been relatively rare. There has also been a tendency for flexible economy fares to rise on routes where regulation has been removed, in part because of recent network-wide fuel surcharges, and in some cases substantially. However, there has been no obvious pattern of widespread dramatic increases, or of the flexible economy option being cancelled altogether. Nor is there any evidence that this "regulated" fare in some sense anchors other, non-regulated fares (the closest linkage probably being with the equivalent fare in the Premium Economy cabin). The CAA has nevertheless considered whether intervention in flexible economy fare levels remained appropriate in today's market.

Recent changes in the aviation market

13. Even in the last few years, the aviation market has continued to change significantly. The following paragraphs summarise the most salient changes.

(a) The number of markets where competition is constrained by government-imposed restrictions is shrinking

14. In 2006, around 40 routes were subject to potential fares regulation. Half are UK/US routes (where negotiations are underway to remove the government

restrictions that are currently impeding competition). The other half includes several relatively thin or leisure-orientated routes, where the number of passengers the CAA's regulation could potentially protect is very small.

(b) Competition between airlines is increasing

15. Even where frequency restrictions in bilateral agreements remain in place, competition has generally increased. The traditional duopoly of one "flag carrier" operating from each country has given way to a greater variety of airlines with a much more commercial, consumer-focused outlook (including those that remain in state ownership). Airlines are now offering a much greater range of products and fare types. Three or four airlines are now operating in direct competition on some denser routes.

(c) The influence of IATA tariff coordination on fares has lessened

16. At one time the primary means of setting international fares was through discussion at IATA trade association conferences. Many airlines did not even publish their own fares in reservation systems used by travel agents, since these were no different to the IATA fares, even for indirect travel. Today, where they still take place, these IATA discussions focus only on fares for a journey involving interlining (travel on multiple airlines) and airlines set most or all of their fares unilaterally or through alliances with partner airlines.

(d) Price competition from airlines offering travel on an indirect basis has greatly intensified

17. 10 years ago there was little variation in fares between airlines; even those offering indirect travel via a third country were obliged by governments to charge the same fares as the airlines serving the route direct, despite the additional inconvenience to the passenger. In practice, this led to price-leading fares being channelled through consolidators in the "grey" or discount market. Most of these restrictions are now falling away. As a consequence, price (and product) competition has significantly expanded the range of options available to passengers prepared to travel indirect and incur a time and inconvenience penalty. Some airlines specialise in this market and a significant proportion of their traffic from the UK is connecting with other flights at their hub in order to continue to points on their network beyond. The growth of alliances has also broadened the range of fares available for indirect travel and the coordination or marketing of connecting possibilities. Even in restricted markets indirect services are providing many lower-priced alternatives to the "regulated" flexible economy fare.
18. However, airlines operating between the UK and US do not have the same freedom in how they price indirect travel. This stems from restrictions on indirect UK/US fares which the UK Department for Transport asks the CAA to apply on behalf of UK airlines, who are denied access to the US domestic market. These restrictions (commonly known as the "sum-of-sector" policy) would be lifted upon liberalisation of the UK/US market.

(e) A proportion of business passengers is prepared to travel indirect

19. Although a business passenger would be unlikely to regard an indirect flight as a perfect substitute, a sample of dense long-haul markets using CAA survey data reveals that on some routes up to 10% of UK-resident business passengers are

flying indirect. On a frequency-constrained route some of this could simply be “forced” spillover from excess demand, but it does suggest that the passenger buying a “regulated” fare, who would be expected to be more price sensitive than the average business passenger, may also be prepared to switch to an indirect flight, even where time was a consideration. Passengers starting their journey from a UK regional airport may, for example, view an indirect routing via a foreign hub as a reasonably attractive alternative to a connection over London.

(f) The internet has given the consumer greatly superior information to compare prices and make purchasing decisions

20. In the past, price competition tended to be significantly muted by the IATA system of tariff coordination and government restrictions, and although grey-market discounted fares were available on both direct and indirect flights with clearer price/quality trade-offs, these had to be bought from consolidator intermediaries, and lacked transparency. The picture is completely different today. The transparency of the internet, and the advent of internet agencies alongside airlines’ own websites, allows consumers to make easy price/quality comparisons very quickly indeed, including, significantly, fares for indirect travel which are generally no longer being constrained by government action. Thus lower-priced fares offered for indirect travel are not only more widely available, but are also transparent and easily accessed by the consumer.

(g) The way airlines price their fares, and consumer expectation, has changed

21. In the liberalised EU and US domestic markets, flexible, last-minute fares can still command a high premium, but passengers who would once have had no choice but to buy the flexible fare – for example those not staying a Saturday night – can now switch to other products on offer with different price/quality options. In other words, relatively competitive liberalised markets do not seem to produce the sort of fare that the CAA’s fares regulation has sought to provide. Recent consumer complaints to the CAA and Air Transport Users Council rarely focus on the *level* of air fares. Passengers generally seem less inclined to pay fares that they would once have considered too high but which they felt obliged to accept in the absence of alternatives. The widening in the choice of fares in the long-haul market described above may be an indication that airlines are reacting to these behavioural changes.

(h) Corporate accounts may exert some countervailing buyer power

22. Corporate accounts are now a more significant feature of the market and those published prices that are currently regulated do not reflect the volume discounts being given. Corporate customers may be able to exercise some countervailing buyer power so as to dampen attempts to raise prices – although the CAA has no firm evidence to support this assertion, and it may be negated by market power exercised by airlines in restricted markets.

(i) Competition law has been strengthened

23. UK competition law has been strengthened considerably since the CAA’s fares policy was last reviewed, and would provide a backstop against any serious competition problems in the market.

The implications of these changes for fares regulation

24. The CAA has continued to review its regulatory policies in the light of the continuing developments in the airline market, and also in the context of wider “better regulation” initiatives. Starting from first principles, the test that should be applied before contemplating or maintaining existing regulatory intervention should be whether the benefits from regulation outweigh the potential burdens, uncertainty and distortions that the regulation may impose. This is a tougher test than the usual market definition approach adopted in competition analysis.
25. Since its inception, the CAA’s policy on the regulation of air fares has secured significant benefits for the user. The policy has offered users some protection from airlines that were relatively immune from competitive pressures and able to exploit “captive” consumers (that is, last minute, “must-travel” passengers). However, as explained above, the CAA recognises that the conditions that gave rise to the policy have altered significantly and permanently.
26. Of particular significance is the greater availability of genuine lower-priced alternatives to the passengers that CAA fares regulation has sought to protect. The inconvenience of indirect travel may well point, in many circumstances, to a conclusion that these alternative fares should not be regarded as a true substitute in terms of traditional competition policy analysis and market definition. However, the test for regulatory intervention should be more stringent, and where reasonably close alternatives, in the form of indirect services, are available at competitive prices, regulation would not seem to be warranted. The CAA concludes that the sum of the effects of changes in the market described above means that continued day-to-day regulation of fares is disproportionate to the risks arising from not regulating. It seems most unlikely that the CAA would see a need to *introduce* regulation of air fares were it considering the issue afresh today.

Conclusion

27. Having consulted the industry, user representatives and others, the CAA has therefore decided that it would be consistent with its statutory duties under the Civil Aviation Act 1982 to withdraw from fares regulation on routes outside the single European market, and to amend its Statement of Policies on Route and Air Transport Licensing, and the conditions requiring tariff filing that form part of UK Route Licences and Air Transport Licences, accordingly.
28. However, the existence of pricing restrictions on indirect fares in the UK/US market has led the CAA to impose a two-stage approach to removing fares regulation. The first stage will cover routes other than UK/US, so that the limited fares regulation currently applied would continue on UK/US routes alone. The second stage, covering UK/US routes, will be deferred until other pricing restrictions are removed, most likely when the UK/US market is liberalised.
29. UK/US routes are regarded differently because in its analysis of the wider choices now available to the consumer – choices which are considered to remove the need for regulation – the CAA attaches some weight to the availability of lower fares on indirect services that involve a change of aircraft en route. This analysis does not hold for UK/US markets, where the ability for indirect airlines to offer lower fares is severely constrained. The constraint is caused by pricing restrictions which the UK Department for Transport asks the CAA to apply on behalf of UK airlines denied access to the US domestic market (commonly known

as the “sum-of-sector” policy). These restrictions would be lifted upon liberalisation of the UK/US market.

30. Consequently the CAA will continue, where necessary, to require the submission of cost, revenue and traffic data from UK-licensed airlines in support of residual potential regulation of excessive fares on UK/US routes.

Revisions to the Statement of Policies, Route Licences and Air Transport Licences

31. Paragraphs 9 and 10 of the Statement of Policies on Route and Air Transport Licensing are revised with effect from 1 December 2006. The new text is shown in Annex 2.
32. Schedule 4 to the CAA’s Official Record Series 1 containing Standard Tariff Provisions that apply to Route Licences and Air Transport Licences is revised with effect from 1 December 2006 in order to remove any need for UK-licensed airlines to file fares and their conditions for approval, except on UK/US routes where the requirements remain unchanged. The revisions are set out in Annex 3.

Annex 1**The CAA's consultation on air fares policy**

1. On 3 August 2006 the CAA wrote to UK industry, user representatives, Government departments, and other interested bodies consulting them on a change to the fares policy expressed in the CAA's Statement of Policies on Route and Air Transport Licensing. The CAA also placed a notice in its Official Record Series 2, and added the consultation document to the Economic Regulation Group section of the CAA website, inviting comments. The consultation document set out the CAA's fares policy and the reasons for the proposed changes in some detail, along with supporting evidence in the form of charts and tables.
2. In all, seven formal responses were received, from the **Association of British Travel Agents**, the **Air Transport Users Council**, **British Airways**, **BA Connect**, the **Gibraltar Government**, the **Guild of Travel Management Companies** and **Virgin Atlantic Airways**.
3. All respondents either supported or had no objection to the proposal, except that **Virgin Atlantic Airways** believed that regulation should also be removed from UK/US routes with immediate effect, rather than as a second stage. Virgin saw little if any connection between the sum-of-sector policy and the CAA's regulation of the flexible economy fare on UK/US routes, and said the consultation document presented no such evidence, relying on assertion of a connection. Virgin believed that the CAA could rely on competitive forces in this market to protect the interests of the consumer.
4. In addition, **British Airways'** support was subject to three points: (a) that the CAA should retain its ability and expertise to require foreign airlines to file fares and to regulate them should UK airlines be subject to onerous filing and regulatory requirements by those foreign airlines' own governments; (b) that any revision to the sum-of-sector policy should be conditional on all US market access restrictions being removed for UK airlines; and (c) that should the new provisions relating to tariffs in the recently signed UK/Canada Air Services Agreement not be renewed, the CAA should reconsider the deletion of Canada from the filing requirements set out in Standard Tariff Provision II.
5. The CAA considered these responses and has taken them into account in its decision. The CAA had the following comments in response to specific points raised by Virgin and British Airways.
6. The CAA does not agree that it relied on assertion in making a connection between the effects of sum-of-sector policy and feeling unable to withdraw from regulation. The consultation document did provide evidence of the impact of sum-of-sector policy on the market (paragraph 24 for example), and also explained how the consequent restrictions on price leadership therefore led to a different conclusion in respect of the UK/US market. Appendix 6 even offered some specific examples, showing how the direct carriers' adherence to the Saturday-night stay condition on most UK/US economy fares meant that for any itinerary not including a Saturday night, the alternatives to the Y2 fare can be much more limited on UK/US routes than in other markets. (Further mentions were made in paragraphs 4, 7, 37 and 44.) In the light of this evidence the CAA believes that the balance of arguments therefore tilts in favour of retaining the policy for now.

7. The CAA continues to require filings from the airlines of two foreign countries on the advice of the Department for Transport (DfT), but in general terms the CAA is not in favour of requiring filings or intervention in foreign airlines' fares except in the most extreme circumstances, since it sees little purpose in doing so. The only justification for such action would be to bring pressure for the government concerned to liberalise, but it is not obvious that such action would have this effect and that intervention would be in the interests of the UK consumer. This would, however, be a matter for discussion with DfT. If the EU and US come to an agreement without full market access, that agreement is still expected to include a pricing article that would not permit intervention by either government. This would prevent any continued application of sum-of-sector fares policy. The revisions to Standard Tariff Provision II remove the filing requirement for *UK-licensed* airlines and do not affect Canadian airlines. Although foreign airlines' tariffs are (where appropriate) filed with the CAA rather than the DfT, the filing requirement is actually governed by the operating permit issued by the DfT and not by Provision II.

Annex 2**Revisions to the CAA's Statement of Policies on Route and Air Transport Licensing**

Paragraphs 9 and 10 of the CAA's Statement of Policies on Route and Air Transport Licensing are amended with effect from 1 December 2006 in order to give effect to the new policy. The new text is shown in italics below.

[New paragraph to remove the CAA's residual regulation]

9. The CAA believes that the interests of users will be best served if airlines are free to set their own fares without regulatory intervention, subject only to the application of normal competition policy. The CAA does not therefore expect to intervene in airlines' fares proposals.

[New paragraph to defer the regulation of UK/US fares for the time being]

10. However, notwithstanding paragraph 9, the CAA believes that special considerations apply on UK/US routes. So long as the UK/US market remains subject to government-imposed constraints on market entry, and airlines offering travel in the UK/US market on an indirect basis are unable to price freely, there is the potential for conditions that would lead the CAA to consider intervention in UK/US fares. The CAA will be prepared to consider intervening where, after taking into account the relevant market, the degree of bilateral constraints, the availability of different fare products and other factors including route profitability, it concludes that airlines possess and exploit market power to the disadvantage of users. In such circumstances, it will be concerned to ensure that all those who require it on international scheduled services have available basic on-demand travel. This will provide at least a commensurate level of seat access, freedom to change reservations and appropriate in-flight facilities, at a price reasonably related to the cost of its provision, including a return on capital. Where this exists the CAA will not expect to intervene in the prices or conditions of other products solely to protect users from being overcharged.

Annex 3**Revisions to Standard Tariff Provisions in Route Licences and Air Transport Licences**

Schedule 4 to the CAA's Official Record Series 1 containing Standard Tariff Provisions that apply to all Route Licences and Air Transport Licences is revised with effect from 1 December 2006 in order to remove any need for UK-licensed airlines to file fares and their conditions for approval, except on UK/US routes where the requirements remain unchanged. The revisions are set out below.

Standard Tariff Provision I is deleted. This provision currently applies to carriage other than to or from the United States or Canada. The change has the effect of removing any residual requirement on these routes for UK-licensed airlines to file fares and conditions with the CAA for prior approval.

Standard Tariff Provision II currently applies to carriage to or from the United States or Canada. This provision **remains unchanged except that the reference to Canada is deleted.** This change is a tidying-up exercise consequent to a new bilateral Air Services Agreement between the UK and Canada earlier in 2006, and is unrelated to the change in fares policy itself. It has the effect of removing any requirement for UK-licensed airlines to file fares and conditions between the UK and Canada with the CAA for prior approval. Fares and conditions between the UK and US will continue to be filed for approval in order for the CAA both to apply "sum-of-sector" fares policy at the request of the Department for Transport, and potentially to regulate the level of flexible economy fares from the UK in accordance with paragraph 10 of the revised Statement of Policies.