

THE PRINCIPLES AND POLICIES OF REGULATING AIRLINE COMPETITION

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SUMMARY

Regulation in its generic sense has existed for a very long time in different forms, with different aims and different problems of accountability, but the study of competition regulation by a Government agency has perhaps become fashionable only in recent years.

This thesis consists of two leading themes. First, it will contend that, whilst the market system has been seriously underestimated as a social institution to the extent that it should be left to operate and organise itself where that is possible, it is at the same time not always self-regulating. Residual intervention by the State or its agencies will remain necessary in strategic cases, either to protect individual autonomy and choice, or to correct failures of the market system. The question is simply more or less regulation.

Secondly, and on that premise, competition regulation must be distinguished into economic regulation and antitrust regulation because the relationship between them is inversely proportional: the more intense economic regulation is, the less important antitrust regulation becomes. By implication then, economic liberalisation or deregulation must be accompanied by a robust framework of antitrust regulation to ensure that the conditions of sustainable competition are not threatened by anti-competitive practices. Conditions of sustainable competition are thus critical for *market contestability*.

For many years, domestic and international airline competition has been the subject of comprehensive regulation. With the passage of time, however, the thinking has changed and, no doubt, liberal policies and practices will continue to find expression in future political and economic sentiments. The responsibility for regulating airlines in the United Kingdom falls on the Civil Aviation Authority, which has played a formidable role in transforming the policy of heavy regulation into minimal regulation, although much of that regulatory landscape has now been altered with the advent of the Single European Aviation Market. The experiences of, both, the CAA and the new SEAM provide an illuminating account of the evolutionary process of regulating airline competition, that from economic to antitrust regulation.

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REGULATING AIRLINE COMPETITION**

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To Judith and Jessica

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ABBREVIATIONS

ADA	Airline Deregulation Act
ALJ	Administrative Law Judge
American	American Airlines
APA	Administrative Procedure Act
ARB	Air Registration Board
AT&T	Aircraft Transport and Travel Ltd.
ATAC	Air Transport Advisory Council
ATLA	Air Transport Licensing Authority
ATLB	Air Transport Licensing Board
AUC	Air Transport Users Council
B.Cal	British Caledonian Airways
BA	British Airways (British Airways Board)
BEAC	British European Air Corporation
BMA	British Midland Airways
BMAN	British Marine Air Navigation
BOAC	British Overseas Air Corporation
BSAAC	British South American Air Corporation
CAA	Civil Aviation Authority
CAB	Civil Aeronautics Board
CFI	Court of First Instance
Continental	Continental Air Lines
CRS	Computer Reservations System
DGFT	Director-General of Fair Trading
DoT	Department of Transportation (US)
ECJ	European Court of Justice
EP	European Parliament
FATURE	Federation of Air Transport User Representatives in Europe
FFP	Frequent Flyer Programme
IASTA	International Air Services Transit Agreement
IATA	International Air Transport Association
IATAg	International Air Transport Agreement
ICAO	International Civil Aviation Organization
ICC	Interstate Commerce Commission
MMC	Monopolies and Mergers Commission
NDPB	Non-Departmental Public Body

OFT	Office of Fair Trading
PSA	Pacific SouthWest Airlines
QUANGO	Quasi-Autonomous Non-Governmental Organisation
RPK	Revenue Passenger Kilometre
SAS	Scandinavian Airline System
SouthWest	SouthWest Airlines
TSC	Transport Select Committee
TWA	TransWorld Airlines
United	United Airlines
Virgin	Virgin Atlantic Airways

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INTRODUCTION

Administrative regulation is a concept neither new nor novel. As a system of regulation, its existence stretches back to the days of the Industrial Revolution although the time lapse has produced little in the way of a coherent and systematic policy explaining administrative regulation and its use. Much of this is evident in the creation of regulatory agencies to oversee the privatised utilities sector without a proper understanding of the aims of regulation and the tool best suited to the task. Consequently, there is a frequent mismatch between regulatory aim and methodology. The study of regulation has only become fashionable in the 1980s with the proliferation of regulatory agencies designed to regulate the privatised industries and the advent of deregulation. Prior to this period, academic attention on public regulation was sporadic; even more so on its constitutional and legal implications especially when the use of multi-powered administrative agencies gave rise to constitutional questions, crucially those on the accountability of regulatory decisions. This was largely due to the lack of effort to promote the study of regulation and the law as a distinct discipline of study.

The aim of this thesis is not to develop a new theory of regulation or economic regulation. What it seeks to do is to chart the evolutionary process of economic regulation within the context of a modern liberal economy, where individualism and choice are given emphasis, but where collectivist strategies remain necessary to protect such individualism and personal choice. It seeks to test the hypothesis that economic regulation is merely a temporary mechanism to procure competition in a given sector, and may be abandoned once the conditions for sustainable competition have been achieved. The thesis will also seek to establish further that any dismantling of an economic regulatory system does not eliminate the continuing need for antitrust regulation so as to ensure that the conditions for sustainable competition are not threatened.

Over the past two decades, so much in the way of social and economic organisation has changed to such an extent that even the role of the State has changed beyond recognition; whether there has been a deliberative process to reflect on these changes is another matter. The commitment to a collective model of social organisation where planning was centralised no longer seems to be as attractive as in the past. Collective strategies such as nationalisation have failed to engender continuing support and are rapidly becoming irrelevant in the wake of dynamic economic performance in capitalist systems. Equally, regulation as a species of centralised command-control procedures is fast losing currency as liberalisation and deregulation increasingly come to be accepted as the dominant organising concept where resource allocation is largely market-based. This is not to say that the shift in preference for a different form of social and economic organisation signifies a collapse in support or desire for public sector provision or intervention. Rather, it is a new political expression and

commitment to personal autonomy and choice, and to reject producer domination as the acceptable balance in the producer-purchaser relationship, characteristic of what Max Weber calls *Gesellschaftlich*. This thesis will argue that residual intervention by the State or its agencies remains necessary in strategic cases, primarily to protect individual autonomy and choices, if not to correct the failures of the *Gesellschaft* model. Implicit in this contention is that markets are not self-regulating, that it sometimes fails to deliver a just distribution of goods and services, or social justice.

Even so, it should be clear from the arguments in the thesis that the market system has been seriously underestimated as a social institution, by suggesting that the market should be left to operate, organise and regulate itself where that is possible. This means that if we set out to regulate a particular sector, there may come a point when regulation becomes redundant or may be dismantled. Clearly, this requires a number of assumptions. The thesis will argue that regulation is a temporary measure where the regulated sector is naturally and structurally competitive. This is true and possible where market conditions have changed, perhaps with the passage of time, to become more competitive. In some cases, however, a given sector may be structurally competitive but artificial measures may have been created to prevent the full operation of the competitive forces such as privileges or endowments conferred by the State. In such cases, the introduction of a policy of economic deregulation, without first removing or diminishing the effects of these artificial barriers, would simply hasten the need for re-regulation since the conditions for sustainable competition will not have been established. By contrast, where the sector is a natural monopoly or structurally uncompetitive, economic regulation will remain essential to avoid the excesses of dominant market power.

The abandonment of regulatory controls, either partially or completely, where a given sector is naturally and structurally competitive does not extinguish the need for some form of regulation to police the actions and behaviour of the participants within the sector. This is known as antitrust regulation, and must be distinguished from economic regulation. Economic regulation is essentially concerned with the regulation of market access, price and capacity. Thus, policies of economic regulation have an instrumental role in determining the level of competition through the control of access or capacity as well as the profitability of an enterprise through price control. Antitrust regulation on the other hand is concerned primarily with the regulation of trading practices of a firm, relative to its competitors within the defined market, to determine whether they are anti-competitive, or amount to an abuse of market power, or result in the elimination of competition. Importantly, antitrust regulation presumes the existence of actual or potential competition and aims at safeguarding the interests of all competing firms within the relevant market. This implies a belief in competitive solutions, though only as a means rather than an end in itself. It also implies that control of market access will have been liberalised or deregulated. This leads to the argument that economic regulation, rather than antitrust regulation, is the appropriate form of regulation for natural monopolies.

Despite this distinction, there is a considerable degree of overlap between economic regulation and antitrust regulation, at least in respect of the way in which economic regulation can be put to achieving the aims of antitrust regulation. This is possible where, for example, the economic regulator has deemed the practice of a firm as anti-competitive or exploitative of its market power, and proposes to vary the conditions of the licence granted to that firm. Likewise, where two firms within the relevant market propose to merge their operations, the economic regulator may propose to vary the terms of their licence to ensure that competition is not eliminated. In these cases, the aims of the economic regulator are indistinguishable from those of the antitrust regulator. What may well differ are the procedures for determining the behaviour of the firm and the manner in which the conditions, if any, are imposed. It will be argued in this thesis that in certain industries such as civil aviation, or indeed telecommunications where the Office of Telecommunications has successfully incorporated fair trading provisions into British Telecommunications' licence, antitrust regulation through the conditioning of licences by the economic regulator is more effective. Indeed, the thesis will conclude with the contention that once economic regulation has created an environment of sustainable competition, by implication a structurally competitive industry, the regulatory process evolves into antitrust regulation. However, liberalisation or deregulation without having created the conditions for sustainable competition, supported by a dynamic framework of antitrust regulation, would simply precipitate the case for economic re-regulation.

To chart the evolutionary process from economic regulation to antitrust regulation at the practical level, the case of air transport will be examined. Although in recent years there has been a proliferation of regulatory agencies, not least those created to oversee the privatised utilities sector, one of the longest standing regulatory agencies is the Civil Aviation Authority. The CAA is the independent Government agency established by the Civil Aviation Act 1971 with a broad responsibility to regulate the air transport industry. Over this period, much has happened and changed in respect of its regulatory methods and more importantly of its regulatory policies. This speaks nothing of the liberalisation of European air transport and its impact on British air transport, and the adequacy of European antitrust laws to protect the conditions for sustainable competition. These measures are important and cannot be ignored. The remarks of a former Chairman of the CAA, Sir Christopher Chataway, encapsulate the very essence of these developments and their effect on British air transport: "This endless debate ignores the obvious fact that geography has already made the decision for us."¹ Thus, in more ways than one, the CAA's philosophy and approach to competition regulation provides a very interesting case study to support the leading theme of this thesis, which major aim is to contribute towards a better understanding of the shift from a command-control to a liberal model of regulating air transport competition, from economic regulation to liberalisation and antitrust regulation, and accordingly the

¹ (1995) *Horizon: Journal of the Civil Aviation Authority* 2. For the sake of simplicity and consistency, "European Community" will be used throughout this study to denote both the European Community and the European Union.

adequacy of the legal institutions designed to secure and protect the objectives of a liberalised air transport order

The general themes of regulation will be considered first to establish a conceptual framework for the thesis. Chapter 1 will attempt to construct a working definition for the concept of 'regulation' to provide a basis for analysing the anatomy of the regulated air transport industry and the reasons why an independent regulatory agency has often emerged as the preferred institutional form. The aim of examining the anatomy of the regulated air transport industry is to identify the 'stakeholders' whose respective interests may well be conflicting or compatible with one another. This will be important for understanding the role of the regulator, as a principal actor within the regulatory complex, in reconciling the claims and counter-claims of the stakeholders. Chapter 2 will provide a more specific review of the theory of regulating competition. This will comprise an analysis of the forms of economic organisation and regulation, their rationales and the place of competition regulation. The distinction between economic regulation and antitrust regulation will also be considered to lay down the foundations for understanding the evolutionary process from economic regulation to antitrust regulation, and in some extreme cases, to economic re-regulation. This will establish the conceptual framework for analysing and understanding the changing role of the CAA in air transport competition regulation.

The suitability of one model rather than another depends on the given set of political, economic and social circumstances. Grafting a regulatory approach conceived in a different political and economic context onto another is a recipe for potential disaster. A specific regulatory approach or strategy cannot be a typology of the general industrial policy. The history of events points decidedly away from this direction. It is important therefore that a study of this nature includes a historical perspective so that in order to move forward we know what we have been, what we are, and what we can become. Accordingly chapter 3 will aim to provide an historical base for the thesis and to provide a review of the regulatory arrangements for air transport prior to the creation of the CAA.

Chapters 4 to 7 are the empirical evidence to support the leading themes of the thesis. Chapter 4 aims to examine the regulatory policies of the CAA and the ways in which such policies are formulated and the extent to which their emphasis have changed. In particular, it will consider how the change in the emphasis of the regulatory policies and aims have had an effect on the role of the CAA especially its long-established system of public hearings. Chapters 5 and 6 examine the manner in which the policies are applied, to procure the objectives of the governing statute and regulatory policies. There is an extensive analysis of the case-law resulting from the licensing decisions of the CAA to lend support to the contention that economic regulation can be abandoned or liberalised and consequently take a different regulatory emphasis, that is antitrust regulation, provided that the sector is structurally competitive and the conditions for sustainable competitive have been established. Chapter 7 is an analysis of the liberalisation measures adopted by the European Community and

the extent to which they have affected the regulatory policies and practices of the CAA.

This thesis would not be complete if it failed to consider the deregulation of the airline industry in the United States, not least because they have been widely argued to be the pioneers of airline deregulation. This issue will be contested in due course. Be that as it may, Chapter 8 provides, first of all, an historical analysis of air transport regulation in the US and how it led to a policy of deregulation. The rationales for the deregulatory policy will be examined to determine whether the reform was based on political motives or economic reasoning, or both. More importantly, it is almost 20 years since the deregulation which will have in store a catalogue of lessons for a study of this kind; that is, whether changes to the industry structure is demanding a return to economic regulation of the old days, or the system of antitrust regulation simply needs to be more strictly enforced.

Regulation of any form is an act of interference in the activities of another. In its generic sense, it represents a form of behavioural control. Thus, whatever may be the nature of the behaviour that is subject to such regulatory control, the authority to regulate requires two essential characteristics: legitimacy and enforceability. The legitimacy of any public act of regulatory intervention stems from the assumption that the interference is for public interest ends. Nevertheless, there have been criticisms levelled at some regulatory systems which have been accused of pursuing private interest goals and thus leading to the capture of the regulatory machinery. Whatever may be the ends pursued by the public act of regulation, accountability for the regulator's actions becomes an important issue to explain the basis for the interference. Chapter 9 will examine these issues as they relate to administrative regulation. Two types of accountability will be considered briefly: political and judicial. It will be argued that a shift in the regulatory role of an administrative regulator from economic regulation to antitrust regulation need not and should not compromise the end objectives as well as the process rights of the participants within the regulatory complex. Indeed, to safeguard some of these rights, there is a case for arguing that a rigorous system of public interest representation should be introduced.

The final chapter of the thesis will be an attempt to draw together the issues surrounding the leading themes, that is the changing role of the CAA from one of economic regulation to antitrust regulation. In particular, they will seek to reinforce the contention that competition regulation is comprised of a three stage life-cycle. First, the crusade of economic regulation. Secondly, assuming that greater competition is a prime objective, economic regulation would either be abandoned or liberalised once the conditions of sustainable competition have been achieved. In the former case, that will be deregulation, whilst economic liberalisation means that there will remain some degree of economic regulatory control because the full conditions of sustainable competition cannot be achieved given some structural problems. This may be described as "managed competition" or "regulated competition". The third stage of the life-cycle is economic re-regulation, where this has become necessary either because economic deregulation or liberalisation has failed.

CHAPTER ONE REGULATION: A GENERAL ANALYSIS

In its most basic and general form, 'regulation' has been in existence from early times. Its evolution since then has been interestingly varied and deeply significant. Over the years, it has become an increasingly contentious issue. Yet, the meaning of 'regulation' remains ever elusive. The aim of this thesis is not to provide a definitive theory of the concept of regulation. What it aims to achieve is to provide an analysis of regulation as a process, and the manner in which one form of regulation evolves into another, depending, first, on the objectives of the regulatory system, and secondly whether the conditions for the transformation in regulatory form have been established without threatening the realisation of the objectives. Regulatory form in this sense is not meant to be understood as regulatory institutions or instruments, though the variety of such institutions and instruments are important in their own right and will be considered accordingly. Rather, the term regulatory form is used here to denote the nature or the type of regulation by reference to the substantive policies on the regulatory system. This may be competition regulation such as predatory practices, social regulation such as health and safety or environmental regulation. The regulation of air transport competition in the UK is a mature system of regulation which has much to illustrate the leading themes of this thesis. Before venturing any further, there needs to be an analysis of the regulatory complex of the airline industry so as to provide a basis for considering the theory of competition regulation in more detail in the next chapter. However, to understand the anatomy of the regulated airline sector and the interplay between the 'stakeholders' of the regulatory environment, a working definition of 'regulation' needs to be adopted. That is the aim of this chapter.

Regulation: A Working Definition

As a starting point, regulation in its generic sense represents a form of behavioural control. The nature of such behaviour is naturally varied, and may be political, economic or social in character, and the nature of the control can be manifested in a variety of institutional forms, whether direct statutory regulation, regulation by a Government department or an independent Government agency, or indeed self-regulation. Whatever may be the nature of the behaviour subject to control, the exercise of such control needs to have two essential elements: legitimacy and enforceability. Legitimacy is the manifestation of an acknowledgement or acceptance that a rule or body is authoritative. This, as Hart calls it, is the *rule of recognition*.¹ Through some formal process, a rule or body is established and is accepted as the ultimate authority by all or a majority of those subject to its jurisdiction. An important assumption in the analysis is that the regulatory interference is for public interest ends. The range

¹ H.L.A.Hart, *The Concept of Law* (Clarendon, Oxford: 1961), p.92 *et. seq.*

of such public interest justifications for the interference would inevitably be considerable and must vary according to the specific political, economic and social cultures of the given area to be regulated. These may include market failure, information deficits, co-ordination difficulties, national security and so on. Even so, there have been criticisms against some regulatory systems which have been accused of regulating for private interest gains and thus leading to the capture of the regulatory machinery. The argument for legitimacy becomes particularly important where the regulation interferes in the activities of private individuals or organisations, even if the aim was to secure some public interest ends.² Accordingly, accountability for the regulator's actions, to explain the basis of the interference, assumes considerable significance. These issues are considered in a later chapter. :

The ability to enforce the control requires the support of law or binding rules mutually agreed in advance. This implies that regulation must be accompanied by penalties or corrective measures in cases where the agreed rules have not been complied with. Without legitimacy for such behavioural control and the ability to enforce compliance, regulation would mean very little. In essence, regulation as a system is a form of control over the behaviour of those it seeks to regulate either to procure or to prevent a certain result in the interest of an identified set or sets of beneficiaries.³ It is a process whereby regulatory interventions, or non-interventions, are based on a set of promulgated policies which seek to balance the competing interests within the given regulated sector. In competition regulation then, the aim can be two-fold: whether regulation should lead to greater competition or should be exercised in a manner which restricts competition. In both respects, it is an act which affects the activities of the private individual or enterprise, either in enabling or prohibiting competitors to enter the relevant market, controlling the prices of products and thus profitability, or specifying limits to the volume of production.

More general theories of regulation have also been established by various studies, some of which deserve a cursory review so as to present a more complete picture of the working definition attempted in this opening section, although a detailed examination of the economic and political science literature on regulation will not be attempted here. A valiant attempt to construct a taxonomy of the regulatory concept was made by Mitnick in *The Political Economy of Regulation*. He suggests that in what he labels as 'static' regulation, there were four definitions. He begins with the idea of deliberate interference in the freedom of a party to carry on an activity so that regulation becomes an "intentional restriction of a subject's choice of activity by an entity not directly party to or involved in that activity."⁴ To narrow the broad

² See also A.Ogus, *Regulation: Legal Form and Economic Theory* (Clarendon, Oxford: 1994), chs.3-4.

³ In its wider sense, a system of regulation to control the behaviour of certain persons will include criminal law and the regulation of crimes. This is a subject in its own right, and is not intended to be part of the definition of regulation adopted in this thesis.

⁴ B.Mitnick, *The Political Economy of Regulation: Creating, Designing and Removing Regulatory Forms* (Columbia University Press, Columbia: 1980). p.5.

definition. Mitnick argues that regulation must be intended for a purpose, but that purpose must be kept in sight. Regulation in the second sense thus becomes "the policing, with respect to a goal, of a subject's choice of activity, by an entity not directly party to or involved in that activity."⁵ To ensure consistency of the goal, however, regulation is "policing, according to a rule".⁶ A fourth, but much more restrictive, definition of regulation consists of regulation by "public administrative policing of a private activity with respect to a rule prescribed in the public interests."⁷ The problem with this definition lies with its limited scope. By restricting regulation to "public administrative" ignores the possible permutations of regulation by virtue of a legislative provision or other forms of regulatory arrangements. Furthermore, as an 'administrative body' charged with the responsibility of regulating, there presupposes a 'principal' to whose authority the 'agent' is subject. If, therefore, the terms laid down by the principal are other than the "public interest", then this definition runs the risk of ignoring more specific and exclusive purposes of regulation. Regulation of "a private activity", likewise, excludes the possibility of private and public parties performing a similar function but with different ends. Prior to the privatisation of British Airways (BA), the regulated industry consisted of a publicly-owned corporation and private entities providing air transport services in competition with each other. Regulation, to Mitnick, is also "a process" consisting of the intentional interference with a subject's choice of activity.⁸

For Daintith, the idea of regulation in its crudest form consists of four dimensions.⁹ First, he postulates the general notion of regulation as "the act of controlling, directing or governing according to a rule, principle or system". In this functional sense, regulation is conceived as "a conscious ordering of activity". The second sense of regulation is taken as the process of State intervention in the operations of the market place. Third, regulation is a facilitative instrument for government policy "often articulated in the form of complex schemes of licensing, inspection, performance standards". In this respect, it differs from the second sense of regulation in that the former applies to all State activities which interfere with the markets whether through the provision of subsidies or taxation, while the latter is characterised by a 'command-and-control' structure. Related to the third sense of regulation is the fourth which simply asserts that the command-and-control structure is expressed in legal rules and measures. On the other hand, Ogus defines regulation in terms of the context within which it exists by reference to its characteristics. He argues that in all industrialised orders, two systems of

5 *Ibid.*

6 *Ibid.*, p.6.

7 *Ibid.*, p.7.

8 *Ibid.*, p.9. Bernstein too argues that regulation is a dynamic process in which outcomes are no pre-determined but are adjusted according to the interests of the subjects to be regulated: M.Bernstein, *Regulating Business by Independent Commission* (Princeton University Press, Princeton: 1955), ch.9.

9 T.Daintith, "A Regulatory Space Agency?" (1989) 9 *Oxford Journal of Legal Studies* 534.

economic organization exist: the market system and the collectivist system.¹⁰ Under a market system, regulation is characterised by the facilitative role of the law; that is, a system in which individuals are left to their own to pursue their respective goals and in which obligations are assumed voluntarily. In the latter respect, therefore, the absence of directed coercion means that these obligations can equally be abandoned by the parties when they deem it to be appropriate. Regulation under a collectivist system consist of, first, the idea of control by a superior so that non-compliance will be met by sanctions. Second, he argues that a collectivist system of regulation is 'public' in nature so that the State or its agencies assumes the role of overseeing those obligations that cannot be reached by private agreements. Finally, regulation in a collectivist system represents a centralised means of administration that is inherent in the fundamental role of the State.

A more recent study into the role of law and regulators of the major privatised industries in the United Kingdom by Prosser suggests that regulation in functional terms involves three different tasks.¹¹ Although he accepts that the general definition of regulation may well be "public interventions which affect the operator of markets through command and control", he argues that this was inadequate as an account of what regulators do. Instead, he submits that the first task of regulation is that of monopoly regulation. The responsibility of the regulator here is to mimic competition or to act as a surrogate for competition by establishing a system of price and service quality control. The second task is competition regulation where the regulator would be seeking to create and police the conditions of competition. The third task of regulation focuses on social issues of the regulated sphere, that is social regulation. This typically involves the regulation of environmental issues and also health and safety issues.¹²

Regulation of course is not a new-found phenomenon. It is practised virtually in all types and at all levels of social organisation so much so that, in its generic sense, several common threads are usually apparent. It is a means for controlling human or institutional behaviour. Its *raison d'être* is usually derived from a superior source, either legal or customary in character, and is typically empowered to impose sanctions for non-compliance with a set of promulgated rules or practices. This superior authority is referred to as 'The Say' by Karl Llewellyn in his law-jobs theory and the imposition of sanctions as the process of preventive channelling or re-channelling or behaviour.¹³ On the other hand, the scope, purposes and forms of regulation will naturally vary from case to case. What needs to be regulated and why they need to be regulated are questions which must be evaluated within the given political, economic and social context. Likewise, the form of regulation can vary from a simple legislation, to an independent Government agency and its rules, to a voluntary

10 A.Ogus, *Regulation: Legal Form and Economic Theory* (Clarendon, Oxford: 1994). pp.1-3.

11 T.Prosser, *Law and the Regulators* (Clarendon, Oxford: 1997).

12 *Ibid.*, pp.4-6.

13 K.Llewellyn, "The Normative, The Legal and The Law-Jobs: The Problem of Juristic Method" (1940) 49 *Yale Law Journal* 1355.

body and its code of practice, to customary practices informally accepted by all the parties. Whichever form that is deemed to be most effective to achieve that purpose must therefore depend on factors which are cultural-specific so that regulation can be understood in the wider environment in which it is embedded.¹⁴

In these respects, in all basic forms of social organisation within which economic activities take place, the scope and purpose of regulation is typically two-fold: economic regulation and social regulation. Broadly speaking, economic regulation is concerned with commercial activities and behaviour whether in respect of ability to run a business, market entry, price or volume. Social regulation, by implication, is concerned with non-economic matters such as health and safety, general social welfare, environment and the like. Neither of the two, however, can always exist in splendid isolation. It is typical that economic regulation can and will have consequences which affect the social setting of the regulated sector, and *vice versa*. A good example is the regulation of aircraft noise. The stricter the standards imposed on noise limits of aircraft, the greater is the likelihood that airlines will have to invest in new aircraft engines which comply with the new standards. Such investment costs can be passed on to the traveller in the form of higher air fares or subsidised by retrenching the number of markets served. Equally, the objectives of economic regulation and social regulation do not necessarily overlap, and consequently give rise to conflicts. In the case of air transport, for instance, an economic objective may be low air fares while a social expectation may be safety in travel. Greater safety requirements may result in higher costs which reduces the possibility of lower fares. An important aim of regulation is to resolve these conflicts either by solutions determined *ex ante* or by evaluating the competing interests within the given context of the objectives. For Llewellyn, this is the law-job of disposing "trouble-cases".¹⁵ In this functional respect, regulation is necessarily bureaucratic, and acts as a forum for resolving fundamental tensions of a socio-economic order. Max Weber refers to these tensions as the contest between the 'formal' and substantive rationality of the economy.¹⁶ Weber argues that the *formal rationality* of a modern economy is the extent to which it is possible to carry through an accurate rational calculation of the quantities involved in economic orientation. A precise value could always be attached to a desired item. The basis for this calculation was capital accounting, and hence, capitalism. *Substantive rationality*, on the other hand, represents the extent to which it is possible to secure what is an adequate provision of a population with goods and services and in the process remain in accord with the ethical requirements of the system of norms. Whatever may be the given set of substantive norms, Weber believes that formal rationality will operate to create conditions and stimulate actions which in various ways will come into conflict with these substantive norms. This argument is premised on the belief that

¹⁴ M.Fainsod, "Some Reflections on the Nature of the Regulatory Process" in C.J.Friedrich and E.S.Mason (eds.), *Public Policy* (Graduate School of Public Administration, Harvard: 1940).

¹⁵ *Op.cit.*

¹⁶ M.Weber, *Wirtschaft und Gesellschaft*, trans. by T.Parsons, *The Theory of Social and Economic Organisation* (Hodge, London: 1947).

substantive rationality is comprised of an "indefinite plurality" of ultimate ends, whether they be political, economic, utilitarian, Hedonistic, or social equality.¹⁷ Capital accounting does not always provide an adequate solution to the problems of a given social organisation. It assumes a constant rational behaviour and knowledge of all relevant information to arrive at a solution. But things are not like that in the real world. The functional aim of bureaucratic regulation is therefore to resolve the lack of 'accord' between formal and substantive rationality, but the regulatory form must correspond to the given political, economic and social circumstances. The indefinite plurality of ends that needs to be reconciled with the demands of formal rationality inevitably requires their prioritisation.

Anatomy of the Regulatory Complex

In 'regulation', there must at least be two sets of participants, the 'regulator' and the 'regulated'. However, implicit in the purpose of regulation which gives rise to the 'regulator'-'regulated' relationship is the 'beneficiary' of the regulatory process; for if the programme of regulation is not intended to benefit any party, then it begs the fundamental question: why is there a need to regulate? The place of the 'beneficiary' and its interests within the *regulatory complex* is crucial to the understanding of regulation since in essence they form the basis for the institutional design and the rationale for any regulatory action. To describe singularly the 'beneficiary' as the remaining participant in the regulatory complex is also to run the risk of oversimplification. Since regulatory objectives in themselves vary, so will the nature and interests of the 'beneficiary'. Some may be leading actors in the complex, while others may only have peripheral interests. There is, therefore, mileage to be gained in this anatomical approach by dismantling the complex of regulation, specifically in relation to air transport regulation, if only to identify the different *loci* of decision-making which are the ultimate sources of tension between 'formal' and substantive rationality.¹⁸

Regulator

In any system or complex of regulation, the principal actor is the regulator, for otherwise it ceases to be 'regulation'. This being so, the fundamental question then becomes what institutional form should the regulation take?

Statutory regulation

A 'regulator' as such does not need to exist in the institutional sense commonly derived from the sort of agency regulation associated with utility regulation; for it is possible to regulate directly through the enactment of statutory provisions complemented possibly by a system of inspection. For present purposes, this will be known as 'statutory regulation'. Health and safety related sectors are

17 *Ibid.*, p.185.

18 This anatomical approach has also been adopted by Emmette Redford in her study of commercial aviation in the US: *The Regulatory Process* (University of Texas Press, Austin: 1969), pp.9-13. See also a similar idea of "regulatory space" in L.Hancher and M.Moran (eds.), *Capitalism, Culture and Economic Regulation* (OUP, Oxford: 1989).

perhaps the most common of such a system. Statutory regulation derives its legitimacy from the structure of the constitution which will inform the 'authoritativeness' of the legislation. Hence, the supremacy of primary legislation in the United Kingdom is inherent in the constitutional doctrine of parliamentary supremacy. This is consistent with Hart's ultimate rule of recognition.¹⁹ As a form, rather than choice of regulatory framework, statutory regulation was much more common-place in the period of the Industrial Revolution. Increased economic activities and greater industrialisation resulted in consequences that could not be left unattended if the benefits of the industrial age were to be appreciated. Legislation had to be enacted to protect those large, yet infant, industries against the uncertainties of a growing economic system. There were, in particular, several industries which were vital to the nation and its security. For instance, the iron and steel industries and the shipbuilding industry were an important military asset in times of war since Britain's military capacity depended in large measure on her industries being able to supply the necessary war equipment. Commenting on the realisation that statutory regulation became necessary to ensure continuity, Mathias observed that the government's "main role was to institutionalize these underlying social and economic forces, to provide security at home and abroad within which market and economic forces, social and cultural drives would operate."²⁰ This would be achieved by creating a statutory framework within which the forces may interact. As might have been expected, however, industrial expansion and societal complexity compounded the difficulties stemming from statutory regulation. Pre-determined aims were far from being achieved and inflexibilities stultified rapid responses to the exigencies of social and economic developments.²¹

Departmental regulation

A greater degree of flexibility was needed and this was thought to be possible by delegating regulatory responsibility to ministerial or departmental units. This will be labelled as 'departmental regulation' for present purposes. The railways are a classic illustration. Departmental regulation arose from the need to preserve the vital communication link with less accessible areas of the country as well as transporting raw materials to these areas, and this led to the passing of the Railway Regulation Act 1840 which created the Railway Department within the Board of Trade.²² In addition, concerns were beginning to mount over the emergence of a monopolistic industry and its ability to ensure a safe

19 *Op.cit.*, pp.102-107.

20 P.Mathias, *The First Industrial Nation: An Economic History of Britain 1700-1914* (Methuen, London: 2nd edn., 1983), p.31.

21 Mathias, pp.166 *et seq.* See also E.J.Evans, *The Forging of The Modern State: Early Industrial Britain 1783-1870* (Longman, London: 1983), ch.11.

22 Of course, the railways were also regulated by Parliament and courts during its early years. For a history of railway regulation, see H.Parris, *Government and The Railways in Nineteenth-Century Britain* (Routledge, London: 1965), C.D.Foster, *Privatisation, Public Ownership and the Regulation of Natural Monopolies* (Blackwell, Oxford: 1992), J.Goh, *Railways Act 1993* (Current Law Statutes Annotated, Sweet & Maxwell, London: 1993), and more recently, T.Prosser, *Law and the Regulators* (Clarendon, Oxford: 1997), ch.7.

and reliable railway system. Hence, the need to balance these conflicts of formal and substantive rationality.

The absence of any effectual check from the absence of free competition on their respective lines [makes] it advisable to subject this monopoly to some general superintendence and control [which] will be most advantageously entrusted to some department of the executive government.²³

The need for delegation was vindicated by the Donoughmore Committee in 1932 when it stated in the light of growing powers of the administration that,

I feel that in the conditions of modern state, which not only has to undertake immense new social services, but which before long may be responsible for the greater part of the industrial and commercial activities of the country, the practice of parliament delegating legislation and the power to make regulations instead of being grudgingly conceded, ought to be extended, and new ways devised to facilitate the process.²⁴

A similar view prevailed over air transport, though at a much later stage. For example, in 1919 the Air Council was established within the Air Ministry to oversee civil and military aviation while later in 1945 the Air Registration Board was created under the auspices of the Civil Aviation Ministry to oversee safety of British air transportation.²⁵

Growth of agency regulation

Departmental regulation does not, of course, foster apolitical nor independent decisions. Neither does it always represent the most appropriate regulatory tool for the activity to be regulated. The complexity of the subject-matter to be regulated calls for expert skills and specialist knowledge which are not necessarily held by ministers and departmental officials; even less so given the array of functions required to be performed by them. Such was also the conclusions of the Northcote-Trevelyan and Fulton Commissions that more accountable and efficient government could be achieved by separating the 'policy' and 'executive' functions. Moving from a generalist to a specialist culture whereby policy-executive functions are separated implies the creation and use of specific bodies or units outside the traditional machinery of government. These have come to be labelled variously as non-departmental public bodies (NDPBs), quasi-autonomous-non-governmental-bodies (QUANGOs) and fringe bodies. A new species, executive agencies, now exists to perform those executive functions which ministers have seen fit to 'hive-off'. Those responsible for regulation, however, are more specifically referred to as regulatory or administrative agencies. In his seminal discussion, James Landis explained in *The Administrative Process* that,

23 *Parliamentary Papers* (1840), vol.x, 139.

24 *Report of the Committee on Ministers' Powers* (Cmnd.4060, 1932), p.137.

25 Air Navigation Act 1919 and Ministry of Civil Aviation Act 1945.

In terms of political theory, the administrative process springs from the inadequacy of a simple tripartite form of government to deal with modern problems.²⁶

Thus, the emergence of 'agency regulation' or otherwise known also as 'administrative regulation'. But this has only become fashionable in the UK as a result of the privatisation programme undertaken by the Conservative Government in the 1980s. Prior to this period, a handful of regulatory agencies were sporadically established including the Air Transport Licensing Board (ATLB) in 1960 as well as others during the 19th century industrial revolution such as the Poor Law Commission of 1834 and the Electricity Commission of 1919.

Notwithstanding the popularity of regulatory agencies, little in the way of a coherent and systematic strategy for their establishment and use was apparent. Some were created for specific reasons, some because they were in vogue, and still others were created from experience or influence by practices abroad. It is arguable whether the experiences in the US has been a source of influence, though the results of the Anglo-American research into the government of democratic societies under the sponsorship of the Carnegie Corporation may have played a part, even if only minor, in shaping the regulatory system in the UK. The conclusions of the research offered six justifications for the use of administrative agencies as a species of quasi-non-governmental-organisations. First, the 'buffer theory' that certain activities would be protected from political interference. Second, the 'escape theory' that the conduct of certain activities would avoid the weaknesses of traditional constraints. Third, the belief that specialisation by vesting the activities in skilled personnel could be achieved. A fourth theory of 'pluralism' was also offered in that by resorting to the use of such organisations, there is wider participation and more centres of responsibility. Fifth, these organisations offered another flexible form of instrument for the government. The sixth theory was that of reducing the size of government or the number of publicly-employed officials since the employees of these organisations need not be classified as government-salaried.²⁷ However, regulatory commissions in the US have been coming under severe scrutiny in recent years as the process of re-inventing government by reducing regulatory burdens continues apace. The Civil Aeronautics Board (CAB) was terminated in 1985 with the advent of airline deregulation, and the "architect of modern administrative hearing", the Interstate Commerce Commission was abolished in 1994 as a result of budgetary limitations.²⁸ Be that as it may, no reversal in policy on the use of administrative regulation in the UK seems imminent despite these developments in the US. Coupled with the return to economic *laissez-faire*, regulatory agencies remain a popular institutional structure to turn to for justifying policies of economic liberalism. Administrative regulation would provide those safeguards as are necessary for

26 J.Landis. *The Administrative Process* (Yale University Press. New Haven: 1938), p.1.

27 B.L.R.Smith and D.C.Hague (eds.), *The Dilemma of Accountability in Modern Government* (Macmillan, London: 1971). pp.74-75.

28 Federal Bar Association, *Administrative Law Notes*, vol.14. no.4. (1995).

protection against the might of large, private corporations whose capitalistic orientations are not necessary in accord with the plurality of societal norms. It creates an institutional means for bridging the gap between welfare objectives of the State and private economic activities. To embrace an ideology that suggests both the dominance of public interest and the superiority of the private sector reveals a potential ideological crisis given the possible contradictions between these two ideas. The needs of the public for regular and safe air transportation, are seldom in tandem with the commercial goals of private enterprises since some of these requirements will involve additional costs which they might be reluctant to incur. The aim of administrative regulation then is to institutionalise and resolve these complex contradictions. At one end of the spectrum, this could be achieved by granting operating licences or franchises only to companies which can demonstrate compliance with the pre-determined standards. Resolution of these contradictions is secured by a method of 'prescription' or 'imposition': unless X does Y, its activities will be prohibited or limited. At the other end of the spectrum, the resolution of these 'rationality tensions' could be achieved by identifying a 'neutral' regulatory space. This means finding a common ground between the aims of the regulated and the beneficiary. Thus, for instance, the CAA has identified the interests of air transport users as the primary concern of the regulatory process. Suffice it to say at this stage that airline operators exist as private entities seeking to maximise profits from the services which they provide to users. Returns on investment therefore depend on the willingness or reluctance of travellers to use air transport services and with which operator. If the aims of the users are regular, efficient and safe air travel between two places, airline operators will need to strive towards these ends to fulfil their aim of maximising profits. In this respect, both the regulated and the beneficiary will be oriented towards a common set of justifications for their different motives. Admittedly, this will not eliminate all tensions, but it will seek to minimise them.²⁹

Other reasons for the use of administrative regulatory agencies have also been identified. Frans Slatter, in his study commissioned by the Law Reform Commission of Canada, noted one dozen purposes for which administrative agencies have been created. His analysis, however, referred to the roles played by these agencies.³⁰

- (i) An assistant to take on the increasing workload of traditional units of government. However, instead of vesting in these agencies existing duties which would relieve the traditional branches, the tendency has been to give them new functions.
- (ii) A substantive expert to provide expertise in complex areas in which the government had had to become more involved.
- (iii) A procedural expert encompassing speed, economy of operations and fostering greater public participation through public hearings.
- (iv) A manager of a specific activity.

²⁹ See ch.2. *infra.* for a more detailed treatment of the theory of user interests.

³⁰ F.Slatter, *Parliament and Administrative Agencies* (Law Reform Commission of Canada, Ontario: 1982), pp.9-19.

- (v) An adviser who may be able to collate relevant information more effectively to formulate the advice
- (vi) An adjudicator to resolve conflicts
- (vii) An arbitrator.
- (viii) A decision-maker as distinct from an adjudicator in the sense that the decision-maker is not involved in an adversarial process or the resolution of disputes.
- (ix) A rule-maker for technical or complex matters.
- (x) A policy-maker.
- (xi) An intermediary between layers of government, which effectively constitute another layer of government.
- (xii) An insulator which either protects the government from a sensitive matter or the activity from political interference.

Slatter stresses that not all of these functions, however, are necessarily performed by one agency, nor is an agency likely to be vested with only one of those roles.

Whatever may have been the policy reasons or strategy for the use of administrative regulatory agencies in the UK, what stands out is the over-pragmatic approach to the building of regulatory institutions. As a leading commentator has observed in respect of utility regulation,

There is no tradition that utilities, as natural monopolies, are somehow held in common. Regulation was designed to be “light” and “flexible”, mimicking what private competition would have achieved had the industries not been monopolies. As a regulatory concept this is woeful, allowing a wide range of views as to how the beast might be shadowed. One regulator may interpret the competitive model as an excuse for breaking up the industry into smaller competing parts; another for setting maximum rates of return; another for regarding pressure for the capital markets as a surrogate for competition and allowing the monopoly to remain intact. None of them have any clear idea of the national or common interest; some may feel that it is naturally achieved by competition, others that it has to be asserted.³¹

It is clear that somewhere along the line the regulatory means and ends became mismatched and this has now become undeniably apparent. Prosser has this to say:

A regulatory system without a clear rationale and without any clear legal structure in which it operates has inevitably assumed what is probably the most frequently criticised regulatory characteristic in the post-privatisation UK; highly personalised regulation.³²

To a very large extent, the Civil Aviation Authority (CAA) is not immune from such criticisms. Indeed, as will become apparent in a later chapter, the civil

³¹ W.Hutton, *The State We're In* (Vintage, London: 1995), p.291.

³² T.Prosser, “Privatisation, Regulation and Public Services” (1994) *Juridical Review* 7.

aviation industry was hardly spared the regulatory rod since about the time of the First World War. Apart from the years when the industry was nationalised, the notion of freedom from regulation was virtually unheard of until about the mid-1970s when the CAA began to introduce more competitive policies. The CAA was created in part because of the unsuccessful experiment with the ATLB and in part because of the desire to bring about airline regulatory reform.

Self-regulation

Although the use of agency or administrative regulation has grown exponentially over the years, a few words must be said of 'self-regulation'. This represents a form of regulation which typically falls outside the State structure and consists of a regulatory institution voluntarily organised by the participants to be regulated. In this respect, the regulated collectively plays the role of the regulator. This has been variously defined as "regulation by peers" and "an institutional arrangement whereby an organization regulates the standards of behaviour of its members."³³ A number of examples are available: financial services (Securities and Investment Board), newspapers (Press Complaints Commission) and advertisements (Advertising Standards Authority). Most of the rules or codes of practice reflect the understandings, habitual practices and mutual respect within the relevant sector. Non-compliance with the agreed rules would usually lead to either expulsion from the regulated environment and thus the termination of certain benefits or privileges, or the imposition of certain penalties. Enforcement within a self-regulatory system is no less important than a regulatory system established by the State. Indeed, there are sufficient legal authorities to suggest that a system of voluntary self-regulation is equivalent, though not identical, to a 'formal', public law-style regulatory structure.³⁴

Regulator re-visited

The regulator is the principal actor within the regulatory complex, and it can take a variety of institutional forms. The aim of this analysis has been to establish and examine a number of these and to emphasise the increasing use of agency regulation as a preferred institutional form in the modern State. First, regulation may be direct statutory regulation such as prohibiting anyone with a high alcohol-blood content to be in charge of a motor vehicle³⁵ or prohibiting a contracting party from excluding its liability for death or personal injury resulting from negligence.³⁶ On the other hand, it may be regulation by a Government department such as the approval of citizenship applications or by an independent Government agency such as the CAA, OFTEL and a host of other regulatory agencies responsible for the utilities sector. At the other extreme, it may be a system of regulation consisting of a voluntary body and its codes of practice or customary practices such as the Press Complaints

³³ R.Baggott. "Regulatory Reform in Britain: The Changing Face of Self-Regulation" (1989) 67 *Public Admin.* 435, at p.436.

³⁴ By a public law regulatory structure, it is meant as a system of regulation subject to the principle of judicial review: e.g., *R v Panel on Take-Overs and Mergers ex p Datafin* [1987] QB 815 and *R v Advertising Standards Authority ex p The Insurance Services* [1990] COD 42.

³⁵ S.5, Road Traffic Act 1988.

³⁶ S.2, Unfair Contract Terms Act 1977.

Commission. Of these, the rationales for the rise in agency or administrative regulation were examined in closer detail on the basis that administrative regulation of competition in air transport is the major focus of this thesis.

Regulated: Airlines

The complex of regulation would be purposeless without a 'target' to be regulated. So would the regulatory strategies. Airlines are operating entities which may be privately- or publicly-owned. In either case, the aim is to provide air transport services although the justifications and motives need not share any similarity. Air transport services which may be the subject of regulation can be classified into three headings: scheduled, charter and freight. The ownership structure of British air transport industry has been privatised since 1987 although privately-owned airlines operated and competed alongside the publicly owned BA in the years preceding. The rationales for regulating are considered in more detail later, but it is helpful to note here that, given a structure of privatised ownership where two or more entities co-exist, the aims or interests of these entities are not likely always to be in accord; even if these aims were similar, the means employed may not be so. This may be explained by the variation in the norms of any social organisation under Weber's theory of substantive rationality. For if these plurality of ends were to be common between them, then regulation will become meaningless. Moreover, it would suffice simply to postulate the criterion of primacy of user interests, an end to which all privately-owned airlines will in any event subscribe. Where this is so, the purpose of competition regulation would become substantially concerned with policing against unfair trading practices although some residual economic regulation would remain where there continues to be structural problems for market entry.

Beneficiary: User Interests

To define user interests is no easy task. To begin with, different users of air transport services travel for different reasons. Business travellers travel for business purposes and have different expectations from leisure travellers. Likewise, users of air freight services. A business user will be concerned with speedy and efficient services and will often have an inflexible travelling schedule. A leisure traveller, on the other hand, will put less premium on time and possibly more on costs. The difficulty is further compounded by what is meant as leisure. Travellers for 'hybrid' reasons such as emergencies of a non-business nature would have little flexibility but would also be constrained by the factor of cost. Although s.4 of the Civil Aviation Act 1982 states nevertheless that CAA is to secure the provision of air transport services "at the lowest charges", it remains true that "lowest charges" must have contextual relevance so that lowest in the view of the business user may not necessarily be so for the leisure traveller. Whatever maybe the purpose of air travel, airline operators exist because of the users; users do not exist for airlines. Without users willing to travel by air, there is little rationality in operating air services. Without airlines, however, users have at their disposal other, perhaps slower and outdated, forms of transportation.

In addition, despite the diversity of expectations of an 'economic' nature, it is arguable that whatever the purpose for air travel, safety will prevail as a fundamental expectation. This is statutorily reinforced in s.4 requiring that air transport services are provided with "a high standard of safety". Even so, there is evidence to suggest that even this expectation varies. Britannia Airways argued in its parliamentary testimony to the Transport Select Committee that, whilst surveys indicate that the vast majority of the public favour increased safety measures and say they will be happy to pay for them, in practice price is often the deciding influence, with the belief that "it won't happen to me" adopted.³⁷

Such is the difficulty that their reconciliation is necessarily complex and informed only by broad statutory terms: "satisfy all substantial categories of public demand" and "further the reasonable interests of users". However, whether regulatory attempts are necessary to reconcile these differences begs the fundamental question of whether regulation is necessary at all. That is one of the leading questions of this thesis. Regulation, as has been noted and will be noted further, is a relative concept. To address the question of whether regulation is necessary, one must first ask in respect of what? This, it is submitted, is two-fold: competition and safety in air transport services. Safety, for its inherent reasons, is too obvious to merit detailed consideration for present purposes. The case for competition regulation, in the forms of economic and antitrust regulation, is, however, less clear and subject to various schools of thought. These are considered further in subsequent chapters.

Beneficiary: Public Interest

The public interest is not synonymous with user interests. To treat them as identical will run the risk of ignoring a wider constituency of the regulatory complex. Users would include actual and potential users of air transport services, but not other sections of the general public who do not use these services nor have the desire of doing so. By way of illustration, s.68(3) of the 1982 Act requires the CAA when licensing air transport services to have regard to the need to minimise any adverse effects on the environment and any disturbance to the public as a result of noise, vibration or atmospheric pollution arising from the activities of civil aviation. The 'affected' public in this sense is not the constituency of users. No doubt, some interests between users and the public will conflict and some will overlap. A good example is safety. Residents in the vicinity of that busy airport will share the concern of users on the issue of safety stemming from air traffic congestion or aircraft taking-off and landing. In a wider sense, the public interest will also incorporate the idea that air transport is a strategic means of communication. The provision of a vital communication link including the protection of national security is a concern extending beyond those of the users.

Peripheral Interests

In a dynamic regulatory complex, the boundaries of actual and potential participants are constantly shifting. Some participants are subject to the direct authority of the regulator, while others are affected as a consequence of certain

³⁷ *Aircraft Cabin Safety*, HC 27 (1989-90), p.45.

regulatory policies or decisions. Yet the extent to which they are affected is sufficiently significant as to merit the consideration of their interests by the regulator even if only informally or subconsciously. The interests of airline employees is one. In a judgment rejecting an application to overturn the decision of the CAA on the licensing of charter services, Roch J. remarked,

In addition, it may adversely affect the employment of those pilots and cabin staff...³⁸

The importance of airline employees' interests within the regulatory complex was noted, for instance, in the parliamentary debate during the passage of the Civil Aviation Bill 1971.

I hope the government will take note of the chapter on human relations in our White Paper and that when the Civil Aviation Authority is satisfied that an airline has adequate financial resources, competent management and the ability to operate safely before a licence is granted, it will also be satisfied about industrial relations and will not grant a licence unless there are also proper negotiating procedures and consultative machinery established.³⁹

Although it is true that a privatised industry implies that matters of industrial relations are the prerogative of the private airline companies, regulatory policies of the CAA potentially affect even if only indirectly the position of the employees. For instance, a competitive strategy may drive an airline to reduce staffing levels in order to achieve greater productivity and consequently compromise safety standards. Are pilots and cabin crew subject to longer working hours or longer flights? How is the maintenance of aircraft affected?⁴⁰ This issue is now the subject of an extensive study by the European Commission, the *Social Impact of Liberalisation*.⁴¹

Another is the case of aircraft manufacturers. Operators of aircraft are required to satisfy the safety and technical specifications of the regulator before they will be permitted to operate. These requirements in turn become the concern of aircraft manufacturers. Consequently, if the policies of the CAA require that all Boeing 747s aircraft are fitted with ten doors, such that every passenger will have an equal opportunity to exit the aircraft in cases of emergency, then these manufacturers will need to ensure that that requirement is met, for otherwise the operator will be refused permission to use the aircraft or will seek to purchase an aircraft meeting the specifications from another manufacturer. Likewise, in the investigation conducted by the Air Accident Investigation Branch (AAIB)

³⁸ *R v CAA ex p Airways International (Cymru) Ltd* [1987] QBD Crown Office List CO/839/87.

³⁹ *Per* Roy Mason, H.C.Debs.814, col.1195. (March 29, 1971). See also *Civil Aviation Policy* (Cmnd.4213, 1969), para.82 and *British Air Transport in the Seventies* (Cmnd.4018, 1969).

⁴⁰ The relationship between the CAA and cabin crew is manifested in the Air Operator's Certificate issued by the CAA to airline companies. The requirements as to the training of cabin staff on emergency and survival are laid down in the Certificate and their compliance are monitored by Flight Operations Inspectors of the CAA.

⁴¹ See COM(96) 514, p.21.

into the M1-Kegworth crash involving a British Midland flight, it found a "genuine difficulty in interpreting the readings on the engine instruments".⁴² It recommended that "regulatory requirements concerning the certification of new instrument presentation should be amended to include a standardized method of assessing the effectiveness of such displays in transmitting the associated information to flight crew."⁴³ No doubt, the manufacture of aircraft in future will be affected if these recommendations crystallised into mandatory requirements.

Drawing the boundaries of peripheral interests, however, involves a necessary degree of arbitrariness. Peripheral participants included within the regulatory complex must possess interests that are substantially but indirectly related to or affected by the policies or decisions of the regulator. This would exclude, say, the interests of the taxi-driver who awaits the arriving passengers.

Concluding Comments

The interests of these participants should not be seen as isolated, compartmentalised sets; they are inter-related and they interact with each other. Some may be compatible with one another, others may be fundamentally conflictual. The regulatory complex, within which the regulator plays a principal role, seeks to rationalise the pluralism of interests, and "to settle assorted disputes trivial to society but important to individuals...to provide legitimate and continuously available arenas for the resolution of such conflicts."⁴⁴

Conclusions

Regulation in its most basic sense dates from early times. Administrative regulation is, by comparison, a more recent phenomenon in the UK and has gained particular significance only in recent years as a result of the privatisation of the utilities sector. Landis contended that this growth of administrative regulation was a consequence of the tripartite system of public administration failing to meet the demands of a modern and complex economy. In Weber's theory of economic rationality, regulatory intervention was necessitated by the complexity of the social structure which compounded the tensions of formal and substantive rationality. Whatever may be the form of intervention, it needs to be related to the ills which it is intended to remedy and to that end, the sources of these rationality tensions must first be identified. The aim of this chapter has been to set out a working definition for the term 'regulation' and to establish a conceptual framework of regulation by reference to the anatomy of the regulatory complex. Regulation is a system of control of the behaviour or activities of individuals or organisations to achieve a certain end and the non-compliance of which can be enforced by way of penalties or exclusion. The

⁴² AAIB. *Report on the accident to Boeing 737-400 G-OBME (Kegworth)*, (8 January 1989). p.97.

⁴³ *Ibid.*, p.101.

⁴⁴ T.K.McCraw. *Prophets of Regulation* (Belknap Press, Harvard: 1984). p.33.

administrative regulation of competition is the process whereby an independent Government agency is entrusted with the responsibility to oversee competition within a given economic sector. This process of regulation takes two forms, that is economic regulation and antitrust regulation. Economic regulation is primarily concerned with the regulation of a sector which typically has structural problems such as high barriers to entry and in doing so has the effect of determining the competitiveness of the relevant sector. Antitrust regulation presumes an underlying preference for competitive solutions to market problems. It also assumes that there are no significant structural problems and is therefore concerned with policing the fairness of a certain action or behaviour relative to the market conditions of the relevant sector.

An analysis of the anatomy of the regulatory complex is also important for considering the accountability issues. Are the decisions of the regulator sound and rational? Are reasons provided to examine the bases of the decisions? Were the decisions partial such as to lead to claims of the regulator being 'captured' by those it is supposed to regulate, an issue which is examined later in the thesis? In what manner were the decisions made? Were there consultations or public hearings? These are the range of questions commonly associated with administrative law and will need to be addressed so that the relationship between administrative regulation and public law can be established.

So far much has been said about the general nature of regulation and its conceptual purposes. Without pre-empting more detailed discussion at a later stage, however, a few words are in order on the European dimension of air transport regulation. It is now no secret that the regulation of British air transport is subject to European Community laws and the impact has been deeply significant. Consequently, any constitutional analysis of administrative agencies and their policies, whether substantive or procedural, must properly take account of these developments. The advent of Community laws has no doubt been an important land-mark in the history of British air transport regulation which is reviewed in chapter 3 and beyond. For now, however, the more specific concept of competition regulation has to be considered further to establish a framework of rationales for the administrative regulation of competition.

CHAPTER TWO A THEORY OF ECONOMIC AND ANTITRUST REGULATION

Introduction

The orientation of a State economy is often seen as one or the other of two traditional models. At one extreme, an economic model based on collectivist values whilst at the other, a model based on the ideals of a free-market. Whichever is the orientation depends on a range of factors, running from the political beliefs of the government of the day through the prevailing socio-economic climate. The former is commonly associated with a planned economy in the form of State monopolies or publicly-owned industries since these are supposed to serve the collective interests of the State. In a free-market model, however, the tendency is to associate it with individual *laissez-faire* in a liberal capital-based system and with the belief that the private sector and competition is more superior and efficient although it is equally possible for public enterprises to achieve competitive efficiency given certain conditions.¹ This contrasting position was usefully put by Ludwig von Mises in 1962.

The main issue in present-day political struggles is whether society should be organised on the basis of private ownership of the means of production (capitalism, the market system) or on the basis of public control of the means of production (socialism, communism, planned economy). Capitalism means free enterprise, sovereignty of the consumers in political matters. Socialism means full government control of every sphere of the individual's life and the unrestricted supremacy of the government in its capacity as a central board of production management. There is no compromise possible between the two systems.²

The impossibility of compromise is, however, inaccurate. The difference between a collectivist model and a free-market model is merely relative. It is a continuum on which the two models occupy the opposite ends. Indeed, it is impossible today to conceive of a system that subscribes exclusively to either the collectivist or free-market model. Features of a free-market model can often be found in a collectivist system; likewise the free-market system cannot operate devoid of some consideration being given to factors which are commonly held to be for the greater good of society such as environmental protection and better quality of life. To make this submission is also to argue that a variety of intermediate models of economic orientation exist along the continuum. These are models which emphasise the interdependence of both the State (collectivist end) and the private sector (free-market end). That this is not impossible has been well encapsulated in a remark by Professor Galbraith.

¹ C.D.Foster, *Privatization, Public Ownership and the Regulation of Natural Monopoly* (Blackwell, Oxford: 1992), ch.9.

² L.von Mises, *Bureaucracy* (W.Hodge, Glasgow: 1962), p.10.

Those who speak for the unbridgeable gulf that divides the free world from the Communist world and free enterprise from Communism are protected by an equally ecclesiastical faith that whatever the evolution of free enterprise maybe, it cannot conceivably come to resemble socialism.³

The aim of this chapter is to set out a theoretical framework for competition regulation, first by reference to the two contrasting economic models and the forms of regulation that they represent, and second to develop the theory of competition regulation by exploring the intermediate models. These will be called *regulated competition* which will enable us to examine further the two-fold distinction of economic and antitrust regulation.

The Collectivist Model: Monopolies

An economic model of monopolies is essentially anti-competitive. By implication, monopolies represent an exclusive right or existence at the expense of a competitor. It assumes that the protectionist benefits stemming from monopolies and cartels often outweigh an economic model exposed to the uncertain forces of market competition. Monopolies can exist by virtue of either a legal sanction or through market development. The former shall be called 'law-monopolies' and the latter 'market-monopolies'. Typically, 'law-monopolies' are created exclusively to perform a certain function usually in the public interest or to achieve certain social objectives. This exclusivity is usually backed by a legal or criminal prohibition against any other operator of that function. The programme of nationalisation in the 1940s which led to the creation of statutory or law-monopolies amply illustrates this point. Much of this reflected the concern over the consequences of the Second World War. The then Labour Government believed that a nationalised system of industries was more appropriate to look after the well-being of the population and to serve the needs of the nation as a whole. *Inter alia*, it would ensure the regularity of employment and the collective protection of employees by institutionalising industrial relations.⁴ Moreover, certain industries were considered inherently important and nationalisation provided a means for protecting them as much as it represented an instrument of public policy for controlling and directing the activities of the national industries. Thus, when the Bank of England was nationalised, it was to reinforce a long-standing desire for a stable financial system provided by some centralised control and co-ordination. Again, the complexity of the gas and electricity industries required some form of central co-ordination that would distribute fuel and energy by efficient means. A White Paper in 1961 on nationalised industries also identified that,

The amounts of money needed are much too large to be raised in the open market without government support and the industries are, of necessity, closely associated in the public mind with the

³ J.K. Galbraith, *The New Industrial State* (Hamilton, London: 1967). p.391.

⁴ See R.Kelf-Cohen, *British Nationalisation: 1945-1973* (Macmillan, London: 1973), ch.10.

Government, so that it would be difficult for the market to regard them as independent financial concerns.⁵

Others had their intrinsic national significance. In the case of air transport for example, it provided a vital communication channel with the world and by conferring a monopoly status on the publicly-owned enterprises then, the legislation nationalising the industry also prohibited others from providing air transport services.⁶ Indeed, commerce, in the European tradition, has always seen monopolies and cartels as a legitimate practice; official approval was widespread and was therefore not difficult to come by.⁷ By contrast, the US has a markedly different approach. They have a strong tradition of common law hostility to monopolies and cartels and accorded primary importance to the idea of an autonomous economic system and individual expression of choice.⁸ Such profound dislike of monopolies and fettered competition is also apparent in the renowned Sherman Act 1890 and Clayton Act 1914. Both, and others, are a resolute restatement of America's belief in commercial pluralism, economic freedom and democracy, as against the enormous powers wielded by monopolies.⁹

The aim of establishing these law-monopolies was also to redress the over-capacity resulting from excessive competition whilst at the same time providing stability to business enterprises that were likely to suffer from the uncertainties of a competitive market system. In addition to providing stability to the industries, monopolies would ensure that the uncertainties of the market system did not operate adversely against the collective needs of the public. Common examples can be found in the form of public service obligations or universal service obligations. Monopolies also enjoy the advantage of being able to concentrate resources and co-ordinate operations so as to reduce wastage or duplication.¹⁰ Furthermore, eliminating duplication would lead to specialisation and innovative initiatives. It is therefore possible to make a case for monopolies on the basis of efficiency. Such claims are, of course, equally applicable to 'market-monopolies'.

Market-monopolies do not have the sanction of law. On the contrary, market-monopolies emerge by reason of a significant competitive advantage. This may be attributed to substantial efficiencies, or insufficient demand to justify the entry of competitors, or a private sector industry such as air transport where

⁵ *Financial and Economic Obligations of the Nationalised Industries* (Cmnd.1337, 1961), para.27.

⁶ Civil Aviation Act 1946.

⁷ W.R.Cornish. "Legal Control over Cartels and Monopolization 1880-1914" in N.Horn & J.Kocka (eds.), *Law and The Formation of Big Enterprises in the 19th and Early 20th Centuries* (Vandenhoeck & Ruprecht, Göttingen: 1979).

⁸ See e.g. S.Buck, *The Granger Movement* (University of Nebraska Press, Lincoln: 1913); *US v Trans-Missouri Freight* 166 US 290 [1893]; *US v Addyston Pipe & Steel Co.* 175 US 211 [1898].

⁹ See e.g. W.Letwin, *Law and Economic Policy in America* (Random House, New York: 1966); H.B.Thorelli, *The Federal Anti-Trust Policy* (John Hopkins Press, Baltimore: 1954); H.George, *Progress and Poverty* (Hogarth Press, London: 1938).

¹⁰ See e.g. C.D.Edwards, *Maintaining Competition* (McGraw-Hill, New York: 1949), pp.110-120.

significant entry barriers can be present as a result of structural problems or historical privileges. Such market-monopolies may of course enjoy the sanction of law to the extent that its monopoly or dominant position is exempt from any prohibition laid down in law, provided that they comply with the conditions stipulated. Exemptions of these nature are characteristic of an antitrust regulatory system, which is considered below. Thus, market-monopolies differ from law-monopolies on the basis that the latter are expressly created by statute.

In his theory of economic rationality, Weber rejects the collectivist model of a centrally planned system as intrinsically impossible. For instance, he argues that a model which "determined" or "assigned" prices to goods and services was not a substitute for prices which were determined by actual market competition. It would be too arbitrary. There would be no rationality because the innate lack of knowledge to plan in a market economy would inevitably confine decisions to shrewd guesses of what might be the responses to or consequences of the projected actions. A centrally planned economy would require the planning authority to be in possession of such information which Weber moderately remarks, "is an enormous task."¹¹ These arguments chime well with the New Right philosophy. In a useful analysis by Norman Lewis, he writes that,

A government committed to choice would produce pluralistic and extensive institutions to encourage rational discourse...Quite apart from anything else, secretive centralism flies in the face of what is part of the hard-core belief of the NR [New Right]; namely that government rarely knows best.¹²

According to Adam Smith in particular, monopolies were a source of encouragement for inefficiency and managerial slackness.¹³ What was required in its place was an economic model that would be based on the ideals of the *laissez-faire* doctrine where individual choice triumphs; an efficient system driven by the natural mechanisms of the market place.

The Free-Market Model: Perfect Competition

The free-market model of economy makes a number of assumptions. First, it assumes that competition will exist and function without formal intervention of the State. It assumes that competition is perfect, and a means adequate to ensure equal economic and social distribution. State intervention is virtually absent, except that it will remain responsible for policing against unfair behaviour or practices - antitrust regulation. In general, therefore, the determination of prices, capacity and entry into the market will be left to the demand-and-supply mechanics of the market system. To the extent that these economic decisions are not regulated, the relevant sector is said to be *deregulated*. Accordingly, an enterprise is permitted to decide whether to invest

¹¹ M.Weber, *Wirtschaft und Gesellschaft*, trans. by T.Parsons, *The Theory of Social and Economic Organisation* (Hodge, London: 1947), p.38.

¹² N.D.Lewis, *Choice and the Legal Order: Rising Above Politics* (Butterworths, London: 1996), p.29.

¹³ A.Smith, *Wealth of Nations* (Baynes, London: 1776).

in the first place, whether to become a competitor, what to produce, how much to produce and what to charge for the product.

A crucial theoretical assumption of deregulation is that 'perfect competition' in the relevant sector is possible. But perfect competition is a notion not susceptible to a precise definition because of the difficulty in ascertaining when perfect competition has actually been achieved. Its shifting boundaries means it is dependent on a host of factors such as the number of competitors and the nature of the market in question.

The extent to which markets adhere to the model of perfect competition is not always easily determined and, even more problematic, is the hypothesis that markets on the whole tend to move away from conditions of full competition.¹⁴

Be that as it may, perfect competition is usually described as *Pareto optimum*. The Pareto test holds that maximum efficiency has been achieved in the allocation of resources when it becomes impossible to make someone better off without at the same time making someone else worse off. This is without question a narrow test; for the circumstances in which a transaction would make an individual better off, but where no one else loses out, would be extremely limited as to make its application near-impossible.

A more practical appraisal of the notion of perfect competition is to assume that the relevant sector enjoys a certain degree of market contestability. While market contestability does not mean that competition is perfect, it does represent the next best thing. The theory of market contestability has been explored by Baumol *et.al.* who assume that in any given industry, usually one which is deregulated or unregulated, their transactions would be organised into two principal sets.¹⁵ One was between incumbent firms where there is a fixed number of firms so that collectively they constitute 'monopolistic competition'.¹⁶ The other was between incumbent firms and *potential or new* entrants. The latter is the focus of their analysis. They claim the behaviour of new entrants to be founded on the calculation of profits that entry into the market would provide. An incumbent who prices his product excessively above costs would provoke the entry of competitors who are prepared to under-cut his price by narrowing the margin of profit. Baumol *et.al.* offer the definition of market contestability as a market,

into which entry is completely free, from which exit is costless, in which entrants and incumbents compete on completely symmetric terms, and entry is not impeded by fear of retaliatory price alterations.¹⁷

14 J-E.Lane. "Public Policy or Markets? The Demarcation Problem" in J-E.Lane (ed.), *State and The Market* (Sage, London: 1985). p.12. See also J.Robinson, *The Economics of Imperfect Competition* (Macmillan, London: 1933).

15 W.Baumol, J.Panzar and R.Willig. *Contestable Markets and The Theory of Industry Structure* (Harcourt Brace Jovanovich, New York: 1982).

16 On which see E.Chamberlin. *The Theory of Monopolistic Competition* (Harvard University Press, Mass.: 1933).

17 Baumol, *op.cit.*, p.349.

An important assumption of their theory is therefore that entry into the market is free so that it "exacts no explicit costs and that entrants suffer from no disadvantages in the techniques available to them."¹⁸ Explicit costs are either those entry costs which are greater than the costs incurred by the incumbents or social costs in the form of undesirable consequences to be borne by society. An implied requisite of a perfectly contestable market is that the 'sunk costs' are either negligible or non-existent.¹⁹ This assumption of freedom of entry where sunk costs are no object, therefore, permits the theory to be equally applicable to monopolies as it would to markets which are competitive. Of course, this is true only of market-monopolies, not law-monopolies which prohibits entry. Their analysis cite the airline markets as "a clear example [of] small, and therefore naturally monopolistic" markets, but are nevertheless contestable. By a natural monopoly, they meant a market or route where the level of demand justifies only one flight per day. It is, however, contestable because entry into and out of the market is easy given that "airline equipment (virtually capital on wings) is so very freely mobile."²⁰ A new entrant would simply fly into an airport and commence services with under-cut prices. If the incumbent responds by reducing its price, then they argue that the new entrant "need only fly his airplane away to take advantage of some other lucrative option - even if he only returns his rented aircraft or resells it in the well-functioning secondary aircraft market." Contestability through the deregulation of entry in particular would consequently aim to secure the ideals of perfect competition.

The virtues of perfect competition are founded principally on the idea of unqualified economic liberty. This exercise of liberty is, however, two-fold: by providers and by purchasers. Liberty of choice for the providers takes the sense of the freedom to decide whether in the first place to invest in the making of a product, the quantity of the product, how and at what price to sell it. This is consistent with Weber's argument that a centrally planned economy, whether by way prescriptive regulation or other methods, would be impeded by the lack of adequate knowledge. The arbitrariness of the decision may not be in accord with the expectations (demand) of the purchasers. By deregulating, the decision of what to provide, how much and at what price would be devolved to those whose business is to provide and specialise in providing the 'what'. Implicit in the decisions of the providers will be those of the purchasers since perfect competition must assume a degree of regular rationality in decisions of providing only what the purchasers would accept; if not, decisions of what to provide and the like would be arbitrary and perfect competition would only be a matter of mere co-incidence. Perfect competition also implies the unfettered liberty of choice for the purchasers by having a range of providers from whom to obtain the particular product. This is typically couched in the terms of "consumer sovereignty", "consumer power" or "consumer choice". However this is labelled, such sovereignty in consumer decisions acts as a discipline on

18 *Ibid.*, p.4.

19 'Sunk costs' are costs which are unrecoverable in the event that the competitor withdraws from the market.

20 *Passim*, p.7.

the providers to rise to the needs of the purchasers whether it is low pricing, reliability of product, attractiveness of product or simply value for money.²¹

In economic terms, the devolution of such responsibilities, particularly to the private sector, is a means for achieving greater efficiency and optimising scarce resources. Adam Smith was one such proponent.²² As one commentator has remarked,

On the familiar long list of the evils of monopoly there figures regularly the charge that it is a barrier to economic progress, a force making for inefficiency and stagnation. Competition, on the other contrary, is usually hailed as a stimulating and invigorating force, or even an indispensable spur to the exertion on which progress depends.²³

More specifically, the traditional economic arguments for a competitive system begin first with the notion of *allocative efficiency*. The argument runs that under conditions of perfect competition, consumer welfare is maximised through an optimal allocation of economic resources. These resources would be allocated between goods and services in a way which matches precisely the quantities desired by consumers, being the price that they are prepared to pay on the market. Economic theories have also argued that competition is the foundation of *productive efficiency*. This means that under conditions of perfect competition, goods and services will be produced at the lowest cost possible so that it also results in less wastage. As little as possible of society's wealth will then be expended in the production process. In this way, the combination of allocative and productive efficiency will lead to the maximisation of consumer welfare and society's wealth, so as to facilitate overall progress. In practice, however, the haphazard behaviour of consumers and irrational economic actions are a real and serious source of distortions for these theoretical assumptions. A model of perfect competition also assumes that consumers have access to all material information that enables them to make fully informed choices. This is not always possible; often, the cost of gathering all necessary information on product or services would outweigh the efficiencies intended by competition. Equally, a free-market model can give rise to 'externalities' which are costs derived from the activity of the producer and imposed on third parties, but which are not reflected in the price of the product. Other difficulties of the free-market model are discussed further below.

21 Norman Lewis has argued that the devolution of such responsibilities to choose is consistent with the theory of empowerment. In the same breath, it may be said that choice constitutes an important prerequisite of empowerment which is embedded in the inherent rights of citizenship: *Choice and the Legal Order: Rising Above Politics* (Butterworth, London: 1996), pp.57-59.

22 *Op.cit.*

23 P.Hennipman. "Monopoly: Impediment or Stimulus to Economic Progress?" in E.Chamberlin (ed.), *Monopoly and Competition and Their Regulation* (Macmillan, London: 1954), p.421.

The Intermediate Model: Regulated Competition and Contestability

For all the economic and social advantages of the free-market model, there is just as much to be said for a collectivist model. The ultimate end of meeting the interests of the public is a constant factor; what differs is the means with which the end is achieved. Whether a free-market or collectivist model is the more appropriate or preferred means must depend on the political, economic and social conditions of the State. The aim of these opening sections has been to explore the claims and counterclaims of the opposing models of economic organisation and the way in which competition regulation is fashioned, if at all. But that discussion merely serves to beg more fundamental questions of economic organisation and regulatory approaches. Can the public policies of a collectivist model combine the efficiency aim of the perfect competition model without destroying its *raison d'être*? How can the incentive structure of a market system be secured for a model of collectivism? Conversely, need a free-market model of economy necessarily imply the subversion of certain collectivist norms? Can the tensions of 'formal' and substantive rationality of these models be reconciled, and if so, how? The rest of this chapter is devoted to addressing these issues and to construct the arguments that the model of regulated competition represents the most satisfactory form of economic organisation in the modern political economy as well as a satisfactory compromise to secure a set of pre-determined objectives. These will be considered under two separate headings, economic and antitrust regulation, although their evolutionary relationship will also be charted.

Economic Regulation

Economic regulation is a second best enterprise. Having considered the arguments for a free-market system based on competitive solutions, it is clear that regulation is an article of faith. It represents an interference in the operation of the market system, for whatever reason, and at best an exercise to procure a result through guess-work. It is a process primarily concerned with the economic behaviour of the participants and their consequences; for instance, the decision whether to introduce a certain product or service, and if so, how much of it and what price to charge for it. Fundamentally, economic regulation is the regulation of market entry, capacity and price. Weber describes the control of such economic behaviour as the *wirtschaftsregulierender verband* in the sense that the regulator imposes regulations which represent a set of limitations on a pre-supposed existing sphere of economic autonomy of the participants.²⁴ Even so, these are observations which amount to a statement of presumption that the free-market system will always provide for results that are fair and rational. In the real world, this is not always the case. There will be cases where positive interference in the behaviour or activities of individuals or organisations will be warranted to secure the realisation of a certain set of objectives, typically the public interest. The vague notion of the public interest itself is an attestation to the need for regulatory intervention in cases where it needs to be more precisely defined. A commonly cited example is the role of regulation in redressing the

²⁴ M. Weber, *Wirtschaft und Gesellschaft*, trans. by T. Parsons, *The Theory of Social and Economic Organisation* (Hodge, London: 1947), p. 182.

deficit stemming from the lack of access to all relevant information for the public to make informed choices and decisions. To consider these claims further, the rationales for economic regulation need to be examined.

Rationales for Economic Regulation

The rationales for economic regulation abound, some of which will account for the rise of economic regulation. First of all, it pays to state Kahn's arguments that the need for economic regulation depended on the industry or sector to be regulated. On a scale of relative importance, the more important the industry and the more unique it is as a "prerequisite to economic development", then the more pronounced is the rationale for economic regulation.²⁵ At a more conceptual level of analysis, Weber argues that economic regulation is one of many socio-economic models and this institutional ordering rests on one of four criteria.²⁶ First, the emanation of economic regulation is attributed to *tradition* in the sense that those regulated economic activities have been traditionally accustomed to some sort of limitations. Secondly, he argues that as a matter of *convention* economic regulation represents a collective social disapproval of certain economic behaviour as contrary to free competition or price determination. The third criterion for this institutional ordering relates to the existence of certain *legal* requirements or the need to implement certain legal requirements. Typically, the system of economic regulation is established by a statute which will also stipulate the objectives to be achieved and the criteria to be applied. Fourthly, economic regulation may be organised as result of *voluntary actions* that represent a substantive restriction on the market but which remains formally free from interventions. The system of self-regulation is a good example; so are cartel agreements.

At this stage, a *caveat* needs to be added. Economic regulation and its objectives need not necessarily be to promote competition, although it will be a key assumption in this thesis. On the contrary, economic regulation is a process or method which is equally capable of being applied to reduce competition, where this is a reasonable interpretation of the aims of regulation. In this sense, economic regulation is a leverage for adjusting the level of competition intended to suit the prevailing economic conditions, or indeed to suit the interests of the regulated and run the risk of 'regulatory capture'. A crucial issue here is the accountability of the regulator whose decisions will need to satisfy the requirements of administrative law. This mechanism for checking regulatory decisions is important to ensure that they are not arbitrary, perverse nor unfair. Amongst other things, the determination of these issues require an understanding, albeit briefly, of the rationales for economic regulation.

(a) *Monopoly power*

A key rationale for economic regulation is the need to promote or to substitute for competition. Since monopolies present the greatest threat to competition,

²⁵ A.Kahn. *The Economics of Regulation: Principles and Institutions* (Wiley, New York: 1970), vol.1. p.11.

²⁶ M.Weber. *Wirtschaft und Gesellschaft*. trans. by T.Parsons. *The Theory of Social and Economic Organisation* (Hodge, London: 1947). p.182.

the case for the economic regulation of monopolies is particularly acute. In such cases, it is presumed that a monopoly is permitted to operate, but will be subject to some form of economic regulation. Typically, and in spite of the potential of products being overpriced or under-produced, the case permitting a monopoly to operate is justified by the lower cost of production to society than would otherwise be the case where two or more firms are permitted to compete.²⁷ On this basis, the aim of economic regulation is ultimately to promote competition and to control the exercise of monopoly power so that long-term monopoly profits are not accrued at the expense of competition.²⁸ The shortcomings or threats of monopolies have already been considered above. The difficulty associated with such a task is clearly to prove that the monopoly power has been abused or exercised in a predatory manner. This is no easy feat.

(b) *Excessive Competition*

Breyer and Stewart has argued that a key rationale of economic regulation has been to check the worse excesses of competition.²⁹ This is in complete contrast to a monopoly situation where the rationale was to prevent the abuse of monopoly power. Although it is clear that the notion of excessive will defy an accurate definition, it may be evaluated against a host of factors such as the unreasonable relation between prices and costs, a substantial slack in consumer demand or a large number of bankruptcies. In this respect, economic regulation has the ultimate aim of moderating excessive or destructive competition to prevent the rapid exit of competitors and consequently leaving the remaining competitors or producers with the free-hand to exploit the absence of competition.

Kahn adopts a similar line of reasoning. He argues that economic regulation is necessitated by the failure of competition in that either competition no longer exists or is operating contrary to the public interest.³⁰ This argument derives its support from the dissenting opinion of Justice Brandeis in *New State Ice v Liebman* on the excessive nature of unregulated competition.³¹ Brandeis was a renowned critic of unregulated competition. He believed that perfect competition was an illusion. It was destructive and a source of irreversible damage to economic life. Brandeis held the belief that unfettered competition was "competition that kills".³² In his view, "there must be reasonable

27 A.Ogus. *Regulation: Legal Form and Economic Theory* (Clarendon, Oxford: 1994), p.30. See also T.Prosser. *Law and the Regulators* (Clarendon, Oxford:1997). pp.11-12.

28 Foster, *op.cit.*, p.164.

29 S.Breyer and R.Stewart. *Administrative Law and Regulatory Policy* (Little, Brown & Co, Boston: 3rd edn., 1992). pp.8-9.

30 A.Kahn. *The Economics of Regulation: Principles and Institutions* (New York: 1970). vol.1, p.11.

31 285 US 262 [1932]. Other court decisions lending support to the view date back to early times: *Munn v Illinois* 94 US 113 [1876] and *Nebbia v New York* 291 US 502 [1934].

32 See T.K.McCraw. *The Prophets of Regulation* (Belknap Press. Harvard: 1984). p.103.

restrictions upon competition else we shall see competition destroyed"³³ His analysis focused very sharply on a particular Supreme Court ruling in *Dr Miles Medical Co. v. John Park & Sons*,³⁴ where it was held that price-fixing was illegal under the common law and the Sherman Act 1893. The decision had the effect of opening the way for a price war in the drug retailing industry by giving greater opportunities to carry out price-cutting, regardless of the battle that might be between larger and established firms against smaller retailers. As a result of this price competition, smaller retailers who could not sustain the battle had to be eliminated. The ultimate consequence was simply the reassertion of dominance by the more established firms which carried not only economic, but constitutional implications as well. Brandeis saw that the real problem in these developments was the circuitous and futile route of introducing and re-introducing competition for the benefit of the consumers.

(c) *Public Goods*

Anthony Ogus postulates another rationale for economic regulation as the distribution of public goods.³⁵ The hypothesis is that the market system cannot achieve an adequate or efficient allocation of the goods for consumption. He cites the example of national security. Here the people of town A may pay the requisite taxes for the necessary protection. The inhabitants of town B cannot refuse to pay on the ground that they do not wish to receive the necessary national defence. To put it another way, a member of town A may refuse to pay the taxes and hoping to enjoy the benefit of protection nevertheless. As a consequence, the allocation process through the market system breaks down.

What constitutes public goods is an issue on which opinions will differ. There are certain goods which fall into the grey area and may be considered as public or 'private' goods. Much depends on one's version of what is meant by public. Education and health service is one. It is possible that the market system can be applied to these areas for their allocation and consumption, so that the purchaser will receive the level of benefit for which he or she has paid. In practice, however, this can lead to overpricing or under-production. In such cases, the true value of the product may not be reflected in the price paid and some regulatory correction becomes necessary.

In the air transport sector, a useful example can be found in the case of commercially unprofitable routes. Assume the travel between two points X-Y. Suppose Y is a destination of remote location so that the number of passengers travelling between X-Y is never 'big' at any one time. In a commercially rational

³³ *Ibid.*, p.102. "Competition That Kills" appeared as a series of articles in the *Harper's Weekly* (US), November 15, 1913, and was intended by Brandeis to educate the public. Congress and judges of the dangers of unfettered competition. The American Fair Trade League sponsored an excerpted version of "Competition That Kills" in twenty national magazines. McCraw described Brandeis' efforts in the following words: "The text displayed Brandeis at his muckraking best. He brought every symbol and ideological appeal to bear, turned every conceivable argument to his advantage, and invested the whole with his distinctive moral passion": *ibid.*, p.103.

³⁴ 220 US 373 [1911].

³⁵ Ogus, *op.cit.*, p.33.

world, no airline would serve the route X-Y because it makes little commercial sense to transport a small number of passengers and, in any event, at a loss unless it decides to charge a premium to cover the costs of operation. The community of Y would consequently be deprived of an access facility in the form of air transport or would have to pay a great deal for X-Y travel. However, imposing what is known as a *public service obligation* on an airline would ensure the continuity of its provision and provided at an 'affordable' price. This requirement may be conditional upon the grant of some other benefit elsewhere - *cross-subsidisation* - or an obligation for which proper remuneration would be given. Consequently, the behaviour of the airline would be regulated to the extent that it is operating or is required to operate between X-Y. In this respect, economic regulation has a wider sense than simply to achieve a particular 'economic' outcome.

(d) *Externalities*

According to Ogus, the false value of products is compounded by the presence of externalities. Externalities are defined as the costs imposed on third parties as a consequence of the producer's activity, but which are not reflected in the prices of the products. Hence, a misallocation of resources. Regulatory action becomes necessary to correct the misallocation, for example, by adopting measures that would force the producer to 'internalise' such costs or compensate for the loss or damage arising from its activities. The most common example is that of industrial pollution. A factory plant may be discharging chemical wastes into the river which may damage the water drinking system or the ecological system. This company may, for example, be required to adopt alternative procedures for waste disposal which ultimately add to the cost of production. Another example is noise pollution from aircraft or fuel emissions from aircraft engines. Noisier aircraft may mean that the quality of life of those living under the flight path will deteriorate. Airlines may therefore be required to purchase newer and quieter engines or to compensate for the insulation of buildings.³⁶ Without such intervention, these costs may be ignored and in certain cases may present a danger to public safety. The only constraint may be one of adverse publicity. For example,

Airlines show a responsible regard for the safety of their aircraft, crew and passengers. Failure to do so would undoubtedly result in adverse publicity, a lack of confidence by passengers reflected in choosing to fly with competitors and the possible closure of the airline by the regulatory authorities.³⁷

(e) *Informational deficit*

The section on the free-market model made it apparent that purchaser or user choice lies at the heart of the market system. It is through such choice, the choice over a range of producers and products or services, that competition is possible. For all its virtues, however, choice is never perfect. This is so for two principal reasons. First of all, an important assumption for effective choice is the

³⁶ See P.Davies and J.Goh. "Air Transport and the Environment: Regulating Aircraft Noise" (1993)18 *Air Law* 123.

³⁷ HC 15 (1990-91). Appx.I, p.1.

extent or adequacy of information possessed by the decision-maker to make an informed choice between alternatives. No doubt, technology and media advertising has an important role to play in bringing forth the relevant information. Fares for flights to a host of destinations are now commonly available in the newspapers, over the radio as well as the 'Internet'. In spite of these developments, information is never 'perfect'. In the real world, some uncertainty as to facts will always be present. The advertised fares may contain restrictions on travel dates or length of stay which a traveller will need to verify and compare with the alternatives. This can result in a costly exercise. Thus, it may be necessary in certain cases for regulatory intervention to remedy the deficit so that more informed choices can be made. The CAA, for instance, requires all organisers of holiday packages to declare in the marketing efforts that they belong to the Air Transport Organisers Licensing scheme (ATOL). ATOL is a system where holiday organisers are required to place a bond in a trust set up by the CAA to compensate holiday-makers in the event that they go out of business. Holiday-makers would therefore be informed as to whether a particular organiser is a member of the scheme and would normally avoid dealing with those who do not belong to it. In that sense, ATOL is a centralised contract to compensate holiday-makers, a less costly way than having individual holiday-makers contract with the holiday organisers or travel agents for a similar protection. Be that as it may, regulatory measures to plug the informational gap does not always guarantee access to or availability of all the relevant information. Moreover, the process of gathering this information may be prohibitively expensive as to outweigh any public policy justifications for intervention.³⁸

A second assumption of the market system is that the decision-maker is able to process the information received and respond in a rational way that maximises his or her choices. This is known as *bounded rationality*. A passenger may decide to travel with a specific airline which need not offer the lowest fare on the basis that he intends to 'experiment' with the services of another airline or to collect loyalty points in exchange for a variety of gifts under a particular so-called frequent flyer programme. This latter issue is taken up in a subsequent chapter.

Regulatory Philosophy

A few words must be said about the approaches to economic regulation. The point has already been made that an economic regulator usually has the discretion to use its authority either to promote competition or to adopt a less competitive stance, though it was also stated that the scope of this thesis is limited to the assumption that economic regulation is designed to promote or mimic competition. This raises a whole range of questions including those on accountability and much else besides. Be that as it may, the aims of the regulatory policy, whether to promote competition or to protect the incumbents, may be approached by adopting an interventionist or 'minimalist' philosophy to regulation. This distinction is clearly relative. Where, perhaps, a given sector has structural problems or is a natural monopoly, it may be

³⁸ Ogus. *op.cit.*, pp.38-41 and Breyer and Stewart. *op.cit.*, p.8.

necessary to adopt an interventionist approach to maintain prevailing levels of competition or to ensure that the monopoly does not exploit its dominant power. Attempts to correct market problems are frequent. These can take the form of pricing review and control, compensation for under-performance according to agreed standards, interconnection or access to network resolutions, capacity control by fixing the volume of production and the like. In the air transport sector, for example, the licensing system which the CAA inherited from the ATLB was highly interventionist so that hearings were necessary and frequent to determine not only new applications to enter the market, but the level of fares and frequency of services of both scheduled and charter services.

On the other hand, a minimalist, or less interventionist, approach was a more apparent part of the CAA's philosophy to regulation. As will be seen in due course, for example, it believes in leaving market problems to be determined by competitive solutions in the first instance rather than regulatory actions. Intervention would be necessary only where the need is evident. This is consistent with the theory of critical market contestability. Under the CAA's responsibility, domestic air fares were freed of any control, so was capacity. As a consequence, hearings for licensing cases tended to be few and far between. In one sense, a minimalist stance is an expression of confidence in the market system to provide adequate solutions. This contrasts with the interventionist approach which perhaps is a manifestation of the desire, not so much to suppress market forces, but to prevent or overreach the anticipated failures of the market system through *ex ante* actions.

Methods of economic regulation

Whether the regulatory philosophy is interventionist or minimalist, the methods or means by which the aims of regulation are achieved are equally an important consideration. In charting these different methods of economic regulation, it is important to be reminded that they are not necessarily separated in a neat fashion; there is a considerable degree of resemblance between the various methods in as much as it is possible to combine the methods in any one approach to economic regulation. First, it will be assumed that the following analysis of the economic regulatory methods is based on the model of administrative regulation, that is economic regulation by an independent Government agency or public administrative body.

(a) Licensing or franchising

Although licensing and franchising differ in some respects, their respective aims are reasonably comparable. Both are processes of allocation usually in cases where the commodity to be allocated or handed-out is in short supply such as broadcasting licences or air transport routes. Both also have two-fold meaning. First, licensing may take the form of a screening process, that is a system of prior approval for 'entry into the profession'. This is typically based on criteria such as fitness, managerial and financial competence. Likewise, franchises are usually awarded only to those bidders who can demonstrate that they have the

requisite qualifications as is the case with television and radio broadcasting.³⁹ The use of such licences can be found in the case air transport where an operator of airline services is required to have been licensed by the CAA as fit and proper to perform the task of providing air services. This continues to be required even under the liberalised air transport market in the European Community (EC) where prospective operators of airline services will need to meet the fitness, managerial and financial conditions laid down in Council Regulation 2407/92.⁴⁰ A typical characteristic of such a prior approval system is the sanction under criminal law which provides that an unlicensed operator would be committing an offence.

Licensing can also be an instrument for prescribing the conditions of approval that relate to prices, quality of services or products, capacity or amount of products to be supplied, or indeed the types of goods that can be produced or services offered. To avoid confusion from the licensing process concerned with screening the fitness of applicants, this second form of licensing will be called *economic licensing*. These licences will contain specific economic conditions such as the RPI-X formula for the utility sectors. The RPI-X formula, in short, is a system for regulating the prices that an operator can charge, taking into account the capital investments and the need for a reasonable return. Additionally, such licences may require certain discounts to be offered such as lower tariffs to elderly or disabled users. This form of price control is no longer practised in air transport. It was first abandoned by the CAA in 1984 in respect of domestic services, and is now expressly prohibited by Council Regulation 2409/92 on fares.⁴¹ Fares relating to international services beyond the EC continue to be regulated in the usual way - through the use of bilateral agreements between the relevant countries.

Licences are also used to set standards with which operators are required to comply as a condition of the licence being granted. Such standard setting is typical in the case of 'social' obligations such as health and safety, or environmental protection, where the market system may be regarded as an inadequate corrective mechanism.

The procedures for issuing licences or franchises are normally governed by statute. These processes vary. Licences can be issued after a detailed public hearing. The hearing may be adversarial in nature and may require legal representation. Where there is no hearing to consider the oral representations of the relevant parties, decisions may be taken after having invited written submissions. This is evident in the use of the 'without hearing' system by the CAA. The procedures have a close resemblance to the provisions of the Administrative Procedure Act 1946 where the proposal to issue or indeed to revoke a licence is subject to the requirement of inviting comments on the proposal within a defined period of time.⁴² Invitations to bid or tender is an

³⁹ Broadcasting Act 1990.

⁴⁰ (1992) OJ L240/1.

⁴¹ (1992) OJ L240/15.

⁴² E.g. s.8(4) of the Railways Act 1993. Beyond hearings, the use of written submissions is also common in the regulation of the privatised utility sectors.

alternative procedure, though this is more commonly associated with the award of a franchise as in the case of railway franchises.⁴³

Although the use of licences has been highly effective in the economic regulation of air transport, as a means for controlling the intensity of competition, their importance will decrease as competition increases. This is so because competition is built on a liberal licensing philosophy, which implies a less prescriptive approach to regulation. Accordingly, there would be greater freedom on the part of the operators to decide the level of fares, the frequency of services, the type of aircraft to use and the markets to enter. Until such time, of course, when workable competition is deemed, licensing would continue to play an important role. This raises the question of whether economic regulation is merely a surrogate for competition so that at a certain point, such regulation can be abandoned in the knowledge that competitive forces will determine the economics of the industry. To put it another way, this means that market contestability has been achieved where entry is free to all able and willing operators. It may be that such workable competition or contestability may never be achieved given the unique structure of the industry. For example, it would seem difficult to dismantle the economic regulation of transmission charges for electricity or gas, or network charges for telecommunications. These are infrastructural charges which need to be regulated because it would be too expensive to build another competing network. Airports are similar to transmission pipes and lines in every sense of the word, and the charges for taking-off and landing will need to be overseen by a regulatory authority, which by happenstance is also the task of the CAA. However, the regulation of airports will be outside the scope of this work.

The airline industry is thus a worthy case-study to establish the theory that certain upstream or downstream services can be subject to a less prescriptive regulatory approach, but only when the structural difficulties of the industry have been overcome. This presumption of allowing the competitive forces of the market to operate, before the need for regulatory intervention, inevitably reduces the significance of the licence as a regulatory instrument. That said, it is important at this point to reiterate the important distinction between economic regulation and antitrust regulation. This is because while sustainable competition may allow for the dismantling of economic regulation, antitrust cannot be removed. Indeed, it is a pre-condition for economic liberalisation or deregulation to ensure that an effective antitrust framework has been established. Without the latter, competition would be jeopardised by the possibility of anti-competitive practices or predatory behaviour by a dominant firm. This is particularly acute where the industry structure is represented by a dominant undertaking which had previously enjoyed a privileged position or special rights. The air transport industry is a classic illustration. This concern was well manifested in a substantial part of the CAA's report from its study into the privatisation of BA. This issue is taken up in a subsequent chapter.

(b) Rate-making

⁴³ S.26. Railways Act 1993.

The system of cost-of-service rate-making involves the regulator setting the prices to be charged which the operator would otherwise have set. This is common in the case of a natural monopoly where regulatory intervention to determine the pricing structure is justified on the ground that the operator may exploit its monopoly power. This method will provide for an amount of revenue sufficient to meet expenses and a reasonable return on investment. To do this, the regulator will need to determine future costs of operation such as salaries, depreciation as well as a 'reasonable rate' of return. Information for such items may be derived from previous periods of operation. Cost-of-service rate-making is more commonly adopted in the US,⁴⁴ although there is a degree of resemblance with the RPI-X formula adopted for the UK utility sectors. It has been argued, however, that the RPI-X formula is significantly different on the basis that it provides an incentive structure for the operator to achieve efficiency savings, though this is not to say that the formula is free of difficulties when it comes to application.⁴⁵

(c) *Historically-based prices*

Another method of economic regulation is based on historical prices. This is now uncommon although it was widely used in times of war to control prices and productive capacity of operators.⁴⁶ Quite simply, prices are set by the regulator on the basis of the prices charged at certain date and modified accordingly to reflect different circumstances. The problem with such a method is that it presumes the ability of the regulator to factor the different circumstances into the new prices. The longer the time lapse between the historic and new prices, the more likely that more different circumstances will emerge, thus complicating the process of determining more precise historically-based prices.

(d) *Public ownership*

It is a contested issue as to whether public ownership constitutes a method of economic regulation. Even so, it is helpful to consider the issues a little further. The proponents of public ownership as a form of economic regulation include Anthony Ogus, Christopher Foster and Stephen Breyer whose works have been widely referred to in this chapter.

Public ownership is not a direct control of the economic behaviour of private actors, but is instead the assumption of proprietary control over the resources of the entity. No doubt, any economic regulatory control can be exercised within the ownership structure itself. While its most distinct difference from classical regulation lies in the institutional structure, the more crucial questions of how and whether the public interest is, or can be, served remain fundamentally similar.

⁴⁴ Breyer and Stewart, *op.cit.*, ch.4 and see also S.Breyer, *Regulation and Its Reform* (Harvard University Press, Mass.: 1982).

⁴⁵ See J.Kay, "The Future of UK Utility Regulation" in M.Beasley (ed.), *Regulating the Utilities: A Time for Change?* (IEA, London: 1996), pp.153-160.

⁴⁶ Breyer and Stewart, *op.cit.*, ch.2.

The system of public ownership is not alien to the British structure of enterprise, nor indeed to the European tradition of economic organisation. Public ownership in the UK peaked in the period between 1946-1951 when the majority of the major industries were nationalised under the auspices of their respective statutes. The rationales for public ownership consisted of a combination of practical motivations to avoid undue duplications, ideological conviction and pre-war policy of centralisation. Where the objective was to avoid duplication in the use of resources, the typical consequence would be the creation of a monopoly, though it is true that a monopoly can equally be created in a private sector entity. The argument runs that, just as much as competitive forces can generate efficiencies, a monopoly can achieve efficiencies of a similar magnitude.

More importantly, however, the golden years of nationalisation was the result of the Morrisonian concept of separating the responsibility of policy-making from the day-to-day operations of the publicly-owned entity. The lines of accountability would therefore be clear and comprehensible. Ministers would be accountable to Parliament for policy matters. There is much to commend in the need for clearer lines of accountability, although in the case of the nationalised industries, the willingness of ministers to intervene for political and short-term reasons left much to be desired.⁴⁷ Such willingness to intervene were seldom accompanied by the corresponding willingness to shoulder the blame when things went wrong. A study of the National Economic Development Office in 1976, which failed to be adopted by the government, sheds an illuminating light on the peculiarities of the relationship between ministers and nationalised industries. Its remarks deserve quoting at length.

[S]uccessive governments have been reluctant to accept the importance of continuity and to recognise that in any large industrial organisation, whether in the public or the private sector, some assurance of stable objectives and policies is a precondition of efficiency...The problem is a familiar one and there is no easy solution for it; but it cannot simply be brushed under the carpet. In all the main nationalized industries, plans for investments, technology and manpower have to be made for periods which extend well beyond the lifetime of a single Parliament. Until a framework is established within which management can plan with confidence, the nationalized industries will never operate at anything like their full potential...At the same time one must recognise the realities of our political system...Ministers in Britain are continually subjected to short term pressures from many quarters and an elected government often feels obliged to respond to such pressures.

At first sight there is a good deal of attraction in the concept of a completely arm's length relationship, in which the difference between commercial and social obligations are precisely defined

⁴⁷ See T. Prosser, *Nationalised Industries and Public Control* (Blackwell, Oxford: 1986) and Foster, *op. cit.*, p.83.

and the rules for departmental and corporate behaviour are neatly codified. But the evidence demonstrates convincingly that in the real world things would not work out like that.

It seems to us that the thinking behind the wholly arm's length approach is based on a false analogy with the private sector. The financial structures and disciplines in the public and private sectors are very different... The issues of public policy involved are so large and politically sensitive that it is not realistic to suppose that they would ever be left for long to management alone to determine, subject only to periodic checks on their financial performance...

Boards of most nationalized industries feel strongly that governments intervene excessively in areas which boards consider to be within their own managerial prerogative. The right of Ministers to issue directions within the terms of the statutes is not in question; the problems arise when government seeks *to influence decisions by means which are not specifically provided for in the statutes*. From the boards' viewpoint the trend towards more frequent and *ad hoc* interventions has delayed decisions, disrupted previously agreed plans, invalidated criteria for planning and assessing performance, resulted in financial deficits, and damaged the corporate morale of management and other employees. The level of decision-making tends to be raised with the resultant increased burden on senior management. The lack of prior consultation, the inconsistency with agreed procedures and guidelines and the apparent *unwillingness of governments openly to carry the responsibility for their interventions* give rise to particular resentment at board level. (Emphasis added) Some corporations base their resistance to certain types of intervention on constitutional and legal grounds, but this has never been put to the test in the courts and board members have not carried their resistance to the point of resigning their appointments.

Ministers and civil servants would concede that the consequences of intervention have often been detrimental, in some at least of the above respects, but would justify many of them on the ground of the wider benefits to the community at large.⁴⁸

Regulated Competition and Critical Market Contestability

In the opening chapter, an attempt was made to identify the possible sets of interests or participants within the regulated airline complex. The three principal actors were the regulator, the regulated being the airline and the beneficiary being the users. It has also been asserted that an important role of the regulator was to harness the interests of these participants and to attempt to reconcile any differences. How this may be done depends on whether the regulator adopts an

⁴⁸ NEDO, *A Study of UK Nationalized Industries* (HMSO, London: 1976).

interventionist or minimalist philosophy of regulation. The aim of this section is to make an attempt at fashioning a regulatory approach that would seek to maximise the interests of the regulated and the beneficiary. This should set the agenda for the next section where it will be submitted that, given certain conditions, economic regulation tend to evolve into antitrust regulation.

In the history of any economic organization, it is typical that economic relationships and transactions have been characterised by the orthodox roles of the 'producers' and 'purchasers'.⁴⁹ While some of the interests of the producers will match those of the purchasers, it is also common that there will be considerable conflict. As a general submission, the primary aim of producers is to maximise their profits and how they achieve that is a matter of detail. Purchasers will tend to have different aims although it is not unfair to assert that value for money is a common aim. The economic relationship of the producers and purchasers is characterised by the demand and supply formula. Put it another way, producers produce what purchasers wish to purchase. Even then, Weber has argued in his analysis that the emphasis on production and producers has been so fundamentally stated that the significance of purchasers of these 'products' has been reduced to a group of "alienated purchasers of fetishized commodities or simple dupes of advertising and public relations."⁵⁰ His analysis claims that the neglect has been so pronounced as to deny the authenticity of purchaser choice. Notwithstanding that contention, he reasons that there is a gradual emergence of a commitment to individual autonomy and choice in consumption which he describes as characteristic of a *gesellschaftlich* model of social organisation. This need to make a renewed commitment towards redressing the imbalance in the producer-purchaser relationship is a reflection of the transition towards a liberal democracy. Such a commitment would restore the freedom of choice of the purchaser as an elementary right by virtue of his or her citizenship.⁵¹ This is also the claim of Lewis who claims that,

choice is a generic concept which can only attach to basic human needs. Those needs are substantially subsumed by the categories of fundamental rights which have recommended themselves to the world's democracies since at least the end of the Second World War. More often than not the expression has been used as shorthand for a conviction in the superiority of economic markets....⁵²

The rationale for *gesellschaftlich* is simply premised on the belief that the individual, or purchaser, is the basic unit of an indefinite plurality of interactions in any economic organization. In its widest sense, the decisions of this individual hold the balance in the political economy, or more narrowly the

⁴⁹ The term 'producers' is used in its global sense to denote 'suppliers', 'providers', 'sellers' and the like. 'Purchasers' likewise is used to include 'consumers', 'customers' and 'users'.

⁵⁰ R.Holton and B.Turner, *Max Weber on Economy and Society* (Routledge, London: 1989), p.3.

⁵¹ E.Lawlor, *Individual Choice and Higher Growth* (European Commission, Brussels: 1989), p.18

⁵² Lewis, *op.cit.*, p.4.

industry, although it is a supreme irony that the behaviour of this individual is necessarily unpredictable. If the ultimate balance of the economy is dependent on the ways in which the individual exercises his will, it must follow that the existence of producers is in turn dependent first, on the existence of the individual, and second, on the final act of the individual. Accordingly, producers exist because of purchasers. For this argument to stand, however, it needs to make one assumption. The first is that there is more than one producer who adopts a 'capital accounting' method suggested by Weber. This means that competition is possible through the choice that the purchasers are able to make. There is contestability in the sector so that no one producer can exploit its market power without inviting the competitive response of its competitors.

This is important because the notions of competition and contestability provides an incentive structure from which all parties seek to maximise their gains or interests. This is not to deny that a natural monopoly would not act in the interest of the purchasers. Indeed, nationalised industries were often charged with the task of meeting the public interest, whatever this meant. Even so, a crucial difference between a competitive market and a monopoly or nationalised industry is the role of or absence of incentives to ensure that the relevant producer is appropriately disciplined to perform the function it has been charged with. In the case of a monopoly or nationalised industry, an incentive structure may be constructed, for example, the RPI-X formula or some other funding formula. In the case of a competitive market, however, where entry is generally free, it is submitted that the incentive structure is inherent in the relationship between the producer and purchaser. Thus, if the aim of producers was to maximise profits perhaps through greater market share, and the aim of purchasers was value for money expressed either in cheaper prices, greater reliability or higher standards of service, then it becomes incumbent upon the producers to produce products or services which are cheaper, more reliable or of higher standard if their aim of maximising profits is to be realised. In the end analysis, producers will have to compete to attract the custom of new purchasers or to maintain the loyalty of existing customers by offering what they deem is desired by the new purchasers or existing customers. Since the producers are acting or competing to meet the interests of the purchasers, so as to maximise their own interests, this mutual space or synthesis of interests is known as *critical market contestability*.

While critical market contestability may be an inherent characteristic of a naturally competitive market, structural problems may require deliberate regulatory actions to procure a maximum overlap between producer and purchaser interests. The aim here would be to correct the imbalance in the producer-purchaser relationship as a result of the structural problems. The privatised utility and transport sectors are good examples. An entity previously in public ownership, but privatised with the privileges and assets intact, or indeed liabilities written-off, will undoubtedly have a leading advantage over any of its competitors, who more often than not would be 'starting from scratch'. Without the regulatory intervention, a monopoly situation may

eventually emerge, as a result of which purchaser interests may be subverted or ignored through the lack of competitive discipline or incentives

The stage of critical market contestability is as close as one can ever get to perfect competition. This implies that regulation can be pitched at its minimum and the approach be described as liberal. Although the liberalisation of regulatory controls is comparable to the deregulation of the relevant sector, they are not identical; liberalisation confers a substantial degree of economic freedom to the regulated, but the possibility of regulatory intervention remains so that perhaps severe market failures can be rectified. The presumption is that producers will be free to choose what it wishes to produce, the quantity to produce and the price to charge on the belief that regulatory intervention would not be necessary because the interests of the producers and purchasers will be drawn together by the common aim of satisfying or being satisfied by the other.

Be that as it may, a minimalist approach to competition regulation does not entail that the relevant sector is entirely devoid of the need for other forms of regulation. Quite apart from social regulation on matters such as safety and environmental protection, liberalisation means the relaxation of only economic regulatory controls on the one hand, and deregulation means the abandonment of only economic regulatory controls on the other. In both instances, antitrust regulation remains important and necessary. To this we now turn.

Antitrust Regulation

Antitrust regulation is a system or process of regulating against what may be described in generic terms as unfair trading practices. The motives for such practices abound, although it is typically the desire to gain additional market shares that drives such actions. In traditional classifications, these practices include anti-competitive practices such as collusion on prices, abuses of a dominant position such as predatory practices aimed at driving out other competitors, and mergers between entities such as to jeopardise competition through substantially enlarged market shares. Hence, the key rationale of antitrust regulation is to prevent such practices which have or are likely to have an adverse effect on competition, the second key task of regulation identified by Prosser.⁵³

This rationale is built on two crucial assumptions.⁵⁴ The first is that a belief in competition and competitive solutions forms an explicit part of public policy and the prevailing thinking on economic organisation. The justification here is to promote and protect the ideals of choice and opportunities in competition. The second assumption is that conditions of sustainable competition has been established either through the natural process of the market place or through deliberate regulatory actions to procure such conditions. A useful illustration of a competitive sector arising from the natural process of the market place is the

⁵³ T.Prosser, *Law and the Regulators* (Clarendon, Oxford:1997), p.5.

⁵⁴ It is entirely possible for antitrust regulation to have non-economic goals, for example the integration of the European single market or, for example, the protection of small business.

double-glazing business for doors and windows. A firm, X, identifies a demand in the market for building insulation and energy conservation. There is no regulation of entry, except perhaps on the standards of glass or materials used in accordance with the safety standards of the British Standards Institute. The absence of such entry controls thus enables another firm, Y, to compete with X. The competitive market arises as a result of some ingenious or innovative product developed by the competitor. Here, antitrust regulation becomes an important issue since it may be necessary to ensure that X, through the advantage it has gained from established clientele and marketing strength, does not engage in activities that would adversely affect Y. Indeed, it becomes an important policing process to ensure that X and Y do not merge their operations to become a monopoly, and if they are permitted, guarantees or undertakings are extracted from them to ensure that their operations do not adversely affect competition in the sector. It is possible that economic regulation may be introduced on some public interest grounds to deal with these shortcomings, but it must be submitted that if no structural problems are present to affect entry, pricing and capacity, then it should be avoided. The point has already been made that economic regulation is a second best enterprise that should only be contemplated where competitive solutions cannot otherwise be achieved.

Not every economic sector is necessarily competitive as a result of the natural market process. Certain sectors may have achieved the conditions of sustainable competition through the deliberate actions of an economic regulator, though it is entirely possible that the sector was once the result of the natural market process before economic regulation of some form was imposed by virtue of certain public policy objectives. The air transport sector is one good example of this development as the following chapter will reveal. The major difficulty of this second assumption is clearly defining the conditions of sustainable competition and when this has been achieved through the process of economic regulation. This task is particularly acute where there continues to be unique structural problems. The scarcity of airport slots for the taking-off and landing of aircraft, and the historical endowment which remained intact when BA was exposed to competition from other airlines, are two of numerous characteristics of a structurally imbalanced sector. More often than not, economic regulation continues to be necessary and operates alongside a framework of antitrust regulation. These problems may or may not be solved which will in turn determine the extent to which economic regulation can be liberalised or, in the extreme, completely abandoned. Suffice it to say, however, that in general the conditions of sustainable competition would have been achieved where economic regulation has reached the stage of critical market contestability. This is the hypothesis on which the present work will proceed.⁵⁵

⁵⁵ Prosser has argued that regulation encapsulates three fundamental tasks, the second of which is regulation for competition, to create competition and to ensure that it continues to exist: *Law and Regulators, op.cit.* He does not, however, attempt to say whether the role of creating competition can be rationally abandoned once the conditions for sustainable competition have been created, so that the second task of regulation becomes confined to ensuring the continuity of these, that is antitrust regulation. This thesis will argue that the second task of regulation can evolve from

It should be added that it is equally possible that the work of antitrust regulation may be performed by the same body or agency through the mechanisms of economic regulation. This may be seen in the case of an economic regulator deciding to vary the conditions of the licence awarded to the licensee on the ground that the latter was engaging or proposing in unfair trading practices. The aim and effect would be much the same, as if it was proposed under antitrust laws. The CAA, OFTEL and the Federal Trade Commission in the US are useful illustrations.

Securing the conditions of sustainable competition is not an end in itself, by implication, neither is the task of antitrust regulation. Both are simply the means for securing the realisation of a set of objectives agreed in advance. These may be to promote the interests of the producers, or by contrast, the interests of the purchasers expressed in terms of their reasonable expectations. It is therefore imperative that the philosophy of antitrust regulation matches the aim or aims to be secured. It is also to ensure that, where the conditions of sustainable competition were brought about by economic regulatory actions, that work is not destroyed. This is especially relevant in sectors such as air transport where a major aim of economic regulation is to deal with the structural problems of the sector and their ramifications for competition. The approach to antitrust regulation may be based on a philosophy of liberal or rigorous enforcement depending on which is most suited to the circumstances, though it is evident that an economic sector with unique structural problems usually requires an austere approach to enforcement to ensure that the propensities of the sector do not lead to a situation which both economic and antitrust regulation were designed to prevent. Indeed, to store up for later development, the liberalisation of air transport within the EC has presented a long list of questions on the adequacy of the antitrust machinery to deal with some persistent structural problems, as well as questions on the absence of taking possible economic regulatory actions except in very specific circumstances.

Conclusions

This chapter began by postulating two models of economic organization: collectivist and free-market. A collectivist model was presented as a system where central planning of the economy dominated; monopolies were the preferred institutional form for the various economic sectors. A free-market model on the other hand was characterised by the notion of perfect competition where formal regulatory actions were virtually absent. It was contested that since perfect competition was not a concept open to a precise definition, a variant had to be constructed to establish a basis upon which the rest of the work can be built. This was the theory of market contestability. It was also argued that under this model of economic orientation, a greater emphasis was put on choice as a tool of empowerment. It would facilitate the process of

creating to policing competition where there are no structural barriers for creating the conditions of sustainable competition.

renewing the commitment to purchaser interests, a characteristic of the *gesellschaftlich* model of social organisation.

It is clear, however, that whichever model of economic organisation is more suited must necessarily depend on the political, economic, social and constitutional conditions. It is simply an impossible task to convert one particular form of orientation into another without having regard to these culturally-specific factors. Be that as it may, most models of economic organisation in the modern state combine the characteristics of these extreme, traditional positions. For the purposes of this thesis, the model adopted was regulated competition. A crucial assumption of this model is the belief that market problems would be determined in the first instance by competitive solutions and regulatory intervention to correct market failures would arise only when the need was evident - the minimalist approach. In particular, this would be aimed at correcting the imbalance in the producer-purchaser relationship.

Competition regulation, it was submitted, is almost always a second best enterprise and at any rate a public act of management. In this respect, accountability for any regulatory actions becomes an important part of the legal analysis. Moreover, in order to appraise the issue of accountability, the rationales for competition regulation must be understood, and to that end, the works of Anthony Ogus, Christopher Foster, Stephen Breyer and Tony Prosser were an important source of reference. Much of what they have submitted on the rationales for economic regulation point to the correction of market or competition failures, whether the lack or excess of it.

A leading theme of this thesis is the evolution of economic regulation into antitrust regulation in the process of competition regulation. The nature of both were examined, and it bears repeating that they are by no means mutually exclusive. On the contrary, it was submitted that in most major economic sectors, it is imperative to have economic regulation alongside antitrust regulation, and *vice versa*, if the public policy aims of competition are to be realised. This is so because of the assumption that economic regulation can only be liberalised or abandoned when the conditions of sustainable competition has been secured. This was described as critical market contestability. The appraisal of these theoretical assumptions in competition regulation will form the basis upon which the empirical evidence in subsequent chapters can be examined to lend support to the contentions of this thesis.

CHAPTER THREE THE POLITICS OF AIRLINE REGULATION: SEARCHING FOR A DESTINY

The present institutional structure for regulating air transport competition has not come about overnight. It has evolved from the birth of the industry. The purpose of this chapter is to chart the development of competition regulation in respect of air transport in the UK. Regulation of aviation, in the broader sense of the word, however, appeared much earlier than economic regulation. The concern at the beginning of the century was attributed to the concept of national defence (which still prevails today), and hence the control over all forms of air navigation; there was little surprise in the emphasis placed on the military aspect of aviation regulation in the light of the First World War. But as shall be noted below, the emergence of economic regulation followed not too long after the end of the War. And thus the regulation of aviation in the UK assumed a two-fold dimension: military and commercial.

Little distinction could be drawn between the two at the outset which meant that a separate regulatory framework for each would have been unjustified. The division of responsibility was nevertheless due at some future point to reflect the expansion in commercial aviation although the economic regulation of civil aviation at the beginning was no more than patchy with frequent transfers of that responsibility between institutions. Yet, these transfers and the creation of new institutions for that purpose were often not accompanied by consistent reasoning to support the exercise. In spite of that, a common theme was detectable: the *prima facie* case that economic regulation of air transport was indispensable. This historical analysis will address the latter point further by examining how economic regulation of air transport first became necessary and how subsequent developments made it difficult to dismantle a system once installed.

The history of regulating air transport competition in the UK can be examined in seven sections encapsulating the land-mark developments between the years of 1910 to 1993.

- 1910 to 1924: The introduction of the first commercial air service and the subsequent emergence of other operators to mark the birth of a new industry.
- 1924 to 1946: A number of mergers were effected to re-organise the industry which resulted principally in the creation of Imperial Airways Ltd, British Airways Ltd, and British Overseas Air Corporation.
- 1944: At the instigation of the UK, and with the support of the US Government, a conference was held in Chicago from which came

the International Civil Aviation Convention, also known as the Chicago Convention.

1946 to 1960: The civil aviation industry was taken into public ownership with the nationalisation statute of 1946, with the notion of regulated competition by licensing emerging by 1960.

1960 to 1971: A framework of licensing was established which was to become the responsibility of an independent authority.

From 1971: The licensing system was reformed and a new regulatory process was set in motion. Subject to the changes under European Community law on air transport, it is the form of economic regulation which exists today.

From 1987: The arrival of EC law on air transport liberalisation and regulation.

The Pioneering Years to 1924

The first commercial air service was an airmail flight from Blackpool to Southport on the 10th of August 1910, provided by Holt Thomas and Graham-White. Regular air services, however, did not appear until after the First World War when in 1919 A.V. Roe and Company Ltd undertook the first passenger service between Manchester, Southport, and Blackpool. This was followed subsequently by the air services of Bournemouth Aviation Company for travel between Bournemouth and Cricklewood in London. But it was not until August of the same year when another land-mark in civil aviation was made by Holt Thomas for the first regular international service between London and Paris, and it was this development which moulded the civil aviation industry in the UK, and indeed the world.¹

This international service provided by Aircraft Transport and Travel Ltd (AT&T) was unsubsidised by the Government. With the introduction of air services on the same route by the French Compagnie des Messageries Aeriennes in September that year,² that meant AT&T had to compete with the French Company for revenue from services. But the position was distorted by the heavy subsidy given to the French carrier by its Government. Despite the introduction of further services from London to Amsterdam and Brussels, the Government showed little interest in civil aviation. The concern at that time was very much with the defence and safety of the realm, and this was evident from the emphasis of the Aerial Navigation Acts of 1911 and 1913. Although the 1911 Act empowered the Secretary of State for Air to prohibit the navigation of all aircraft over prescribed areas for the protection of the public by

¹ A more detailed analysis is provided in the comparative work of D. Corbett. *Politics and the Airlines* (Allen & Unwin, London: 1965), pp.26-32.

² *Ibid.*

issuing an order, the legislation was rooted in the military aspect of aviation rather than commercial. As a result of this policy orientation, the Government was therefore unperturbed by the competition in commercial air service between AT&T and the French carrier

Immediately following the introduction of the French services, another unsubsidised passenger, mail and freight service was commenced between Cricklewood in London and Paris by Handley Page Transport Ltd, which was to play an equally instrumental role in the subsequent development of British civil aviation. Like AT&T, it went on to develop services between London and Amsterdam, and Brussels. In October 1919, Instone Air Line Company Ltd was conceived and began commercial air services between London and Paris. Given the popularity of the London-Paris route, another airline company, Air Post of Banks plunged into the civil aviation market to compete for a share of the revenue from services on that route.³

Competition between unsubsidised and subsidised air services was potentially unsustainable, and this was proven so when the unsubsidised services of AT&T, Handley Page Transport and Instone Air Line ran into severe economic difficulties. Subsidised air services could be provided at below the rate of return whilst unsubsidised undertakings had to justify its existence by making a positive rate of return. In spite of these difficulties, the Government remained impervious to the desperate economic conditions, preferring to adhere to its "fly by themselves" policy. The closest to any interest which the Government had shown in the matter was represented by the recommendation of an Advisory Committee set up by the Secretary of State for Air, Winston Churchill, that these airlines should be given governmental assistance in the form of subsidies to compete with their rivals; but that was to fall on deaf ears as the Secretary of State insisted that they should not be seeking subsidies. As R.E.G. Davies described, this was "one of the most short-sighted decisions this great statesman was to make".⁴ The state of helplessness led to further financial difficulties, and AT&T, Handley Page Transport and Instone Air Line were driven to withdraw the services in 1921 which they had been providing in the face of direct competition with heavily subsidised services. The collapse of the British civil aviation became a contemplated prospect.

This prompted the constitution of a committee under the chairmanship of Lord Londonderry which recommended a temporary scheme of subsidy to air services to restore the plight of British civil aviation. Handley Page Transport and Instone Air Line availed themselves to the assistance for services on the London-Paris route, whereas AT&T had by then ceased operating. These subsidies from the Government also represented an attraction for other airline operators who were previously fearful of the distorted competition between subsidised and unsubsidised services. Daimler Hire Ltd. began to fly the London-Paris route while British Marine Air Navigation (BMAN) was

³ Memorandum of the Air Ministry to the Cadman Committee of Inquiry into Civil Aviation. (Cmnd.5685, 1938). Appendix B. See *infra*.

⁴ R.E.G.Davies. *A History of the World's Airlines* (OUP, London: 1964), p.17.

subsidised for services to the Channel Islands and Cherbourg in France. The scheme of subsidies was, however, lacking in direction. Three airline companies were subsidised for services which were virtually identical in character and which operated on the same route. It was not long before the Government realised that this arrangement was highly uneconomical since competition was unnecessarily duplicated between British airline companies in receipt of Government subsidies. New service agreements were therefore entered into with Handley Page Transport for the provision of services from London to Paris, with Instone Air Line on the London-Brussels and London-Cologne routes, with Daimler Hire on the Manchester-London-Amsterdam-Hamburg-Berlin route, and with BMAN on the Southampton-Cherbourg-Havre-Channel Islands route.⁵ The die was cast.

These arrangements, although spurred on by unfortunate developments, marked the turning point for British civil aviation. Government involvement in the industry on a wider scale was clearly becoming imperative since the provision of subsidies inevitably required the imposition of conditions and control either directly through a Government department or indirectly through an administrative body. Re-organising the provision of European air transport services to avoid the duplication of services was a step forward to establish an integrated air transport network that would protect not only the public interest, but also the wider economic interests of the nation. The temporary collapse of the industry in February 1921 following the defeat by French airline companies, albeit a blessing in disguise, put Britain behind other countries in the likes of the United States, Germany and The Netherlands which had or were beginning to enter the world of civil aviation. In order, therefore, to ensure that no further time was lost, and that the UK was able to provide sustained competition against these new competitors, the Government had to intervene to provide assistance to British airline companies.

The re-distribution of services between Handley Page Transport, Instone Air Line, Daimler Hire and BMAN was, however, far from satisfactory. In January 1923, the Secretary of State for Air constituted a committee to investigate into the operation of the subsidy scheme and to recommend on the future shape of the scheme. This committee came to be known as the Hambling Committee which recommendations were responsible for the first of a series of amalgamation of British airline companies.

The Amalgamated Years 1924-1946

Imperial Airways: A Chosen Instrument

The Report of the Hambling Committee attributed the difficulties experienced by British airline companies chiefly to the heavily subsidised form of competition provided by the French Government to its airlines. By implication, however, that observation reflected on the lack of assistance on the part of the

⁵ *Supra.* n.3.

British Government in respect of its airlines. The Committee went on to state that

commercial civil aviation has, in fact, made little progress towards being able to "fly by itself" without financial assistance from the Government.⁶

This view underlined the recommendations first made by the Advisory Committee to the Secretary of State for Air on the need to subsidise the airlines, a view which was also taken up by the Londonderry Committee which led to the temporary subsidy scheme. On the strength of these recommendations for governmental involvement, it would have been a perverse decision if the industry was further neglected. The Government had to become involved and the view of the Hambling Committee of this role was to set in place a monopoly by creating a new "Corporation or Company administered under Government control, but of a commercial organisation run entirely on business lines with a privileged position with regard to air transport services".⁷ It found that the subsidy scheme in operation then provided little incentives for the subsidised companies to seek improvements and to provide services beyond the level agreed. To avoid this difficulty, it recommended that subsidies to the new Corporation or Company had to be accompanied by the condition of "requiring the Company to perform services in connection with the operation and development of commercial air transport."⁸

Although the new Company was to be run on commercial lines, the Committee highlighted that the Government would need to maintain a degree of control over the Company through the appointment of Directors and "for the purpose of such checking as may be necessary to determine the amount of subsidy payable [and] for such control as may from time to time be exercised by the Government through the Civil Aviation Department over all civil flying in the country."⁹ The provision for appointing Directors of the Company provided the Government with a strategic tool to implement its civil aviation policy which had been lacking previously. The advantage was two-fold: on the one hand, the Government would continue to exercise control over the military aspects of aviation by directing the Company through the Directors when necessary, and on the other hand, to control the general direction of the civil aviation industry.

A new Company in the form of Imperial Airways Ltd was eventually created in 1924 by the Government in accordance with the recommendations of the Hambling Committee. Imperial Airways was an amalgamation of the four airline companies: Handley Page Transport, Instone Air Line, Daimler Hire and BMAN. The new Company was to operate air services as a "chosen instrument" of Government policy.¹⁰ The services provided by Imperial Airways initially emphasised on European services, but in 1926, there was a marked shift in policy over the emphasis of services provided by Imperial

6 *Government Financial Assistance to Civil Air Transport Companies* (Cmnd.1811. 1923), para.27.

7 Para.+1.

8 Para.+4(c).

9 Para.+4(d).

11 Specific responsibility for civil aviation was to be vested in the Air Ministry.

Airways. The new airline company was to be given a new direction and to focus its services on routes within the British empire. This was evident from the level of subsidies given to the airline for European and Empire services. In 1926, the subsidy for European services was £137,000 while £30,000 was provided for Empire services. By 1930, the amount of subsidy for the former had declined to £125,000 while the subsidy for Empire services had increased to £303,000. The stark difference appeared in the subsidies for 1935 where European services were provided with £80,000 while those on the Empire routes received £350,000¹¹. Nevertheless, Imperial Airways was to dominate British civil aviation up to 1935 when yet another land-mark in British civil aviation was recorded.

British Airways: A Second Chosen Instrument

Being the sole British carrier of passengers, mail and freight, it soon became clear that the magnitude of the task to be undertaken by Imperial Airways was proving difficult. Furthermore, with the limitation of finance as a result of the recommendations of the May Committee on National Expenditure in 1931,¹² the Air Ministry and Imperial Airways were restricted in making further commitments, particularly in respect of European services where competition was increasing from heavily subsidised airline companies.

At about the same time, a number of companies were attempting to introduce unsubsidised passenger and freight services, the most significant and ambitious was perhaps Hillman Airways Ltd. In 1935, the Government set up a Standing Inter-Departmental Committee on International Air Communications, under the chairmanship of Sir Warren Fisher. One of its first tasks was to consider the state of affairs relating to European air services. The Standing Committee recommended to the Government that the situation no longer justified the provision of subsidies exclusively to Imperial Airways on European services. Instead, the government should be giving subsidies to other airline companies for a more effective use of the subsidies since Imperial Airways was experiencing difficulties in meeting its tasks. Partly on the basis of this recommendation, and partly on the enthusiasm of the Air Ministry for a second British carrier to provide European services, Hillman Airways amalgamated with United Airways Ltd, Spartan Air Lines Ltd, British Continental Airways Ltd, and named themselves British Airways Ltd (BA).

With the support of the Air Ministry and the circumstances prevailing at that time in relation to European services, it was not difficult for BA to gain favour with the Government. In addition, it possessed sufficient "elements of air operating experience, coupled with business and financial experience".¹³ A combination of these factors led to BA becoming the second "chosen instrument" of Government policy on civil aviation. Although BA was seen as a potential competitor to Imperial Airways, little competition existed between them. BA was required by the Air Ministry to operate services on routes which

11 Memorandum of Air Ministry to the Cadman Committee. *supra*, n.3.

12 (Cmnd.3920, 1931).

13 Memorandum of Air Ministry to the Cadman Committee. *supra*, n.3.

Imperial Airways had found difficult to do so, and at any rate, BA was only concerned with European services at that time while the policy shift since 1926 focused the services of Imperial Airways on Empire routes. Any competition that existed between them was limited to such indirect competition for the provision of new monopoly services and hence Government subsidy. But there was no direct competition between them on a same route which the Hambling Committee had suggested in 1924 as wasteful competition.

In spite of all these efforts to re-organise the civil aviation industry either on a competitive or non-competitive basis, the situation was not as favourable as it could have been. Competition from European airlines posed the single most serious threat to the success of British airline companies, as they were given an upper-hand by generous subsidies from their respective Governments. In its memorandum to the Cadman Committee, the Air Ministry observed that,

If British services are to secure an equal footing within the already closely knit Continental air system, the Government is still faced with the position resulting from the heavy subsidies which foreign Governments grant to their national companies. Taking every mitigating factor into account, it seems unlikely that the remedy for this situation could be found without a substantial increase in Government subsidies.¹⁴

Air Transport Licensing Authority: A Glimpse of Licensing

In the meantime, an important legislative development was taking place. The Government enacted the Air Navigation Act 1936 to make several amendments relating to civil aviation in particular the payment of subsidies and the appointment by the Secretary of State of one or more directors of the airline company receiving subsidy.¹⁵ For present purposes, the notable feature of the statute was the provision for the making of an Order in Council prohibiting any carriage of passengers or goods by air for hire or reward unless a licence had been granted by the licensing authority.¹⁶ The Under-Secretary of State for Air explained that the section provided for "the setting up (as and when circumstances require it) of a licensing system in respect of air transport services, as distinct from the licensing of flying personnel and the certification of aircraft as airworthy."¹⁷ It also set out the circumstances to which the licensing authority must have regard in granting, refusing, revoking or suspending a licence to carry passengers or goods by air for reward. The decision of the authority could be challenged through an appellate process to the Secretary of State. Where a licence was granted, the licensing authority was empowered to attach conditions to it. The power to create this licensing authority was, however, not exercised until two years later following the report of the Maybury Committee in 1937.

14 *Ibid.*

15 S.1(1) and (3).

16 S.5(1). This was later re-enacted as s.7 of the Civil Aviation Act 1949.

17 H.C.Debs.310. col.1700 (30 March 1936).

The Maybury Committee was set up in 1936 to inquire into the development of domestic civil aviation within the UK.¹⁸ The Committee considered itself "forced to the conclusion that if air transport is to become fully self-supporting, it is a pre-requisite that cut-throat competition must be eliminated and that some measure of restriction must be applied to avoid indiscriminate multiplication of services."¹⁹ The way in which the measure of restriction might be achieved was by instituting "a provisional regulation of selected route" under the provisions of the Air Navigation Act 1936.²⁰

The following year, another Committee of Inquiry was constituted by the Government to look into the state of British civil aviation following a detailed debate in the House of Commons. The Committee, which came to be known as the Cadman Committee, was not given any official terms of reference by the Government, but the Under-Secretary of State for Air stated in the course of the debate that,

In view of the specific allegations that have been made, the Secretary of State will, in fairness to both sides, set up a Departmental inquiry into the charges of inefficiency made during the Debate... There will be no inquiry into matters already dealt with very recently by the Maybury Committee, the Government's decisions on which were announced to and approved by the House.²¹

When the constitution of the Committee was announced, its scope of inquiry was expanded by a further statement from the Under-Secretary of State.

[My Noble Friend] would, therefore, welcome the Committee dealing with questions not specifically raised in the Debate, provided that they had not already been settled by existing Cabinet decisions.²²

The Committee therefore interpreted its terms of reference as including the charges of inefficiency in the Air Ministry and Imperial Airways, the present state of British civil aviation, the system of industrial relations within Imperial Airways, and other matters not raised during the debate. Findings of the inquiry led to a highly scathing report of the organisation and management of the civil aviation industry and in particular the incoherence of governmental policy and direction.²³ It observed that if the creation of Imperial Airways in 1924 was a necessary response the Government had to make "to secure the establishment and progressive development of British air services in Europe",²⁴ having then created and vested it with monopoly rights, little, if anything, was done subsequently to encourage the development of British civil aviation by taking advantage of the progress that was being made in civil aviation and other

18 Maybury Committee, *The Development of Civil Aviation in the United Kingdom* (Cmnd.5351, 1937).

19 Para.125.

20 Paras.126-7.

21 H.C.Debs.329, col.479 (17 November 1937).

22 H.C.Debs.329, col.1218 (24 November 1937).

23 Cadman Committee, *Committee of Inquiry into Civil Aviation* (Cmnd.5685, 1938).

24 Para.13.

cognate areas. Nor was there a well-thought through policy that would map out the future shape of the industry.²⁵ The Committee stated,

If...the Government desire this country to take a leading place in civil aviation, much reorganisation and additional expenditure of public money will be necessary.²⁶

In addition, it emphasised that the Government would need to play a more active role in developing the industry rather than adopting an attitude of indifference to commercial aviation which led to the painful collapse of the industry in 1921. This, it recommended, could be achieved by

initiating policy, taking a forward view, considering the international implications of civil aviation, promoting the establishment of airlines and civil flying, stimulating the development and production of aircraft, conducting the necessary international and inter-Imperial negotiations, and exercising such control as will safeguard the public.²⁷

This recommendation represented a very comprehensive role for the Government in relation to civil aviation which was then very much alien to the practices of the Government in this sector previously.

These two reports were published amidst a torrent of criticisms against Imperial Airways from a number of quarters, particularly in respect of its system of management. One specific aspect of its management which the Cadman Committee found highly unsatisfactory was its relationship with the Air Ministry. There was a lack of communication and co-operation between the two sides.²⁸ It also found that a part-time chairman in Imperial Airways was not justified given the importance of the airline and the magnitude of the task that it was undertaking.²⁹

The Committee found further that the system of industrial relations within Imperial Airways was open to criticisms and this was particularly true in the context of its approach to collective representation over employment matters.³⁰ Perhaps the most vulnerable aspect of Imperial Airways opened to attack was the level of director fees and shareholder dividends it had been paying. The Cadman Committee found that in 1937 "Imperial Airways not only cut the salaries of its pilots [threatening a strike], but increased its dividend from 8 per cent to 9 per cent, and more or less doubled its Directors' fees."³¹

In the light of these criticisms and recommendations of both the Maybury and Cadman Committees, the Government took steps to address them which resulted in two important developments. First, as the Maybury Committee had already recommended, the Government enacted a system of licensing regular

25 Paras.14-16.

26 Para.7.

27 Para.17(a).

28 Para.46.

29 Paras.46-7. Sir Eric Geddes was the chairman of Imperial Airways at the time, and he also held the chairmanship of Dunlop Rubber Company.

30 Paras.103-5.

31 Para.107.

services in November 1938 by setting up the Air Transport Licensing Authority (ATLA)³² The new licensing authority would operate as an independent tribunal responsible for the licensing of air transport services. Little public debate was entered into for the creation of the ATLA notwithstanding the Special Orders Committee of the House of Lords report that the Draft Order establishing the ATLA raised important questions of policy and principles which were unprecedented.³³ But the absence of lengthy debates was no surprise since the ATLA represented an overdue measure, and which happily was also in accordance with the recommendations of the Maybury Committee for the rationalisation of air transport services.

The exercise of its powers to license proposed air transport services required the ATLA to consider the matters which the Order had specifically laid down. Generally, it was to have regard to the overall development of British civil aviation such that the most effective and efficient air services may be provided for the public. The Order also required the ATLA to have a special regard to a number of more specific matters including, for example, existing air services in the light of the proposed service, degree of efficiency and regularity of existing services, financial competence of applicant, and objections or representations made in respect of the application.³⁴

The advent of the Second World War proved fatal to the fate of the ATLA and the experimental licensing system. As would be expected, in times of war or emergency, the Government would acquire the control of all navigational activities whether military or commercial for the safety of the realm. In a way, there was no surprise that the ATLA was ushered to the side. As conditions returned to normal, commercial air transport services resumed, but the ATLA did not. The experiences of the War in relation to civil aviation and the political complexion of the succeeding Government clearly suggested that the ATLA was no longer required.³⁵

British Overseas Air Corporation: A Monopoly

A second development which took place was the amalgamation of Imperial Airways with British Airways creating the British Overseas Air Corporation (BOAC) based in large measure on the Cadman Report.³⁶ BOAC was to be a publicly-owned corporation which meant exclusive Government control. Its terms of reference was to secure the fullest development consistent with the economy and efficiency of overseas air transport services rather than to require it to achieve a self-supporting status, as was required of Imperial Airways. It was duly recognised that "in no country in the world today is aviation within measurable distance of paying for itself."³⁷ The creation of BOAC was the first, but important, step towards the nationalisation of the civil aviation

32 *Air Navigation (Licensing of Public Transport) Order 1938*, SI 1938/613.

33 H.L.Debs.109, col.458 (24 May 1938).

34 Art.11.

35 *Air Navigation (Licensing of Public Transport) Order 1938 (Revocation) Order 1939*, SI 1939/1588.

36 British Overseas Air Corporation Act 1939.

37 H.C.Debs.349, col.1833 (19 July 1939).

industry It is worth noting that the amalgamation was initiated by a Conservative Government, and this measure would seem to represent a significant departure from its political ideology on private enterprises and competitiveness. But it is submitted that the importance of civil aviation as a strategic national tool posed too great an asset to be sacrificed on the altar of political ideologies. The importance attached to civil aviation was also apparent in a departmental organisation of 1945 where the functions of the Secretary of State for Air and Air Ministry were transferred to the newly created Minister of Civil Aviation.³⁸ The statute creating the new Ministry charged the Minister with "the general duty of organizing, carrying out and encouraging measures for the development of civil aviation, the designing, development and production of civil aircraft, for the promotion of safety and efficiency...and for research into questions relating to air navigation."³⁹ This legislation, however, was not enacted until after the Second World War which had severely disrupted the progress of British civil aviation, and indeed international civil aviation. Nevertheless, suffice it to say here that the discussion so far is illustrative of the constant re-organisation and adaptations to reflect new developments or the findings of Committees of Inquiry given what is arguably a short period of time since air transport services were regularised. Inherent in these re-organisations, however, was the point made earlier on the inevitability of Government involvement.

A Land-mark Intervention: Chicago Convention 1944

While efforts were being consolidated to develop a more coherent policy framework for British civil aviation, a parallel development was taking place in relation to international civil aviation: the Chicago Conference of 1944. This development is worthy of a brief note here given the instrumental role of the UK which also indicated the changing attitude of her Government towards civil aviation. The Chicago Conference was convened at the instigation of the UK with support coming from the US in response to post-war civil aviation. It was felt at the time that international commercial aviation was advancing at a very rapid speed and for the prevention of aviation accidents, an international effort to lay down safety standards had to be made to avoid them. The increase in international civil aviation activities was very much due to the surplus aircraft that was available after the War and which were put to commercial use. Although no multilateral agreement was achieved at Chicago in the context of economic regulation, the end-result, which was the International Civil Aviation Convention, represented a highly important document for the future of civil aviation as a whole. The International Civil Aviation Organization (ICAO) which has its permanent seat in Montreal, Canada, was constituted under the Convention.⁴⁰

³⁸ Minister of Civil Aviation Act 1945.

³⁹ S.1(1).

⁴⁰ A more detailed account of the ICAO and the provisions of the Chicago Convention is inappropriate here, but see B.Cheng, *The Law of International Air Transport* (Stevens, London: 1962). More of the issues raised by the international air transport system and airline competition are discussed in subsequent chapters.

The involvement of the UK leading to the Chicago Convention marked an obvious shift in the interest of the UK Government in civil aviation. It was a safe assumption to make that the importance of the industry was being recognised by the Government increasingly, and in particular, it was essential, as the Cadman Committee had advocated, for the UK "to take a leading place in civil aviation".⁴¹

The Nationalised Years 1946-1960

The first step towards the nationalisation of British civil aviation was taken in 1939 when the Conservative Government amalgamated Imperial Airways and British Airways. The principal reason for doing so was financial and related in particular to the criticisms against the airlines for the high levels of director fees and dividends, as the Cadman Committee had noted. Sir Kingsley Wood, the then Secretary of State for Air remarked,

Another important aspect of the financial side of the matter was referred to by the Cadman Committee, who expressed the opinion that the subsidies granted to air transport companies should not be used for raising dividends to undue levels.⁴²

In addition, Wood referred to the inherent economic difficulties of operating air transport services. Profit margins were either low or non-existent especially with the stiff competition from foreign airlines which, as before, were heavily subsidised by their Governments. The Secretary of State explained that by merging the two carriers, efforts could be concentrated in one organisation rather than a number which, in the past, had led to wasteful competition between airlines receiving Government subsidies. Pooling their experience and knowledge would also have the advantage of putting national interests first. More importantly, by merging the two airlines and bringing them under public ownership would, on the one hand, give the Secretary of State important and strategic powers over the new Corporation such as the appointment of directors of the board and the supervision of its expenditure while at the same time giving the management of the Corporation "full independence and freedom of action in all day-to-day affairs of the Corporation".⁴³

The amalgamation provided a very fertile ground for the Labour Government which came into power in 1945 to take the process further by creating a publicly-owned monopoly under the terms of the Civil Aviation Act 1946. The 1946 legislation nationalised BOAC and created a monopolistic environment not only for BOAC, but also two new corporations, British European Air Corporation (BEAC) and British South American Air Corporation (BSAAC).⁴⁴ This measure effectively ended the era of airline competition which had existed since Holt Thomas brought about a revolution in travel and communications;

⁴¹ *Supra*, n.27.

⁴² H.C.Debs.349, col.1833 (10 July 1939).

⁴³ H.C.Debs 349, cols. 1842-1843 (10 July 1939).

⁴⁴ S.1(1) and s.23. BSAAC was subsequently absorbed into BOAC: Air Corporations Act 1949.

consequently, any residual competition would only come from foreign airlines competing with one of the corporations on a particular route.

Given the significance of this nationalisation exercise, it was no surprise that the Government had to make a cogent case for its acceptance. During the Second Reading debate of the Bill, Herbert Morrison, Lord President of the Council, put forward several reasons which he thought justified the cause. First, he argued that public ownership provided the advantage of using or ensuring that subsidies given will be more purposeful and specific to the task which was not readily achieved with privately-owned airlines. His speech is worth quoting at length here to shed some light on the rationale of this point.

Public ownership means that the substantial public subsidies which will to a greater or lesser extent, and in some way or another, go into this great public utility service will, rightly, be accompanied by efforts to ensure that the subsidy is adequate but not excessive and that it is used in the right way, for it is far easier for the Exchequer to subsidise a public concern and give it reasonable elbow room than to do the same thing for a private concern. Parliament itself will be more considerate in the extension of subsidies to concerns which are conducted in the public interest, and not for private profit than they would be in putting the subsidies into a private concern.⁴⁵

Inherent in the latter part of his speech was the concession that effective control must be maintained over the civil aviation industry rather than leaving it to the mercy of the market system which at any rate would lead to wasteful competition. It was also implicit in his speech that civil aviation was a "public service utility" and therefore had to exist for the benefit of the public instead of a small group of private investors and shareholders. In other words, the public interest had to be given priority, and to be protected against any potential abuse in the market place by privately-owned airlines.

Secondly, it was argued that public ownership provided the freedom to co-ordinate the provision of air transport services in the absence of private sector interests. Morrison pointed out that "under comprehensive public ownership and public enterprise, we can have sweep and boldness in our civil aviation policy."⁴⁶ Morrison also thought that public ownership of the airlines would secure a clearer direction in policy decision-making and particularly in providing greater accountability for the decisions taken and for the performance of a public service utility function. His third argument for public ownership of the airlines, therefore, rested on the case that,

Parliament can have a more effective say in the general policy which should govern our civil aviation policy. If we have a series of private concerns...Parliament will always be in a dilemma in discussing their policies and development...Under this new dispensation, the right dispensation, Parliament will have every right to discuss the broad and general policy of civil

⁴⁵ H.C.Debs.422. cols.602-603 (6 May 1946).

⁴⁶ *Ibid.* col.603.

aviation, and to bring the Ministry of Civil Aviation to book if Parliament is not satisfied with what is being done.⁴⁷

Two points emerge from this argument. It was clear from what Morrison had been arguing that to ensure coherence and structure for British civil aviation, the airlines must be directed against the wider background of national economic policy. The importance of civil aviation as a contributor to the national economy was becoming more obvious and the history of neglect up until then could only have been a hard lesson to learn. Its importance related not only to the fact of being a public service, but also to the broader role of the UK in the international order. The Industrial Revolution gave the UK the leadership of the world, and somehow, that dominance, in so far as it related to civil aviation, had to be re-asserted. According to Morrison, nationalisation was the solution. A second, but related, point arises from his argument for greater control, and hence accountability. He argued that privately-owned airlines could not be effectively controlled because of the potential conflict of interest, and this difficulty would not be readily obviated whatever organisational form the control took.

Morrison argued further that public ownership provided the perceived advantage of giving to the employees of the public corporations "a better status" than would be the case with privately-owned airlines.⁴⁸ And finally, he argued that the concept of public ownership would introduce a commercial novelty by combining "modern business management with a proper degree of public accountability."⁴⁹

The irony of the Second Reading debate was the omission of any reference to the ATLA and its function as a licensing body responsible for approving or refusing air transport services prior to this Act. The central thrust of the debate focused on the issue of private and public enterprises. Little discussion, if any, went into the possibility of delegating to the ATLA the task of implementing Government policy on civil aviation through the licensing process. No doubt, the need for a licensing authority would be redundant if the airlines were publicly-owned, but that does not also detract from the need at least to consider the merits of an alternative system which had existed previously. The ATLA may have been short-lived, but its abandonment was brought about by the unfortunate intervention of the Second World War. At the end of the War, the new Ministry of Civil Aviation was created instead, and under the nationalisation statute, a different authority known as the Air Transport Advisory Council (ATAC) was also constituted.

S.36 of the Civil Aviation Act 1946 made provision for the creation of the ATAC⁵⁰ and required it "to consider any representation...with respect to the adequacy of the facilities provided by any of the three corporations, or with respect to the charges for any such facilities." The ATAC was given the

⁴⁷ *Ibid.* cols.603-604.

⁴⁸ *Ibid.* col.604.

⁴⁹ *Ibid.*

⁵⁰ The ATAC was brought into being by the *Civil Aviation (Air Transport Advisory Council) Order 1947*. SR & O 1947/1224.

discretion to refuse the consideration of any representation which appeared to it to be frivolous or vexatious, or to be a matter considered previously, or to be a matter involving an international agreement between the UK Government and another. Its principal role was to represent the public interest in relation to air transport services and charges. To that end, the legislation required the ATAC to ensure fairness in its proceedings by disqualifying any member of the ATAC who had any special interest in the representation.⁵¹ Furthermore, expert assessors may be appointed to advise the ATAC on "matters affecting the interests of persons who use air transport services."⁵² As its name would suggest, the ATAC was also under a duty to provide the Minister of Civil Aviation with advice on questions that might be referred to it by him on the "facilities for transport by air or any part of the world, or relating to the charges for such facilities" or questions which in the opinion of the Minister required consideration with a view to the improvement of air transport services.⁵³ Although the role of the ATAC was by no means unimportant, it was merely an advisory body whose independent decisions would not necessarily shape the civil aviation industry since the responsibility over civil aviation remained with the Minister. During the Second Reading debate of the 1946 Bill, Mr Alan Lennox-Boyd in the Opposition criticised the proposal for an ATAC as a "complete illusion". He argued that British civil aviation needed an independent body that would have the trappings of a court of law and the responsibility for licensing air transport services. A useful example, he thought, could be drawn from the US.

[T]here should be an executive council, and organisation similar to that in operation in the United States where the Civil Aeronautics Board have continued to give competition and service within the framework of a general Government supervision. We favour an independent tribunal to which any independent operator can apply in regard to routes at home or overseas. If the tribunal is satisfied that there is inadequate service, or no service at the moment, on a particular route and the tribunal is also satisfied as to the financial soundness of the proposal and the technical ability of the people concerned, they would have power to grant a licence to operate over that route.⁵⁴

Furthermore, Lennox-Boyd thought the ATAC to be highly deficient in that it lacked any authority but would merely function in an advisory capacity. To that extent, therefore, British civil aviation would remain completely in the hands of politicians. He set out his argument with the following points.

The body has no power to alter facilities or fares, however inadequate the facilities or excessive the fares. If the tribunal really believes that a route should be made by some independent operator, or even by one of the Corporations, it has no power to insist on this being done...We hold that the

51 S.36(6).

52 S.36(5).

53 S.36(3).

54 H.C.Debs.422. col.604 (6 May 1946).

only real remedy for bad services is the right of the tribunal to be able, as in the United States, to license a second operator.⁵⁵

His arguments have been worth quoting at length at this stage because they were instrumental to subsequent developments which are considered below. Even if they had failed to influence the 1946 legislation, they provided a valuable insight for British civil aviation as to what was in store in the not too distant future.

A final note on the nationalisation period is in order here before considering the independent licensing body which Lennox-Boyd had forcefully argued for. Under the nationalisation statute of 1946, s.14(4) enabled charter services to be provided by private independent companies as "associates" of the Corporations⁵⁶ which, by virtue of the exclusive right conferred on the public Corporations, were not permitted to operate scheduled services.⁵⁷ But these private companies were more ambitious than merely providing charter and seasonal services. They lobbied the Government for permission to operate scheduled services. But if these private airline companies were permitted to operate scheduled services, there were difficulties, including legal ones, which had to be overcome. First, it would have meant amending or repealing the 1946 legislation and therefore removing the monopoly of the Corporations. Second, still labouring under the fear of wasteful competition from the duplication of services, the Government had to find an institutional and procedural means for avoiding that.

It decided to set up a Committee under the chairmanship of Lord Douglas of Kirtleside to review the provision of charter services by private airline companies and the expansion of their functions to scheduled services.⁵⁸ The subsequent report, which was not published, made two principal recommendations. First, it found that there was a justifiable demand for charter services to continue to be provided as scheduled services. This could be achieved by requiring the private airline companies to become "associates" of the Corporation, namely BEAC (since it was primarily European services which attracted the interest of these companies). That being so, the burden that might be placed on BEAC would be alleviated to a considerable extent although BEAC was still engaged in the expansion of its services. Furthermore, if BEAC was asked to meet the demand there would also be an unjustifiable burden on the tax-payer. The second recommendation dealt with the procedures for operating scheduled services. Applications to operate such services should be made to the ATAC which decision would form the basis of its advice to the

55 *Ibid*, col.623.

56 An "associate" is defined as "any subsidiary of the Corporation, or any undertaking which (a) is constituted for the purpose of providing air transport services or of engaging in any other activities of a kind which the Corporation have power to carry on; and (b) is associated with the Corporation under the terms of any agreement for the time being approved by the Minister as being an arrangement calculated to further the efficient discharge of the functions of the Corporation."

57 They continued, however, to carry troops, to provide aerial photography services and other irregular services.

58 See H.L.Debs.157, col.1117 (21 July 1948).

Minister; to facilitate this process, a directive would need to be issued to the ATAC to ensure that its advice was in accordance with the policy of the Government. The Minister remain the responsible authority for approving such applications.⁵⁹

A directive was duly issued to require the Corporations to appoint the private airline companies as "associates" under s.14(4) of the Civil Aviation Act 1946 to assist them in the performance of their functions. That would, however, be restricted to certain classes of services and there was to be no overlap with the existing or planned services of the Corporations. Those services were internal "ferry" and "cross-country" services including internal seasonal services to holiday resorts where no services were being provided by the Corporations or where there was an excess demand over the capacity of the Corporations to provide these services. It would be an exception for an "associate agreement" to be approved for scheduled services other than the above. No subsidies, however, would be available to these private companies. In accordance with the Douglas recommendation, applications to operate such services would, in the first instance, be submitted to the ATAC which would then be required to take into account, *inter alia*, the cost of supplying ground and navigational facilities, if not already available. As a matter of practice, it should avoid recommendations which would involve new expenditure of this character. In addition, it should not recommend the approval of an "associate agreement" where it would hamper the planned developments of the Corporation. Other powers of the ATAC included the imposition of maximum fares and freight rates of services, but in any case, they were not to be less than those charged by the Corporations. "Associate agreements" would be approved for a period of two years subject to termination by the Minister if safety or other conditions were not being met.

While the permission to enable private airline companies to operate regular scheduled services seemed innocuous to the Corporations at first sight, these opportunities provided them with the basis to develop more services in pursuit of their ambitions which by 1960 had grown into a force to be reckoned with by the Corporations. The concept of "associated companies" made an important in-road to competition in civil aviation,⁶⁰ and in particular, it gave the ATAC a new dimension to its role which was to become responsible for the changes made in 1960 on the regulation of British civil aviation.

In 1951, when the Conservative Government came into power again, Lennox-Boyd, who became the Minister of Civil Aviation, seized the opportunity to bring his vision outlined in 1946 into reality. His cause was very much driven by other prevailing factors at the time. As Baldwin noted, the constraints imposed on the private airline companies by "associate agreements" to operate services which were not otherwise provided by the Corporations became increasingly unjustifiable, and "operators had been hindered in attempts to

⁵⁹ H.L.Debs.160, col.350 (26 January 1949).

⁶⁰ Corbett describes the "associate agreements" as "hunting licences" for these private airline companies: *op. cit.*, p.153.

create networks of routes" ⁶¹ In a succession of ministerial statements given to the House of Commons, Lennox-Boyd gradually removed the privilege accorded to the Corporations, particularly that of BEAC. He stated on May 27, 1952,

[W]e seek to improve the position of the independent companies, which with few exceptions lack long-term security and opportunities of expansion. They cannot establish their position if they cannot plan firmly ahead. We therefore intend to give them more scope and security...the development of new overseas scheduled services shall be open to the Corporations and independent companies alike...Associate agreements for new routes will normally be granted for seven-year periods with extension to ten years in special cases.⁶²

This statement clearly constituted a considerable expansion not only with respect to the role of the private airlines companies, but also the role of the ATAC which would continue to receive applications and "administer a procedure on licensing lines".⁶³

No more than two months later, Lennox-Boyd made yet another statement of policy on the provision of scheduled services by private airline companies.

[T]he existing international passenger services run by the Corporations will be preserved, but the Corporations will no longer be protected against competition over what might be called their planned routes, but only over their existing routes...it is also proposed that in future the Corporations, while preserved in their first and tourist class activities, shall have to apply to the ATAC for any extension of their services outside this field. On all new routes outside their preserved sphere they will be on the same terms as private operators.⁶⁴

It is evident from his statements that the monopoly of the Corporations would be gradually dismantled, and a greater degree of competition injected into the provision of scheduled services. Security would be given to the independent airline companies by extending the two-year "associate agreements" to seven-year agreements. The class of services were also expanded considerably leaving the corporations a residual protection in respect of their *existing* services. These arrangements could only have given the private airline companies more encouragement to introduce new services and to make further in-roads into the dominance of the Corporations.

The implications for the ATAC were equally important. It was beginning to assume a changing role from what was merely an advisory body to a quasi-licensing authority. Increasingly, it was given responsibilities which were not envisaged by the founders of the 1946 Act. The changing circumstances and the pressing need for more competition had led to two successive policy

61 R.Baldwin, *Regulating the Airlines* (OUP, Oxford: 1985), p.22.

62 H.C.Debs.501, col.1152 (27 May 1952).

63 *Ibid.*

64 H.C.Debs.503, cols.2181-2182 (16 July 1952).

statements which revised its terms of reference. The only question that remained was how long before the ATAC would become overwhelmed by the magnitude of its task.

The Competition Years 1960-1971

Air Transport Licensing Board: A Lesson

For almost eight years, the ATAC was left to its own devices without any substantial interventions by the Government, but it was becoming clear from the developments which were taking place *vis-à-vis* the role of the private airline companies and the expanded role of the ATAC that British civil aviation was heading in a new direction. Not only had the privileged position of the Corporations been gradually eroded, but there was a notable shift in the way in which the industry was being regulated. The original purpose of the ATAC was to provide advice to the Minister who retained the authority to approve services and to act as the representative body of consumer interests. It was a matter of time before the already detectable wind of change would sweep across the existing institutional structure of the civil aviation industry.

It will be remembered that during the passage of the nationalisation statute, the then opposition set out what they would have done with the civil aviation industry had they been the Government: to set up an independent tribunal which would license air transport services. And towards the late 1960s, that vision of Lennox-Boyd gradually became a reality. His mission was also given support by the increasing discomfort that was being felt with the existing institutional structure. The *de facto* role of the ATAC to act as a licensing authority especially in relation to the private airline companies had to be put on a more formal basis. As he explained,

with the rapid growth of air transport, it would clearly not be right to rely indefinitely upon these somewhat makeshift arrangements.⁶⁵

Of course that was not an attack on the ATAC and its role. Those "makeshift arrangements" were a consequence of the *ad hoc*ery in civil aviation regulation as evidenced by the Douglas report and the successive ministerial statements of policy which expanded the role of the ATAC.

"Associate agreements" were also beginning to take their toll. There was a mutual dislike for them by the Corporations and the private airline companies. For the former, it was a complete farce that they had to enter into an agreement which would subject themselves to competition that was not particularly welcomed. For the latter, the "associate agreements" provided little room for innovation. The ideological basis for change, however, was not without relevance. The Government had a dislike for public monopolies which repeal would seek to provide greater efficiency and higher standards.

⁶⁵ Civil Aviation (Licensing) Bill 1960, H.C.Debs.618, col.1227 (2 March 1960).

These developments provided an ideal setting for Lennox-Boyd, with the support of the Government, to bring the changes he had advocated. In his opening speech on the Civil Aviation (Licensing) Bill 1960, he stated that the legislation constituted two main purposes

First, to ensure that all who provide public transport by air shall be required to maintain proper standards of safety. Secondly, to establish an independent authority to whom all airline operators can apply on an equal footing for licences to run regular air services.⁶⁶

The equality of treatment necessarily required the abolition of the monopoly position which the corporations had enjoyed since the nationalisation statute of 1946.

The independent authority was to be known as the Air Transport Licensing Board (ATLB). Its functions were essentially those previously performed by the ATAC, that is, the granting, revocation or suspension of licences for air transport services. S.2(2) of the Civil Aviation (Licensing) Act 1960 provided for the considerations which the ATLB had to have regard to when deciding a licence application. But apart from these, the ATLB was given little guidance as to the way in which its discretion ought to be exercised, or the emphasis to be given to a particular consideration at a particular point in time. There was, however, a procedure for appeal to the Minister against the decision of the ATLB. It was stated during the debate on the Bill that an appeal to the Minister was more appropriate than an independent tribunal since air transport licensing would inevitably involve issues of Government policy and public policy.⁶⁷ The irony in this statement lies of course with the lack of any direction to the ATLB as to the policy being adopted by the Government since it was the first port of call for air transport licensing.⁶⁸ Nonetheless, the Minister was confident that a set of consistent principles would eventually be formed upon which future decisions of the ATLB would be based.

The future pattern of British aviation will emerge progressively from the decisions of the Board and from the results of appeals to the Minister. A kind of case law will gradually be built up.⁶⁹

Although the ATLB was created as an independent licensing authority to regulate an expanded and competitive civil aviation industry comprised of public and private airline operators, a large measure of protection would continue to be given to the corporations including their "associate agreements". But clearly, the extent to which that protection would be given would differ from whence they were a public monopoly. The Minister referred to the need for stability in British civil aviation as the principal basis for this approach.

The last thing any of them wants is to compete free-for-all. Nobody is prepared to put up the large sums of money required for the purchase of modern aircraft and the setting up of maintenance bases and sales organisations without some measure

66 *Ibid.* col.1225.

67 *Ibid.* col.1228.

68 See generally, Baldwin, *op.cit.*, pp.71-72.

69 Civil Aviation (Licensing) Bill 1960, H.C.Debs.618, col.1231 (2 March 1960).

of security. They naturally wish to be assured that, having built up custom on a particular route, they will be given some reasonable protection against interlopers who seek to reap where others have sown.⁷⁰

The system of public hearings, licensing by the ATLB and appeals to the Minister under the 1960 Act was by any measure the most comprehensive that British civil aviation was to have had up until then. Credit must be given for an ambitious and courageous attempt to deal with the pressing issues of commercial aviation which had become a relatively permanent feature of the industry. A major transport industry was itself transported up and down the scales of success and depression of which the Governments' different political complexions must take their share of the blame. If anything was to be learnt at this stage, it was surely the dynamism of the industry which called for flexible and, more importantly, prompt responses. Setting up the ATLB was a major step towards a sustainable framework of air transport competition between private and public operators while at the same time ensuring the necessary degree of resilience to adapt to the conditions of an industry encapsulated in what is very much an erratic market.

The Edwards Committee: A Timely Saviour?

Barely ten years later, British civil aviation was once more bracing itself for another major re-organisation. And the root cause of this was perhaps the lack of foresight on the part of the sponsors of the 1960 legislation. They failed to see that the newly created ATLB was only given the bare-bones of a licensing system expecting it to carry out its tasks with the vigour and effectiveness which the legislation had envisaged. It was clearly an overstated ambition to see a newly born creature to walk on its own when it was barely able to stand. There was no ministerial power to issue directions to the ATLB to guide its exercise of discretion, a point raised in the House of Commons.⁷¹ The need for such a measure gradually became apparent as the ATLB was confronted with issues of some difficulty, from the speed with which it ought to be disposing licensing applications to the imposition of frequency limits on services as a condition of the licence.⁷²

At the same time, criticisms were beginning to mount which did little justice to the ATLB and its role because they were largely misdirected. In particular, the Select Committee on Nationalised Industries published a report in 1967 criticising the licensing machinery of the ATLB.⁷³ Amidst some severe criticisms, which in all fairness were related to the procedural aspects of the licensing system, the President of the Board of Trade decided to launch an inquiry in the hope that any uncertainty in the civil aviation industry would be promptly resolved. He conceded the fact that the importance of the industry stemmed from its potential contributions to the national economy and an urgent

70 *Ibid.* col.1233.

71 *Ibid.* cols.1236-1238.

72 See H.C.Debs.740. col.1642 and H.C.Debs.745. col.1573.

73 *British European Airways* HC 673 (1966-67).

review was therefore in order ⁷⁴ A Committee of Inquiry was hence appointed under the chairmanship of Sir Ronald Edwards,

To inquire into the economic and financial situation and prospects of the British civil air transport industry and into the methods of regulating competition and licensing currently employed; and to propose with due attention to other forms of transport in this country what changes may be desirable to enable the industry to make its full contribution to the development of the economy and to the service and safety of the travelling public.

The subsequent report of the Committee⁷⁵ became the basis for major changes to the regulatory structure of the industry. A number of its findings and recommendations are both interesting and appropriate for consideration in some detail here, not least because it represents the most comprehensive review of air transport regulatory policy since the industry was founded.

From the terms of reference of the Committee, it was evident that some form of regulatory control was essential to avoid wasteful provisions of air transport services that would fail to make positive contributions to the economy as a whole, and it was equally apparent that the Government was then committed to licensing as the form of regulation although the organisational features for that regulatory form was yet to be unresolved. But these points underscore very much the proposition that governmental regulation, either directly through a Government department or indirectly through an administrative agency, remains an inevitable fact of the civil aviation industry.

The Committee first undertook to examine the place and relevance of regulation to British civil aviation, and gave almost instant recognition to the inevitable fact of regulation referred to above. It made the following observation.

The structure of world civil aviation has been fashioned by many forces amongst which economic logic has played only a modest part. There has rarely been a time in the short history of air transport when governments have not taken a hand, for better or worse, in determining the way in which air services should be developed...Almost universally governments have regarded air transport as an industry to be regulated.⁷⁶

According to the Committee there were a number of cogent reasons for governments to show an interest in civil aviation including air space sovereignty, maintenance of a strategic reserve of aircraft in times of war, safety, and the major political, economic and social implications which transport systems gave rise to.

Looking at the systems which obtained in other countries such as Australia, Canada and the US (which had not been deregulated then), the Committee argued that an important objective of providing some governmental control was

74 H.C.Debs.751. col.6+1 (26 July 1967).

75 *British Air Transport in the Seventies* (Cmnd.4018. 1969). (The "Edwards Report").

76 *Ibid.* para.13.

to secure stability in the civil aviation sector by ensuring its protection against the exploitative forces of an economic system.

[I]t has become accepted in practice in world civil aviation that the operator of regular services needs and is entitled to some degree of protection against the operator who threatens to cream off traffic in periods of high traffic demand and thus to undermine the basis of the regular operator's planning...completely free competition is out.⁷⁷

It also referred to a further point for consideration in examining the place of regulation within the wider socio-economic setting. Civil aviation was a part of the system of domestic transportation which must therefore be assessed in the light of other transport sectors which were then regulated or subsidised.

A regulatory process, however, could not exist in a vacuum; it had to be justified by, and to function for, a set of objectives. The Committee therefore explored several objectives relevant to the civil aviation industry and sought to explain the method it felt appropriate to adopt to pursue those objectives.⁷⁸

- (i) To satisfy the customers.
- (ii) To create conditions for achieving profits by airlines which were efficient.
- (iii) To hold a fair balance between customer groups.
- (iv) To achieve safe operations.
- (v) To improve the balance of payments.
- (vi) To create opportunity for employees.
- (vii) To create opportunity for enterprise.
- (viii) To improve internal communications.
- (ix) To maintain external strategic communications.
- (x) To support British aircraft industry.

Some of these objectives were mutually conflicting, while some were in tandem. It would therefore be inappropriate, the Committee argued, if their prioritisation was left solely to the airline companies which operations were often dictated by market forces. Instead, these airlines should be charged, either directly by the Government or indirectly through other regulatory controls, to achieve those objectives in accordance with the policy of the Government on civil aviation at the time.

[I]t is not enough merely to enact a list of objectives including every desirable end, some perhaps, mutually incompatible, and then expect others to determine the right balance.⁷⁹

Achieving a satisfactory balance between those objectives implied independence of assessment. And this independence would be vested in, and exercised by, a regulatory authority. The Committee set out a number of further advantages that a regulatory authority and a regulated system would provide. In relation to the degree of protection that airlines should have in the interests of the industry as a whole rather than the microcosmic interests of a particular airline company, a regulatory system could keep traffic requirements under review and could

77 *Ibid.* para.21.

78 *Ibid.* paras.46-67.

79 *Ibid.* para.70.

therefore modify the degree of protection to accord with the changing market circumstances. The Committee reported that the number of air services being provided by the multitude of airline companies, as a result of their new found freedom in the 1950s, were in excess of what the market made it possible to achieve an optimum level of efficiency. They had to be rationalised, but only within a framework that would give sufficient flexibility to reverse the trend if changes in the market place permitted. As the Committee said, they were "totally convinced of the need for a structure which can be adapted to meet the changing needs."⁸⁰

In a regulated system, the regulatory and licensing body would be able to "maintain a check on the efficiency of airlines which have been granted the protection of a licence."⁸¹ The competition which may (or may not) exist between the licensed airlines "provides the regulatory authority with yard-sticks for which it is extremely difficult to find alternatives" to measure their efficiency levels.⁸² This would then become matters for consideration by the regulatory authority in dealing with a licence application, or indeed revocation.

It is evident from the Edwards Report that British civil aviation required a system of regulation that would both rationalise air transport services and provide for a sound development of the industry. The ATLB had not managed to achieve them, although in respect of the former, it needs to be remembered that the ATLB was created at a time when enthusiasm for expanding air transport services was running high on all sides. Having therefore considered the place of regulation in British civil aviation, the Committee examined the failure of the system set up by the Civil Aviation (Licensing) Act 1960.

As noted earlier, one reason for this Committee of Inquiry was the mounting criticisms that were being made against the ATLB and the system. Prime among those criticisms was the lack of any licensing policy or statement leaving a high degree of uncertainty within the industry. The fundamental problem, according to the Committee, was the process of formulating policies itself which was lacking in this case. It identified three features of the system as illustrative of this basic problem.⁸³

- (i) Lack of ministerial power to issue directions on policy which meant there was uncertainty as to the approach that would be adopted in licensing.
- (ii) Lack of procedure to bring a matter of policy arising from a particular case to the Minister except by way of an appeal initiated by one of the parties to the case.
- (iii) Lack of a system of binding precedent which meant that the ATLB was not compelled to follow a decision of the Minister.

On the basis of these, the Committee made a preliminary conclusion that there was "an imperative need for future licensing policy to incorporate provisions by

⁸⁰ *Ibid.* para.453. See also ch.11 of the Report on the role of the private airlines.

⁸¹ The Edwards Report, para.294.

⁸² *Ibid.*

⁸³ *Ibid.* para.639. See also Baldwin, *op.cit.*, ch.7.

which all statements of policy are formulated by the Government from time to time and are published in a statutory instrument as the legally-binding guidelines upon which licensing policy should be based "84

The appeals procedure, although initially seen as a process to facilitate the injection of Government policy into the civil aviation industry, overwhelmed the entire system of licensing but at the same time leaving rather ironically the industry without any clear guidance as to the policy of the Government.⁸⁵ The Committee thought the system of appeals had come to operate in a way which greatly undermined the authority of the ATLB as the licensing authority under the 1960 Act. It was clearly not the intention of Parliament at the time to allow the gradual erosion of its authority nor was it the intention that the appeals procedure should have operated in the way it had. The cause of this state of affairs was in part attributable to the unrestricted grounds for appeal, and in part to the lack of limitation on the evidence that may be presented on appeal. Thus, an appellant was entitled to appeal without any restrictions on the basis of the appeal and to reserve evidence for the purposes of such an appeal. The ATLB procedure therefore became "no more than the preliminary round in a major case."⁸⁶ The solutions to this difficulty were fairly obvious: (i) specified or restricted grounds for appeal and (ii) limited circumstances for the admission of new evidence on appeal.

It should be said, however, that the majority of the criticisms was against the *system of licensing* itself rather than against the ATLB as a licensing authority. Nevertheless, in the light of this experience, the Committee was of the opinion that a new institution would be necessary in the future for the regulation of British air transport services. Its functions would include several specific, economic regulatory functions, in addition to its general duties.⁸⁷ As to the form of the new institution, the Committee set out four options, each worthy of a brief consideration here.

*A strengthened ATLB*⁸⁸

This would entail a more strategic role for the ATLB particularly in the formulation and execution of policies. More importantly, the strengthened ATLB should be authoritative and independent to attract the confidence of the airline companies which it had lost. While this option would require minimal organisational change, and constitutional difficulties, there would continue to be a division of economic and technical regulatory responsibilities between the ATLB, the Air Registration Board (ARB) and the Board of Trade (BoT) which the Committee had found not to be the most satisfactory of arrangements.

*Two regulatory authorities*⁸⁹

84 *Ibid.*, para.640.

85 See also Baldwin. *op.cit.*, pp.41-47.

86 *Ibid.*, para.646.

87 *Ibid.*, para.654.

88 Paras.991-996.

89 Paras.997-1000.

The essence of this option would resemble the first where the ATLB would have a strengthened character for economic regulation, while a new, but separate, body to be known as the Air Safety Board (ASB), would assume the merged functions of the ARB and the BoT on technical regulation. The obvious advantage would be the rationalisation of technical functions. The Committee felt, however, that there would continue to be two separate bodies whose functions may overlap. As an economic regulator, the ATLB would take into account indirectly the safety competence of an applicant for an air service hence, for instance, by assessing his experience, financial resources, equipment, organisation and staffing arrangements. By the same token, it ran the risk of missing certain matters altogether.

*A Government department*⁹⁰

Although there was an advantage in vesting the economic and technical regulatory functions in a single Government department, in that effective policy co-ordination could be achieved, there was also a fear that such an arrangement would not guarantee the regulatory independence needed to command the confidence of airline companies (other than perhaps the publicly-owned Corporations).

*A new Civil Aviation Authority*⁹¹

This was the favoured option of the Committee for a number of reasons. First, it would remove the dichotomy of economic and technical regulatory functions. Second, it would require the Government to work closely with the new authority and to issue a statement of policy that would guide the authority in performing its functions. In this way, policies on civil aviation would be known in advance thereby opening them to public debate and scrutiny while maintaining an oversight of the policies through the parliamentary process. Third, the independence of the new authority would represent the interests of air transport users and equally those of the airline companies more effectively than would, say, a Government department.

A Constitutional Innovation: 1971

Civil Aviation Authority: The Way Forward

In response to the Edwards Report, the Government published a White Paper indicating its intention to implement the recommendations contained in the Report.⁹² According to the Government, the White Paper was to be “a new charter for the industry”.⁹³ It set out the principal objectives of civil aviation as being,

the provision of air services by British carriers, in satisfaction of all substantial categories of demand, at the lowest levels of charges consistent with a high standard of safety, an economic

90 Paras.1001-1002.

91 Paras.1003-1019.

92 *Civil Aviation Policy* (Cmnd.4213, 1969).

93 *Ibid.*, para.8.

return on investment and the stability and development of the industry.⁹⁴

These objectives would be set out subsequently in a policy statement which in accordance with the Edwards recommendation would bind the new regulatory authority. In that respect, therefore, the Government indicated in the White Paper that a Civil Aviation Authority would be established under a forthcoming legislation.

The essential feature of the relationship between the Government and the CAA would be the separation between policy formulation and the detailed application of policy.⁹⁵ But a sufficiently wide degree of discretion would be given to the CAA for the implementation of those policies. As an economic regulator, it would act positively in pursuit of Government policies and objectives set out in the policy statement. More importantly, however, the CAA, unlike its predecessor, would be given the discretion "to take the initiative rather than just to respond to the initiatives of the applicant airlines".⁹⁶ It would also have to shape route networks and to take measures to strengthen the structure of the industry within the terms of the declared policy so as to ensure that excess capacity would not result. Where circumstances so dictate, the CAA may require the protection of certain routes against competition from new entrants, or to encourage or discourage the diversification of air transport services.⁹⁷ The CAA would further engage in "more purposive regulation of the industry than the present legislation and licensing system permits."⁹⁸ By purposive regulation, it meant that the CAA would have to adopt a broader approach to its tasks by considering issues arising from the interrelationship between economic, operational and technical regulation. This would facilitate the CAA gaining as much knowledge as possible about civil aviation activities. This line of approach is consistent with the idea already discussed previously; that economic regulation functions as a leverage for either promoting or discouraging competition in accordance with a certain set of objectives or purposes, and emphasises also the proposition that economic regulation is an indispensable mechanism to pursue wider objectives within the band of discretion the responsible authority would have been given.

The White Paper also provided for a re-organised system of appeals from the decisions of the CAA. For the *review* of CAA decisions, the matter may be brought before a court of law on grounds of *ultra vires* or procedural defect. But an *appeal* against the decision on the basis that it represented a departure from the declared policy should not lie to the court. As the White Paper stated,

The formal policy statement, being concerned with essentially economic criteria, is unlikely to be expressed in terms lending themselves to judicial interpretation.⁹⁹

94 *Ibid.* para.10.

95 *Ibid.* para.121.

96 *Ibid.* para.87.

97 *Ibid.*

98 *Ibid.* para.15

99 *Ibid.*, para.104.

In such cases, the appeal should be judged by the BoT. But an appeal could be brought only on the ground that "the decision cannot reasonably be brought within the terms of the Government statement of policy". That meant the discretion of the BoT to interfere with the decision would be limited to cases where they deemed there had been an inconsistency.¹⁰⁰

It also became clear during the parliamentary debates leading up to the creation of the CAA that, an independent regulatory agency implied not only operational autonomy but also financial independence. Putting the responsibility of regulating a major industry in the hands of a regulatory agency provides the government with the opportunity to remove itself from the costs of industrial regulation. During the second reading of the Civil Aviation Bill 1971, Michael Noble, the Minister for Trade, spelt out the envisaged financial position of the CAA as follows:

The functions which the Authority will assume are not at present financially self-supporting, but the intention is that they should become so, so that the annual grant in aid can be progressively reduced and finally dispensed with. This means that the Authority will be required in due course to recover from the airlines and other users the full cost of navigational and ground services it provides.¹⁰¹

The CAA is now statutorily required to "conduct its affairs as to secure that its revenue is not less than sufficient to meet charges properly chargeable to revenue account".¹⁰² This will be achieved by imposing a levy on the industry. The significance of this financial independence is to limit the leverage for any short-term political interference.

A final feature of the White Paper that must be noted here was the creation of a "second force" carrier, an idea first conceived by the Edwards Committee.¹⁰³ This airline would be established through a process of encouragement to private airline companies to amalgamate. Being the second flag carrier on international routes, it would be given preference in the allocation of licences. Clearly, however, the place of this airline in British civil aviation must depend on the capacity of the market to allow for double-designation (alongside the Air Corporations which would merge into a national carrier to be known as British Airways Board), and on the terms of an international air service agreement. The Government, however, was keen to ensure that the formation of this "second force" airline was not conditional upon an assurance to transfer a significant number of routes operated by the Air Corporations then. Although the setting up of a "second force" airline was to strengthen British civil aviation, it will be seen below that it contributed indirectly to a legal challenge that resulted in the demise of the policy guidance system which both the Edwards Committee and the White Paper had advocated for.

100 *Ibid.* para.105. It is worthy of note that during the parliamentary debates on the legislation to establish the CAA, appeals to the Minister would *not* be restricted to cases of inconsistency: H.C.Debs.814, col.1174 (29 March 1971).

101 HC Debs.814, col.1178. (29 March 1971)

102 S.S. Civil Aviation Act 1982.

103 Edwards Report, paras.38-42.

The White Paper proposals which reflected the recommendations of the Edwards Committee were subsequently enacted in the Civil Aviation Act 1971 (as consolidated in Civil Aviation Act 1982). The legislation comprised of two main parts: (i) the setting up of the CAA, described as "a constitutional innovation"¹⁰⁴ and (ii) the creation of British Airways Board (BAB) from the merger of BOAC and BEAC. The functions of the CAA were two-fold: economic and safety regulation.¹⁰⁵

The Policy Guidance: An Unhappy Ending

As promised in the White Paper, the 1971 legislation made provision for the issuing of a written guidance through which the policy of the Government would be communicated to the CAA. Among other things, it was stated in Parliament that the guidance would "apply to the granting of air transport licences and the regulation of fares and charges".¹⁰⁶ The first guidance was published in 1972 and it set out three broad objectives for the CAA.¹⁰⁷ Four issues were involved in the first objective: satisfying all substantial categories of the market, securing low fares, securing a high standard of safety, and ensuring an economic return for investment to obtain a sound industry. The second objective related to the opportunities for the "second force" airline, but the preference in the allocation of licences to it would not be automatic. In other words, a case had still to be made to demonstrate that it was deserving of the designation.¹⁰⁸ The third objective related to the balance of payments and the contributions to the national economy. This merely gave recognition to the major economic asset in a civil aviation industry, and it was therefore essential for the CAA to have regard to this fact when performing its function as an economic regulator.

A second policy guidance was issued in 1976, prompted in large measure by the depression into which the industry had been plunged as a result of the oil crisis of the 1970s, and by the consequential decline in demand for air transport services.¹⁰⁹ The guidance addressed these difficulties by referring to the concept of double-designation and its increasing inappropriateness in an industry plagued by the oil crisis and the inevitable contraction of opportunities for double-designation as foreign governments attempted to protect their national carriers. More particularly, British Caledonian Airways (B.Cal), as the second force airline, had failed to establish itself as a strong carrier in the North Atlantic market, perhaps because of the decline in air travel on that route. In the light of the severe oil crisis and the decline in demand, it was difficult to see how double-designation could be justified on a major long-haul route unless the

104 H.C.Debs.814, col.1173 (29 March 1971).

105 S.3 of the 1971 Act and s.4 of the 1982 Act.

106 *Ibid.* col.1175.

107 *Civil Aviation Policy Guidance* (Cmnd.4899, 1972). For the parliamentary debates on this guidance, see H.C.Debs.833, col.120 *et seq.*

108 The "second force" airline emerged as a result of an amalgamation between Caledonian Airways and British United Airways, later to be known as British Caledonian Airways.

109 *Future Civil Aviation Policy* (Cmnd.6400, 1976).

Government was prepared to face the consequence of having to reduce the capacity of the national carrier, BA. Therefore, it was decided that "in future it should be the general policy not to permit competition between British airlines on long-haul scheduled services and therefore not to license more than one British airline on any given long-haul route."¹¹⁰ Exceptions, however, would still apply. The CAA was thus under a requirement to license air transport services by having regard to this shift in the policy. No doubt, this policy affected the services of B.Cal on major long-haul routes. Likewise, it affected the "Skytrain Services" that had been proposed by Laker Airways between London and New York. Its earlier designation as a scheduled operator would therefore be withdrawn.¹¹¹ Minor, as the decision to withdraw may have seemed, the legal consequence was enormous.¹¹² When eventually the Civil Aviation Act 1982 was enacted to consolidate the law relating to civil aviation, the provision for issuing a written guidance was omitted. If double-designation had been permitted as a general policy, excess capacity would probably have been the result - a phenomenon which the Edwards Committee had laboured at length for its avoidance by a process of rationalisation. The issuing of this second guidance was an illustration of the rationalisation exercise and the flexibility in responding to market changes which, prior to the guidance system, had been found wanting.

Notwithstanding that the system of written guidance was omitted in 1982, the CAA continued with a positive approach to the development of policies and a procedural framework for airline licensing that was transparent. These issues and more recent history of the CAA's role in the regulation of airline competition are developed in later, substantive, chapters, including also the arrival of the liberalisation measures to create the Single European Aviation Market in 1987.

European Community And Liberalisation: 1987-1992

Although the European Economic Community (now the EC), was first conceived in 1957 under the Treaty of Rome and membership of the UK did not happen until the passing of the European Community Act 1972, rules governing air transport did not emerge until 1987 when following a series of European Court of Justice (ECJ) decisions, the Council of Ministers found their inaction increasingly indefensible. Much of this was due to the lack of political will and compromise, made worse by the fact that the powers of the Council on air transport were fashioned in highly discretionary terms in the Treaty. Article 84(2) states that,

The Council may [acting by a qualified majority] decide whether, to what extent and by what procedure appropriate provisions may be laid down for...air transport.¹¹³

110 *Ibid*, para.7. See also H.C.Debs.896, col.1502 (19 July 1975).

111 *Ibid*, paras.14-15.

112 See ch.4, *infra* and R.Baldwin, "A Quango Unleashed: The Abolition of Policy Guidance in Civil Aviation Licensing" (1980) 58 *Public Admin.* 287.

113 Majority voting was introduced by the Single European Act 1985.

However, in *European Parliament v Council*,¹¹⁴ the European Parliament initiated action under Article 175 against the Council for failing to introduce a common transport policy, in spite of 16 Commission proposals to that effect, and which therefore amounted to an infringement of the Treaty, specifically on the introduction of the freedom to provide transport services. Institutionally, this decision is significant because it clarified the position of the European Parliament on the initiation of an action under Article 175. On the substantive issues, the ECJ ruled that although the Council retained the discretion to adopt a common position on transport, that discretion was limited by the *requirement to establish* a common transport market and by the *time period* within which it was required to achieve that common position. The margin of discretion was only in relation to the *objectives* and the *means* of achieving a common transport policy. The real significance of this decision lies in the argument that political, technical or economic difficulties could not constitute an excuse for inaction nor failure to perform Treaty obligations. The decision provoked a response from the Council whose statement indicated that it regarded the decision as "very important and providing an impetus for progress in the development of the common transport policy."¹¹⁵ For air transport specifically, the land-mark took the form of a subsequent ECJ decision in *Ministère Public v Asjes* which concerned the application of Community competition laws to air transport.¹¹⁶ This latter decision revealed a serious crack in Community air transport policy, and together with the combined pressures of the Commission and its policy proposal, propelled the Council into action. The end result was the adoption of the first of three liberalisation "packages" in 1987 designed to introduce more competition into Community air transport. This was followed by the second package in 1990 and the third in 1992, all of which are considered in depth in a later chapter.

Conclusions

This chapter set out with the aim of showing how the events of the past have shaped the regulatory structure and approach that presently exists. It started with a persistent, but unfortunate, neglect until the collapse of the civil aviation industry in 1921 when a shift in attitude became detectable. Since then, there was no turning back on the role of the Government in the civil aviation industry which so many different committees, and indeed events, have suggested as the quintessence for success, if not for survival. Ownership of the industry had swung from private hands, when no government subsidies would be given, to public hands, where monopoly privileges were conferred, then to a mixture of both, and now back to where it began - private ownership.¹¹⁷ The changes in the ownership structure also resulted in seismic changes to the economic orientation of the industry where unregulated competition was replaced by public monopolies, though they were subsequently to face a revival of the

114 Case 13/82. [1986] 1 CMLR 138.

115 See Bull. EC 5/85, p.8.

116 Case 209/84. [1986] 3 CMLR 173.

117 BA was privatised in 1987.

competitive spirit from the efforts of their very own 'associates'. A key issue in this historical analysis is the shaping of the industry structure where a dominant carrier, BA, was eventually exposed to competition and transferred into private sector hands lock, stock and barrel with the privileges and assets it had inherited from its monopoly position. This has a direct bearing on a leading contention of this thesis, that is economic regulation tends to evolve into antitrust regulation when the conditions of critical market contestability have been secured. The way in which BA was privatised and the responses of the CAA are examined in the following chapter, but suffice it to add that privatising BA with its dominance intact, even if this may be regarded as promoting the industry, meant that the task of promoting competition within the industry was made all the more difficult. The barriers derived from the structural imbalance impinges upon the ability of the regulatory agency to abandon the role of economic regulation and to confine itself to the task of antitrust regulation. Conditions for competition are less likely to be sustainable without continuing regulation over entry, price and capacity. The history of airline competition discussed in this chapter is ample evidence of the difficulty in abandoning the task of economic regulation, typically licensing, where the constraints from structural imbalance exist.

Apart from the varied experience in relation to the ownership of the industry, more remarkably the industry has seen a plethora of regulatory bodies of different forms. Some were short-lived, others were blessed with longevity. There was nevertheless a conspicuous lack of a structured strategy and regulatory philosophy; little thought seemed to have gone into the design of the regulatory system, and the objectives which it was intended to achieve. Be that as it may, they all had an important function to perform: the regulation of air transport services. The most common approach adopted in the past was by licensing the airline companies, and this was particularly true in respect of the ATAC which advisory role was greatly expanded to embrace quasi-licensing functions. It is also true to say that it was the experience with the quasi-licensing role of the ATAC which gave further credibility to the approach itself and it became readily accepted that a licensing system provided a useful and strategic instrument to achieve wider objectives of the national economy including the balance of payments.

The licensing system which obtains today is vested in the regulatory authority first conceived by the Edwards Committee, the CAA. Its terms of reference are essentially two-pronged: economic and safety regulation. The consolidating Civil Aviation Act 1982 vests in the CAA a large measure of discretion to perform the two functions. Amongst other things, the CAA has taken on for some time, particularly since the abolition of the written guidance system, a role of positively developing strategic policies on air transport competition, and it is to this that the following chapters will focus. Nevertheless, its function of economic regulation has been affected in many ways, both in width and depth, with the advent of EC liberalisation measures on air transport, and the implications must be examined accordingly.

CHAPTER FOUR POLICY FORMULATION: THE ROLE OF THE CAA AND GOVERNMENT

It should be clear from the foregoing chapter that, whatever, the political complexion of the Government, economic regulation of air transport in the UK seems to be an indispensable requirement and arguably an irresistible fact. It should also be apparent that the history of air transport regulation in the UK suggests that the realisation and co-ordination of public interest objectives cannot be left solely to the participants in the industry. If this argument holds, then issue becomes one of more or less regulation, not whether to regulate or deregulate. But it should also have been clear that this presumption of the need to regulate stems from the inherent characteristics of the structure of the industry in the UK. The role of the Government and the exclusive privileges which it conferred on British carriers meant that when competition was introduced and the last airline monopoly, BA, was privatised, the industry had inherited a dominant incumbent, and consequently a less-than-level playing field. So to ensure that competition is preserved, and choice and equality of opportunities are given to new airlines, regulatory intervention must remain possible to counter any anti-competitive practices or abuses of market power by the dominant incumbent. To submit this is not to argue that economic regulation of airline competition is the first order of solutions to market problems. The opening chapters have already established that where possible, competitive solutions should be preferred over regulatory interventions. This means that economic regulation can be minimal. Indeed, where the conditions of sustainable competition have been secured, that is critical market contestability, economic regulation may be liberalised or, in the extreme, abandoned altogether. At this point, however, antitrust regulation of airline competition begins to assume a much greater significance. Whether these assumptions are applicable to British air transport, taking into account the effects of European legislation, will be the subject of the analysis in the rest of this thesis. In the following chapters, the empirical evidence will address the questions of whether, on balance, the model of regulated competition constructed in chapter two is a more effective machinery than the two extreme alternatives of monopolies and unfettered competition for achieving the objectives of the airline industry within the context of a *gesellschaftlich* model of social organisation, that is, to acknowledge the commitment towards autonomy and individual choice and a paradigm shift from the primacy of producer interests to user interests.

The aims of this chapter are to examine the role of the CAA in formulating air transport competition policies, and also the role of the Government in providing a general policy framework. It will begin with an examination of the statutory provisions governing the licensing and policy-making role of the CAA since licensing decisions and policies are likely to have a direct effect on each other.

More specifically, in discussing the development of air transport competition policies, it will also be important to consider the issues of consultation and participation by the actors within the regulatory complex, and their role in shaping the policies. This chapter will also be concerned with the contributions of the CAA to the formulation of broader Government policies on air transport competition, in particular its role in the privatisation of BA. It should be noted that EC law and policy has changed the face of licensing air transport competition considerably following the adoption of three sets of measures aimed at introducing more competition to air transport. To that extent, it will be necessary to mention briefly the effect of EC law on the role of the CAA and the Government in policy-making. The chapter should provide an understanding of the extent to which the principles and policies of air transport competition and regulation have changed over the years since the CAA was created, and provide the background for examining the empirical evidence in the following chapters. More importantly, perhaps, this chapter should provide the basis for understanding the relationship between procedures and substance, and the extent to which substantive changes in policies can, unwittingly, affect and change established procedures, an issue which will be taken up in more detail in the next chapter.¹

The Policy Framework of Economic Regulation

Statutory Objectives

Administrative regulation in the sense captured in the opening chapter, implies the delegation of a certain regulatory task to a subordinate body or agent. As noted hitherto, the task of regulating for airline competition in the UK is now the responsibility of the CAA which was created by the Civil Aviation Act 1971 following the far-reaching report of the Edwards Committee. The governing statute of Civil Aviation Act 1982 charges the CAA by virtue of s.4 with a two-fold statutory objective to lead the industry by positive action:

- (i) to secure the provision of air transport services by British airlines which satisfy all substantial categories of public demand which provides the lowest charges consistent with:
 - a high standard of safety
 - an economic return to efficient operators
 - securing a sound development of the British civil air transport industry;
- (ii) to further the reasonable interests of users of air transport services.

These objectives have been laid out in a slightly different manner from the way in which they have been arranged in the statute to appreciate the interpretation given to them by the CAA. The Director of Economic Regulation pointed out that the statute made the interests of users paramount; all other objectives were subsidiary or incidental to the aim of satisfying all substantial categories of public demand and furthering the reasonable interests of users.² This provision is significant given that it represents a departure from the practice under past

¹ See J.Goh, "Airline Deregulation and Representation: Public Hearings and The Changing Nature of Regulation" (1998) 27 *Anglo-American Law Review* 87.

² Interview with the author, 8 November 1994.

legislation where the interests of airlines were accorded priority consideration, not least because they were either statutory monopolies under the nationalisation statutes or given special privilege over user interests as set out in the 1971 Act.³ S.3 of the 1971 Act, for example, stated that the CAA was to secure the provision of air transport services by British airlines and "subject to the preceding paragraphs, to further the reasonable interests of users". To the extent that the emphasis on user interests is a derivative of a renewed commitment towards individual autonomy and choice, that is consistent with the idea of *gesellschaftlich* in Weber's theory on economy and society.⁴

Statutory Criteria

Both the substantive and procedural duties of the CAA in respect of air transport licensing and policy formulation are set out in ss.64-69 of the 1982 Act and which main features are *inter alia* the grant, refusal, revocation or variation of an air transport licence application, the broad criteria of competence and financial fitness to be applied, and the publication of a statement of licensing policies by the CAA. A background understanding of these provisions is necessary to better appreciate the underlying basis of past and present licensing policies.

S.64 sets out the scope of the licensing framework, first of all, by prohibiting any carriage by air of passengers or cargo unless the operator of the aircraft is licensed by the CAA as well as having complied and is complying with terms of the licence. That prohibition is applicable "to any flight in any part of the world by an aircraft registered in the United Kingdom and to any flight beginning or ending in the United Kingdom by an aircraft registered in a relevant overseas territory or an associated state". The categories of flight excepted from the section are:

- (i) a flight of a description specified in an instrument made by the CAA, which takes effect only when it is published in the prescribed manner;
- (ii) a particular flight or series of flight specified in an instrument made by the CAA, who has a duty to publish the instrument forthwith in the prescribed manner;
- (iii) a flight by an aircraft operated by the CAA;
- (iv) a flight for which a valid operating licence issued in accordance with the Council Regulation on licensing of air carriers is required.⁵

The provisions of s.65 deal with the grant or refusal of an air transport licence application. Under this section, the CAA is under a mandatory obligation to refuse an application where it is not satisfied that the applicant has met the criteria laid down in sub-s.(2). The criteria for the grant of an air transport licence are detailed and complex, reflecting very clearly the public interest

³ The Government has also explicitly recognised this change in its White Paper of 1985 that "the interests of the air transport users were put on equal footing as those of the airlines". para.7. *Airline Competition Policy* (Cmnd.9366, 1984).

⁴ See M.Weber. *Wirtschaft und Gesellschaft*, trans. by T.Parsons. *The Theory of Social and Economic Organisation* (Hodge, London: 1947).

⁵ This paragraph was inserted by *Licensing of Air Carriers Regulations 1992*. SI 1992/2992, reg.20.

element in a highly important public economic service attended by high expectations of safety. First, the applicant must demonstrate that he is "a fit person" to be licensed to operate aircraft. In deciding whether or not the applicant is such a fit person, the CAA will assess the experience of the applicant and his employees, or that of the persons appearing to the CAA to be controlling a body corporate, in the field of aviation. This assessment extends to past activities of the applicant, his employees and the persons deemed to be in control of the corporation. Secondly, the applicant must be able to satisfy the CAA that he has adequate resources, including financial arrangements, to discharge his actual and potential obligations related to any business activities he is engaged in and those arising from any aviation activities in which he may be engaged as a result of the licence being granted. Thirdly, and furthermore, the CAA must be satisfied that the applicant is either a UK national or, in the case of a body incorporated in the UK, a relevant overseas territory or an associated state, is controlled by UK nationals. The importance of this latter criteria is magnified still by the role of the Secretary of State in having the authority to consent to an application from a person or body not meeting the "nationality" criteria. Sub-s.(4), however, vests in the CAA an overriding discretion to turn down an application which is not prejudiced by the foregoing criteria to refuse an air transport licence.

Provision is made under s.66 of the Act for the CAA to revoke, suspend or vary an air transport licence. The power to do so may arise in three situations. First, "a person of a prescribed description" may apply at any time to the CAA to revoke, suspend or vary *an air transport licence*. The application may therefore relate to the licence held by another operator other than the applicant. The *locus classicus* to which we shall be returning is the application by Virgin Airways in 1990 to vary the London-Tokyo licence held by BA. Secondly, the CAA is empowered to revoke, suspend or vary an air transport licence independently of any application "if it considers it appropriate to do so".⁶ This discretion has been invoked on a number of occasions including the difficult case involving BA and Virgin on the London-Tokyo(Narita) route. But the use of this discretion is rare and often limited to instances where special circumstances dictate such as restrictions arising from bilateral agreements. S.66(3) on the other hand makes it a duty, rather than a discretion, of the CAA to revoke, suspend or vary an air transport licence if it is no longer satisfied as to either of the following two matters.

- (i) The licence holder in question is no longer a fit person to operate aircraft, taking into account those matters specified in s.65(2)(a).
- (ii) The licence holder is not longer financially able to discharge his actual or potential obligations.

Where the CAA is no longer satisfied that the licence holder meets the nationality criteria, it is under a statutory obligation to inform the Secretary of State who is empowered to make a determination as to whether or not the CAA should be directed to revoke the licence.

⁶ S.66(1) and (2).

Procedurally, the CAA is required by s 67 to furnish a statement of reasons for its decisions relating to an application for, or revocation, suspension or variation, of an air transport licence. A party which has submitted an objection to a particular case is similarly entitled to a statement of reasons, as is anyone who has requested for such a statement. The obvious implication of this requirement is the transparency of the decisions of the CAA that could be regarded as "a principle of good administration". This duty, however, is subject to a number of exceptions. In particular, the CAA has to refer to the Secretary of State for determination a case in which it reasonably believes that furnishing that statement of reasons "might be contrary to the interests of national security or might affect adversely the relations of the United Kingdom with another country or territory". Furthermore, the CAA has the discretion either to refrain from furnishing such a statement to any party or to exclude from such a statement matters which relate to the "commercial or financial affairs of another person and cannot be disclosed...without disadvantage" to the person concerned.⁷

S.67(5) further provides that the Secretary of State may establish by regulations an appeal procedure from any decision of the CAA to the Secretary of State but only in respect of decisions relating to an application for air transport licence.⁸ Under such regulations, the Secretary of State may direct the CAA to reverse or vary its decision in question, but successive Secretaries of State have given an undertaking that the discretion to reverse or vary will be exercised only sparingly such that to overturn a decision of the CAA would require nothing short of a clearly justified case.⁹ This latter provision is interesting in a number of respects, particularly the findings of Baldwin relating to the exercise of a similar discretion under the previous regime. It will be recalled that the Civil Aviation (Licensing) Act 1960 provided for an appeal from the decision of the ATLB to the Secretary of State. Baldwin noted that,

If there was a single reason why the ATLB system of licensing was eventually perceived to have failed it was the manner in which appeals were decided. This power allowed Ministers to review not only politically significant decisions but also issues of Board judgement.¹⁰

The readiness with which the appeal system was opened to discredit was apparent since the regular overturning of the Board's decisions was tantamount to the rejection of a specialist body established by Parliament. When the Edwards Committee came to its conclusions, it reported that the absence of restrictions barring the introduction of new evidence at appeals or restrictions on the grounds for appeals enabled airlines to come to regard the ATLB hearings as nothing more than "a preliminary round in any major case".¹¹

7 See s.67(3).

8 See *Civil Aviation Authority Regulations 1991*, SI 1991/1672.

9 See the two policy guidances issued in 1972 (para.17) and 1976 (para.17) and the White Paper, *Airline Competition Policy* (Cmnd.9366, 1984), para.33.

10 R. Baldwin, *Regulating the Airlines* (OUP, Oxford: 1985), p.41.

11 *British Air Transport in the Seventies* (Cmnd.4018, 1969), para.646.

S 68 has two parts *air transport licences* and *route licences*. The provisions for both types of licences are identical except that an air transport licence is granted to airlines based outside the EC but whose aircraft are registered in the UK for the provision of services anywhere in the world, while a route licence is granted to airlines already holding *operating licences* to enable them to serve routes outside the EC. Under Council Regulation 2407/92 on common criteria for licensing air carriers, these operating licences are granted to airlines whose principal place of business and registered office is in the UK and which are owned and effectively controlled by Member States or their nationals.¹² This is the freedom to establish within the EC. In accordance with this Regulation, the CAA grants two classes of operating licences, Type A for operators of larger aircraft and Type B for those of smaller aircraft. For routes within the EC, Council Regulation 2408/92 confers a general right of entry to all Community carriers, and thus rendering a route licence from the CAA redundant.¹³

The provisions of s.68 make it a duty of the CAA when licensing airlines to ensure that British airlines compete effectively with other airlines on international routes, and to pay particular attention to :

- (i) any advice from the Secretary of State in relation to the likely outcome of bilateral negotiations with the government of a foreign country;
- (ii) the need to secure the most effective use of airports within the UK.

Furthermore, in deciding whether or not to grant an air transport or route licence, the CAA is required to have regard to a number of other matters. First, to consider the effect that any newly licensed air transport services may have on existing services. Secondly, where the proposed services are similar to an existing service in terms of the route served, it is to assess the benefits which may accrue from enabling two or more airlines to compete among themselves to provide those services. Thirdly, the CAA is to have regard to need to minimise so far as reasonably practicable any adverse effects on the environment and disturbance to the public as result of noise, vibration or atmospheric pollution from air transport activities. Fourthly, it is instructed to impose minimum regulatory burden on the air transport industry as a whole and the provision of air transport services. The latter is particularly significant in the CAA's efforts to develop a system of minimal regulation, and indeed to refrain from positive interventions in matters which the market is the better judge such as the levels of fares and frequency of services. The next chapter will chart the initiatives of the CAA in eliminating to the maximum extent possible the regulatory controls pertaining to airline competition.

CAA and Policy-Making

The role and process of policy formulation by the CAA are governed by the Civil Aviation Act 1982. The CAA is charged with the duty set out in s.69 of the Act to "publish from time to time a statement of the policies it intends to adopt" in performing its licensing functions. How policy statements are published is a matter for the CAA to decide, and its practice has been to issue Civil Aviation Policy statements, known as CAPs, and appropriately numbered.

12 OJ [1992] L240/1.

13 See ch.7. *infra*.

Before the publication of such a statement, the CAA is also required by s 69 to "consult such persons as appear to it to be representative respectively (a) of the civil air transport industry of the United Kingdom; and (b) of users of air transport services." This is in contrast with the position under the common law where no general duty exists to require public decision-making bodies to consult. Be that as it may, two issues arising from the s.69 provision require further consideration: the consultation procedures and the persons to be consulted

Policy Development: Procedures

First, while the statutory provision requires the CAA to "consult such persons...", there is a considerable latitude of discretion as to the method of consultation which consequently will have a bearing on the range of persons who will be consulted ultimately. Furthermore, the scope of s.69 on the publication of policy statements and the *a priori* requirement of consultation is limited to the functions of the CAA under ss.64-68 of the Act which are provisions dealing with the licensing of air transport services. In the context of rule-making by regulatory agencies today, it is generally accepted that three different procedures are possible.¹⁴ First, the traditional trial-type procedure or rule-making by adjudication, and second, rule-making by written representations. A third methodology combines both the oral procedures with written representations, which is also known as the 'hybrid procedure'. Although the trial-type procedure is more common in the US, it is one which the CAA has adopted in respect of its licensing cases. The use of written representations are becoming more common in British administrative practice including the regulation of the utility sectors.¹⁵ The CAA has construed the procedure of consultation with considerable width so that on certain policy issues it would for instance adopt the written submission procedure while on others it would adopt the much formal procedure of adjudication. To these we now turn.

In the years of its existence, the CAA has developed a commendable methodology in the development of its regulatory policies. A review of its policy-making procedures will reveal a gradual evolution of procedural variety, adapted to suit the nature of the policies to be formulated and the circumstances in which the policies are to be formulated, such as for instance the degree of controversy likely to be involved or the significance of the proposed policy to the industry. On the other hand, its predecessor, the ATLB, was deeply reliant on the trial-type procedure, one of whose consequences was the inflexibility in and the resultant bureaucratic dominance of administrative rule-making, contrary to one of the principal ideas behind the growth of administrative agencies. Policy development thus depended on case-law and that in turn

¹⁴ I make no attempt here to distinguish between formal and informal rule-making. In practice, the use of informal rules and rule-making processes is extensive, though it is not suggested that these should not be subject at least to the same degree of scrutiny and control as formal rules and rule-making processes. For the distinction, see D. Galligan, *Due Process and Fair Procedures* (OUP, Oxford: 1996), ch.16.

¹⁵ Telecommunications Act 1984, s.8(5); Gas Act 1986, s.7(4); Water Act 1989, s.13(2); Electricity Act 1989, s.6(4); Railways Act 1993, s.8(4).

depended on the frequency of cases brought before the agency for determination. As a result, policies were often developed by accident. It is, however, true to state that in its initial years, the CAA tended to adopt procedures that were trial-type oriented. Policies would be evolved on a gradual basis during licensing hearings. But as it began to develop a considerable body of licensing principles, hearings from which licensing policies would evolve became less significant. No doubt, there will be occasions when novel policy issues will arise during a licensing hearing which will need to be addressed. The system of hearings as a whole, however, is becoming less significant and rare.

The procedure of policy-making by adjudication is highly formalistic and bureaucratic. It is generally legalistic and confrontational. As the CAA is a quasi-judicial body for the purposes of its licensing functions, it comes within the supervisory jurisdiction of the Council of Tribunals.¹⁶ Legal representation is permitted in hearings and top litigation counsel are sometimes engaged by the parties. This can have the effect of turning the proceedings into a show-case for counsel who seek to persuade the panel by performance rather than substance; it is not suggested that the panel attaches any great value to it. Policy-making by a procedure of written representations, otherwise more commonly known as the notice-and-comment procedure is on the other hand less formal and probably more effective; less confrontational, more consensual. In 1979, for instance, the CAA, as part of its continuous process of reviewing domestic air fares, published the *Domestic Air Fares: A Review of Regulatory Policy*¹⁷ and it stated that the aim of the document was to "stimulate discussion" on the issue of regulation and deregulation of domestic services through a process of consultation in which written comments could be submitted. The discussion and submissions would eventually form the basis for "definitive proposals for change".¹⁸ In a similar way, the most recent *Statement of Policies on Route and Air Transport Licensing* of 1993 was adopted following the publication of a draft proposal to amend the previous Statement in the light of the developments in European air transport policies.¹⁹ Respondents to the consultative exercise were varied and naturally the responses varied considerably. The significance of this divergence represents a counter-claim to the notion of "regulatory capture" since the CAA would not have confined itself solely to the views of a particular party or set of interests. While it may be a relative truth that the public is not likely to be concerned with making representations to a policy proposal, the opportunity to do so by a less expensive and rule-bound means contrasts markedly with the trial-type alternative. The issues of time and expense are dominant considerations even for those whose interests are affected.

The latitude to adopt a notice-and-comment procedure constitutes an important device for the efforts of the CAA in developing its policies. In particular, it

16 See s.1 and Sch.1 of the Tribunals and Inquiries Act 1992.

17 CAP 420 (1979).

18 *Ibid.*, para.1.4.

19 CAP 620 (1993).

enables the CAA to initiate policy proposals which could subsequently be subject to consultation or hearings without being constrained by the precondition of having a case or dispute brought before it as an opportunity to announce its policies. In an important sense, this provided the CAA with a procedural device to lead the industry by positive action by seizing the initiative for policy development, an initiative which emerged in the early 1970s not long after its creation. More importantly, participants of the industry would know in advance what to expect.

While it is arguable that procedural variety in the formulation of policies by the CAA may lead to inconsistency and lack of procedural coherence including the systematic consideration of affected interests, the flexibility of procedural choice has also enabled the CAA to exercise its discretion on policy-making procedures in a more effective and efficient manner. Indeed, the experience of the CAA suggests that its procedural discretion has been exercised in a coherent and structured manner. The obvious importance of such flexibility is the ability of the CAA to focus on the substance of the policy proposal as a determinant of the appropriate procedure rather than to be unduly concerned with the procedure without regard to the ends with which the procedure is designed to achieve. Regulatory capture which results from a narrow representation of interests might be avoided by tailoring procedure to the possible range of interests likely to be affected.

Policy Development: Participation

Paradoxically, the requirement of consulting representatives of the air transport industry and users is both sufficiently precise and vague. The CAA is required, on the one hand, to consult such persons who represent the air transport industry and users of air transport services, but on the other hand, only in respect of such persons which appear to the CAA to be so representative. Although in practice it is difficult, nor desirable, to define such representatives, the CAA generally adopts the view that an intrinsic value of consultation is to consult widely. Persons who are directly involved or affected will be sent a draft copy of the policy proposal clearly because their rights or obligations may be the subject of the proposal or that certain conditions vest in them a legitimate expectation to be notified of the proposal.²⁰ In addition, a press notice is made to inform others who may wish to respond to the policy proposal. In fact, just about anyone who is interested will be given an opportunity to respond. The main difficulty affecting the CAA is not so much as to *invite* responses, but to *obtain* responses from the parties.²¹ Participation is accordingly liable to be limited to those with a significant degree of interest.

From an analysis of the primary documents concerning a selected number of consultation exercises, it is apparent that parties which respond to the call for submission of opinions vary from individuals to large airline companies.

²⁰ *Council of Civil Service Unions v Minister for the Civil Service* [1984] 3 All ER 935.

²¹ Director of Economic Regulation, CAA: Interview with the author, 8 November 1994.

Invariably though, the majority of these respondents were airline operators whether British-registered or foreign. This is hardly surprising. Representation of air transport users often takes the form of the Air Transport Users Council. Submissions from individuals, often experts in the field of civil aviation, were common. With the new liberalisation measures adopted by the EC in 1992, several amendments to the 1988 version of the *Statement of Policies on Air Transport Licensing*²² became necessary in order to incorporate the new licensing regime. The CAA initiated a consultation exercise to review its civil aviation policy in the light of this development by publishing a draft *Statement of Policies on Route and Air Transport Licensing*. Interested parties were invited to submit written representations within a period. A detailed list of respondents is unnecessary, but suffice it to add that the representations were invariably lengthy and comprehensive, some of which contained highly innovative submissions. The CAA is clearly concerned to ensure that its consultation exercises are not simply symbolic gestures, but rather a genuine invitation for the submission of representations and their proper consideration. The problem of regulatory capture, although very real in a regulatory setting where the statutory objectives have been interpreted as giving priority to user interests, does not appear to have affected the CAA to any objectionable extent in its consultation exercises. On the contrary, it takes the view that a comprehensive consultation framework is an important requisite for the avoidance of regulatory capture in policy-making.

The Competition Policies

The analysis of British air transport competition policies should begin with the Government's White Paper of 1984 which sought to re-affirm the statutory criteria and to give direction to the industry.²³ It reinforced the prevailing view of the Government, and existing regulatory policies, that economic decisions of air transport services, whether the pattern of route network or the level of fares charged, should be determined by market forces while at the same time ensuring that airlines are "continuously open to challenge by competitors". Its importance stems from the need to ensure that "the barriers to new services and airlines who can provide a safe and reliable service should be low."²⁴ Five general objectives were set out in the White Paper.

- (i) To maintain high standards of safety.
- (ii) To encourage a sound and competitive multi-airline industry with a variety of airlines of different characteristics serving the whole range of travellers' needs and sufficiently strong to compete aggressively against foreign airlines.
- (iii) To promote competition in all markets. In international civil aviation, the Government aims to reduce restrictions on services to enable easier access to the market by competitors while reducing any control on the introduction of new services, level of fares charged and capacity in relation to domestic civil aviation.

22 CAP 539 (1988).

23 *Airline Competition Policy* (Cmnd.9366. 1984).

24 *Ibid.*, para.2.

- (iv) To ensure adequate safeguards against anti-competitive or predatory behaviour. This would be secured through a competitive industry which in turn would protect the long-term interests of the public.
- (v) To transfer the ownership of British Airways into the hands of the private sector. This objective is now academic since British Airways was privatised in 1987. The aim of this exercise was to remove the restrictions and protection commonly associated with State ownership, but little relation was made to the ways in which the "privatisation" would promote competition nor develop further a multi-airline industry (given at that time a number of independent airlines were already existing and competing with British Airways).

The Government recognised in this policy paper that while a shift in policy emphasis itself towards more competition was a simple enough task, its execution was a much more difficult task. Certain inherent characteristics of the air transport industry tended to inhibit the cultivation of competition on a major scale. In particular, the level of competition was dependent on market capacity which could not always produce sufficient demand to attract competitors and new services. On certain routes it was unlikely that more than one carrier would be operating the services although that did not necessarily mean "the entrenched positions of inefficient operators will be preserved".²⁵ Competition, therefore, would be stimulated by the *threat of competition* rather than *actual competition*. This is a variant of the contestability theory, although economic regulation would remain an implied necessity. This was further marked out in the White Paper where the Government stated,

Nor will it be possible to deregulate domestic services completely, given that there cannot be free access to all UK's airports. The Civil Aviation Authority will need to continue regulating entry to many of the routes airlines wish to fly.²⁶

Although it is true that certain economic characteristics unique to air transport may impede the realisation of a fully competitive industry, a major factor affecting the policy aims of establishing a multi-airline industry that would lead to sustainable competition is the very structure of the industry which the excesses of a once dominant carrier can still be felt across the spectrum of competing airlines. This has a direct bearing on a key contention of this thesis, that is economic regulation tends to evolve into antitrust regulation when the conditions of sustainable competition have been achieved.

International air transport competition, on the other hand, takes a different dimension. This was duly recognised in the White Paper. There is a much greater degree of uncertainty as to how and the extent to which competition might be introduced, for the basic reason that international air transport services involve carriers and governments of other countries and agreements for those services would therefore require their consent. Hence, whether or not competition will prevail under a particular air service agreement cannot be determined on a unilateral basis. Economic regulation of international air

25 *Ibid.*, para.8.

26 *Ibid.*, para.30.

transport services is too sensitive a matter to be resolved readily. This observation, however, does not preclude the theory of contestability from being applied to British carriers engaged in international services where an inefficient carrier may be substituted. The only difficulty surrounding this approach, that is designating a different carrier, is the approval required from the opposite country who is party to the agreement since almost every international air service agreement would have designated a particular airline or airlines to serve on the route concerned. Any proposal to modify that designation will often involve a similar attempt by the opposite party to extract concessions or to secure maximum advantage for its airline or airlines before granting the approval. The protracted negotiations between the US Government and the UK Government over the request by the former to designate United Airlines and American Airlines in the place of Pan Am and Trans World Airlines under the "Bermuda Agreement" is a classic case in point.²⁷ Where this has not been specified, a general clause will provide some latitude for one party to apply the contestability theory and to determine if a more deserving carrier should be awarded the right to provide the services set out in the bilateral agreement. Even so, unless and until the protectionist tradition in international air transport competition is abandoned, competition on a wide-scale will remain very much an unlikely reality and deeply uncertain.²⁸

Although the involvement of the CAA in providing advice to the Government is characteristic of the policy formation process, there are nevertheless limits. The White Paper is essentially a political document. It would be inappropriate for the CAA to be involved in the final stages of the process when political considerations begin to dominate the policy. Nor do they wish to be involved. Indeed, it may be argued that the need for White Papers as an instrument of restating the policies of the Government is becoming, if it has not already become, unnecessary. It is evident from the regulatory policies and practices that the CAA can do without the White Paper if the Government can. Unlike the Airports Act of 1986, the Civil Aviation Act 1982 recognises the need for competition in air transport. An analysis of past legislation on air transport licensing adequately reveals an incremental move towards more competition in the sector, and this has been duly interpreted by the CAA in its series of licensing statements. Indeed, the White Paper of 1984 was itself a significant departure from previous national policies on air transport competition. With the inception of the new regulatory system in 1971, the Government had at the fore of its mind a much more restrictive regime where protection would be given to the interests of airlines, even if this was at the expense of user interests. This was set out in s.3 of the Civil Aviation Act 1971 where the CAA was required principally to secure the provision of air transport services by British airlines in accordance with public demand, and to secure opportunities for another airline other than BA to provide such services. However, the CAA was only required, "*subject to the preceding paragraphs*, to further the reasonable interests of

27 See *Independent on Sunday-Business Supplement* (17 February 1991) for an account of the negotiations.

28 See ch.6. *infra*.

users of air transport services"; the "preceding paragraphs" being those conferring a preference on airline interests.

Competition and the Policy Guidance System

A most obvious testimony to this development remains, what is still the *cause célèbre* of air transport politics, the Laker Airways litigation over the legality of the policy guidance issued in 1976.²⁹ The policy guidance system, as noted in the previous chapter, provides the mechanism for ensuring maximum compatibility between national economic policies and air transport regulatory policies as developed by the CAA. The system was the result of a number of recommendations presented by the Edwards Committee to empower the Secretary of State to "give guidance to the Authority in writing with respect to the performance of the functions conferred on it otherwise than by this subsection; and it shall be the duty of the Authority to perform those functions in such manner as it considers is in accordance with the guidance".³⁰ This was then considered a "constitutional innovation" in public administration.³¹ Two such policy guidances were issued pursuant to that provision,³² the second of which led to *Laker Airways v Board of Trade* and eventually the writing of its obituary.

Inter alia, the first policy guidance provided for a large measure of competition in air transport. It stated that activities which had the effect of restraining competition or innovation in air transport should only be accepted by the CAA if they contributed to the attainment of the statutory objectives. To that end also, the CAA "should not reserve any particular type of operation exclusively to public or private enterprises by reason of their being publicly or privately owned or impose any particular balance as between public and private enterprises."³³ However, that did not mean the CAA should license liberally. British Caledonian Airways (B.Cal), the "second force" airline as envisaged by the Edwards Committee, had to be given "a measure of preference over other airlines in allocating licences for new scheduled service routes" at the expense of granting to other independent airlines licences to serve additional international scheduled routes.³⁴ Any competition envisaged in the guidance was effectively between B.Cal and its principal rival, BA. Nevertheless, the notion of according a special measure of preference to B.Cal underlines the restrictive or protective approach contemplated under the 1971 legislation.

The second policy guidance was the product of a review of the civil aviation policy in 1974 under the chairmanship of Peter Shore, then the Labour Secretary of State for Trade - this was widely known as the *Shore Review of Civil Aviation Policy*. Although the contents of the policy guidance were largely similar to the first guidance, they differed in a number of significant respects

29 *Future of Civil Aviation Policy* (Cmnd.6400, 1976).

30 S.3(2). Civil Aviation Act 1971.

31 H.C.Debs.814, col.1173 (29 March 1971).

32 *Civil Aviation Policy Guidance* (Cmnd.4899, 1972); *Future of Civil Aviation Policy* (Cmnd.6400, 1976).

33 *Civil Aviation Policy Guidance* (Cmnd.4899, 1972), para.13.

34 *Ibid.*, paras.15 & 17.

worthy of note here. First, the second guidance introduced a "no-competition" policy for long-haul services. Paragraph 7 required the CAA to license no more than one British airline to operate a same long-haul route, thereby reversing substantially the provision in the first guidance which provided some competition between BA, B.Cal and other independent airlines. Routes of B.Cal were reorganised into its "sphere of interest" while BA became the preferred airline for all other long-haul routes. The licensing of other airlines to operate long-haul routes was restricted to "exceptional circumstances". Before such licensing, it required the CAA to be satisfied that a substantial demand existed, that the service could be operated profitably, that the preferred airline (whether BA or B.Cal) would not be likely to introduce an adequate service within a reasonable period, and that it would not conflict with the objective of maintaining and developing a viable network for scheduled services. Secondly, it required the CAA to make public any factors it had taken into account when applying the international short-haul competition policy.³⁵ A third feature of the guidance was the instruction given to the CAA to revoke the licence previously granted to Laker Airways to operate its "Skytrain" services on the busy trans-Atlantic routes.³⁶ These instructions, taken collectively, amounted not only to a substantial departure from the original thinking that the policy guidance was to be in general terms although economic issues would remain the prime consideration,³⁷ but also a radical shift in the emphasis of British air transport competition policy. One of the first responses to the second guidance was a letter from Lord Boyd-Carpenter (CAA's first chairman) to the Secretary of State, amplifying the importance with which the CAA regarded its regulatory independence.

The Authority dissents from the provisions...of the draft of the new guidance insofar as they are intended to and would have the effect of inhibiting the Authority from granting, even in the most exceptional circumstances an air transport licence to more than one airline on the same route. This would severely limit the use of the licensing system to secure improvements in air services over the main air routes otherwise than at the discretion of the monopoly carrier. It would also inhibit, *inter alia*, the licensing of experimental services such as "Skytrain", and remove the possibility of the Authority using its licensing powers to deal effectively with circumstances at present unforeseen unless and until further amendments were made in the guidance.³⁸

The latter point is particularly significant since it effectively amounted to a revocation of the licence held by Laker Airways if the instruction in the guidance was executed. Both, the instruction to revoke and the decision to withdraw its traffic rights, prompted Laker Airways to seek judicial redress.³⁹

35 *Future of Civil Aviation Policy* (Cmnd.6400, 1976), para.9.

36 *Ibid.*, para.15. In addition, the Secretary of State also withdrew the UK/US traffic rights for Laker Airways, which were necessary to operate the international service.

37 H.C.Debs.814, col.1174 (29 March 1971).

38 The letter subsequently appeared as a parliamentary written answer. H.C.Debs.905/6, col.107 (23 February 1976).

39 *Laker Airways Ltd. v Department of Trade* (1977) 2 All ER 182.

It applied for judicial review seeking a declaration to the effect that the (then) Department of Trade, not the CAA, was not entitled to withdraw its designation. The Court of Appeal, affirming the decision of Mocatta J., ruled that a policy guidance can be used to explain or supplement statutory objectives, but it could *not* contradict or reverse them because to do so would be *ultra vires*. Lord Denning went on to state,

So long as the "guidance" given by the Secretary of State keeps within the due bounds of guidance, the authority is under a duty to follow his guidance...But, if the Secretary of State goes beyond the bounds of "guidance", he exceeds his powers, and the authority is under no obligation to obey him.⁴⁰

The court held that paragraphs 7 and 8, which constituted the revocative effect, were more akin to "directions" rather than "guidance" because in the opinion of Roskill LJ,

...guidance is assistance in reaching a decision proffered to him who has to make the decision, but that guidance does not compel any particular decision. Direction on the other hand...is compulsive in character. It requires the person to whom the direction is given to decide as directed. It deprives him of any freedom of decision, of any power to make his own decision as opposed to that which he is directed to make.⁴¹

Although the decision was addressed only to the relevant provisions, it nevertheless called into question the credibility of the policy guidance system and its use. When the Civil Aviation Act 1982 was passed, the provision for a policy guidance was omitted. Hence, what was heralded as the constitutional innovation to British public administration, had to have its obituary written in just a little over ten years. It was not the system itself, however, which was at fault.⁴² A number of other significant, albeit gradual, developments were also responsible for the eventual decision to abandon the policy guidance system. In particular, the CAA was beginning to formulate and publish policies more frequently and on a level which was capable of achieving far greater precision than a policy guidance could. Furthermore, these policies were the product of wide-ranging consultation with the industry and the representative bodies of air transport users. Since 1979 the CAA has been publishing a statement of its regulatory philosophy and its licensing criteria which sought to give more clarity to its air transport licensing functions. The most recent of these is the *Statement of Policies on Route and Air Transport Licensing* of 1993 marking yet another step towards more liberal licensing.⁴³

In spite of the abolition of the policy guidance system, it is still the case that national air transport policies can be communicated through White Papers and for more specific or exigent matters, through the use of statutory directions

40 *Ibid.*, p.188.

41 *Ibid.*, p.199.

42 See Baldwin, *op.cit.*, p.238. More recently, the use of the policy guidance system has been revived under the Railways Act 1993: s.4(5).

43 CAP 620. This is considered further in the following two chapters.

which the Secretary of State is empowered to issue. However, these are limited to a number of areas.

- (i) national security,
- (ii) international relations and obligations,
- (iii) enabling the UK to become a member of an international organisation or agreement,
- (iv) noise, vibration, pollution or other disturbance⁴⁴

In addition, s.72 of the Act empowers the Secretary of State to issue directions, after consulting the CAA, in relation to air navigation services. These directions, however, "have been given sparingly"⁴⁵ and, if given, are published in the Annual Reports of the CAA.

Policy-Making and Competition: The Privatisation of British Airways

The emergence of a structured policy-making process and the opportunities for participation by those involved necessarily meant that the policies adopted were more acceptable than it would have been otherwise. It was therefore sufficiently clear that the CAA need not necessarily be in complete reliance on a policy guidance system to structure the exercise of its discretion. As Baldwin puts it, "the guidance had served its purpose and had to be dismantled".⁴⁶ The system of guidance was no more than an opportunity for the Government to restate its policies with greater detail and to provide "a better idea to the CAA of the policy to be pursued".⁴⁷ Its abandonment could only be for the better because it removed an instrument by which ministerial intervention in the operations of the CAA was carried out. However, such interventions would be less objectionable if glory and blame were equally accepted by ministers for success and failure.⁴⁸ Consequently, in the absence of an explicit mechanism for providing guidance to the CAA, Government policies on air transport continue to be published in White Papers as part of its overall national economic policy. As has been noted, although limited in its own way, the CAA plays an instrumental role in its provision of advice and policy formulation. For example, prior to the publication of the White Paper in 1985, the CAA was instructed to initiate "a review of civil aviation policy and the structure of the British aviation industry to explore all opportunities for increasing competition and fairness."⁴⁹ The findings of the CAA are set out in *Airline Competition Policy*.⁵⁰ Among the issues discussed, two appeared to be most prominent. The first related structural imbalance of the industry and the competition consequences flowing from it. As a publicly-owned corporation, BA enjoyed all the advantages of size, strength and economies of operation. Its privatisation as a whole enterprise would do no more than to preserve the monolithic structure

⁴⁴ S.6(2), Civil Aviation Act 1982.

⁴⁵ R.J.Britton, Secretary and Legal Adviser to the CAA. Letter to author (12 February 1991).

⁴⁶ Baldwin, *op.cit.*, p.243.

⁴⁷ A member of the CAA in an interview with the author, 8 November 1994.

⁴⁸ This has most recently been borne by the debacle over the Prison Service and the dismissal of its first Chief Executive, Derek Lewis: see *Independent* (17 October 1995).

⁴⁹ H.C.Debs.62, col.597 (22 June 1984).

⁵⁰ CAP 500 (1984).

of the once nationalised industry and present a great potential for market abuse and anti-competitive practices. For instance, the size of its aircraft fleet, the network of routes and the possession of scarce airport slots would vest in it such strength and power that any competitor was not likely to be able to sustain competition for any length of time with BA. At any rate, as the CAA noted, granted these "many advantages that British Airways has been endowed with, the country might willy-nilly find itself with one privately-owned but less than efficient monolith at the end of the day."⁵¹ In more than one respect then, this would be a drawback from the competitive policies of the Government and the CAA which have evolved over time. If British air transport was effectively represented by a single major carrier, particularly in international air transport,⁵² the CAA felt that it would no longer be possible for the objectives of its competition and licensing policies to be realised because,

it would be the more difficult for this Authority to bring effective pressures to bear upon it to remain efficient while the Government, having no other voice to listen to, would have little choice but to reinforce the protected position of the airline in dealing with governments of other countries.⁵³

At a time when there was a deliberate policy to expand the then B.Cal as well as to develop London(Gatwick) airport into a viable competitor with London(Heathrow) and other European airports, the CAA argued for the need of "some reduction in the relative size of British Airways so that other airlines have adequate opportunity to develop and prosper."⁵⁴ This would be achieved by a rational transfer of certain routes from BA to B.Cal. For instance, services operated by BA to Harare would be transferred to B.Cal as part of its existing services to Lusaka from its base at (London)Gatwick. However, the CAA recognised that BA was by any standard of measure a strong and competitive airline in international air transport. It remarked,

If one were to ignore the external dimension - the question of the United Kingdom's competitive strength vis a vis foreign airlines - it might well be argued that these recommendations do not go far enough to create a fair competitive balance between British Airways and other British airlines. It is essentially the external dimension, the consideration of the United Kingdom's competitive strength in the world at large, which determines that British Airways should not be broken up and that no greater reduction in the scale of British Airways should take place.⁵⁵

Thus, to ensure that the interests of the UK were adequately protected, there cannot be a substantial diminution of BA's competitive edge over foreign airlines. In the end, the recommendations of the CAA were not adopted by the Government⁵⁶ and BA was privatised with relatively few changes to structure of

51 *Ibid.*, para.9

52 See *infra*, ch.6.

53 CAP 500, para.7.

54 *Ibid.*, p.21.

55 *Ibid.*, para.81.

56 *Airline Competition Policy* (Cmnd.9366, 1984). See also J.Goh, *Regulating Air Transport Competition in the UK and the EC* (Fundación de Estudios de Regulación, Spain: 1998), and the audit report by the Comptroller and Auditor General: National

the industry due in large measure to the lobbying initiatives of Lord King, the chairman of B.A at the time ⁵⁷

The second, but related, consideration was concerned with the relationship between competition policy and airports policy. The pursuit of air transport competition, even by way of liberal licensing, is only one part of the equation because the other half is the capacity of the airport at which air transport services begin or terminate. Where, therefore, the maximum capacity of an airport has been reached, whatever licence to operate would only remain as a licence to operate, as opposed to the actual delivery of services. Such is the case with congested airports where demand is high, but where capacity is limited by reason of infrastructural, environmental or other social considerations. Accordingly, competition at such airports would be limited. These infrastructural constraints on air transport and the regulatory responses are considered in more detail in chapter six. However, suffice it to say at this stage that the London airport system, comprising of Heathrow, Gatwick, Stansted and Luton airports, is subject to such airports policies as are published from time to time, typically dealing with the ways in which air traffic should be distributed between them against the backdrop a wider policy on airports development such as that noted above.

The findings and recommendations of the CAA for a more liberal approach to air transport competition reflect its regulatory philosophy that competitive solutions should be the preferred method of regulation as set out in successive policy statements, of which the most recent was published in 1993, and evidenced by the body of case-law on licensing. To this extent, it is also possible to detect a large measure of parity with the aims of Community policy on air transport competition. Without pre-empting more detailed discussion in chapter seven, suffice it to state that Community policy is comprised of "three phases" of liberalisation measures. The first were adopted in 1987, the second in 1990 and the third in 1992. These measures, however, were preceded by two memoranda from the Commission to the Council setting out the crucial need for a common air transport policy which until 1987 was desperately lacking for a variety of reasons. The first of these memoranda was published in 1979 in which the Commission, although fully aware of the delicate nature of the industry, argued the importance of the role of air transport in contributing to the harmonious development of the Community.⁵⁸ It identified four *operational objectives* as comprising of:

- (i) a network of efficient air transport services unhampered by national barriers which would serve the needs of users;
- (ii) conditions of financial soundness for airlines through the diminution of costs and increase in productivity;
- (iii) a system of safeguards for airline workers;
- (iv) improved conditions of life for the general public.

Audit Office, *Sale of Government Shareholding in British Airways plc* HC 37 (1987-88).

⁵⁷ *The Observer* (19 July 1987).

⁵⁸ *Contribution of the European Communities to the Development of Air Transport Services*, Bull. EC Supp.5/79).

These policy aims were reiterated in a second memorandum of 1984, in which the Commission provided an analysis of the progress made towards a common air transport policy in the light of new economic and regulatory conditions.⁵⁹ Although some air transport measures were adopted in the period between 1979 and 1984, most had little to do with competition.⁶⁰ In one respect then, the second memorandum was a manifestation of the delay on the part of the Council to adopt air transport competition legislation. The *immobilisme* was, in large measure, attributable to the highly discretionary Treaty provision of Article 84(2) on air transport.

The success of an air transport proposal depends on the voting within the Council, as the principal legislative body. Article 84(2) states that

The Council may [acting by a qualified majority] decide whether, to what extent and by what procedure appropriate provisions may be laid down for sea and air transport.

The qualified majority requirement was inserted by the Single European Act (SEA) in 1986 to amend the previous requirement of a unanimous vote. It is evident from the provision that a large measure of discretion has been entrusted to the Council which simply reflects the special characteristics of air transport and the need for cautious actions. By the same token, the vulnerability of the sector to such political 'horse-trading' and difficulty of securing consensus is clear. This is well illustrated by the supreme reluctance of the Council to adopt a common air transport policy, despite persistent communications from the Commission, until some 30 years after the conclusion of the Treaty of Rome⁶¹ and also the difficulty in agreeing to an external relations policy.⁶² In one sense, therefore, the insertion of majority voting, as opposed to unanimous voting, has served to limit the breadth of the Council's discretion.

The process of policy-making at the Community level is necessarily complex and lengthy. Granted that consensus is often achieved at the end of the day, it comes not without protracted and difficult negotiations. The dominance of political characteristics in air transport makes the problem of achieving consensus between Member States particularly acute. No secret can be made of the fact that tension exists between Member States in formulating air transport policies; while some Member States are in favour of a liberal approach, others may be less convinced of the virtues of abandoning interventionist practices. The arrival of the principle of subsidiarity is likely to magnify the complications. This is already evident in the dispute over external air transport competence.⁶³

59 *Progress Towards The Development of A Community Air Transport Policy*, COM(84) 72.

60 For instance, aircraft noise. See P.Davies and J.Goh, "EC Law on Aircraft Noise: Recent Developments" (1993) *European Environmental Law Review* 229.

61 This discussion has been made elsewhere. See J.Goh, "Regulating The Skies of Europe: Air Transport Competition" (1992) 27 *European Transport Law* 272.

62 See J.Goh, "External Relations in Community Air Transport: A Policy Analysis" (1996) 2 *European Public Law* 453.

63 *Ibid.*

Government and the Development of Air Transport Policies

It should now be taken as read that governmental involvement in air transport is an inescapable feature. Its role in shaping and directing the industry stems from the strategic importance of air transportation as a means for communications and speedy transactions. Its potential contribution to the economy as a whole is indisputably significant, as s.3(1)(c) of the Civil Aviation Act 1971 had expressly recognised. Consequently, there can be little surprise that air transport is frequently charged with political overtones. These observations are applicable whether in respect of domestic or international air transport. In respect of the latter, the need to protect a nation's air space and territorial sovereignty is regarded as quintessential and more often than not the primary source from which restrictive practices emanate. The rules governing international air transport ensure the centrality of the government intervention in the form of bilateral negotiations and any eventual conclusion of air service agreements. The need for protection has further extended the role of governments to other areas such as the control of foreign investment in a domestic carrier, and the resolution of differences between airlines in the provision of air services. To a certain extent, the international air transport policy of the UK, and of other member countries of the EC, will be subject to the policy of the EC on external relations in air transport by virtue of their membership of the EC when such a policy is eventually adopted.⁶⁴

Primary responsibility for the formulation of air transport policies in the UK rests with the government, and specifically the Department of Transport (now the Department of Transport, Environment and the Regions). But the involvement of other Departments is inevitable and policies are often formulated under an inter-departmental network of committees. The Foreign and Commonwealth Office is frequently asked for its advice on international aspects of air transport treaties and the like. The need for or the purpose of specific governmental policies stems from what is often only a broad legislative definition of the regulatory objectives on a particular issue. These provisions seldom provide a sufficiently precise guidance of the remit of the agency vested with the regulatory responsibility, and arguably therefore governmental policies are designed to structure the (political) width of discretion entrusted to the agency. Thus, in many ways, the system of policy guidance was a manifestation of an industry often characterised by political considerations, whether they be national security, or factors of social or economic kind such as employment and industrial investment.

Although the charge has been frequently made that consultation for public decision-making is far from systematic, and indeed that there is no general duty

⁶⁴ For a discussion of the external relations policy, see J.Goh, "External Relations in Community Air Transport: A Policy Analysis" (1996) 2 *European Public Law* 453 and "Turbulence in the Skies of Europe" (1995) 145 *NLJ* 1665.

in law requiring public agencies to consult prior to decision-making,⁶⁵ this is not borne out by the record of the CAA and the Government in the formulation of air transport policies. The previous chapter, in particular, has shown that historically the Government relied on committees of inquiry to assess the direction in which the nation's air transport should take, and whose recommendations would often form the basis for government policies. Beyond the use of these committees, such as the Maybury, Cadman and Edwards committees, the Government would often consult the CAA for advice. Thus, in 1984, the CAA published its report into the likely impact of BA's privatisation on airline competition policy.⁶⁶ Indeed, the Civil Aviation Act 1982 empowers the Secretary of State to require the CAA to provide assistance either in the form of advice or material information held by the CAA. On the giving of advice, s.16 of the Act empowers the Secretary of State to require from the CAA "such assistance and advice" for the purposes of his civil aviation functions. S.17 on the other hand, imposes a duty on the CAA to supply the Secretary of State with "such information as he may specify" provided it is information already held by the CAA or can reasonably be expected to obtain. This section further requires the CAA to notify the Secretary of State of any proposal by an air transport licence holder to merge with another body, or any matter which affects international relations or the environment.

Furthermore, and in spite of there being no general legal duty to consult on the part of public agencies, the courts have gradually begun to construct a jurisprudence for participation. They have recognised that in certain circumstances consultation may be a legitimate expectation of the affected party or parties so that a failure to consult may either render the administrative act invalid or non-applicable in respect of the complainant by a process of severance.⁶⁷ Legitimate expectation is a concept first coined by Lord Denning in the case of *Schmidt v Secretary of State for Home Affairs* in which his Lordship said,

The speeches in *Ridge v Baldwin* show that an administrative body may, in a proper case, be bound to give a person who is affected by their decision an opportunity of making representations. It all depends on whether he has some right or interest or, I would add, some legitimate expectation, of which it would not be fair to deprive him without hearing what he has to say.⁶⁸

65 P.Craig, *Administrative Law* (Sweet & Maxwell, London: 3rd edn., 1994); P.Birkinshaw, *Grievances, Remedies and the State* (Sweet & Maxwell, London: 2nd edn., 1994).

66 CAP 500 (1984).

67 For the idea of severance, see e.g. *DPP v Hutchinson* [1990] 2 AC 783.

68 [1969] 2 Ch 149, at p.170. See also *Ridge v Baldwin* [1963] 2 All ER 66; *Re HK* [1967] 2 QB 617; *Re Liverpool Taxi Owners' Association* [1972] 2 All ER 589; *R v Secretary of State for Health ex p US Tobacco International* [1992] 1 All ER 212; *R v British Coal Corporation ex p Vardy* [1993] IRLR 104; *R v Secretary of State for Transport ex p Richmond-upon-Thames LBC* [1994] 1 All ER 577.

That view was later affirmed by Lord Diplock in the leading case of *GCHQ*⁶⁹ In seeking to explain the concept of legitimate expectation, his Lordship stated that a decision qualified for judicial review if its consequences affected some person by depriving that person of some benefit or advantage which he was permitted to enjoy in the past before rational grounds and an opportunity to comment had been given for its withdrawal, or by depriving him of some benefit or advantage on which he was assured of an opportunity to make representations before it was withdrawn.⁷⁰ The formulation seems concerned with the conduct of the decision-maker which gives rise to the expectation, and not on the expectation *per se* that it is an inherent expectation of a person affected by the decision of a public authority⁷¹

Be that as it may, effective participation requires also transparency in decision-making. That is to say, for participants to make informed contributions, all relevant information must be forthcoming and that none is hidden or tempered with. Free-willing dialogue cannot be possible if deceit or entrapment is intended. This is perhaps consistent with Habermas' idea of the "ideal-speech situation".⁷² Although the CAA is committed to consultation and openness, in particular by virtue of its system of public hearings and publication of reasons for its decisions, the same cannot always be said of the Government and its process of framing wider air transport policy objectives. There remains a detectable degree of unevenness in terms of access to the policy formulation machinery as borne out by the lobbying tactics of BA's chairman prior to its privatisation. It is possible that the proposal to enact a Freedom of Information legislation would do much to redress the deficit on the transparency of decision-making by the Government.⁷³

Conclusion

The previous chapter which charted the history of regulation in British air transport made it clear that the industry structure which emerged as a result of Government policies over the years made it necessary also to establish and maintain an economic regulatory framework when the industry was eventually exposed to competition, and particularly when BA was transferred to private sector with virtually all its privileges and assets intact. These included not only the fleet of aircraft, but also the priceless airport slots at London(Heathrow) airport which it inherited from its monopoly years. Accordingly, policies to deal with potential problems arising from these disparities have had to be formulated. This chapter was a combined attempt to examine the role of the CAA and the

69 *Council of Civil Service Unions v Minister for the Civil Service* [1984] 3 All ER 935.

70 *Ibid.*, p.949.

71 See now *R v Secretary of State for Transport ex p Richmond-upon-Thames LBC* [1994] 1 All ER 577.

72 J.Habermas, *Communication and the Evolution of Society* (Heinemann, London: 1979).

73 *Your Right To Know: The Government's Proposal for a Freedom of Information Act* (Cm.3818, 1997)

Government in formulating air transport competition policies generally and the extent to which these policies have had to change over time to reflect new developments, including the EC developments. Since the arrival of EC measures on air transport, policy formulation both by the Government and the CAA cannot now take place in splendid isolation. Indeed, regulatory policies of the CAA have been amended to the extent that they now reflect Community policy on air transport competition. Of course, membership of the EC and the legal effect of Community legislation and decisions have much to do with it although these will not be rehearsed here.⁷⁴

In terms of their role in policy formulation, there is a large degree of co-operation between the CAA and the relevant government department, particularly in the form of assistance and advice given by the CAA to the Secretary of State. The impact of privatising BA lock, stock and barrel on the competition policies was an instance of the instrumental role expected of the CAA, even though its recommendations in respect of slimming down the size of BA before its privatisation were not taken up. The relationship between the Government and the CAA has clearly changed over the years, and more so since the abandonment of the policy guidance system which in fairness had its purpose. But the maturity of that relationship had to be recognised, as must the maturity of the CAA itself in terms of its ability to develop coherent and structured procedures. Indeed, it will become apparent in the following chapters that the abandonment of the system of statutory policy guidance has not halted the progression with which the airline industry has been led by positive action by the CAA. Policy initiatives have been taken by the CAA, and subjected to wide consultative procedures much akin to the US administrative rule-making procedures under the federal Administrative Procedure Act 1946. This development alone, if not others, has brought credibility to the process of economic regulation in civil aviation by an administrative agency in the UK. It is axiomatic that a highly developed set of procedures for policy-making is both desirable to justify the existence of the regulatory system as well as important to give legitimacy to the policies which will ultimately have to be interpreted by the regulatory agency in fulfilling its functions.

It should also be clear from this chapter that over time, and through a change in the instincts of the authorities, there was a detectable paradigm shift from an emphasis on airline interests to user interests. It is submitted that this is a precondition for critical market contestability because unless a substantial mutuality between the interests of the producers and purchasers can be found, economic regulation will continue to be necessary until it is deemed that the conditions of sustainable competition have been achieved. This shift has no doubt led to significant changes in the substantive policies of the CAA, which the empirical evidence in the following chapters will demonstrate, can affect, even if only

⁷⁴ See generally, D.A.C. Freestone and J.S. Davidson. *The Institutional Framework of the European Communities* (Croom Helm, London: 1988) and leading cases of Case 26/62, *N.I. Algemene Transport En Expeditie Onderneming Van Gend En Loos v Nederlandse Tariefcommissie* [1963] CMLR 105; Case 6/64, *Costa v ENEL* [1964] CMLR 425; Case 221/89 *Factortame v Secretary of State for Transport* [1991] 3 All ER 769.

unwittingly, the established procedures of the regulatory agency: for example, lesser of use of the public hearings system. To that extent, this chapter has sought to provide the background for understanding the relationship between procedures and substance.

CHAPTER FIVE REGULATING COMPETITION AND ITS CHANGING NATURE

*I will not speak to you about yesterday because I was not the same person
(Alice in Wonderland)*

Economic regulation of air transport entails the regulation of economic activities performed by an air transport operator. These include decisions whether to commence services on a particular route, decisions on the frequency of services which consequently determines the number of seats to offer over a period of time,¹ and decisions on the fares to be charged to users of the services. By implication, economic deregulation means the freeing of such decisions from control. If competition for custom is determined by these economic decisions, that is where one could fly to, the choice of schedule or of fares, then economic regulation or deregulation represents two extreme methods of determining how much competition there will be in air transport services. And because regulation is a relative concept, then so must competition. The latter is likely to be absent if regulation was absolute and prescriptive, approximating a structure of law-monopolies by virtue of the regulatory authorisation. This is possible even if there were two or more operators providing services on the same routes. If their decisions on frequency or fares were determined by the regulator, there is then no freedom of decision-making; by setting a fare which had not been previously authorised by the regulator would probably incur a penalty of some kind. Nor is there likely to be the incentive to compete, for example, by providing a more superior quality of service if such regulation amounted virtually to a protection of revenue.

In chapter two, *regulated competition* was argued as an approach which aims to provide the combination of regulation on the one hand, and freedom in decision-making on the other hand. In such an instance, some economic aspects of air transport continue to be regulated by the public regulatory authority while some others are free to be determined by the operators according to the forces of the market place. What, and how much of it, should be regulated is a matter of degree which must depend on a number of variables. Political considerations, amongst others, is often a dominating factor. Economic conditions and international relations are equally influential as to the level at which airline competition should be pitched. Domestic air fares, for example, have been deregulated and that entails the level of fares are decided by airline operators according to what they judge users are prepared to pay. However, some public regulation of fares continue to exist. The CAA, for instance, continues to ensure that airline operators do not set predatory fares so as to drive out other competitors who cannot provide sustained competition at that level of fares. More recently, the introduction of air transport liberalisation measures by the EC requires the CAA to abandon, *inter alia*, the regulation of

¹ Both the frequency of services and the number of total seats is also referred to as the "capacity".

access to the market by airline operators from Member States since that would be contrary to the right to establish and provide services as recognised by the Treaty of Rome. These are considered in due course. Regulated competition is therefore a regulatory process demanding a delicate balance to be struck between, on the one hand, economic regulation to ensure that a certain objective, for example the public interest, is not prejudiced, and on the other hand, sufficient economic autonomy enabling decisions to be made on a purely commercial basis. Regulated competition entails a framework within which boundaries for competition between airline operators are set and to be observed, so that an infraction of these framework rules may lead to sanctions of one form or another.

How the routes, fares and capacity of an airline operator are regulated varies, and it varies according to the regulatory system. In the case of a statutory monopoly, and therefore the existence of no more than one airline operator, this may be achieved by a system of statutory regulation. Routes could be prescribed in statutory provisions; so could the level of fares to be charged for each service on each route as could the capacity to be provided for services. But this would be ridiculously cumbersome; for each alteration to routes or fares could only be effected by statutory amendment or some delegated means of legislative amendment. The inefficiency of such an approach dictates against the system of direct regulation by statute. Even in the years when British civil aviation was dominated by a statutory monopoly in the form of British Overseas Airline Corporation, the prescription of routes, fares and capacity was devolved to a Board of the Corporation which maintained a constant liaison with the government department responsible for civil aviation. In a framework of regulated competition, where more than one airline operator exists, and where some specification of routes, fares and capacity may be required, then these may be communicated to the operators in the form of an air transport licence, franchise or other contractual agreements. In the previous chapter, the various types of licences used by the CAA including operating licences, route licences and air transport licences were considered.

The system of licensing in British air transport first emerged with the creation of the Air Transport Licensing Board in 1960 when the decision was made to introduce competition to the industry.² Henceforth, the development of the licensing system has taken various turns and has been modified to adapt to changing circumstances in the industry, not least the changes brought about by new EC rules on air transport licensing. Licences of different classes for different purposes are now granted. An operating licence, for instance, is a prerequisite for airline operations, without which no operator could provide air transport services. This is set out in s.64 of the Civil Aviation Act 1982 which makes it an offence for any operator of an aircraft to carry passengers or cargo on a flight if the operator has not been licensed according to the Act. Being the essential basis for airline operations, an operating licence is usually granted on the grounds of managerial competence and financial fitness. Further conditions

² Although see ch.3 on the emergence of "associates" of the nationalised Air Corporations.

may also be imposed on operators, and these may be economic or social in nature, for example safety and environmental. The former is set out in the Air Operator's Certificate which determines the worthiness of an aircraft. Environmental regulation may include the control of aircraft noise for instance.³ The validity of a licence depends significantly on compliance with the conditions of the licence by its holder, the failure of which will render the licence liable to revocation. It is by virtue of the imposition of any such conditions and their compliance which makes the licence a key instrument in the regulation of civil aviation.

This chapter and the next will consider first, the criteria for air transport licensing by the CAA and the body of licensing case-law which has evolved over time as changes in the regulatory emphasis were introduced. These will provide a basis for assessing the extent to which the CAA has responded to the changing economic climate. In particular, as will be considered in depth in the next chapter, they will allow for conclusions to be made on the manner in which the CAA has developed more specific regulatory responses to persistent barriers which impede competition.

Licensing for Competition: Policy Statement of the CAA

The Bias Towards Competition

The principal policy document on air transport licensing is the *Statement of Policies on Route and Air Transport Licensing*⁴ which sets out the philosophy and approach of the CAA. CAP 620 is the most recent of a series of policy statements on air transport licensing which have gradually emphasised the importance of competitive solutions on the allocation of routes, and of liberalising regulatory controls over fares and capacity. In comparison to previous policy statements, the scope of the current statement has also been modified substantially to reflect the requirements of the common licensing criteria for European air transport. *Licensing of Air Carriers Regulations 1992*,⁵ which gave effect to Council Regulation 2407/92 on common licensing criteria and amended s.68 of the 1982 Act, removes the licensing jurisdiction of the CAA from services provided by EC-based airlines within the Community, whilst *Access for Community Air Carriers to Intra-Community Air Routes Regulations 1992*⁶ gave effect to Council Regulation 2408/92 on market access. Together with Council Regulation 2409/92 on fares,⁷ these EC measures apply to intra-Community air transport including British domestic air transport. Accordingly, the scope of CAP 620 is effectively restricted to the licensing of routes *not* covered by the Community Regulations.

³ E.g. see P.Davies and J.Goh, "Air Transport and The Environment: Regulating Aircraft Noise" (1993) 18 *AIR and Space Law* 123.

⁴ CAP 620 (1993). The previous policy statement on licensing was published as CAP 539 (1988).

⁵ SI 1992/2992.

⁶ SI 1992/2993.

⁷ Incorporated by *Air Fares Regulations 1992*. SI 1992/2994.

The Statement sets out the prime concern of the CAA in the performance of its economic regulatory functions as "the reasonable interests of users"⁸ and it sees those interests as best served by an environment of active competition which would ensure "the widest possible choice of products, services and airports...quality of service is maintained fares are set at reasonable levels in relation to cost".⁹ A competitive environment will also provide a strong incentive to achieve efficient operations and sound allocation of resources. This policy, however, has not been an overnight development. It comes in the light of increasing, but gradual, exposure of the industry to competition over a period of time as legislation are enacted and policies formulated.

For reasons already identified and which will be treated in more detail in the following chapter, the air transport industry is not readily susceptible to competition. A sound approach is therefore required to ensure that not only can active competition be introduced, but is capable of being sustained. To that end, the CAA sets out its central principle for achieving a competitive air transport environment as a multi-airline industry in which,

the interests of users are best met by the existence of a number of efficient and profitable British airlines strong enough to compete with each other and with foreign airlines, directly or indirectly, where the opportunity arises or can usefully be created. Thus, it will seek to encourage the development and maintenance of an environment in which efficient British airlines can operate profitably and in which competition between British carriers and with foreign airlines can flourish and user choice is enhanced.¹⁰

This policy statement creates a general presumption that the CAA will license air transport services liberally to encourage a competitive environment by maintaining a multi-airline industry. Applicants for air transport licences and objectors to such applications will therefore have prior knowledge of the premise on which the CAA will begin its consideration of these applications. A multi-airline policy, however, is not a policy set in stone; nor should it be without running the risks of fettering its own discretion.¹¹ Indeed, the CAA has stated explicitly that it sees competition as no more than a tool for securing the interests of users.

The policies set out in the Statement of Policies do not have a life of their own: they exist to achieve the objectives of the Act. The multi-airline policy is not an end in itself, as the Statement of Policies makes clear, but rather a means to an end. If the Authority were persuaded that the multi-airline industry policy was no longer in the interests of air transport users, it would abandon it.¹²

This approach is evident in the interpretations which the CAA has adopted in respect of its policy when adjudicating air transport licensing cases in which it

⁸ CAP 620, para.3.

⁹ *Ibid.*, para.4.

¹⁰ *Ibid.*

¹¹ See e.g. *Lavender v Minister for Housing and Local Government* [1970] WLR 1231.

¹² Decision 7/90.

has demonstrated that it is more concerned with licensing competing rather than replacement services. Thus, in rejecting BA's application following its merger with B.Cal to operate on the London(Gatwick)-Paris route in competition with the incumbents Air Europe and Dan-Air, the CAA reasoned that,

BA did not propose any new products or lower fares beyond those already offered from Heathrow. Nor, given its cost structure, could it expect to develop the low fare market any more actively than the incumbents. Additional flights would of course widen choice, but only if they did indeed supplement rather replace those already on offer.¹³

Similarly, in the first case under the new European licensing measures, the CAA stated that the application made by Jersey European Airways, and objected to by CityFlyer Express, must proceed on the "explicit assumption that it should grant a licence" on the London(Gatwick)-Jersey route because of its established policies on competition.¹⁴ Since the policy presumption is to satisfy the reasonable interests of users, where an application has been made with demonstrated benefits for the users, such as a broader range of available products in the form of fares or schedule, the CAA would require powerful objections before an application on that basis would be refused.¹⁵ Where the proposed provision of such benefits has been decided as a matter of commercial judgment, the CAA would be tended to leave the forces of the market place to determine the feasibility of the proposal unless "the need is evident" for regulatory intervention. This was so stated in a decision of the CAA on the Birmingham-Berlin route in which it took the view that where "there was scope for UK airlines to compete effectively on international routes, and potential for bringing new benefits, operators should be allowed to put their services to the test of the market".¹⁶

A multi-airline policy, however, cannot be pursued in a manner oblivious to circumstances which may threaten the realisation of the statutory objectives. It is part of a broader system which must be flexible to accommodate the specific features of each case in which the policy is to be applied. As a general presumption, therefore, this policy approach is of course open to rebuttal. The CAA will depart from its normal licensing policy where a strong case has been made to persuade it that special circumstances dictate such departure. Accordingly, in considering the application of its policy, the CAA would analyse the benefits which the proposed service would entail. In Decision 6/91, for example, it examined the density of the routes in question and the availability of slots at particular timings to enable the provision of a competitive and viable service. To that end also, it may decide to refuse an application of, say, BA, to operate competing services from London(Gatwick) while also operating from London (Heathrow) on the basis that its dominance over London routes, as a result of historical endowment, would lead to unfair competition and thus threaten the realisation of the statutory objectives. This approach was

13 Decision 3/90.

14 Decision 1/93. para.12.

15 See e.g. Decision 8/91.

16 Decision 3/91.

particularly evident in the applications following the BA-B Cal merger where BA had been required to surrender a substantial number of slots at Gatwick. In one of the applications, the CAA noted that "while Heathrow continues to enjoy its present advantage over Gatwick and other airports, airlines which do not operate there or cannot get into it will be at a permanent disadvantage and all applications for Gatwick services by airlines already established at Heathrow must be seen in that light."¹⁷ The relevance of this line of argument would be exceptionally acute if the application involved services to the same destination so that it would,

give it [BA] unassailable advantages over airlines who, de jure or de facto, can operate only from Gatwick. Thus, where BA applies to begin a new route from Gatwick in addition to a Heathrow service and against the objections of airlines which have established successful and valuable services there, it will need to demonstrate convincingly that it has a reasonable prospect of doing so profitably and, more importantly, that the overall impact of its serving that destination from Gatwick in addition to Heathrow is more likely to bring some notable additional benefits to users than to jeopardise existing benefits.¹⁸

In such instances its multi-airline industry commitment will have to be departed from, though this does not detract from the notable shift in the onus of arguing for an air transport licence to a general policy of liberal licensing. So long as the generality of policy remains open to change or persuasion, the regulatory framework will continue to offer the flexibility to pursue the statutory objectives. As Lord Reid has espoused in *British Oxygen Co Ltd v Board of Trade*,

The general rule is that anyone who has to exercise a statutory discretion must not "shut his ears to an application". I do not think there is any difference between a policy and a rule. There may be cases where an officer or authority ought to listen to a substantial argument reasonably presented urging a change of policy. What the authority must not do is to refuse to listen at all. But a Ministry or large authority may have had to deal already with a multitude of similar applications and then they will almost certainly have evolved a policy so precise that it could well be called a rule. There can be no objection to that, provided the authority is always willing to listen to anyone with something new to say....¹⁹

Air Transport Deregulation in the UK

In the years when liberalisation or deregulation was unheard of, command-and-control regulation was the norm. Air transport licences were allocated subject

17 Decision 3/90.

18 *Ibid.* See also Decisions 7/88 and 7/90.

19 [1971] AC 610, at p.625. See also *R v Port of London Authority ex p Kynoch Ltd* [1919] KB 176.

to highly prescriptive conditions dealing with routes, fares, capacity and the like. When the ATLB was responsible for licensing air carriers, it sat on an average of 142 days each year. This contrasts very sharply with the average of 40 hearings by the CAA in the years leading up to 1994 and perhaps more significantly with the year of 1994 in which no more than two hearings were held, both of which were in fact dealing with the same case, and with 1996 in which no hearings were held. In an interview with the author, a member of the Authority, who postulated a number of explanations for the decline in the frequency of hearings, advised that "whenever an opportunity to attend a hearing arises, seize it".²⁰ This decline, however, is not illustrative of a decline in the number of applications for air transport licences; rather, it is instructive of the changing nature of civil aviation regulation including the liberalisation of Community air transport and hence the need for conducting a hearing for the purposes of allocating the licence. Hearings are now virtually dependent on an instruction from the Secretary of State, for example, to allocate scarce capacity under a bilateral agreement.

The contrast between the ATLB and the CAA lies very much in their philosophy of regulation. The former regulated not only the scheduled passenger market but also the charter market, and the majority of its licensing hearings was to deal with applications for the provision of charter services. When the CAA was established in 1972 to replace the ATLB, amongst its first initiatives was the study into the possibility of deregulating the charter market. It sought to determine whether it was necessary for charter operators to submit themselves to the formal process of a hearing for, say, a proposal to lower fares or a decision to increase capacity. It concluded that control of fares would be abandoned from 1973, but to ensure that charter operators did not disappear from the market to the detriment of the users, the CAA required additional bonding under its new system of Air Transport Organiser Licence (ATOL). Both of these conclusions were consistent with the recommendations in the Edwards Report,²¹ that is, to experiment with deregulation of charter fares but to provide at the same time further safeguards. The significance of deregulating charter fares was to remove the opportunity for other operators, in particular scheduled operators, to object to a proposal on fares in a public hearing since these scheduled operators were anxious to preserve their share of the market on package holidays and the like. Charter fares would quite simply be decided on a commercial basis of demand and supply although operators continued to be required to file the fares with the CAA. This is also in accordance with s.68(4) of the 1982 Act which requires the CAA "to impose on the civil air transport industry of the United Kingdom and on the services it provides for users of air transport services the minimum restrictions".

20 Interview with the author, 8 November 1994. It is interesting that four hearings were held in 1998, one of which, however, was a re-hearing ordered by the Secretary of State on the London-Moscow route.

21 *Op.cit.*, paras.704-719. A review was initiated in 1994 to recommend changes to a system introduced since 1972 to reflect a more complex travel environment and these came into effect in 1995: *Civil Aviation (Air Transport Organisers Licensing) Regulations 1995*, SI 1995/1054.

Thus, although the deregulation of air transport is widely deemed to have been pioneered by the US almost two decades ago, any analysis of deregulatory policies must begin with the assumption that economic regulation and deregulation differs only in degree. The model of deregulation in the US was the complete abandonment of any economic regulatory control, and this will differ from a model of partial deregulation, which also may be described as liberalisation. This is consistent with a key theme of the thesis, that is the models of 'monopoly' and 'perfect competition' are two extremes on the same spectrum of economic models. This implies that intermediate points exist to provide the possibility of combining the need for regulation to the extent necessary and a measure of freedom at the same time. The intermediate model adopted in this thesis is known as regulated competition. If this latter model is accepted as providing for some form of deregulation, then whether airline deregulation, as a principle, was pioneered by the US must be considered in this wider context. Chapter 8 has been devoted to examining the system of deregulation in the US and to argue further that whatever the degree of economic regulation needs to be adopted must depend on a number of important factors, the most significant of which is the structural balance of the industry. For now, more needs to be said of this point by reference to the CAA's (de)regulatory policies on route entry, fares and capacity.

Regulated route entry

The deregulation of entry, that is route licensing, does not necessarily enjoy the ease which goes with fares or capacity deregulation. The major obstacle to a successful deregulation of route entry is undoubtedly the restrictions brought about by both natural and artificial constraints on competition. Where, however, opportunities exist, the CAA has attempted to extend its liberal licensing policy to route entry. In most cases, this would assume a certain pre-existing degree of parity in terms of market access; that is to say, for instance, BMA switching its use of a slot for destination X at a congested airport such as Heathrow to destination Y so as to compete with, say, BA. If entry competition was simply deregulated, an industrial structure characterised by a dominant airline is likely to lead to the fortification of the dominance by reason of its size, scope and strength. Those airlines which do not enjoy such qualities will be perpetually disadvantaged and possibly out-performed. Regulated entry, although it does not entail the diminution of that dominance by positive action, enables the CAA to harness equal opportunities for competition between airlines, both large and small alike. The aims of entry deregulation are consequently capable of being achieved to an equivalent extent within a structure of regulated entry, provided of course the aims remain constant and regulatory actions are taken in accordance with these aims. Under CAA's policy of liberal route licensing, the effects have been significant in two particular respects. First, a new entrant has often provided the stimulus for price competition and this is evident in the remarks of the CAA when it examined the trends of competition in relation to Community air transport. For instance, it noted that the "most significant developments in the realm of fares have been those provoked by BMA on its international routes from Heathrow." Secondly, it noted further that in cases where price competition has traditionally been less elastic such as business fares, competing services have entailed new

products for users including, for example, BMA's separate business class cabin, Diamond EuroClass, for passengers travelling either on the Eurobudget, three-day Executive return or Executive fares.²²

In 1987, the CAA carried out a study of competition on the main domestic trunk routes²³ and concluded in respect of route entry that competition from a second entrant against BA resulted not only in a new product being introduced by the incumbent, but led to greater frequencies and improved in-flight service at a reduced average cost. Prior to 1982, competition on these trunk routes were limited to those between BA's Heathrow services, and B.Cal's services from Gatwick to Glasgow, Edinburgh and Manchester, and BMA's services from Gatwick to Belfast. Any direct competition for services originating or terminating at Heathrow was therefore conspicuously absent, principally for historical reasons. In 1981, however, BMA applied to the CAA in the very first case under the terms of the new Civil Aviation Act 1980 to operate the Heathrow-Glasgow and Heathrow-Edinburgh routes. The application was initially rejected on the grounds that the recession and losses of both airlines did not justify the licensing of competing services on those routes.²⁴ On appeal, however, the Secretary of State overturned the CAA's decision²⁵ and BMA was eventually licensed to operate on the Heathrow-Glasgow route in 1982, and subsequently on the Heathrow-Edinburgh in 1983. This was followed by another application in 1983 to serve the Heathrow-Belfast route on the back of its success on the Scottish trunk routes.²⁶ BA objected strongly to this application. Its main objection was that the proposed conventional service by BMA, if licensed, would lead to a diversion of traffic, which could lead to its decision to withdraw the shuttle services it was already providing. This would ultimately have an effect on its network of services.

Although the policy of the CAA had changed little since its decision on the Glasgow and Edinburgh routes, the reasoning behind that decision was central to the Heathrow-Belfast application. The CAA noted first of all that the Heathrow-Belfast application differed from the Glasgow and Edinburgh routes in a number of respects. First, when the CAA refused BMA's application on the Scottish trunk routes, it did so because the economic conditions then did not justify two carriers. The economic climate was now much improved, and both BA and BMA had returned to profitability. Secondly, the CAA observed that the benefit of user choice was more important on the Belfast route than the Scottish routes because of the relatively poor surface alternatives from London. In the absence of competition, BA would be operating in a near monopoly position. The CAA also pointed out that the other user benefit in the context of the Scottish routes was the decision of BA to introduce a much improved Shuttle product (Supershuttle) in response to the competition from BMA. It could not therefore deny that BMA's proposed services to Belfast would play

22 CAA, *Airline Competition in the Single European Market*, CAP 623 (1993), para.44.

23 These were London to Glasgow, Edinburgh, Manchester and Belfast: *Competition on the Main Domestic Trunk Routes*, CAA Paper 87005 (1987).

24 Decision 19/81.

25 Official Record Series 2, 529 (3 August 1982).

26 Decision 7/83.

no part in the improvement of services. In particular, the CAA was also not convinced by BA's argument that there was little or no demand for a conventional scheduled service on that route. On the contrary, the CAA accepted the claim by BMA that "a substantial minority of passengers preferred a conventional service and that there was a benefit to users in having a choice."

Accordingly, BMA was granted the licence for the Heathrow-Belfast route. An important reasoning behind the CAA's decision was the new emphasis on competing services in the 1980 Act and its benefits to users and the sound development of the industry. Undoubtedly, these benefits "would carry a price in terms of loss of economies of scale and the less efficient use of resources", but the policy objectives of the 1980 Act was that the benefits of competition could outweigh this price and should therefore be positively promoted where it was practicable to do so. Consequently it did not accept that short-term loss profitability on the part of BA was a sufficient justification to refuse licensing BMA. It said,

The introduction of a competing service on a route must almost always take traffic and revenue away from the incumbent operator and affect that operator's profit. It must be presumed therefore that the Act requires that these effects on existing services do not constitute in themselves a reason for denying a licence to a competing service where the particular benefits of competition are likely to be substantial and there is no international obstacle to the introduction of the competing service.²⁷

BA applied for a judicial review of the decision although the application was ultimately refused on the ground that the CAA had not misinterpreted its duties nor misapplied its discretion.²⁸

With the exception of the Heathrow-Manchester services, on which Dan-Air was licensed in April 1985 to compete with BA, the introduction of a second carrier at Heathrow led to a significant reduction in BA's market share and its passenger load factor (calculated as a percentage of passengers carried against the number of seats available). On the Glasgow route, for example, BA carried just in excess of 650,000 passengers and achieved a market share of 78.9% in 1982. This was more or less consistent for the levels of 1980-1981. B.Cal, which operated from Gatwick, maintained a steady share of the passenger number and thus its market share of 17%.²⁹ In 1983, when BMA's services could be assessed over a period of 12 months, BA carried 530,000 passengers and had a reduced market share of 60.2%, while B.Cal's market share fell to 14.7%. In that year, BMA carried 221,000 passengers and managed to secure a market share of 25.1%. Although total passenger number grew by 52,000, it would be misleading to attribute this development solely to the competitive stimulus provided by BMA's entry; some would have been due to natural

²⁷ *Ibid.*, para.77.

²⁸ *R v CAA ex p British Airways Board* CO/943/83, Transcript of 21 December 1983. See *infra*.

²⁹ The remaining share of 4.1% of the market share was achieved by BMA although this was only for the period of October-December 1982.

growth in traffic and in particular the series of railway services disruptions in 1982 and 1983. Nevertheless, BA responded to the competition and revised its SuperShuttle product in September 1983. As a result, its traffic level was improved in 1984 and its market share increased to 65.4%, while BMA's share of the latter was reduced to 21.1%. The conclusion that may be drawn on the Glasgow route is similarly possible in respect of the Edinburgh and Belfast routes. In contrast, the Manchester route received little in the way of competitive stimulus for BA to respond by introducing a new product, or sustain a reduced market share. When Dan-Air was licensed in April 1985, it operated three daily services on the basis of an aim to fill in certain gaps left by BA's schedule. Thus, it proceeded to offer an early morning service in advance of BA's first service by 20 minutes. In response, BA re-scheduled its first service so as to be available 10 minutes before Dan-Air's. This had a severe impact on Dan-Air's market share and ability to sustain the competition not least in the light of BA's eight daily services on the route. By the autumn of 1985, Dan-Air was forced to reduce two of its services including the early morning service, and subsequently withdrew the remaining service in October 1986. On these route by route comparisons alone, the CAA noted that frequency was an important strategy of competition.³⁰

Table 5.1 London-Glasgow

	British Airways		British Caledonian		British Midland	
	Passengers (000s)	Market Share (%)	Passengers (000s)	Market Share (%)	Passengers (000s)	Market Share (%)
1980	664.7	80.4	162.4	19.6	-	-
1981	614.2	81.3	141.1	18.7	-	-
1982	654.6	78.9	140.7	17.0	34.3 ³¹	4.1
1983	530.6	60.2	129.4	14.7	221.5	25.1
1984	660.8	65.4	136.2	13.5	213.7	21.1
1985	706.8	65.4	147.2	13.6	226.7	21.0

³⁰ Para.14.3.

³¹ For period October-December 1982.

Table 5.2 London-Edinburgh

	British Airways		British Caledonian		British Midland	
	Passengers (000s)	Market Share (%)	Passengers (000s)	Market Share (%)	Passengers (000s)	Market Share (%)
1980	564.8	77.8	160.8	22.2	-	-
1981	540.3	79.9	136.1	20.1	-	-
1982	613.6	81.9	135.3	18.1	-	-
1983	501.3	63.0	124.1	15.6	169.8	21.4
1984	615.8	65.0	130.2	13.7	201.7	21.3
1985	661.9	64.0	140.4	13.6	231.6	22.4

Table 5.3 London-Belfast

	British Airways		British Caledonian		British Midland	
	Passengers (000s)	Market Share (%)	Passengers (000s)	Market Share (%)	Passengers (000s)	Market Share (%)
1980	602.3	84.5	110.5	15.5	-	-
1981	568.0	84.4	105.2	15.6	-	-
1982	585.1	88.0	79.8	12.0	-	-
1983	636.6	91.0	62.8	9.0	-	-
1984	633.2	71.9	98.1	11.1	150.0	17.0
1985	549.6	61.4	109.4	12.2	236.2	26.4

Table 5.4 London-Manchester

	British Airways		British Caledonian		Dan-Air	
	Passengers (000s)	Market Share (%)	Passengers (000s)	Market Share (%)	Passengers (000s)	Market Share (%)
1980	493.6	82.7	103.6	17.3	-	-
1981	458.5	81.0	107.7	19.0	-	-
1982	539.7	81.1	125.5	18.9	-	-
1983	526.7	80.6	127.1	19.4	-	-
1984	615.0	80.4	149.6	19.6	-	-
1985	681.9	78.5	168.8	19.4	18.4	2.1

Source: CAA Airline Statistics and CAA Paper 87005.

Competition on these domestic trunk routes was the result of the decision to license liberally and to foster greater freedom in decision-making by airline operators, so that the incentive to succeed would be driven by the need to provide a wider choice of products for users, whether in the form of fares, in-flight service or schedule, rather than the imperfect estimates of the regulatory agency. In this way also, for airline operators to meet the challenges of competition, for example by offering lower fares, efficiency gains have to be made to meet the short-fall in revenue. An interesting analysis of this point was made by the CAA in its study of competition on the four trunk routes.

Table 5.5 Index of Costs

	Costs per Seat	Costs per Passenger	Revenue per Passenger	Retail Price Index
Glasgow				
1980	100.0	100.0	100.0	100.0
1981	114.4	107.8	112.4	111.9
1982	112.7	112.3	117.0	121.5
1983	101.1	112.6	119.5	127.1
1984	108.7	115.2	118.7	133.4
1985	116.1	118.6	127.3	141.5
Edinburgh				
1980	100.0	100.0	100.0	100.0
1981	113.0	110.2	114.6	111.9
1982	111.1	105.4	119.9	121.5
1983	107.1	118.9	123.1	127.1
1984	115.4	125.0	123.2	133.4
1985	122.5	124.4	130.4	141.5
Newcastle/ Teeside				
1980	100.0	100.0	100.0	100.0
1981	123.1	109.4	105.9	111.9
1982	126.9	114.0	119.7	121.5
1983	130.4	119.7	138.0	127.1
1984	127.2	123.7	137.5	133.4
1985	136.3	132.7	138.4	141.5

Source: CAA Paper 87005

Assuming a base index of 100.0, it was evident on the Glasgow route that the costs of providing one seat were reduced by 10.3% on 1982 levels although unit costs for passengers remained at around 112 following the introduction in late 1982 of BMA services from Heathrow. This was also evident on the Edinburgh route. In contrast, the Newcastle/Teeside route which had no direct competition recorded an increase in unit costs for passenger seats from 126.9 to 130.4 for 1982 to 1983, and to 136.3 in 1985, while unit costs for passengers increased two-fold in percentage terms over the same periods of comparison. The regulatory rationale for competing services came in the light of the CAA's proposal in 1984 to deregulate route entry and to issue instead an "area operating facility" on an experimental basis, which was subsequently accepted by the Government. This would enable airlines to add to their existing licences for domestic services those routes between two points which have not been excluded from the designated area.³²

In many respects, therefore, the advent of Council Regulation 2408/92 to provide EC-based airlines the freedom of entry to intra-Community routes is a policy that mirrors CAA's liberal route licensing policy; that is, the decision as to which route to provide air transport services would rest with the operator to be decided according to its commercial judgment. The crucial difference

³² CAA, *Airline Competition Policy*, CAP 500 (1984), paras.91-93.

between CAA policy and Council Regulation 2408/92 lies in the much more "deregulated" nature of the latter. Casting aside the catalogue of exemptions permitting derogation from the general principle of freedom of entry, the Regulation grants unlimited access to intra-Community routes regardless of size, market position, or existing network of routes of an airline. Competition is consequently presumed to be equal. In practice, this is unlikely to be always true, for a variety of reasons stated in the previous and following chapters. Some airlines will have a better starting position than others either by reason of historical endowment if they have been transferred into the private sector (e.g. BA) or by reason of public policy if they are publicly owned (e.g. Air France). This structural imbalance will clearly preclude equal opportunity of competition between an incumbent airline and a new or smaller airline. No measure of preference for new or smaller airlines would be possible, if for example this was deemed to be an appropriate way of redressing the imbalance unless it was disguised under one or more of the exemptions permitted under the Regulation.

Deregulation of fares

In respect of scheduled fares for domestic services, the CAA made a recommendation to the Government in 1984 that it no longer saw the need for their detailed regulation, but would nevertheless retain the powers to deal with anti-competitive behaviour.³³ The proposal came in the light of the Government's request to the CAA to review the airline competition policy and the effects of privatising BA on UK airline competition. The response of the Government to this proposal was favourable and it stated in its White Paper that the deregulation was welcomed to the extent that it would foster greater price competition between airlines.³⁴ The effect of this deregulation has not been remarkably different from that on charter services. In terms of licensing and hearings, it has removed the necessity for the specific approval of the CAA for each change in fares and consequently eliminated the opportunities for objections against such changes. There is consequently a greater degree of freedom for air transport operators to set fares which they judge as acceptable by users, although the CAA continues to require the filing of fares to monitor any anti-competitive or predatory practices. In terms of user benefit, price competition has no doubt entailed lower air fares although this is more apparent at the lower end of the market, principally the flexible and leisure travel market. Business fares are generally inelastic since demand are less susceptible to change although BMA's challenge to business class pricing on European routes is a notable exception.³⁵ Nevertheless, competition in quality or product variety can still be intense even within the constraints of demand inelasticity. More recently, however, the EC Commission has published a report on the progress of liberalisation and noted that all categories of fares except promotional fares had risen in spite of the liberalisation measures intended to increase the competitiveness of the industry.³⁶

33 *Ibid.*, paras.94-95.

34 *Airline Competition Policy* (Cmd.9366, 1984), para.26.

35 CAA, *Airline Competition in the Single European Market*, CAP 623 (1993).

36 *Impact of the Third Package of Air Transport Liberalization Measures* COM(96) 514.

Although the direct effect of competition on the level of fares or the range of products is seldom determinable with any degree of accuracy, an inference can nevertheless be drawn. For instance, when competition was first introduced on the Heathrow-Glasgow route in 1982, BMA priced a one-way Economy fare at £49.50, providing around a 10% reduction of BA's Economy fare which itself had been reduced from £57 to £55 just prior to BMA's entry. However, by 1985, the 10% differential had disappeared following a series of increases by BMA which were faster than BA's rate of increase, and by the end of 1986, the one-way Economy fare was £72 for both BA and BMA. Whilst it is true that the fare reduction had only been temporary, the stimulus to introduce product variety within the confines of price inelasticity was evident in BA's decision to "recapture" its market share by introducing the SuperShuttle fare which guaranteed seats for all passengers, including a back-up service if necessary, and provided a normal refreshments service. This was in response to BMA's normal catering service of hot meals and snacks including a full bar service. A significant product change or addition as a result of competition on these routes was the introduction of the promotional Advanced Purchase Excursion (APEX) return fare in 1984 which undercut the comparable Excursion return fare by almost 30%. At the end of 1984, BA was offering an APEX return fare of £68 compared to its Excursion return of £96. This 30% differential was broadly similar to BMA's fares which charged £67 and £96 respectively. Although the one-way Economy fare had increased in real terms, the APEX return fare remained broadly similar in 1986 to the level when it was first introduced in 1984. BMA, for instance, was charging £71 for the APEX, which represents approximately 37% reduction of the £114 Excursion return fare. BA, however, had withdrawn the Excursion return fare but offered the APEX return at £74. These changes represented a substantial savings for the users in real terms for fares at the lowest end of the market and "will almost certainly have stimulated some traffic growth."³⁷ The CAA concluded,

This, together with a high level of satisfaction indicated for other services suggests that the presence of a second Heathrow operator has improved directly or indirectly the quality of the air product offered on these routes.³⁸

Recent developments have also provided a clearer relationship between the effect of competition and fares. EasyJet, a low-cost carrier, operating out of Luton Airport has introduced a £29 one-way fare as its lowest applicable fare for services to Scotland including Glasgow. Although this is in no-way an airport-airport competition, but as a city-pair service between London and Glasgow or Aberdeen, it has pioneered low-cost services in competition with BA and BMA. Much of this can be attributed to the freedom to set fares and Community legislation. New carriers including Go and others have also seized on this freedom to enter the market and to set competitive fares against the incumbents.

Fares deregulation for intra-Community air transport was introduced in 1993 in accordance with Council Regulation 2409/92, though the removal of

³⁷ Para.3.14.

³⁸ CAA Paper 87005. para.14.9.

restrictions on fares under this Regulation is no more than a confirmation of the CAA's regulatory policy since 1984. The Regulation, however, consists of a number of exemptions which permit the control of fares. These are considered in chapter seven. Notwithstanding that fares are to be determined "freely by market forces" under this Regulation, routes which fall outside this Regulation, that is international routes between the UK and a non-member country, will continue to be subject to the CAA's liberal regulatory policy on fares. In this regard, regulatory intervention would be minimal, and limited to instances when it is required to act in accordance with an international agreement or anti-competitive allegation.

Deregulation of capacity

Likewise, the CAA has abandoned the regulation of capacity because it believes that decisions on how frequent services should be scheduled or the size of aircraft to use are those which need to be left to the operators rather than second-guessed by the regulator. For instance, in its decision on Jersey European Airways' application to operate on the London(Gatwick)-Jersey route, the CAA stated in response to a capacity objection that it was not persuaded of the need to impose any capacity restriction, a practice which it has not adopted for some years. Capacity would only be restricted in cases where there are constraints on competition.

Its policy of not restricting licences except in these circumstances is based on a view that airlines should be free to respond to changes in demand and to market conditions generally and it would need compelling reasons to depart from this policy in the absence of any external constraints.³⁹

Freedom to decide on frequency or capacity levels has, with hindsight, become a key strategy for securing or maintaining market share in the face of increasing competition. In the absence of such freedom, operators would be constrained to a much wider extent including decisions on the types of product which they may wish to introduce. For instance, in its analysis of competition on the domestic trunk routes, the CAA noted that the freedom to set frequency and capacity levels enabled airlines "to restrict or control capacity made available for promotional traffic and the market expansion which occurred may have resulted from an increase in capacity made available at the lower fare levels."⁴⁰ Consequently, the deregulation of capacity has not only provided the freedom to decide, but has enabled airlines to focus more sharply on particular sections of the market through the highly effective tool of yield management, and the evidence accumulated by the CAA in its study points to the increasing significance placed by airlines on frequency as a key competitive service feature. This was apparent in the competition between BA and Dan-Air on the London-Manchester sector. Of course, the effect of increased frequency may lead to a fall in the "passenger load factor" initially, but if growth in traffic can be stimulated by the combination of frequency choice and product variety, the load factor may recover to previous levels. The decision of the CAA to deregulate capacity has now been underlined by Article 10 of Council Regulation 2408/92

39 Decision 1/93, para 12.

40 CAA Paper 87005, para.3.14.

which prohibits capacity restrictions on intra-Community routes, thus providing freedom of decision to operators. This, however, is subject to a number of exemptions which are considered in a subsequent chapter.

General Observations

The essence of deregulation is to remove the regulatory constraints imposed on airlines on matters such as route, fares, capacity and frequency of services. This is premised on the belief that forces of the market place would ensure that air transport operators act sensibly so as not to drive themselves to the brink of collapse. A competitive, multi-airline industry is, however, not conditional upon total deregulation. On the contrary, the effect of deregulation may be exactly the opposite if the structural problems of the industry were not addressed in the first instance. It would have been impossible in the case of British air transport to achieve any substantial degree of contestability if the conditions for sustainable competition were not procured through the positive regulatory actions of the CAA. It is therefore arguable that the aims of total deregulation are just as attainable under a system of regulated competition, where the regulatory policy is to bring about more competition, rather than restricting it. Fares and capacity no longer require the approval of the CAA, and routes no longer have to be allocated by a regulatory body subject to legalistic contests. A principal force behind the US deregulation movement in air transport was the very rigidity of such a system which impeded innovation and destroyed incentives. An industry in which there is a high rate of change simply has no room for such constraints. A regulator or a regulatory agency cannot always be the best judge of what are the appropriate fares to charge nor the route to operate without creating a degree of artificiality in the operations of an air transport operator. On the contrary, these are matters which ought to be decided by the operator as part of its daily commercial decisions.⁴¹ Disciplining commercial decisions of air transport operators by reference to market forces is essentially a system of "regulation by incentives". By this, it is meant that a carrier will make a decision on the basis of whether it will provide an adequate level of return, without direct regulation or coercive direction from the government or its agency. If a particular decision, whether on fares, capacity or routes to operate, is not likely to produce such a return simply because there is a lack of demand, there will be neither commercial rationality nor incentive to implement the decision.⁴²

While there is little doubt that the CAA would not subscribe to the deregulation model in the US in introducing unregulated competition, where necessary it would seek to reduce the prescriptive regulation of airlines and their commercial decisions so as to enable the forces of the market system to act as a discipline for their behaviour and decisions. The view of the CAA on necessary

⁴¹ Of course, exceptions will have to be made, say, in a case where a public service obligation exists to ensure regularity of services is maintained even if those services are not profitable.

⁴² On incentive regulation, see the efforts of James Landis at the US Securities and Exchange Commission, an administrative agency often cited as "the most successful of all federal regulatory agencies": T.K. McCraw, *Prophets of Regulation* (Belknap Press, Harvard: 1984), ch.5.

regulation is in accordance with its belief in a minimalist philosophy on regulation as well as the statutory duty to minimise regulatory burdens imposed on the industry. Nevertheless, regulation will continue to be appropriate in instances where competition is lacking to satisfy the interests of users or where it may be open to abuse. The question is not one of regulation or deregulation for the CAA. It is a question of more or less regulation. The body of case-law which the CAA has developed through its licensing function since 1972 amply demonstrates that while it has adopted a more liberal licensing approach, needing compelling evidence to be persuaded against the grant of a particular licence, it continues to maintain regulatory oversight of fares through the fares filing system and through the monitoring of market developments to ensure that a competitive, multi-airline industry is maintained and, if so required, to exercise its regulatory powers to that end. Likewise continuous regulatory oversight is required on route licensing so that restrictions on competition such as bilateral conditions stemming from an air service agreement with another country and access to congested airports can be duly considered.⁴³

It should be added that the early years of licensing competition by the CAA were not without difficulties. Indeed, with hindsight, the CAA accepts with much regret that certain of its decisions were not what they should have been. A good case was its refusal to license BMA on the Scottish trunk routes, that is London-Glasgow and London-Edinburgh, because it regarded that the time was not appropriate,⁴⁴ but which was subsequently overturned by the Secretary of State on an appeal.⁴⁵ When, however, it did decide to license BMA on the London-Belfast route, BA applied for judicial review against that decision on the ground that the CAA had departed from the requirements of the Act and the CAA's own policy on competition. In particular, it argued that the CAA had placed an undue emphasis on competition when it remarked that "competition should therefore be allowed where it is practicable to introduce it" contrary to the terms of s.68(2) of the Civil Aviation Act 1982. Furthermore, BA claimed that if there had been such a policy change, they were not consulted so as to enable them to make the appropriate submissions.⁴⁶

The basis of the CAA's decision was that BA was then operating a shuttle service from Heathrow to Belfast. It was therefore beyond dispute that a conventional scheduled service operated by BMA alongside BA's shuttle service would be a benefit to users. The question remaining was whether BA might discontinue its shuttle service in the face of the competition from BMA. On this point, the CAA concluded that the risk of BA withdrawing its service was small and "certainly not sufficient to justify refusing" BMA's application. It added that,

It is hardly credible that no profitable way can be found to cater for this traffic volume, particularly in the light of British Airway's own improvements in its costs levels... Whilst therefore

⁴³ See ch.6, *infra*.

⁴⁴ Decision 17/81.

⁴⁵ Official Record Series 2, 529 (3 August 1982).

⁴⁶ *R v CAA ex p British Airways Board* (1983) CO/943/83. Transcript of 21 September 1983.

it is quite possible that British Airways may incur some losses in the short term on the Belfast route and possibly, in view of the integration of the shuttle network, on that network as a whole, it is to be expected that in the longer term it will not be beyond the ability of British Airways to restore both the route and the shuttle network as a whole to profitability, so long of course as the market continues to require the shuttle product.⁴⁷

The CAA reasoned further that it was almost always the case that an incumbent's profit would be affected with the introduction of a competing service. Nevertheless, under the terms of the Act it could not be taken that this was itself sufficient to deny a licence for a competing service where the benefits are likely to be substantial.⁴⁸ This interpretation of its duties was simply stating the obvious. If the loss of profit of an incumbent was regarded as the overriding consideration against licensing a competing service, then the benefits of competition would never be realised. Even so, the question remained as to whether the CAA had placed an undue emphasis on competition and in doing so failed to have sufficient regard to other effects that "any newly licensed air transport services may have on existing services" in accordance with s.68(2) of the Act. (sic) Woolf J, as he then was, was emphatic in his judgment that the statement cited by BA must not be taken out of context, but be read as part of the entire decision, especially in respect of administrative decisions where "errors of expression can occur which do not necessarily mean that proper consideration has not been duly given to the decision." Accordingly, Woolf J rejected the submission of BA that the CAA had not taken into account the short term loss of profitability as a factor among others, except in the context of whether it was a matter to be considered as a total bar to the grant of a licence. He said that it was clear from the decision as a whole that the CAA appreciated that there were broader issues involved, and that there were circumstances where consideration of short term profitability together with others might constitute a reason refusing a licence.

This decision was important in a number of important respects. First of all, it reaffirmed the discretion of the CAA, and the interpretation it had adopted as appropriate under the terms of the Act, that is to license liberally for competition. Secondly, it was also a vindication of the overall approach by the Government in respect airline competition in the form of the earlier appeal decisions of the Secretary of State concerning the Scottish truck routes.

Deregulation and Antitrust Safeguards

Since the consequence of economic deregulation is to expose the economic operations of an airline to the forces of the market place and to remove regulatory intervention in the decisions of airlines, there is nevertheless a continuing need to ensure that this freedom is not abused or exploited beyond

⁴⁷ Decision 7/83, para.76.

⁴⁸ *Ibid.*, para.77.

the norms of accepted practices. Both theory and practical experience suggest that deregulation precipitates the tendency in airlines to merge or consolidate their resources. Whilst mergers or cartelisation may often be aimed at the rationalisation of resources, they may also have the effect of creating a dominant position that leads to the elimination of competitors.⁴⁹ However, the existence of a dominant position *per se* is not unlawful. Indeed, as the CAA recognises, some mergers "may have neutral or beneficial effects in terms of the objectives of the Act."⁵⁰ Others, however, may lead to market abuses which are not compatible with the public interest. It is in respect of the latter which has required certain regulatory safeguards. However, enacting regulatory measures on their own against abuses of dominant positions is insufficient. They need to be enforced vigorously. It was the failure to adopt this attitude which led to the criticisms against the Department of Justice of the US Government for waving past post-deregulation mergers when it took over the antitrust enforcement responsibility of the CAB. Equally, removing economic regulatory oversight enables airlines to set fares or capacity according to their commercial judgment, though some regulatory intervention remains necessary to reflect the disparities in the economic strength of the participating airlines. Some airlines will be bigger and economically stronger than others, and this clearly creates a non-level playing field. Stronger airlines may be able to set fares which are below the costs of operations more readily and for a much longer period than a smaller competing airline since it would be more able to absorb the losses. A smaller airline which pursues a similar line of competition for the same period of time is likely to be driven to the brink of bankruptcy. This is generally regarded as an unfair or anti-competitive practice against which there has to be regulatory safeguards either to prevent such practices or to provide remedies for any damage caused by such practices.

It is a key contention of this thesis that where critical market contestability has been achieved, that is sustainable conditions of competition, the liberalisation or removal of economic regulatory controls must be accompanied by a system of antitrust regulation. In most cases, economic regulation and antitrust regulation are required to operate side by side particularly where the need for competition regulation arises in the first place as a result of some structural barriers. The task of antitrust regulation may be conferred on the same economic regulatory agency or a different agency. Accordingly, the remaining part of this chapter is divided into two sections, in which the first will examine the role of the CAA in antitrust regulation through the economic regulatory machinery and the use of licensing conditions. The second will look at the general antitrust laws as they apply to air transport.

Licensing Against Anti-Competitive Practices

The antitrust enforcement responsibility in the UK is two-fold, although it is primarily the responsibility of the competition authorities, namely, the Office of Fair Trading (OFT) and the Monopolies and Mergers Commission (MMC), now the Competition Commission. The role of the CAA is limited though by

⁴⁹ A dominant position is usually characterised by a market share in excess of 25%.

⁵⁰ CAP 620, para. 10.

no means insignificant. For a number of years, the CAA has represented to the Government of the need to confer on it formal competition enforcement powers, but which the Government has flatly refused on the basis that the "existing powers are adequate to maintain and promote competition in the airline industry including action against anti-competitive and predatory behaviour."⁵¹ The Government recognised in its White Paper that regulatory actions against anti-competitive behaviour may be taken by the CAA indirectly by virtue of its licensing powers by, for instance, attaching conditions to an air transport licence, refusing to lower fares which are predatory or enforcing capacity or frequency reduction. To that end, the CAA has included in its *Statement of Policies on Route and Air Transport Licensing* when and how it intends to intervene against *mergers, abuses of dominant positions and anti-competitive behaviour*.

Mergers

While the CAA recognises that certain mergers or acquisitions may have effects beneficial to user interests, it has explicitly stated in its policy statement that acquisitions, particularly of routes, does not generate any preference on the part of the acquirer.

Where...the acquisition by one airline of another together with its routes could lead to a reduction in competition the Authority will give no preference simply on the grounds of incumbency on the route in question. In reaching its decisions, the Authority will have regard in particular to the maintenance of a competitive environment.⁵²

This is a striking illustration of how the CAA will exercise its regulatory powers of licensing air transport to deal with merger cases, in relation to which it lacks direct enforcement powers. A useful case in point is the merger of BA and B.Cal. which happened soon after the privatisation of BA. In accordance with the undertakings given to the MMC,⁵³ BA surrendered the licences of B.Cal which the CAA had recommended in its submission during the inquiry. These licences would then be opened to application by other airlines. While the applications which ensued were unique in the sense that they followed the first ever merger reference between two UK airlines to the MMC to which also the CAA had submitted its views, the CAA refused BA's applications for a re-allocation of the surrendered licences on the strength of its long-term policy to achieve a competitive environment between UK airlines. In doing so, it made the following observations.

If licensed on Gatwick-Brussels, BA would have the ability to operate as many services as they thought appropriate from either Gatwick or Heathrow, limited only by their slot access at each airport. Given their control of nearly 40% of the slots at Heathrow, and 25% at Gatwick, the limiting factor for BA

51 *Airline Competition Policy* (Cmnd.9366, 1984), para.28.

52 CAP 620, para.10.

53 *British Airways plc and British Caledonian Group plc Merger* (Cm.247, 1987).

would be the opportunity cost of those slots rather than their availability as such.⁵⁴

Specifically, it noted that it was improbable that Air Europe could succeed in their plans if their policy was simply emulation of BA's activities. According to the CAA, BA's history, expertise and market power would threaten to condemn Air Europe "to being but a pale shadow of the major UK airline."⁵⁵ Hence, if Air Europe were to succeed, they would be able to do so only if they had the ability to offer a product which was potentially and significantly different from that offered by BA. The CAA added that this difference was likely to evince itself mainly in the lower-cost, lower-price but nonetheless good quality product features. In the final analysis, the CAA did not believe that there was any real likelihood that Air Europe was able to act in this way if BA had a substantial presence on the route in question from both Heathrow and Gatwick.

Market Abuses

Abuses of dominant positions, or the exploitation of market power as the CAA calls it, would trigger the regulatory intervention of the CAA if to do so would be acting in the interests of users. The intervention would take the form of a change to the conditions of the air transport licence. The CAA accepts that competition cannot be possible in every situation to realise of the objectives of the Act for a number of reasons. But where the realisation of these objectives was threatened by an exploitation of market power, it would act promptly to investigate and to ensure appropriate remedies. In particular, it would intervene,

where, after taking into account the relevant market, 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.⁵⁶

But it is not likely to invoke its regulatory powers for this purpose if the overcharging or conditions of travel such as in-flight facilities could be demonstrated as reasonably related to the costs of provision. Regulatory intervention under the market exploitation concept appears to focus primarily on the issue of fares and their effect on users, and less so on the effect of the exploitation on competitors even though damaging competitors is likely to have the effect of threatening the realisation of the statutory objectives. Such cases, however, may be more appropriately examined as one of anti-competitive behaviour.

Anti-competitive behaviour

As regards the regulation of anti-competitive behaviour then, the policy statement indicates the willingness of the CAA to intervene in a broader range of cases.

The Authority will use its regulatory powers where the realisation of the objectives laid down in the Act is threatened by anti-competitive behaviour including but not limited to:

⁵⁴ Decision 7/88, para.61.

⁵⁵ *Ibid*, para.63.

⁵⁶ CAP 620, para.15.

- (a) the charging of fares and rates at levels which are insufficient to cover costs of providing the services or facilities to which they relate or which are otherwise unreasonably;
- (b) the payment of commissions at rates which are higher than the airline otherwise pays;
- (c) the addition of excessive capacity or frequency of service;

where such behaviour would have or would be likely to have or is explicitly intended to have the effect of crippling, excluding or driving off a competitor.⁵⁷

Although the CAA does not possess the enforcement powers against such behaviour or practices nor powers to award damages, the use of its regulatory powers against them is equally, if not more, effective. How its regulatory powers are to be exercised must clearly vary according to the circumstances of each case. In one instance, it may be that the charging of fares at an unreasonably low level is not compatible with the statutory objective of furthering the reasonable interests of users since the effect of an anti-competitive behaviour may be to cripple, exclude or drive off a competitor, thus eliminating active competition and threatening the multi-airline policy conceived under the Act. Variation of the licence, whether the revocation of a particular route authorisation or indeed substitution by another airline, may ensue. A similar situation in which there has been an addition of excessive capacity may also be conceived. No air transport licence holder would cherish the prospects of having its licence varied, nor in an increasingly liberal and competitive environment, would it wish to see the return of more interventionist economic regulation. However, before a regulatory remedy is handed-out the CAA will need to be convinced that the anti-competitive behaviour complained of would have "a serious effect on the complaining airline". And if it did, whether also there would be an offsetting user benefit which otherwise may render the remedy disproportionate to the perceived ill.⁵⁸

In 1990, BMA applied to the CAA asking it to vary the licence held by BA on a number routes originating from Heathrow on the ground that the latter had introduced excessive capacity or frequency of service, thereby threatening the objectives pursued by the CAA. The application represented one of the most difficult cases which the CAA had been invited to adjudicate, principally because it was being asked to restrain BA's actions "even though there was nothing inherently improper about them and they could not be characterised as 'anti-competitive' in the sense that they were actuated by malice."⁵⁹ It was therefore being asked to decide the difference between legitimate competitive behaviour and anti-competitive behaviour, which difference at any rate would only be a matter of degree. In this context, the CAA noted that the application went to the heart of its regulatory policy. It explained that the regulatory policy in respect of anti-competitive behaviour was designed to eliminate "behaviour

57 *Ibid.*, para. 12.

58 *Ibid.*, para. 13.

59 Decision 7/90.

whose ultimate effect may be to undermine or destroy competition, irrespective of motive." It accepted that this conferred a considerable wide margin for the interpretation of its powers although it pointed to the need for such anti-competitive behaviour to threaten the realisation of the statutory objectives as a means of structuring its discretionary powers. The anti-competitive behaviour complained of does not, therefore, have to have repercussions on the operations of competitors so long as intervention can be justified either on the ground that the multi-airline policy or the statutory objectives were being threatened.

The determination of an anti-competitive behaviour is dependent on three basic tests.⁶⁰ According to the CAA, it would have to ask itself first, whether the actions complained of have a serious effect on the complaining airline. Secondly and if so, whether there is an offsetting benefit for the users. Thirdly and perhaps more significantly, the remedy sought must be proportionate to the perceived ill. In disposing of the first question, the CAA began with the proposition that neither BMA nor any other airline can hope to be immunised against competition under the regulatory policy. An argument to the contrary "would be to deny the very benefits the Authority's policies are intended to achieve". While it accepted that the prospects of BMA would be affected to some extent by BA's actions, the former had not indicated that its presence on the routes concerned would be eliminated by those actions. On the contrary, the CAA reasoned that,

If two airlines are in nose-to-nose competition at the same airport, the suggestion that the larger cannot increase frequency unless the smaller is both able and willing to do so as well would put shackles on one of the most effective competitive weapons in an airline's armoury. It cannot be right that an airline's freedom to meet what it perceives as a passenger demand can be frustrated in so arbitrary a way.⁶¹

In respect of the second question, the CAA decided that the additional frequencies at more attractive times and the different quality of service by BA were evidence of improved user benefit. Finally, the CAA was not persuaded that by putting the actions of BA into reverse was an appropriate remedy in the light of the benefits countenanced. An aggrieved airline must, at any rate, be able to demonstrate convincingly that detriments outweighed the benefits such that the remedy sought would not be disproportionate to the perceived mischief of the anti-competitive action.

The role of the CAA, however, in enforcing its regulatory powers is *reactive* rather than *proactive* since it takes the view that unless an airline has complained to it about a particular anti-competitive behaviour, it should not busy itself with interfering in a matter of which the airline concerned has not seen necessary to complain. It would act only where individual allegations of anti-competitive behaviour suggest the existence of a *prima facie* case.⁶² This was the view of the Economic Regulation Group Director in an interview when

60 *Ibid*, para.30.

61 *Ibid*, para.36.

62 CAP 620, para.4.

asked about the unprecedented spectacle between Virgin and BA over the latter's alleged anti-competitive practice. Not only did the Chairman of the CAA offer its good offices to mediate the allegations, Virgin was properly advised that it could seek the intervention of the CAA in the matter.⁶³ Clearly though, unless Virgin was interested in the variation of BA's licence and which would generate tangible benefits, arguably, the regulatory intervention of the CAA will not compare well to the punitive or "triple" damages obtainable under the antitrust laws of the US.⁶⁴ It must also be said that the advent of Community legislation, however, has restricted the role of the CAA in antitrust regulation through the use of its economic regulatory powers to those routes or services involving a non-Community destination.⁶⁵

General Antitrust Regulation

As the regulatory powers of the CAA on competition is no more than a matter of coincidence arising from its licensing powers, the direct responsibility for competition regulation and enforcement is vested in the OFT, the MMC and ultimately the President of the Board of Trade. Other than subject-specific legislation on competition,⁶⁶ there are three principal legislations governing unfair conduct in competition: Fair Trading Act 1973 (FTA); Restrictive Trade Practices Act 1956-1976 (RTPA); Competition Act 1980 (CA).⁶⁷ The application of these legislations to air transport is ironically limited and less rigorous, *despite* the submission of the Government that antitrust regulation of air transport must remain with the national competition authorities. For the purposes of the present analysis, it would be convenient to classify air transport services as international, domestic, scheduled, and charter.

Fair Trading Act 1973: Monopoly References

The initial authority to investigate a monopoly rests with the Director-General of Fair Trading (DGFT). A monopoly situation *per se* is not prohibited, unless it operates against the public interest. To determine whether a monopoly exists the DGFT has to consider whether an undertaking or combination of undertakings has at least 25% of the market in question.⁶⁸ Where the monopoly in question has been established according to these terms, a reference may be made to the MMC to determine whether the monopoly operates against the

63 Interview with the author, 8 November 1994.

64 This has been documented elsewhere, see J.Goh, "Fear and Loathing in the Air" [1992] 142 *New Law Journal* 822; 868.

65 See ch.7, *infra*.

66 E.g. legislation for the utilities sector. Competition and Service (Utilities) Act 1992.

67 At the time of writing this thesis, the Government had just enacted the Competition Act 1998 to make a comprehensive amendment to the competition law by introducing a prohibition approach to anti-competitive agreements and abuse of dominant position, consistent with Community competition law. In addition, the MMC would be replaced by a Competition Commission which will have an appellate function from the decisions of the DGFT and a reporting function. However, the legislation will not come into force before 2000. The proposals do not include any plan to change the powers of the CAA in respect of airline competition: Department of Trade and Industry, *A prohibition approach to anti-competitive agreements and abuse of dominant position: draft Bill* (August 1997) and the Competition Act 1998.

68 Ss.6-8, Fair Trading Act 1973.

public interest.⁶⁹ S 50 and Schedule 7 to the Act, however, exclude from the scope of monopoly references certain provision of goods and services one of which is the carriage of passengers and goods by air. The position has since been amended by the *Monopoly References (Alteration of Exclusions) Order 1984*⁷⁰ which brings within the jurisdiction of the DGFT and the Secretary of State to make monopoly references in respect of international charter flights. It provides that the exclusion continues to apply only to "international carriage by air, otherwise than on a charter flight". Since monopoly references for domestic flights were already within the jurisdiction of the DGFT and the Secretary of State, the effect of this order was, therefore, to enable monopoly references to be made in respect of all domestic and international charter services. This arrangement is a logical complement to the liberalisation of the air transport sector since it would seek to ensure that freedom from economic regulatory controls did not lead to monopoly situations. This is especially true of domestic and all charter flights where a substantial degree of liberalisation has been introduced. International scheduled flights, however, are complicated by the use of bilateral agreements between the two countries and it seems appropriate that monopoly or antitrust issues are resolved within the bilateral framework.

Be that as it may, the economic theory of competition would seem to suggest that monopoly references are likely to be rare. This would be so as long as the contestability of the relevant market is ensured so that where a monopoly situation does arise it would be because of market efficiency gains including mergers. This factor alone cannot justify regulatory intervention unless it is convincingly demonstrated that the monopoly would operate against the public interest or that competition would be adversely affected. To put it another way, the presumption must be to let the forces of the market place to operate. Thus, a very hard look at the case must be taken. This argument would seem to accord with the approach envisaged under Community antitrust laws, where the provisions of Article 86 are concerned with only abuses of a dominant position. The presumption would be that monopolies or dominant market positions as a result of efficiency gains are not prohibited unless it can be shown that their practices are anti-competitive or amount to an abuse by virtue of that market power. Under UK competition law, the jurisdictional test of whether to intervene is not an economic one but rather a question of whether the undertaking dominates at least 25% of the relevant market. Having established the existence of this dominance, the substantive test of intervention becomes whether the dominant undertaking would operate against the public interest.

Fair Trading Act 1973: Merger References

Merger references to the MMC are made if the proposed merger qualifies for investigation because it results in two or more undertakings ceasing to be distinct enterprises and that the merger provides for a market share of more

⁶⁹ Under the planned changes, the DGFT will also be given the power to require information to decide whether to recommend that the Secretary of State should accept the enforceable undertakings in lieu of a monopoly reference. The power to seek enforceable undertakings was introduced by the Deregulation and Contracting Act 1994: *passim*, para.11.17.

⁷⁰ SI 1984/1887.

than 25% in the UK or a substantial part of it or the value of assets to be taken over exceeds £70 million.⁷¹ A merger, however, would only be prohibited if it was expected to operate against the public interest. Merger references in air transport have not been subject to exclusionary measures, but they have instead been exposed to political considerations much more conspicuously. Two merger cases are worthy of note here. In 1988, when the "second force" airline, B.Cal., had demonstrably failed to achieve the aims set for it and subsequently failed to compete successfully with the newly privatised BA, the latter proposed a bid for the take-over of B.Cal. Since both BA and B.Cal. together dominated the services from London(Heathrow) and London(Gatwick), the consolidation readily satisfied the thresholds as a qualifying reference to the MMC. In the first ever airline merger reference, the MMC findings confirmed the fears that many shared of the possible elimination of active competition with the take-over against which a number of remedial steps were required including highly significant undertakings from BA to surrender all the licences of B.Cal on domestic routes, certain licences on European routes and to surrender a minimum of 5,000 slots at Gatwick.⁷² The MMC concluded that in the light of this, the merger would "make the market power of the merged airline in relation to other British airlines smaller than we originally thought it was likely to be."⁷³ More significant, however, was the intervention of the European Commission to investigate the merger on which it concluded that the proposal on its original terms would substantially reduce airline competition within the Community. The result of the investigation led to further and considerably more substantial undertakings from BA, in addition to those already given to the MMC, to foster the emergence of new competitors.⁷⁴

Whether this merger was the consequence of BA's privatisation is clearly arguable.⁷⁵ In one respect, it may be argued that B.Cal's position would eventually have become untenable even if BA had stayed under public ownership. The difficulties which it was then experiencing, namely the lost of profitability on key routes to Tripoli after the US bombing of Libya, to the recession struck Middle East, and to Western African countries which were facing currency problems, would have remained regardless of whether BA was under private or public ownership. In the end, the Government would either have to intervene directly to disband B.Cal as the 'second force' airline or at least to require BA to take-over B.Cal's routes. Privatisation of BA in a sense simply made it easier for B.Cal to survive.

71 Ss.64-75, as amended by the *Merger References (Increase in Value of Assets) Order 1994*, SI 1994/72.

72 It was noted that the surrender of these licences which were not subsequently re-issued to BA by virtue of a renewed application would involve the return of approximately 20,000 slots of the total 33,500 available at Gatwick: *British Airways plc and British Caledonian Group plc Merger* (Cm.247, 1987).

73 *Ibid.*, para.8.80.

74 See Press Release ISEC/7/88 (10 March 1988).

75 See R.Baldwin, "Privatisation and Regulation: The Case of British Airways" in J.J.Richardson (ed.), *Privatisation and Deregulation in Canada* (Dartmouth Publishing, Dartmouth: 1990).

A second and more recent merger case is the take-over of Dan-Air by BA. After an initial consideration, the Secretary of State in agreement with the OFT refused to refer the merger to the MMC on the basis that "the public interest would be better served by not referring".⁷⁶ This decision subsequently became the subject of a judicial review application by BA's competitors, namely, BMA who were particularly concerned with the competition implications of the merger on its services, but more generally with the policy implications of such a merger. If BA, a dominant airline, was permitted to take-over financially troubled airlines, serious doubts would be raised as to the integrity of UK airline competition policy. The European Commission had refused to intervene in the matter on the ground that the merger did not have a "Community dimension" under the Merger Control Regulation 4064/89.⁷⁷ In the High Court, Schiemann J. refused to grant the leave sought by BMA, Virgin and others. An appeal was subsequently dismissed by the Court of Appeal.⁷⁸ The refusal to grant leave in this case seems consistent with a fashion that has perhaps gradually become predictable in comparable cases where the courts have been reluctant to intervene even at the substantive stage of the proceedings.⁷⁹

If any particular aspect of antitrust regulation was to be singled out as especially important, it would be the regulation of airline mergers. This is because the airline business is capital intensive and depends substantially on the economies of scale and scope. Given this, there is a great propensity to consolidate resources, either for greater access to a particular market or access to more airport slots. Liberalisation has given airlines more freedom to decide on matters such as markets and routes. A large airline, for example, may not consider penetrating a particular market as viable because its fleet of aircraft is not suited to the nature of the market in question. Merging with another airline may therefore give access to the 'feed traffic' of the market. In addition, national laws may prevent or limit the acquisition of a local airline by a foreign-owned airline. This has seen a variety of responses ranging from code-sharing agreements to franchise agreements. Not all mergers are detrimental to competition and user interests. But where these are threatened, to maintain critical market contestability demands an austere antitrust policy in the first instance and a searching approach to each individual case.

⁷⁶ *Financial Times* (4 November 1992). Among the dominant issues was that of employment and the impact that the merger or non-merger would have on the employees of Dan-Air.

⁷⁷ The "Community dimension" threshold is (i) an aggregate world-wide turnover of all undertakings concerned in excess of ECU 5000M and (ii) an aggregate Community-wide turnover of each of at least two of the undertakings concerned in excess of ECU 250M: see Council Regulation 4064/89, OJ [1989] L395/1.

⁷⁸ *R v Secretary of State for Trade and Industry ex p Airlines of Britain, Virgin Atlantic Airways and Others*, *The Independent* (8 December 1992).

⁷⁹ See e.g. *R v MMC ex p South Yorkshire Transport* [1993] 1 All ER 23; *Lonrho plc v Secretary of State for Trade and Industry* [1989] 2 All ER 609; *R v Secretary of State for Trade and Industry ex p Anderson Strathclyde plc* [1983] 2 All ER 233. It is interesting to note that under the proposed changes to the competition law, the Government intends to improve the transparency of competition decisions by providing greater reasoning where the minister disagrees with the recommendations of the MMC: *passim*, para. 11.12.

Restrictive Practices in Air Transport

When the FTA 1973 was enacted, a provision was inserted to extend the RTPA 1956 to include restrictive agreements relating to services.⁸⁰ The effect therefore was to bring restrictive agreements relating to both goods and services within the ambit of the restrictive practices legislation. Agreements relating air transport *as a whole* were and continued to be excluded by the *Restrictive Trade Practices (Services) Order 1976*.⁸¹

Competition Act 1980: Anti-Competitive Practices

The chief purpose of the CA 1980 is to control anti-competitive practices pursued in a course of conduct which has or is intended to have or is likely to have the effect of restricting, distorting or preventing competition.⁸² A preliminary investigation into a course of conduct may be carried out by the DGFT where an anti-competitive practice has been alleged which may lead either to undertakings being given if an anti-competitive practice is established, or to a MMC reference. As regards anti-competitive practices in air transport, the Secretary of State invoked his powers under s.2(3) of the CA to make exemptions by enacting the *Anti-Competitive Practices (Exclusions) Order 1980* which provides, *inter alia*,

a course of conduct is excluded from constituting an anti-competitive practice if it is (1)(a) a course of conduct described in Schedule 1 to this Order.⁸³

Paragraph 4 of that Schedule provides further,

1 Any course of conduct pursued by an air transport undertaking solely in respect of international carriage by air [otherwise than on a charter flight];

2 Any course of conduct required or envisaged by a restriction accepted under an agreement described in paragraph 3(2) of the Schedule to the Restrictive Trade Practices (Services) Order 1976, being a course of conduct pursued solely in respect of international carriage by air [otherwise than on a charter flight].⁸⁴

The effect of the Orders is to exclude from the scope of the CA 1980 international scheduled services, but to make competition references in respect of all domestic services and international charter services possible. This is important because international scheduled services are still widely regulated by bilateral agreements, while domestic and international charter services have virtually been deregulated. Since liberalisation means airlines are able to make their own decisions and govern their own behaviour, it becomes important to ensure that decisions or behaviour which threaten competition are promptly

80 FTA 1973, s.107.

81 SI 98/1976.

82 S.2(1).

83 SI 1980/979, s.2, as amended by *Anti-Competitive Practices (Exclusions) (Amendment) Order 1994*, SI 1994/1557.

84 The words in parentheses were inserted by *Anti-Competitive Practices (Exclusions) (Amendment) Order 1984*, SI 1984/1919.

checked. A common example is the 'dumping' of capacity by which it is meant that an airline decides to increase excessively the capacity which it offers on a particular route with the intention of eliminating its competitors

Some Observations

Whilst a much thorough consideration of the detailed provisions of the competition legislation would undeniably have been more informing, it is sufficient to draw the observation that the competition framework in general is highly politicised, and more specifically in respect of air transport is unfortunately narrow. The take-over of Dan-Air by BA amply illustrates the point. The reluctance to vest in the CAA the antitrust enforcement powers is precisely related to the nature and characteristics of such cases. The CAA is a statutory corporation and an independent regulatory agency operating at arm's length from the ministers and Government Departments. Ministerial directions to the CAA are governed by statutory procedures and limited to statutorily specified circumstances which would not have envisaged directions relating to competition cases. And the system of written policy guidance which may have afforded the opportunity to communicate the intentions of the Government no longer exists.

Moreover, a strong and effective air transport competition policy cannot be developed through the adversarial processes of the courtroom. Judges are not equipped to do so nor do they necessarily have the specialist knowledge required to regulate air transport competition, although the intervention by the ECJ in similar cases may seem to suggest otherwise.⁸⁵ At any rate, the courts have shown a supreme reluctance to interfere in the exercise of discretionary enforcement powers. The combination of these barriers and reluctance to entrust the antitrust responsibility to the CAA has required the latter to harness fair competition through the use of its regulatory powers, namely by its system of licensing airlines, though the changes brought about by Community liberalisation measures have affected the extent to which the CAA is able to flex its regulatory muscle against practices which constitute either an exploitation of market power or an anti-competitive behaviour.⁸⁶

In any event, it should also be added that the antitrust provisions under EC law now apply to British air transport within the wider context of the Single European Air Transport Market. Of particular relevance are Articles 85 and 86 of the Treaty of Rome which deal with anti-competitive practices and abuses of a dominant position respectively. Mergers are dealt with under Council Regulation 4064/89 which stipulates a number of thresholds before a merger has "a Community dimension" and thus qualifies for investigation by the European Commission.⁸⁷ These issues are considered in more detail in a

⁸⁵ See ch.7, *infra*.

⁸⁶ In so far as the proposed changes to the competition law materially affect the CAA, the Government will consider whether the CAA should be given concurrent powers to prohibit anti-competitive agreements and abuse of dominant position in respect of airports. Any conflict over jurisdiction between the CAA and the DGFT would be resolved within the terms of a non-statutory concordat: *passim*, paras.9.1-9.2.

⁸⁷ (1989) OJ L395/1 as amended by (1990) OJ L257/14.

subsequent chapter dealing with Community competition law and the liberalisation programme for air transport

Consistency in Policy Application and Standard

The change in the regulatory emphasis of the CAA from the need for an air transport licence applicant to establish its case to the general presumption that licences will be granted liberally is perhaps the most significant, yet subtle, change in the regulation of civil aviation since competition was first introduced. Over the years of its existence, the CAA has exposed UK airlines to increasing competition, and this is well reflected in its body of licensing case-law and its successive policy statements. Where possible, the CAA has sought to deregulate subject to regulatory safeguards against anti-competitive practices. Where there are difficulties in doing so, the CAA has continued to regulate but within a liberal policy framework. For instance, entry into those routes falling outside Council Regulation 2408/92 is still regulated by the CAA although within a policy framework of liberal licensing which aims to create through competition equality of opportunities rather than equality of strength between airlines. Under this policy, applications for route licences will be granted unless otherwise shown to be inappropriate. Such a licensing framework providing for general statements of policy and exceptions to be made is what Galligan has called the principle of individuation which involves a "process of adopting or developing guides by generalising policies to give content to discretionary power".⁸⁸ Exceptions to the policy may be necessitated in a number of instances particularly those in which competition is likely to be absent or distorted. In spite of such exceptions to the general policy, the manner in which the policy of air transport licensing has evolved to create predictability and consistency of standard has also enabled future applicants for air transport licences to establish a reasonable idea of the prospects of its case.

Consistency in policy application, however, has also affected the long-standing system of public hearings of the CAA, though this can only be an inevitable consequence of policy clarity and coherence. A system of public hearings in which policy development has, in the past, taken place and from which a transparent, yet coherent, policy on economic regulation has gradually emerged, will inevitably lose its significance in so far as the latter is capable of informing air transport operators in advance of the approach to be taken by the CAA. Weak applications and undue objections, for instance, will be deterred. Furthermore, the use of a systematic policy on consultation and research knowledge from independent studies, thus avoiding the adversarial trappings of a quasi-judicial tribunal, has shifted the emphasis from hearings which characterised the ATLB in its days. Likewise, the deregulation of entry into intra-Community routes, of fares and of capacity have diminished the importance of hearings as a forum for policy development.

⁸⁸ D J Galligan. "The Nature and Function of Policies within Discretionary Power" (1989) *Public Law* 332. See also, L.L.Fuller, *The Morality of Law* (Yale University Press, New Haven: 1969).

The importance of regulated airline competition should be apparent from this chapter. In the main, if deregulation aims to procure more competition, then it is also true to say that a system of regulated competition can equally attain the same aim, and at the same time enjoy the benefit of being able to intervene to correct failures in the market place. These failures may be caused either by infrastructural limitations, or protectionist policies in international air transport, or restrictions from past practices. Accordingly, regulatory responses to these policies become important.

Even so, it is clear that the need for positive economic regulatory interventions have and will become less frequent; their importance will diminish as the ills of the structural imbalance are gradually eliminated, and the discipline of sustainable competition begins to play a more instrumental role. The deregulation initiatives on fares and capacity and their effects are a strong testimony to the argument that the approach to economic regulation may be minimal or liberalised where the structure of the industry is naturally competitive. Although certain constraints will prevent the full effect of competition to operate, such as the scarcity of airport slots, it is nevertheless possible to procure the aims of competition in areas where the structural barriers are no longer present, that is to say, a competitor who has the necessary capital equipment, resources and airport slots to begin a service. The freedom of the incumbent and the new operator to compete to meet the demands of the users has been described as critical market contestability.

However, to ensure that this contestability can be sustained, it is important at the same time as economic regulatory controls are relaxed or abandoned to put in place a framework of antitrust regulation that can and will be rigorously enforced. This may be the job of the same economic regulatory agency or that of another separate agency. To that end, this chapter charted the role of the CAA in using the conditions of licensing as a means for enforcing the objectives of antitrust regulation. The jurisdiction for general antitrust regulation even as they apply to air transport rests with a separate corpus of competition agencies including the European Commission in so far as an antitrust case falls within the scope of Community law.

CHAPTER SIX BARRIERS TO COMPETITION AND THE REGULATORY RESPONSE

Under conditions of perfect competition, the theory of contestability would apply to its fullest extent free from the need to make any assumptions. Economic regulation would not be needed. For reasons that are classified into three general headings, institutional, infrastructural and market-based, this chapter will set out the issues to assess the extent to which the theory is applicable to air transport in the light of those considerations and thus to question the validity of the assumption that the air transport industry is naturally competitive. For these reasons too, it will become apparent that where the conditions of natural competition can be secured, economic regulation may be liberalised or abandoned, and leaving the task of competition regulation to the antitrust laws. But where competition is not natural to the sector, economic regulation will play an important part to prevent, where possible, distortions or to eliminate restrictions in competition so that equality of opportunities can be brought about. These distortions may have been artificially created either as a deliberate public policy or through historical privilege; some, however, may have arisen over time as a consequence of industrial expansion and growth though this would not be sufficient to justify any regulatory intervention. To these issues we now turn.

Institutional Barriers: International Civil Aviation and Bilateral Agreements

Chicago Convention

The instrument central to international air transport is the International Civil Aviation Convention of 1944 concluded in Chicago (ICAO Convention) and which brought about a new, post-war system of regulation for international air transport. Part I of the Convention lays down the general legal principles of international civil aviation while Part II creates the International Civil Aviation Organization (ICAO) charged, *inter alia*, with the tasks of developing the principles and techniques of international air navigation and fostering the planning and development of international air transport to ensure safe, regular, efficient and economical travel.¹ The plenary body is the Assembly while the Council acts as the governing body entrusted with the tripartite functions of legislating by formulating Standards and Recommended Practices for international air transport, adjudicating over disputes, and supervising the implementation of international air service agreements.

¹ Article 44.

The pivotal point of international civil aviation, however, is set out in Article 1 of the Convention.

The contracting States recognise that every State has complete and exclusive sovereignty over the airspace above its territory.

This sovereignty is further re-inforced in respect scheduled international air services by Article 6.

No scheduled international air services may be operated over or into the territory of a contracting State, except with the special permission or other authorisation of that State, and in accordance with the terms of such permission or authorisation.

A different treatment, however, is accorded to non-scheduled international air services, and this is recognised in Article 5 of the Convention. :

Each contracting State agrees that all aircraft of other contracting States, being aircraft not engaged in scheduled international air services shall have the right, subject to the observance of the terms of this Convention, to make flights into or in transit non-stop across its territory and to make stops for non-traffic purposes without the necessity of obtaining prior permission, and subject to the right of the State flown over to require landing...Such aircraft, if engaged in the carriage of passengers, cargo, or mail for remuneration or hire other than scheduled international air services, shall also, subject to the provisions of [cabotage], have the privilege of taking on or discharging passengers, cargo, or mail, subject to the right of any State where such embarkation or discharge takes place to impose such regulations, conditions or limitations as it may consider desirable.

This latter provision is decidedly more liberal than those governing scheduled services, where the rights recognised under it are positively expressed. Competition is consequently more apparent in, say, charter services.

Equally restrictive is the provision on so-called cabotage services in Article 7 of the ICAO Convention. Cabotage in air transport is a highly sensitive issue, and many a time has hindered the successful conclusion of air service agreements. Cabotage, which essentially means the provision of services between two points in the same Contracting State by a carrier which registered in another State, (that is, domestic services) is defined by the Convention as "the right to refuse permission to the aircraft of other contracting States to take on in its territory passengers, mail and cargo carried for remuneration or hire and destined for another point within its territory". Furthermore, and implicit Article 7 of the Convention, a contracting State which chooses to permit the airlines of one country to exercise cabotage rights is also obliged by the Convention to make that right available to all other signatories to the Convention.

Each contracting State undertakes not to enter into any arrangements which specifically grant any such privilege on an exclusive basis to any other State or an airline of any other State, and not to obtain any such exclusive privilege from any other State.

Although the Chicago Conference was convened to organise a system of regulation where international air transport would be provided in a safe and orderly manner within an environment of fairness and equality, it also attempted to secure a multilateral agreement on the commercial rights of scheduled international air services, perhaps ambitiously. This attempt failed, but two supplementary agreements to the eventual ICAO Convention which went some way in that direction were nevertheless adopted though not by all of the signatories to the Convention itself. They are the *International Air Services Transit Agreement* (IASTA) and the *International Air Transport Agreement* (IATAg).² Both of these agreements provide for what is commonly known today as the *freedoms of the air*. The IASTA enables airlines of signatories to the agreement to exercise non-commercial rights, namely the right to fly over the territory of the State concerned without stopping and the right to land for non-traffic purposes such as, for instance, refuelling and repairs. The IATAg,³ on the other hand, provides for flights with traffic purposes.

- (i) The privilege to fly across the territory of a contracting State.
- (ii) The privilege to land for non-traffic purposes.
- (iii) The privilege to put down passengers, mail and cargo taken on in the territory of the State whose nationality the aircraft possesses.
- (iv) The privilege to take on passengers, mail and cargo destined for the territory of the State whose nationality the aircraft possesses.
- (v) The privilege to take on passengers, mail and cargo destined for the territory of any other contracting State and the privilege to put down passengers, mail and cargo from any such territory.

In addition to these five freedoms, a range of other freedoms have also emerged as result of progressive development. The sixth freedom, for example, is a species of the fifth freedom which enables a carrier to carry traffic between two different countries with an intermediate stop in the country of its registration, but which permission is not contained in a single air services agreement. As an illustration, take a UK carrier operating between Mexico and Russia with a stop in the UK. The carriage of passenger traffic between the two countries is dependent on *two* air services agreements, that is a Mexico-UK agreement and a UK-Russia agreement. The seventh freedom, a much more radical air traffic right, entails the right of an airline to operate free-standing services between two different countries without any stop in the territory of the State in which it is registered. An example of this right may be a BA flight originating in the US and terminating in New Zealand, although the consent of these two countries will still be required. This seventh freedom is new and will undoubtedly emerge as a highly controversial issue. Whether or not it will be widely embraced is a matter surrounded by some degree of uncertainty.⁴ An eighth freedom has also been created and this is commonly known as *cabotage*. This is a concept

² As at 30 June 1998, there were 185 signatories to the Convention: (1998) 53 *ICAO Journal* (no.6) p.30. By contrast, there were 115 signatories to the IASTA and only 12 signatories to the IATAg.

³ This is not to be confused with the International Air Transport Association (*infra*), and hence is abbreviated as IATAg.

⁴ J.Fox, *The Regulation of International Commercial Aviation: The International Regulatory Structure* (Oceana, New York: 1994) is a useful handbook on the freedoms of the air.

borrowed from maritime practices and denotes the right of a foreign airline to provide domestic services within the territory of a country in which it is not registered. The highly contested issue between the governments of the UK and USA over the right of BA to provide cabotage services, say, from New York to Los Angeles, is a good example. The cabotage right is highly protected and jealously guarded for the exclusive use of the national rather than foreign carriers. Indeed, the restrictive practices which have evolved in international civil aviation creates a certain sense of irony: that is to say, what have been described as freedoms of the air are, in essence, restrictions.

These traffic rights or privileges are clearly more extensive than those embraced by the IASTA and they have a much more obvious bearing on the commercial aspects of international air transport services. The IATAg also requires its signatories to renounce "all obligations and understandings between them which are inconsistent with its terms, and undertake not to enter into any such obligations and understandings."⁵ It is therefore of no surprise that, at the conclusion of the agreement, no more than a handful of signatories to the ICAO Convention were also signatories to the IATAg. As at 31 October 1997, there were 11 signatories to it, while IASTA had 112.⁶ The lack of interest for multilateralism in the commercial rights of international civil aviation explains the great number of bilateral agreements that exists today, which in most cases would also include the provisions of the IATAg. Bilateral agreements have evolved simply by virtue of "the special permission or other authorisation" required by Article 6 of the ICAO Convention, but they have also provided the forum for the contracting parties to extract valuable traffic rights as a condition to certain other traffic rights being given up. They provide to the parties concerned the "contracting freedom", such as it is, to decide whether and which of the traffic rights to include in the agreement, thus providing them with a strategic regulatory instrument to exercise control over the conduct of the services in question. Until more recently when the concept of privatisation began to dominate political agenda, most airlines were State-owned and were used as an instrument of public policy. This is true whether in the context of international or domestic air transport. Countries which are dependent on the international airline industry to make a significant contribution to their national income would seek to ensure that this interest was not prejudiced, and State ownership would provide the necessary tool for intervention so that, for instance, the industry may be protected from any undue or unforeseen economic difficulties and any social or political obligations could be upheld. The rationale for this approach is that "increased [international economic dependence] erodes the effectiveness of national economic policies and hence threatens national autonomy in the determination and pursuit of economic objectives."⁷ One commentator has suggested that,

Governments use a variety of policy instruments to shelter their economies from the competition risks of the international

⁵ Article II, s.1.

⁶ (1997) 52 *ICAO Journal* (no.8) p.23.

⁷ R.N.Cooper, "Economic Interdependence and Foreign Policy in the Seventies" (1972) 24 *World Politics* 159, at p.164.

economy Some states adopt explicitly neo-mercantilist policies, others favour certain enterprises, whether in the private or public sector, as "national champions"; still others adopt a variety of industry-specific protectionist measures.⁸

Every country will always feel the need for an airline of its own. A national carrier flying in the international skies will convey a sense of national prestige and international recognition. In spite of greater globalisation and multi-national ownership of airlines, there is still a large degree of protection given to the national carriers. However liberal the policy on airline competition, much of this can be readily compromised. This can be seen in the proposed take-over of B.Cal in 1987 by the Scandinavian Airline System (SAS) which was rejected in favour of a BA-B.Cal merger. A study into the SAS in 1988 noted that political considerations surrounding the possibility of B.Cal, which at that time was the "second force" airline, falling into foreign ownership were always going to lead to the proposal being rejected.

A major issue during the takeover battle was the implication of SAS gaining control of a British airline. The question of national control was important....⁹

Likewise in the US, where, until more recent recommendations, foreign ownership in an US-based airline was restricted.¹⁰

However, it is also true that airlines have always been regarded as a vital military asset and this is evident throughout the history of aviation. Indeed, the impetus behind the Chicago Conference was the consequences and experiences arising from the inter-War years. The guarded agreement reflects the belief of many countries that commercial aviation becomes a useful means of transportation, "providing the benefits of swift travel to diplomats, soldiers and administrators, besides carrying vital supplies of lightweight goods" in times of hostilities.¹¹ In the UK, s.62 of the 1982 Act allows the Secretary of State to issue an order to regulate the navigation of air services over the UK airspace or an order to take possession of aerodromes or aircraft for military purposes in times of war or emergency.

Mercantilist Attitude

The system which the ICAO Convention has created and the practice which has since evolved holds out little in the way of competition in international air

⁸ D.R.Cameron. "The Expansion of the Public Economy: A Comparative Analysis" (1978) 72 *American Political Science Review* 1243, at p.1260. See also G.Lehmbruch, "Liberal Corporatism and Party Government" (1977) 10 *Comparative Political Studies* 91.

⁹ S.Ghoshal, *Scandinavian Airline System in 1988* (INSEAD-CEDEP discussion paper, 1988), p.14.

¹⁰ 49 U.S.C. sec.1378(a)(4) states. "Except as provided in subsection (b) of this section, it shall be unlawful...for any foreign carrier or person controlling a foreign air carrier to acquire control in any manner whatsoever of any citizen of the United States substantially engaged in the business of aeronautics." Subsection (b) provides that an application may be made to the Attorney-General and the Secretary of Transportation who will consider the application primarily on the grounds of public interest and fair competition. See n.15, *infra*.

¹¹ R.E.G.Davies. *A History of The World's Airlines* (OUP, London: 1964), p.225.

transport unless the significant step is taken to depart from the original philosophy of protection. Although there is already evidence that testifies to the benefits of increasing competition, for instance in some areas of Community air transport as a result of the liberalisation programme, much is still to be desired in the way in which and the extent to which the principle of fair competition is applied. This is true even between two countries purported to have a liberal air transport policy. Illustrative in this respect is the bilateral agreement between the UK and the US on which the most recent efforts to conclude a new agreement have come to a complete halt as both parties refuse to reciprocate on the demand for new air traffic rights. While the US on the one hand wishes to have greater access to London(Heathrow), the UK has consistently maintained that such a concession could only be granted if it was reciprocated by the right to provide cabotage services in the US by UK airlines. Access to Heathrow Airport is a prized commodity as much as the US domestic traffic is lucrative section of the market. Since much of the debate on the provision of cabotage services centres on the US market because of its value, the US Government is naturally cautious and hesitant to accede to this request.¹² The ratio of domestic-international operations for UK and US airlines is significantly different and clearly indicates that UK airlines were more dependent on international services while US airlines derived a substantial part of its revenue from domestic services. While there would be gains, both would also emerge as losers from the bargain. This contrasts remarkably with the "open-skies" agreement between the US and the Netherlands, an agreement which effectively provides for unlimited access. In that case, however, the Netherlands stood to lose virtually nothing, and indeed would benefit from greater access to the US market, and vice versa. The whole process of negotiating for a new UK-US air service agreement has now been complicated by the proposed alliance between BA-American Airlines where the *quid pro quo* for their approval by the US antitrust authorities is an open-skies agreements which gives US airlines greater access to Heathrow Airport.

Perhaps more interesting in this regard has been the decision of the French authorities to refuse BA and other European carriers to exercise their right of access to Paris(Orly) airport under the Council Regulation 2408/92 which eventually led to a number of Commission decisions that held the French authorities had acted in breach of Community obligations. These are explored in detail in the following chapter.

Bilateral agreements are also highly prescriptive, from detailing the designated carrier permitted to operate on a certain route, to the level of fares that may be charged and to the frequency and density of capacity to be provided by that carrier per period of time.

¹² The US domestic market provides for 70% of the total of operations of its airlines. European airlines, on the other hand, are more dependent on international services which accounts for approximately 50% of total operations, compared to a much smaller margin of domestic operations of less than 30%: COM(92) 434.

Probably no other world-wide economic activity of comparable magnitude is more thoroughly regulated, less free of official restraint and guidance, than is world air transport ¹³

The bilateral agreement between the UK and Japan for air transport services between London and Tokyo(Narita), for instance, restricts the number of frequencies operated by British carriers to 38 round-trips per week, divided between Polar and Siberian routes, and imposes a minimum fare level. These are clear limitations to the licensing policy of the CAA on a competitive, multi-airline industry and a significant deprivation of the full effect of Government policies. On routes where no more than two airlines operate, usually by the national carriers, there is little incentive to compete and be efficient, and hardly an economic manner of allocating resources. The inefficiency and the resulting distortion in the proportionality of fares in relation to costs will not benefit users.

Such restrictions as are used in bilateral agreements do not foster growth nor innovation. A poignant remark to a similar effect was made by the US National Commission to Ensure A Strong Competitive Airline Industry in its report to the President and Congress.

The Commission believes the current bilateral system is no longer sound or sufficiently growth-oriented in the global trade environment...efforts to create a more open, competitive international aviation environment have been stymied repeatedly by nations [and thereby] suspend growth in international markets...The increasingly contentious bilateral relationships already mentioned are resulting in agreements or de facto relationships either markedly more rigid and protectionist than before, or seriously out of balance.¹⁴

Whether it is the restriction on fares or the number of designated carriers, or indeed the number of total seats permitted for sale to the public, these are constraints which have been artificially imposed for whatever reasons, legitimate or irrational. Although negotiations on international services are inter-governmental, the role of the CAA in regulating for competition is by no means insignificant. Bilateral agreements which provide a general framework without, for example, naming a particular airline or airlines, will mean that the rights resulting from the agreement will have to be allocated to a UK airline. Where the rights are less than what the UK airlines require, the shortfall in supply will make it necessary for the CAA to allocate those rights on a competitive basis following a public hearing. Since competition is likely to be limited, especially so where only one airline is permitted to serve on the route, regulatory measures will have to be adopted to ensure that the airline granted with the rights is not unduly protected from the forces of competition. If, therefore, the airline in question fails to provide services to the standard which meets the interests of users, those rights will be withdrawn from it and a competitor with

13 O.J.Lissitzyn. "Freedom of the Air: Scheduled and Non-scheduled Air Services" in E.McWhinney and M.A.Bradley (eds.), *The Freedom of the Air* (Sijthoff, Leiden: 1968).

14 The National Commission to Ensure A Strong Competitive Airline Industry. *Change, Challenge and Competition* (1993). pp.20-21.

promises to deliver user benefits will be substituted in its place. These issues are taken up in detail in the section

International Air Transport Association

The International Air Transport Association (IATA) is a non-governmental organisation established in 1919 as the International Air *Traffic* Association, the year when the first recorded international scheduled air service was operated. The modern IATA today is a by-product of the international system of civil aviation which grew out of the 1944 Chicago Convention. The aims of the Association are many-fold:

- (i) to promote safe, regular and economical air transport;
- (ii) to foster air commerce, including the study and solving of related problems;
- (iii) to provide a forum for discussion and consultation on the problems of the air transport industry, including the provision of centralised services and research;
- (iv) to co-operate with the ICAO and other organisations;
- (v) to represent an association of airlines committed to competition and free trade.¹⁵

Membership of the Association is voluntary and is automatically open to any airline engaged in international services, whose government is also eligible for membership of the ICAO. The functions of IATA include tariff co-ordination and scheduling services although the emphasis of its work is now on the setting and co-ordination of tariffs, a task which otherwise would have to be devolved to the often protracted bilateral negotiations. Now bilateral agreements commonly refer the setting of fares for international scheduled services to the IATA system. Its other efforts are by no means unimportant. It simplifies the travelling experience by facilitating through-ticketing, even between different airlines, so that air travel reservations can be made through one telephone call and paid in one currency. However, it is an institutional system perpetuating the tradition of collusion in air transport. The nature of its principal function in fare-setting runs the risk of being declared as contrary to the principles of fair and equal competition. Indeed in 1978, the CAB in the US issued a "show-cause" letter to IATA for the anti-competitive nature of its fare-fixing system although this was eventually withdrawn on the basis that the benefits derived from the IATA system outweighed any of its anti-competitive effects.¹⁶ Similarly, it is open to question under the competition laws of the EC laid down in Article 85 although in respect of certain functions, exemptions have been granted.¹⁷

¹⁵ See IATA, *IATA: Aims and Objectives* (1991). For a more exhaustive consideration of the role of IATA, see J.W.S.Brancker, *IATA and What It Does* (Sijthoff, Leiden: 1977).

¹⁶ *CAB Order 76-6-78* (12 June 1978).

¹⁷ Commission Decision 91/480, [1991] OJ L258/18 and Commission Decision 91/481, [1991] OJ L258/29. See generally J.Goh, *European Air Transport Law and Competition* (John Wiley, Chichester: 1997), ch.3 and A.E.Salzman, "IATA, Airline Rate-Fixing and the EEC Competition Rules" (1977) *European Law Review* 409.

Market barriers

In any given airline industry, homogeneity in the size, economies and politics of the airlines is never possible. Thus, how a market position is to be assessed depends on how the size of the airline is to be measured. This may be the size of aircraft fleet, or the network of routes served, or output measures such as the total number of passengers carried or the revenue earned from passengers for the total number of kilometres flown, otherwise known as revenue passenger kilometres (RPK).¹⁸ Whichever factor is chosen for measuring airline size in order to determine its market strength, the results can be significantly different. For instance, an airline with a large fleet, but carries significantly less passengers than a smaller fleet-size airline on the same route will have a lower RPK than the latter. If measured in RPK, then the latter will have significantly greater market dominance than the former. More straightforwardly, a larger fleet-size airline which carries significantly more passengers than a smaller fleet-size airline on the same route will assume a greater degree of dominance in the market.

Market dominance, of course, has a direct bearing on the conditions of competition. If market dominance was measured in RPK terms, then any diminution of the dominance through competitive solutions must mean a competitor successfully attracting passengers away from the incumbent. How the incumbency is derived may be explained in two ways. First, an airline may secure a greater share of the market through 'internal' attributions by making efficiency gains, by aggressive marketing or by offering innovative products. Second, the incumbency may be derived from historical endowment or deliberate public policy. For example, in explaining the structure of EC air transport industry, the CAA remarked,

What the national airlines of the Member States each have in common is dominance of their home markets...This dominance has often been built up over many years during which national airlines enjoyed positions of near or actual monopoly as a matter of government policy...Even in the UK, despite its having the largest and most diverse airline industry in Europe, BA still accounted for 83% of the total scheduled rpk's in 1992.¹⁹

Although the British air transport industry has been privatised since 1987, and competition in place since before then, BA continues to enjoy a stable RPK output relative to other British operators by virtue of its network of routes, size of fleet, publicity and, take-off and landing slots in one of Europe's most congested airports, most of which stem from its previous monopoly as a publicly owned corporation. The ability of a competitor to reduce that dominance must accordingly depend on other factors such as its own economies of scale and scope as well as its pattern of routes. In its analysis of the structure of industry in the EC, the CAA referred to the emergence of BMA and Air UK to compete with BA on domestic and international scheduled services as a result

¹⁸ RPK is computed by multiplying the number of paying passengers by the number of kilometres flown for a given sector.

¹⁹ *Airline Competition in the Single European Market*, CAP 623 (1993), para.7.

of its multi-airline policy, although it concluded that "they accounted for only 10% and 5% of total UK scheduled passengers and only 2% and 1% of rpk's in 1992."²⁰ This is still the case in the EC where the intervention of the Commission has been necessary in a number of instances ²¹

Such imbalance in the industry structure, where an airline enjoys a dominant position by virtue of either a law-monopoly or market-monopoly, is liable to create high barriers of entry for competitors and consequently effective competition. Indeed, in the case of a law-monopoly, competition is likely to be expressly prohibited on the grounds of public policy. Nevertheless, if government or regulatory policies are aimed at protecting such dominance rather than creating equality of opportunities for competition, then little in the way of incentives will exist for competitors to compete with the incumbent. A tendency to form alliances of some kind with the latter is more likely to emerge. The economies of scale, of scope or of network in air transport is considerably higher than other industries such as the bus or haulage industries. Likewise, the capital costs of running an airline business is considerably in excess as is access to the infrastructure such as air space and airports. Whilst economic deregulation in the US may have provided the opportunities for more airlines to compete, more recent evidence suggests that these high barriers have had the effect of either preventing a new operator from entering the market to provide competing services, or forcing an operator to cease its services, or to merge with a larger and more dominant airline operator.²² For less dominant or smaller carriers, the temptation of forming an alliance or merging with larger carriers either to gain access to a wider geographical area or to important air service routes is seemingly overwhelming. Rather than compete against the might of large carriers, and eventually losing out, more could be gained by co-operating. One notable exception is the "largest and most long-standing challenge" by BMA against BA initially in the latter's most densest domestic routes, namely the London(Heathrow)-Glasgow route.²³

One of the most pressing barriers to competition in modern air transport is access into a congested airport whether in securing air space to approach the airport, or in securing an airport slot for taking-off or landing, or in securing a "gate" for the embarkation or disembarkation of passengers, all of which are treated further below. A dominant carrier which is likely to also have dominance at the airport in question will offer attractive incentives to another operator which is prevented by these barriers to form an alliance whether by merging operations or co-operating in one way or another. Unless an alternative neighbouring airport to the one in question exists to provide the opportunities for a competitor to offer competing services, for example the London airports of Heathrow and Gatwick, such barriers have the effect of preserving or re-asserting the dominance of the incumbent.

20 *Ibid.*, para.8.

21 See ch.7, *infra*.

22 See ch.8, *infra*.

23 CAA, *The Single European Aviation Market: Progress So Far*, CAP 654 (1995), para.226.

A resulting question in the formulation of air transport competition policies arising from such developments is whether a policy of competition between a few airlines is more likely to produce the intended benefits, or whether such benefits could be better achieved by competition between a greater number of airlines. The policy of multi-airline industry in the UK subscribes to the former. The CAA recognises that to achieve an environment in which a large number of airlines would compete with each other is not only impossible but need not necessarily produce the benefits envisaged for the users under a competitive industry. The real difference is therefore between an industry comprising of a few but competitive airlines, and one of many but characterised by relative weakness. In its memorandum to the Transport Select Committee, the CAA made an observation along the similar line in that,

...even if current trends lead to an industry dominated by a small number of very large airlines, competition between these remaining "mega-airlines" should still be workable and deliver benefits to passengers [although] in practice much will depend on whether the existing pattern of operation, whereby typically no more than two of the major...airlines operate alongside each other on any one route, is likely to break down substantially....²⁴

The barriers created by such dominance flowing from either a deliberate public policy, or historical endowment, or 'internal' attributions, is applicable to both domestic and international air transport. Of course, the latter is complicated by the fact of government intervention in their negotiations for air service agreements. Nevertheless, global alliances have not been uncommon either as an effort to rationalise resources or simply to avoid competition. Indeed, there is ample evidence pointing to a trend which suggests greater consolidation rather than competition. BA and American Airlines, for example, are spearheading the OneWorld global alliance, which includes Qantas, Cathay Pacific, Iberia and others, although this has been challenged by the Star Alliance consisting of between Lufthansa, United Airlines, SAS, Thai International Airways, Ansett Australia and others.

Within British air transport markets, BA acquired Dan-Air in 1992 as the latter failed to sustain the intense, low-cost competition in charter services, in addition to its earlier acquisitions of the Plymouth-based Brymon Airways and GB Airways. Within the EC too, since the gradual process of liberalisation was introduced in 1987, mergers in the form of acquisition by Air France of the French airlines UTA and Air Inter, and the acquisition by BA of 49% stake in the German Deutsche BA and the French TAT, are two of many instances which typify the continuing dominance of a number of European airlines. Whilst the CAA has acknowledged the certain degree of inevitability of consolidation as the different national markets merge into one, and has indeed suggested that there can be no presumption in EC mergers policy against mergers between dominant carriers, it advocates the need to treat with caution the argument that the Community's largest airlines can only hope to compete with the biggest

²⁴ Transport Select Committee, *Developments in European Community Air Transport Policy*, HC147-II (1991-92), paras.20-21.

airlines from the US and the Far East if they were permitted to grow through mergers or acquisitions between themselves. Neither should the approach be to soften substantially the requirements of competition law to allow for such an airline to emerge.²⁵ This degree of inevitability has emerged as a consequence of carriers recognising that they are not suitable to all markets. Thus, by forging an alliance, less profitable or less important routes in strategic terms could be abandoned. Such market barriers then become fortified: for new entrants seeking to challenge the increased dominance would need to commit themselves to long-term investments and to offer much more attractive products against the backdrop of the incumbents' identity and ability to respond by virtue of their larger resources.

Infrastructural Barriers

Runway Capacity and Slot Allocation

However well-intended the practice of liberal licensing may be, there will always exist significant barriers to be overcome to achieve a competitive environment. A number of these barriers may not necessarily be broken down by a multi-airline licensing policy. These are worthy of further consideration here as they pose not merely a significant impediment to competition unique to air transport in the UK, but also across the air transport world. Perhaps the most significant barrier acknowledged by the industry and regulatory bodies across the world is the lack of infrastructural capacity. The problem of congestion and the lack of slots for take-off and landing, most acute at popular airports, prevent competing airlines from introducing services. Likewise, limited airport terminal capacity or apron capacity at an airport or air space surrounding an airport would hinder the introduction of additional or competing services whether by incumbents or new entrants. While an air transport licence may be an authorisation to operate aircraft and provide air transport services, it does not guarantee the availability of infrastructural resources nor capacity to enable the authorisation to be put into use. Yet capacity constraints and slots allocation is a pre-requisite of air transport safety. Overloading the available air space and airport capacity is a potent disaster. At the present time, there is a maximum of 81 aircraft movements per hour during peak times at London(Heathrow) airport providing an average of one and one-third movements (or aircraft) in any one minute on the runway. This represents a 17% increase in runway capacity over the 1978 level of 69 movements.²⁶ This increase has been possible for a number of reasons including technical improvements and greater willingness on the part of airlines to accept delay. Nevertheless, Heathrow remains one of the most congested airports with the highest number of slots in the EC.

25 CAP 623, paras. 231 *et. seq.*

26 CAP 623 and CAA, *Slot Allocation: A Proposal for Europe's Airports*, CAP 644 (1995).

Table 6.1 Declared Capacities - Parallel Runways

Airport	Summer 1993	Summer 1995
Heathrow	77-79	77-81
Paris (CDG)	76	76
Copenhagen	74	76
Paris (Orly)	70	70
Munich	68	70
Frankfurt	68	70
Brussels	53	60
Rome	50	56
Milan (Malpensa)	30	30

Source: CAA, *Slot Allocation: A Proposal for Europe's Airports* (CAP 644)

The allocation of these scarce slots at UK airports is co-ordinated by Scheduling Committees, specifically Airport Co-ordination Limited. These Committees are comprised of representatives from the airlines, the airports and the CAA. The detailed procedures by which slots are allocated are complex depending on such variables as peak or off-peak times, the size of aircraft used which bears on the time per aircraft movement (e.g. the bigger the aircraft, the more time it will need for taking-off), and others. These are based on the IATA *Scheduling Procedures Guide* which incorporates a number of principles including historical precedence, new entrants, and emergencies. Slots held by an airline need not be used. This may be due to the lack of demand for services at that particular time or to other extraneous circumstances such as international embargoes, hostilities or industrial actions at the airport of destination. Slots may also be traded between airlines, or indeed by the airline itself within its pool of slots to achieve a better allocation of resource. For instance, a BMA service on the London-Paris at an 0930 slot may be switched for the use of a London-Brussels service to meet demand. The CAA, however, has stated in its policy statement that it would be prepared to exercise its regulatory powers indirectly to ensure that allocated slots would be maximised.

The possession of a route licence by an airline which does not itself serve the route will confer no preference on the holder in the event of an application from another airline. If the holder starts or proposes to use the licence after such an application has been made, the Authority will need to be convinced that this was not merely pre-emptive.²⁷

Slot allocation at EC airports are now governed by Council Regulation 95/93 which essentially preserves the current practice under the IATA guidelines.²⁸ The important difference is that the Regulation creates rights which may ultimately be enforceable by the courts. Equally important, is the system of 'slot pool' established under the Regulation where a designated percentage of slots ending up in the pool must be allocated only to new entrants who are defined in

²⁷ CAP 620, para.11. See Decision 1/94 relating to the bilateral restrictions on the London-Beirut route, requiring the CAA to make a choice between BA and British Mediterranean Airways.

²⁸ (1993) OJ L14/1.

the Regulation. The application of this Regulation and its impact on competition is considered more fully below

While in general the system of slots allocation lacks any legal sanction except in the case of Community airports, and indeed comprises of anti-competitive overtones, it is generally accepted as the best available method of distributing airport slots. Other methods of slot allocation exist including slots trading and peak pricing of slots. The latter involves a premium being placed on peak period slots, and airlines will have to weigh the higher cost of operation against a service in which there is a lack of demand, and therefore consider the possibility of operating the service using an off-peak slot. Indexing demand to slot prices, however, requires a high probability of change in demand. But where demand for peak slots is generally inelastic, change would only take place when there is a drastic change in demand for that service or in circumstances when the likely loss in operations could not be rationally subsidised from gains in other operations. A system of slot trading, on the other hand, involves the buying and selling of slots between airlines, although a possible consequence of this system would be higher fares and the strengthening of the position of dominant airlines which are more capable of outbidding smaller airlines. This is a common practice in the United States except at the four slot-controlled airports, namely New York(Kennedy), New York(La Guardia), Chicago(O'Hare) and Washington(National). The allocation of slots at these high density airports are regulated by legislation on the number of movements per hour. This slot rule was the subject of the most comprehensive review in 1994 since its adoption 26 years ago to deal with the problem of airport congestion which included delays that eventually led to the cancellation of flights. However, the review recommended no substantive changes to the existing system.²⁹ For the CAA, slot trading as a peripheral mechanism to achieve effective slot allocation and usage is inevitable, but "these exchanges should be transparent."³⁰ These alternative methods of allocating slots are by no means without their faults and perhaps are no better than the scheduling system internationally accepted. This view was implicit in a response from a member of the CAA to the author;³¹ a view also echoed in the evidence given to the House of Commons Transport Select Committee.

The difficulty in intervening in slot allocation, Mr Chairman, is that one has to find a system better than that which now exists...We are unhappy with the present system of slot allocation and we cannot think of anything better.³²

Yet the restrictive effect of limited runway capacity on competition is not only real, but severe. If the present system of slot allocation is based on historical

²⁹ Department of Transportation. *Report to Congress: A Study of the High Density Rule* (1995).

³⁰ CAP 644, para.123. The EC Commission is now considering the option of legalising slot trading; *Financial Times*, 4 October 1996.

³¹ Interview with the author, 8 November 1994.

³² Director of Economic Regulation Group. Transport Select Committee. *Developments in European Community Air Transport Policy* (First Report), HC 147-II (1991-92), p.40.

precedence, then the obvious implication of this constraint must be to preserve the dominance of existing airlines who have slots at such airports. Although the dominance of BA at Heathrow airport is apparent, its share of the total slots allocated is no comparison to those held by other State-airlines in the EC who have virtual control of slots at principal airports.³³ When BA was privatised, the slots which it then had at Heathrow and Gatwick airports were not removed but were instead endowed in the newly privatised carrier. The result of this historical endowment clearly reduces the ability of new competing services being introduced. Of course, this system of "grandfather" rights where slots used for one traffic season can be used in the same traffic season the following year, is not without its merits, and is indeed universally accepted, since it gave proper recognition and security to the investments incurred or to be incurred for developing new services. Nevertheless, in the case of BA's market share, it has been greatly eroded on those routes which BMA has managed to secure the slots to offer competing services. The following table illustrates the division of departing flights from Heathrow and the frequency share of the major airlines on the densest routes in the EC on which BMA operates.

Table 6.2 Departing Flights from Heathrow in 1993

Paris		
Airline	Departing Flights	Frequency Share
BA	3,489	32%
BMA	2,934	27%
Air France	4,322	40%
Total	10,745	
Amsterdam		
Airline	Departing Flights	Frequency Share
BA	2,380	29%
BMA	2,805	35%
KLM	2,920	36%
Total	8,105	
Brussels		
Airline	Departing Flights	Frequency Share
BA	2,266	32%
BMA	2,239	31%
Sabena	2,612	37%
Total	7,117	
Frankfurt		
Airline	Departing Flights	Frequency Share
BA	1,398	33%
BMA	1,042	25%
Lufthansa	1,762	42%
Total	4,202	

Source: CAA, *Slot Allocation: A Proposal for Europe's Airports* (CAP 644)

³³ See submission of the CAA to the Commons Transport Select Committee. *ibid.*, para.8.

Although the overall departing slots for UK carriers from Heathrow is between 58%-64%, these slots are shared by two carriers each with no more than a 10% differential. It is also clear from this that the success of effective competition depends on a comparable number of slots or frequencies held by the competitor as against those of the incumbents. Thus, unless such comparable number of slots are held, operators seeking to enter the relevant market are not likely to achieve the minimum service levels so as to offer attractive schedules. This is most acute in the case of short-haul services. To maximise the utilisation of an aircraft and to achieve minimum traffic threshold, an operator is assumed to need to make a sufficient number of rotations per day. This in turn depends on the number of available slots and the timing of the slots. The latter is particularly significant where the passengers are primarily intra-lining traffic, either bound for a connecting service or derived from a connecting service, so as to maximise route and fleet synergies. The problem is less pressing in the case of long-haul flights in that the number of required rotations decreases as the length of the flight increases and given this lower frequency, they are consequently less dependent on slots at particular times of the day.³⁴

Undoubtedly, it is open for argument that the simple solution to the infrastructural constraints would be the creation of additional capacity such as the construction of new airports or additional runways as in the case of Manchester Airport. But these are developments which will impact other sets of interests within the regulatory complex, most acutely, environmental interests and are likely to attract severe objections.³⁵

Terminal Capacity

Terminal capacity relates to the capacity of an airport to accommodate aircraft and traffic for embarkation or disembarkation. It bears a direct relationship with the permissible number of airport slots and aircraft movements at any one time, so that any limiting effects will also have a consequence on airline competition. For instance, at Berlin(Tegel), the limited number of terminal gates restricted the number of hourly runway movements to a maximum of 34 in 1994.³⁶ Any expansion of terminal capacity to alleviate this barrier is not without its difficulties, whether of a political or environmental nature as is evident in the inquiry relating to the proposed Terminal 5 at Heathrow.

Air Space Capacity

Air space capacity is much more technical and sophisticated, and so are its control and problems. The concern of the economic regulatory functions of the CAA with the increasing congestion of air space is minimal, but the effect of air space congestion on airline competition is nevertheless critical. At Barcelona airport, for example, air space restrictions have meant the limiting of aircraft

³⁴ See generally CAA. *Airline Competition on European Long-Haul Routes*. CAP 639 (1994).

³⁵ The environmental issues of air transport have been considered elsewhere. See P.Davies and J.Goh. "Air Transport and the Environment: Regulating Aircraft Noise" (1993) 18 *AIR and Space LAW* 123.

³⁶ CAP 654, para.219.

movements to 30 an hour.³⁷ Like surface expansion, air space expansion to accommodate a greater number of aircraft at any one time is limited. Thus, the need to look towards more efficient and effective systems of air traffic management, a task which has led to combined international efforts such the construction of various navigational systems including the Global Navigation Satellite System (GNSS) and the Communications, Navigation and Surveillance/Air Traffic Management Systems (CNS/ATM).

Regulatory Response

These institutional, market and infrastructural constraints are real impediments to dynamic airline competition. At the same time, however, the CAA has had to secure the reasonable interests of users, lest it fails to fulfil its statutory duty. In some instances, the remedy may be provided by regulatory means, but in some others regulatory remedies may be inappropriate or undesirable. Where regulatory remedies are possible, this has frequently entailed the CAA making a choice between airlines and services, if not to prescribe detailed conditions in the licences. This was witnessed in its recent decision on the application by both BA and British Mediterranean to operate the London-Beirut route. The bilateral agreement between the UK and Lebanon, however, restricted the number of weekly frequencies to five. British Mediterranean had applied to operate seven weekly flights while BA applied to operate two weekly services. The CAA's role in that case was to reconcile the applications and the bilateral restrictions having regard at all times to its statutory duty of furthering the interests of users. BA contended that the British Mediterranean weekly services should be cut back to three so that the remaining two frequencies could be allocated to it. Although the CAA was at pains to meet the objectives of its policy such that BA could also provide the services in competition, it nevertheless allowed British Mediterranean to continue to operate its five weekly services. In reaching that conclusion, it reasoned that,

As a new airline its financial position is inevitably far less secure than that of an established carrier. If the Authority wishes to pursue a long term multi-airline policy it cannot ignore the differences in size and resources between British Mediterranean and BA. Restricting British Mediterranean to three services per week as suggested by BA would substantially reduce the chances of the airline's survival...the Authority must try to ensure that British Mediterranean receives a sufficient allocation of the available frequencies to stand a reasonable chance of operating a viable service.³⁸

The CAA was clear in its reasoning, however, that the decision did not entail a policy which would give a measure of preference to smaller airlines, although it would always be minded of the background of the statutory objectives and its

³⁷ *Ibid.*, para.221.

³⁸ Decision 2/94.

own policy that significant inequalities in size and economies of scale exist between the airlines.³⁹

Prominent also amongst its regulatory responses to ensure that the effect of these constraints on competition is minimal is the provision for artificial contestability which requires an incumbent airline to operate efficiently. This is the policy of *substitution*.

In a limited number of cases competition may be precluded, or unattainable on acceptable terms, because of international constraints. In these circumstances, the Authority will be ready to consider substituting another carrier for an incumbent so as to safeguard or further the interests of users.⁴⁰

The incentive to be efficient is the *status quo*. Air transport operators are expected to provide services of the level envisaged in the statute and policy statement such that the reasonable interests of users are satisfied, and where this is so, they will continue to provide those services. But where they fall short of the requirements, for example by failing to compete effectively or by providing inferior and non-competitive services, the sanctions of this policy may be invoked. An operator will have its licence withdrawn and therefore lose the right to provide the services. In deciding whether to invoke this sanction, the CAA will take into account the length of time the incumbent has taken to establish itself on that route and the degree of commitment displayed in providing the said services. Substitution, however, will be applied sparingly, and only in circumstances "when to do so would *manifestly enhance* the achievement of the objectives of the Act."⁴¹ Indeed, the CAA has never exercised this authority despite its long-standing existence.⁴² The one occasion when it came closest to using the policy of substitution was in respect of services between London and Tokyo-Narita. The CAA was called upon to decide how frequency restrictions of 38 round-trips per week arising from the UK-Japan bilateral agreement had to be shared between BA and Virgin, a decision which, if the policy of multi-airline competition was to be maintained, involved the substitution of BA by Virgin on certain routes and services. Of the 38 slots available, BA had 30 and Virgin eight; Virgin operated four "terminating" services to Narita while BA operated a number of "transit" services to Narita with onward services to other points such as Osaka. A London-Narita-Osaka round-trip service would therefore use a total of four slots at Narita instead of two if they were terminating services: London-Narita; Narita-Osaka; Osaka-Narita; Narita-London. BA claimed that it was commercially irrational to operate direct London-Osaka services since there was no sufficient demand for them. In its application, Virgin had asked for a total of 16 slots enabling it to operate 8 weekly round-trips and leaving BA with 22. The case was unique in two respects. First, it was the first occasion when the CAA had been called to amend the licence of an airline by reducing the number of runway slots at a foreign airport against its will. Second, it was the first time

39 See generally Decision 7/90.

40 CAP 620, para.9.

41 *Ibid.*

42 Decision 1/91

that it had itself proposed to vary the licence in that manner. Both of these combined to make the decision a significantly difficult one. The CAA reasoned that in the application of its licensing policy to secure a multi-airline industry, it did not imply that smaller airlines would be given an automatic preference over BA. However,

if the Authority's and the Government's multi-airline policy is to have its desired effect of creating and maintaining an environment in which efficient British airlines other than BA can operate profitably and in which competition between British carriers and with foreign airlines can flourish, it must mean that where a carrier such as Virgin is operating successfully and to the obvious benefit of users the Authority will do all that it reasonably can to allow the airline the opportunity to grow and compete.⁴³

The CAA in making that statement noted also that, in spite of the restrictions on the London-Narita route, Virgin was providing travellers with the choice of flying on an airline with a very different style from others serving the route as well as offering business travellers a high quality product while charging only the same fares as other airlines' more conventional business class products. BA's licence was eventually varied to limit its number of round-trip services to Narita to 26 and Virgin's limited to 12. Although this decision represents a direct regulatory intervention by the CAA, it had the characteristics which would deprive the users on such services of the benefits of competition since Virgin would not have had the opportunity to enter the market given the frequency restrictions. Such cases are rare and certainly lack precedents. The intervention of the CAA was therefore necessitated by the "highly unusual circumstances" of the case and was by no means "some sort of 'open season' on the route rights and slots" of any airline.⁴⁴

Whatever may be the flaws of administrative regulation, the theory of substitutability represents a highly important regulatory policy within a framework in which market forces are permitted to operate. It is clearly an important alternative to unregulated competition, which by virtue of certain structural constraints cannot be possible in any event if the interests of users are to be protected. More significantly, the threat of substitution has never needed to be invoked frequently to introduce greater competitiveness in circumstances in which competition has been artificially depressed by institutional, market or infrastructural limitations; much of this can be attributed to the liberal air transport licensing policy of the CAA. But where the liberal licensing policy cannot be applied satisfactorily, as in international air transport, the policy of substitution is a strategic instrument for inducing competition.

But since the invocation of the substitution policy essentially amounts to a direct regulatory intervention which the CAA has sought for many years to avoid, the aim of the policy is to enable the CAA's liberal licensing policy for a multi-airline industry to be applied to the fullest extent possible. Thus, in

⁴³ *Ibid.*, para.30.

⁴⁴ *Ibid.*, para.51.

circumstances where competition under a bilateral agreement between UK airlines are possible, though largely restricted, the CAA would seek to license liberally to achieve maximum competition if this was likely to benefit users. Accordingly, in an application to provide a competing service which is expected to result in benefits to the users and which are likely to outweigh the detriment to the existing British operator or operators, the CAA may "require an enforced reduction in the capacity or frequency" of the incumbent ⁴⁵

The bench-mark, therefore, will be the likelihood of benefit to users. But whether or not any such benefits are likely to arise, and if so, whether they outweighed the detrimental effects to existing operators is a matter of value judgment which the CAA has to make. On the means and ends of this though, it took the opportunity in a 1991 licensing decision to explain that,

It regards the encouragement of a competitive multi-airline industry as a major means of securing its statutory objectives, but the fact that the competitive balance between a large and small airline has been shifted cannot of itself justify intervention to try to restore the status quo ante. Simple transfer of profit cannot be an objective. Establishing greater opportunity for smaller airlines by cutting back the opportunity available to larger ones is justified only where there is a clear case that users would benefit thereby and where there is no effective alternative. Such a decision must ultimately be a matter of judgement rather than of fact. ⁴⁶

Administrative Law and Substitution

It is obvious from the outset that variations of licence conditions are possible, and indeed recognised by s.66 of the Civil Aviation Act 1982. Be that as it may, the legal implications of a substitution policy are many. It raises questions as to whether its application may be contrary to principles of due process particularly on the issue of adequate representations prior to the invocation of the sanction. It also raises a further, but related, question of whether the *legitimate expectations* of the incumbent operator may have been adversely prejudiced.

The process of regulating and licensing air transport competition is characterised by a system of public hearings. Typically, an application would be made to the CAA for the grant of an air transport licence, against which objections may be raised. Similarly, an air transport licence holder may apply to the CAA to have its licence varied, as may an application to vary the licence of *another*. Variations may also be proposed by the CAA in circumstances in which it is required to intervene. In such instances, objections may again be submitted. Applications may also be proposed to revoke an air transport licence. In all such cases, a public hearing is held to determine the application. An air transport licensing case is usually heard by a panel of three consisting of two members of the CAA and an official of the CAA who may be able to advise on technical issues such as market forecasts or fares statistics unless, for

⁴⁵ CAP 620, para.7.

⁴⁶ Decision 10/91, para.21.

instance, the persons having the right to be heard have consented to the quorum of one CAA member⁴⁷ These officials, however, cannot make the decision. The panel acts as a quasi-judicial body and is subject to the supervisory jurisdiction of the Council of Tribunals which members may attend such a hearing.⁴⁸

The detailed procedural requirements for a licensing hearing is presently contained in the Civil Aviation Authority Regulations 1991⁴⁹ In an application for an air transport licence the applicant is vested with a right to be heard by virtue of Reg.25, as is the holder of any air transport licence, in particular the holder whose licence may be the subject of an application by another licence holder to be varied. The CAA, however, has a measure of discretion to refuse a hearing to a licence holder if the licence holder has not served its objection or representation to application in accordance with Reg.20.⁵⁰ Neither will the CAA require a hearing in cases where no objections have been submitted nor in cases where the licence holder concerned has chosen to exercise its right not to be heard. Essentially, a system of public hearing is designed to enable parties whose interests are affected to make representations on the case. But clearly, and more importantly, the CAA is a quasi-judicial body which procedures are subject to the principle of natural justice, specifically that of *audi alteram partem*.

Where an application proposes to invoke the policy of substitution, both the applicant and the affected licence holder will have the right to be heard. Substitution is a species of revocation which would seem to fall within the categorisations by Megarry V-C in *McInnes v Onslow-Fane*⁵¹ as requiring the affected party to be given the opportunity to represent its case. At any rate, a licence holder from whom a certain benefit or advantage is to be withdrawn is entitled to expect to continue to enjoy it "until there has been communicated to him some rational grounds for withdrawing it on which he has been given an opportunity to comment".⁵² Public hearings, therefore, represent an important and open procedural safeguard against the unfair treatment of an incumbent's rights.

The Special Case of Slots and Airport Capacity

47 See *Civil Aviation Authority Regulations 1991*, SI 1991/1672, reg.15(2).

48 See s.1 and Sch.1 of the Tribunals and Inquiries Act 1992. See also D.Foulkes, "The Council on Tribunals: Visits Policy and Practice" (1994) *Public Law* 564

49 SI 1991/1672.

50 See e.g. Decision WH2/94.

51 [1978] 1 WLR 1520.

52 *Council of Civil Service Unions v Minister for the Civil Service* [1984] 3 All ER 935, at p.949. The breadth of Lord Diplock's formulation has arguably been qualified in a number of cases such that legitimate expectation is confined only to a procedural right, not a substantive right: see *R v Secretary of State for Transport ex p Richmond-upon-Thames LBC* [1994] 1 All ER 577 and *R v Secretary of State for Health ex p US International Tobacco* [1992] 1 All ER 212.

Although restrictions on airline competition stemming from international agreements or market dominance can be met by certain regulatory response either by a substitution measure or enforced conditioning of air transport licences subject to appropriate procedural safeguards, regulatory intervention in the allocation of airport slots or the difficulties of other infrastructural constraints is less straightforward and, at any rate, not a direct function of the CAA. Nevertheless, the fact that the way they are allocated affects or can affect competition significantly, merits a more detailed treatment. On the allocation of slots, the views of the CAA on the difficulties of regulatory intervention are set out in a number of its publications resulting from extensive studies and in which it explained that there would be more harm than benefit if the system of slot allocation was subject to official intervention.⁵³ Although it has consistently adhered to this view that its regulatory role was not about slot allocation at airports, it cannot turn a blind eye to this real difficulty. It stated in Decision 7/88 relating to the re-allocation of route rights following the merger of BA and B.Cal during which inquiry the CAA had recommended the surrender of slots, that it "would be irresponsible of the Authority having made that recommendation, then to try to avoid the consequences, de facto, of that advice being taken." The view that it must not become involved in the problems of slot allocation were, however, restated forcefully in its decision distributing the frequencies on the London-Tokyo(Narita) route between BA and Virgin. There it stated that official intervention in the slot allocation process was counter-productive and "would risk seriously undermining the existing system unless and until it has been clearly demonstrated that there is a genuinely practical and superior alternative which would better meet the objectives which the Authority seeks to secure."⁵⁴ This, however, did not preclude the CAA from expressing a view on the allocation of slots particularly in cases where it was required to make choices.

The Commission shares the same view. When assessing alternative systems on slot allocation in order to formulate recommendations for a Council Regulation, it noted that,

[T]he scheduling procedures as developed among airlines provide for a reasonable system of schedule co-ordination. It is widely accepted among airlines as the best possible way to deal with the difficult issue of co-ordination in a non-political and reasonably neutral way.⁵⁵

But there were also system difficulties which affect competition between the airlines since as a set of guidelines, "the procedures are not always applied" in particular the guarantee of neutrality and transparency.⁵⁶ These required a Community response.

⁵³ *Air Traffic Distribution in the London Area*. CAP 522 (1986) and CAP 644. See also its submission in *Developments in European Community Air Transport Policy* (First Report). HC 147-II (1991-92).

⁵⁴ Decision 1/91, para.27. See also Decision 5/88.

⁵⁵ COM(90) 576, para.8.

⁵⁶ *Ibid.*

Accordingly, Council Regulation 95/93 has now been adopted to provide common rules for the allocation slots at Community airports, typifying the US approach of designating slot-controlled airports and others. In essence, the Regulation gives its blessing to the existing slot allocation and scheduling procedures, provided that the airlines involved are entitled to participate and that the agreement has regard to the traffic distribution rules set by national and international authorities.⁵⁷ It is, however, based on a number of fundamental principles: expansion of capacity; transparency, neutrality and non-discrimination; forfeiture of unused slots; establishment of a slots pool with a measure of preference to new entrants at the airport.⁵⁸ Its objectives are to foster airline competition and encourage new entry to routes. The CAA has since conducted a review into the operation of the Regulation against the background of these principles and aims, and published its findings in *Slot Allocation: A Proposal for Europe's Airports*. Its opening remark stated that, at least in the case of London especially Heathrow, the Regulation "has fallen a long way short of achieving this [aims]... In no case has the Regulation resulted in effective new competition from an additional carrier on an intra-EC monopoly or duopoly from Heathrow."⁵⁹ It noted further that the lack of defined priorities led to the ineffective allocation of scarce "pool slots" in that little distinction was made between short- and long-haul services proposed by new entrants.⁶⁰ In particular, it stated in respect of the summer season slots in 1994,

There were 24 incumbent airlines eligible for pool slots because they were already operating at most a daily service at Heathrow and they applied for a total of 69 new departing slots per week. By the start of the summer season [1994] 20 airlines were holding 40 new departure slots and these were used to increase frequency on existing routes rather than to introduce new ones. The airlines concerned were almost exclusively those serving destinations in Eastern Europe, the Middle East, the Far East and Africa.⁶¹

⁵⁷ In respect of the UK, the air traffic distribution rules for the London airports were abolished in 1991 when the CAA recommended to the Secretary of State that operators should be free to choose between Gatwick and Heathrow where conditions permitted since the combination of passenger volume at Heathrow with the same level of air transport movements was "a rational use of scarce capacity": CAA, *The Need for Traffic Distribution Rules*, CAP 578 (1991), para.4.5.

⁵⁸ A new entrant is defined by the Regulation as: "an air carrier requesting slots at an airport on any day and holding or having been allocated fewer than four slots at that airport on that day, or, an air carrier requesting slots for a non-stop service between two Community airport where at most two other air carriers operate a direct service between these airports or airport systems on that day and holding or having been allocated fewer than four slots at that airport on that day for that non-stop service", provided the holding does not represent more than 3% or 2% respectively of the total available slots.

⁵⁹ CAP 644, p.v.

⁶⁰ A "slot pool" is a repository into which newly created slots, slots returned voluntarily, slots withdrawn for non-usage, or slots unclaimed under grandfather rights are placed. Of these pool slots, 50% must be designated for new entrants.

⁶¹ CAP 644, para.16.

This contrasts significantly with the slots which were secured and put to use by new entrants. At the time of applications for new slots, ten new entrants were granted slots but which did not necessarily accord with the number of slots nor the timing of slots applied for. As a consequence of this mismatch whether for reasons of viability or otherwise, a number of airlines subsequently returned the slots to the pool leaving five wholly new entrants who eventually took up the slots to commence services: Alyemda, Canadian International, Shorouk Air, TAT and South East European. Two explanations were identified in the CAA's analysis. First, the number of slots granted amounted merely to one-third of those sought and second, the majority of these were outside the peak periods of 0700-1300 and 1600-1900. Of the slots sought within the peak periods only 13% were granted, while up to 68% of those allocated were outside those times. If most of these were for short-haul services, the lack of peak period slots to achieve minimum traffic threshold will affect the viability of these services and inevitably the effectiveness of competition from new entrants. The effect would be to preserve the dominance of incumbents. In one of its deductions, the CAA noted that,

The concept of the 'S' curve, which suggests that to be successful a new entrant will normally need a frequency close to that of the incumbents, appears to be borne out in practice. The evidence is that, on routes with a substantial volume of business traffic, the greater a new entrant's frequency, the more effective a competitor it is likely to be.⁶²

Its proposal was to distinguish between allocation of slots on a 'routes' basis and an 'airlines' basis. That is to say, routes which have the densest traffic and airlines which are proposing to offer competing services on a monopoly (second carrier) or duopoly (third carrier) route should be given priority in the allocation of new slots. Importantly, the CAA proposed that all pool slots should "remain earmarked indefinitely for second or third carrier new entry so that over time sufficient slots could be accumulated to enable new entry on all routes on which it was commercially viable."⁶³ Of course, the notion of a second or third carrier implies a competitive approach, an objective not necessarily subscribed to by all Member States, an issue which is considered in the following chapter.

Conclusion

The primary aim of this chapter has been to chart the substantial barriers to effective air transport competition and the ways in which the CAA has responded to them. While it may be argued that liberalisation or deregulation can work to bring about greater competition as a means for meeting the reasonable demands of users, this cannot be so if the conditions for effective and sustainable competition do not exist *a priori*. This may either be the result of protectionist policies, or historical endowment. This still obvious in the case

⁶² *Ibid.*, para.50. The 'S' curve, however, assumes that the competition will stimulate traffic growth so that the additional capacity will not lead to a deterioration of profitability for the carriers involved in the long-term.

⁶³ *Ibid.*, para112.

of several Community airlines which are State-owned where the disparity in strength and size between competing airlines and the national carriers leaves much to be desired.

Although it should be clear by now that certain features of air transport do not lend themselves readily to the argument that the air transport industry is naturally competitive, it is by no means the case that competition cannot be secured. What is required is a system of economic regulation which can create the conditions for competition and supported by an antitrust framework that safeguards against anti-competitive practices. Even in the case of international air transport, where competition is limited, the CAA has shown that a competitive approach to the allocation of traffic rights between the airlines can bring about the necessary degree of contestability to ensure sustainable competition. Even more so, where the bilateral agreement allows for only one airline from each country to be designated, the CAA has responded by imposing conditions on the incumbent that its standard of service meets the expectations of users. Failing this, the CAA would apply the policy of substitution. Competition in this respect is potent, in the sense that the 'artificial' effect of contestability seeks also to realise the aims of competition so that the reasonable interests of users can be met. It is therefore a policy which accords with the theory of critical market contestability where the mutual interests of airlines and users meet substantially, but a regulatory measure which force has been underrated.

While the considerations in this chapter provide a cogent case for economic regulation, nothing in it has suggested that antitrust regulation has no role to play. On the contrary, the restrictions under the bilateral agreements in international air transport, the unbalanced structure of the industry and the difficulties of access to infrastructural facilities, suggest that competition is always vulnerable to the anti-competitive behaviour of the incumbents. While it is true that some of these anti-competitive behaviours can be dealt with more effectively through the conditioning of the respective licences, this may not be the case where broader issues concerning competition policy are involved. Indeed, where there has been substantial liberalisation, as is true in British air transport, it becomes difficult to reverse a policy decision for the sake of one particular case unless the circumstances of the case were shown to be highly exceptional. Thus, for instance, a sole airline operating on a particular route, which may have a low traffic density, may choose to exploit its monopoly position by raising the fares substantially in the knowledge that the lack of airport slots will prevent competitors from entering that market. Unless this can be regarded as a highly exceptional case, antitrust control would seem to be more appropriate.

More specifically, the liberalisation of air transport in the EC which has removed the jurisdiction of the CAA in respect of Community routes without substituting an equivalent form of economic regulation must mean that the antitrust laws will have a very significant role to play if the conditions of sustainable competition supposedly attained are to be preserved. It should be added that in any event the CAA itself has adopted a policy where interventions

would only be made if the need was evident. Economic regulation was at its minimum. International air transport is unique in the sense that it continues to be largely regulated bilateral agreements and infrastructural problems, although they are taken into account, are not part of the direct regulatory function of the CAA. In so far as market barriers are an impediment to competition, these have been substantially reduced as a consequence of regulatory policies which give priority to user interests and presume in favour of market solutions to serve these interests. This manner of approach has brought about a substantial mutuality between airline and user interests to ensure that the conditions of sustainable competition would allow for a greater liberalisation of economic regulatory controls. The point is therefore clear that the more emphasis is placed on market forces, the less important will be the economic regulatory process to provide competitive solutions. Accordingly, antitrust regulation begins to assume a more critical role to safeguard the conditions of competition.

CHAPTER SEVEN AN OLD SYSTEM, A NEW BEGINNING: THE EUROPEAN FRAMEWORK

*Geography has already made the decision for us
(Christopher Chataway, Chairman of CAA)*

The study of air transport regulation resembles a shooting game that is aimed at a constantly shifting target. This is particularly true with the rapid changes which have taken place since the single European market for air transport began to take shape. While consistency and predictability has been a familiar theme of the CAA regulatory process for many years, the introduction of the liberalisation measures designed to secure competitiveness in Community air transport has yet to earn a similar distinction. The single air transport market is only four years old, even though the first measures were adopted in 1987; by contrast, the CAA and its policies have been established since 1972. Accordingly, any comments or analyses must be made in this perspective. Even so, these measures have brought about a whole new era and have made significant in-roads into the established structures of civil aviation regulation not merely in respect of the UK, but of other Member States. The penetration of Community air transport law and policies, and more generally of Community law, into the legal system of Member States has been succinctly put by Lord Denning in 1974 as "an incoming tide [that] flows into the estuaries and up the rivers. It cannot be held back."¹ More eminently, the effect of these liberalisation measures, which have necessitated a re-shaping of policy content and direction, may be seen in a number of licensing decisions handed down by the CAA.

The issue of air transport, and indeed transport as a whole, in the Community has been and will no doubt continue to be fraught with difficulties and controversies. No where has this been more apparent than in the progress towards a Common Transport Policy as well as a Common Air Transport Policy. The former in particular resulted in one of the most important decisions of the Court of Justice on judicial review. The difficulties and the delay in formulating Community transport policies, however, is not a matter of great surprise. The Treaty of Rome itself recognises the "distinctive features" of transport which required special treatment to avoid detrimental consequences to the efforts of creating a unified Europe.² The need for separate treatment stems from its embodiment of public service connotations and from its high susceptibility to fluctuating economic conditions that is not always consonant with the public interest. The founders of the Treaty took stock of the wide divergence in the political philosophies and policies of national transport industries which inevitably magnified the difficulty of stipulating more precise

1 *Bulmer v Bollinger* [1974] 2 All ER 1226. at p.1231.

2 See Article 75

provisions in the Treaty. Hence, unlike agriculture, no provision has been made to extend the concept of a common market to the transport sector, leaving the objectives of the Treaty to be pursued instead "within the framework of a common transport policy."³ This meant that the task of adopting a common policy and specific measures for transport would be left to the institutions of the Community. This is stated in Article 84(2) of the Treaty which provides that,

The Council may [acting by a qualified majority] decide whether, to what extent and by what procedure appropriate provisions may be laid down for...air transport⁴

But that was always going to be "a lengthy, laborious and difficult task. Great difficulties are bound to be encountered...It is the duty of the political authorities to ensure that solutions are sought on the Community level and in a European spirit."⁵

This chapter has a number of aims. First, it intends to assess the extent to which the work and policies of the CAA have been affected by the liberalisation programme. It will be seen that an important consequence of the liberalisation programme is the removal of the CAA's jurisdiction in a number of areas where it had previously enjoyed an economic regulatory role. In accordance with the theory of competition regulation in this thesis, the liberalisation or removal of economic regulatory controls implies a necessary shift in the regulatory focus to antitrust regulation. It considers the extent to which the conditions of sustainable competition have been achieved so that this shift to antitrust regulation is adequate to ensure the contestability of the air transport market, but it will not examine the detailed application of the antitrust laws under the Treaty.

Competition Principles of the European Community

The basic competition principles of the Community are contained in Article 85 and Article 86 of the Treaty of Rome. The former is in essence concerned with agreements, decisions of associations of undertakings and concerted practices which affect trade between Member States and have the effect of distorting, preventing or restricting competition. Article 86 on the other hand focuses on cases relating to abuses of dominant market position. Together they provide a powerful weapon against unfair competition of various kinds, including an emphasis on the substance rather than simply the form of agreements, decisions or concerted practices.⁶ While Article 86 represents a strict prohibition in the sense no exemptions are provided for, Article 85(3) sets out the categories of agreements, decisions and practices which may be exempted from the prohibition in Article 85(1). A qualifying agreement for the purposes of Article 85(3) is one which contributes:

³ Article 74.

⁴ Majority voting was introduced by the Single European Act 1985.

⁵ Bull EC. 5/60. pp.5-8.

⁶ See e.g. Case 41/69. *Chemiefarma v Commission (Quinine)* [1970] ECR 661.

- to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit.

However, it must not:

- impose indispensable restrictions for the attainment of such objectives, nor afford the possibility of substantially eliminating competition in the relevant market.

The powers of the Commission to enforce the rules of competition, however, were not established until 1962 when Regulation 17/62 was adopted.⁷ The scope of the Regulation was amended in the very same year when Regulation 141/62 was enacted to remove the transport sector from the earlier Regulation on the basis that the special features of transport required a separate corpus of competition rules.⁸ A further Regulation 1017/68 was subsequently adopted to amend the scope of Regulation 141/62 by limiting it to sea and air transport. The consequential effect was to subject rail, road and inland waterway transport to the competition rules of the Treaty and Regulation 17/62. Sea and air transport remained outside the enforcement powers of the Commission. But they were by no means unregulated against unfair competition. Article 88 and Article 89, otherwise known as the transitional Articles, empowered competition authorities of Member States and the Commission to take enforcement actions in the period prior to the adoption of specific measures applying Articles 85 and 86. These transitional provisions were originally intended to deal with cases which arose in the immediate years after the inception of the Treaty.⁹ Article 88 provides that until the adoption of specific implementing measures, the authorities in Member States shall rule on the admissibility of agreements, decisions, practices and abuses market power in accordance with their national competition laws and Articles 85 and 86. On the other hand, Article 89 empowers the Commission to ensure the application of Articles 85 and 86 and to investigate in co-operation with national authorities cases of suspected infringement. Where there has been an infringement, "it shall propose appropriate measures to bring it to an end." Thus, in respect of those areas which are within the scope of the implementing Regulation 17/62, the transitional provisions will cease to be of any effect. Since air transport was excluded from the scope of that Regulation, enforcement of Articles 85 and 86 continued to be dealt with under the transitional Articles until 1987 when specific measures applying the competition rules were introduced in respect of air transport.

7 OJ (Sp Ed 1959-1962), p.204.

8 OJ (Sp Ed 1959-1962), p.2751.

9 Case 209-213/84, *Ministère Public v. Asjes* [1986] 3 CMLR 173.

Air Transport Competition in the European Community

Although other air transport measures have been adopted in earlier years, for instance on aircraft noise¹⁰ and inter-regional services,¹¹ the delay in adopting both a common transport policy and a common air transport policy was far too obvious to be justifiable. The European Parliament (EP) in a land-mark application to the ECJ for judicial review not only successfully established itself as one of "the other institutions of the Community" with *locus standi* to challenge the failure of the Council and the Commission to act under Article 175, but also extracted a substantive ruling from the Court that the discretion of the Council to adopt a common position on transport was limited by the *requirement to establish* a common transport market and by the *time period* within which it was required to establish that common position. Its margin of discretion was in respect only of the *objectives* and the *means* by which to achieve a common transport policy.¹² The significance of this case lies in the argument that the reality of political, economic or technical differences could not constitute an excuse for inaction nor failure to fulfil a Treaty obligation. Nor could the absence of positive action be hidden under the guise of the special treatment envisaged by the Treaty. The Court had already ruled in 1974 in the *French Merchant Seamen's* case that the special treatment accorded to sea and air transport was only in respect of the Transport Title in the Treaty and not the general rules of the Treaty, of which Articles 85 and 86 are part. It said, far from involving a departure from these fundamental rules, therefore, the object of the rules relating to the common transport policy is to implement and complement them by means of common action. Consequently the said general rules must be applied insofar as they can achieve these objectives [of Articles 2 and 3].¹³

The same point was emphasised by the Court again in *Ministère Public v Asjes*, otherwise known as the *Nouvelles Frontières* case, that:

the rules in the Treaty on competition, in particular Article 85 to 90, are applicable to transport. As regards air transport in particular, it should be noted that, as is clear from the actual wording of Article 84 and its position in the Treaty, that Article is intended merely to define the scope of Article 74 *et seq.* as regards different modes of transport, by distinguishing between transport by rail, road, inland waterway, covered by paragraph (1), and sea and air transport, covered by paragraph (2)...It follows that air transport remains, on the same basis as the other modes of transport, subject to the general rules of the Treaty, including the competition rules.¹⁴

10 On this, see P.Davies and J.Goh, "EC Law on Aircraft Noise: Recent Developments" (1993) *European Environmental Law Review* 229.

11 Council Directive 83/416. OJ [1983] L237/19.

12 Case 13/83, *European Parliament v EC Council* [1986] 1 CMLR 138.

13 Case 167/73, *Commission v French Republic* [1974] ECR 359, at p.370. See also Case 45/85, *Verband der Sachversichere EV v Commission (Fire Insurance)* [1987] ECR 405.

14 Case 209-213/84. [1986] 3 CMLR 173, at p.215.

The real significance of this case, however, lies in the revelation by the decision that the inadequacies stemming from the absence of specific measures applying the competition rules to air transport was so manifest as to jeopardise the attainment of objectives laid down by the Treaty. *Nouvelles Frontières* was a case referred to the ECJ under Article 177 by the Tribunal de Police de Paris for a preliminary ruling on the question of whether certain sections of the Code de l'Aviation Civile were compatible with the competition rules of the Treaty and whether these rules were applicable to international air transport beyond the Community. But the determination of compatibility must be preceded by a resolution that the competition rules applied to the air transport sector regardless of the absence of specific measures of enforcement. That these rules applied to air transport was in no doubt as the *French Merchant Seamen's* case had established. The Court then proceeded to rule that in the absence of such measures, Articles 88 and 89 must continue to apply. If such was the case, then the question of whether the agreements, decisions, and concerted practices were compatible with Community law must fall to be determined first by the authorities in Member States under Article 88¹⁵ and by the Commission under Article 89 either as a result of an application from a Member State or on its own initiative. The Court noted that neither the national authorities nor the Commission had ruled on the compatibility of the Code with the competition rules, and accordingly, Articles 85 and 86 could not extend to the Code so as to enable the Tribunal de Police as an ordinary court of law to rule on its compatibility with the competition rules. In 1990, the Court was called upon yet again to decide on the application of Articles 85 and 86 to air transport, a judgement in which it seized the opportunity to reiterate the obvious.¹⁶ The gap left by the absence of specific measures and more significantly the likelihood of legal uncertainty contrary to the rule of law was well amplified by the Court so that both decisions were in more than one sense the real impetus which finally propelled the Council into action. A policy was therefore adopted setting out the liberalisation measures for the industry in three phases.¹⁷

15 The Court re-stated the formulation in Case 127/73, *B.R.T. v SABAM* [1974] ECR 51 that the "authorities in Member States" were either "administrative authorities entrusted, in most Member States, with the task of applying domestic legislation on competition subject to the review of legality carried out by the competent courts, or else the courts to which, in other Member States, that task has been especially entrusted." (*ibid.*, at p.217). The UK authorities would therefore include the Office of Fair Trading, the Monopolies and Mergers Commission and the Restrictive Trade Practices Court. It is less clear, however, whether the CAA would fall within this formulation although it is submitted here that it would not since it requests for enforcement powers in air transport competition have been rejected by the Government. See also J.Basedow, "National Authorities in European Airline Competition Law" (1988) *European Competition Law Review* 342.

16 Case 66/86, *Ahmed Saeed Flugreisen & Silver Line Reisebüro v Zentrale Zur Bekämpfung Unlauteren Wettbewerbs* [1990] 4 CMLR 102. ("Ahmed Saeed").

17 See N.Argyris, "The EEC Rules of Competition and the Air Transport Sector" (1989) 26 *CMLRev* 5 for a first-hand account of the history of these legislation.

First Phase of Liberalisation

The first phase of liberalisation was marked by the adoption of four legislative measures in 1987, 30 years after the Treaty was founded. These were

- Council Regulation 3975/87 - procedures for the application of the rules on competition to undertakings in the air transport sector;¹⁸
- Council Regulation 3976/87 - the application of Article 85(3) to certain categories of agreements and concerted practices in the air transport sector;¹⁹
- Council Directive 87/601 - fares for scheduled air services between Member States;²⁰
- Council Decision 87/602 - sharing of passenger capacity between and access for air carriers on scheduled services and route between Member States.²¹

A number of substantive and technical amendments have since been made but they need not detain us.²²

The main purpose of Council Regulation 3975/87, as stated in its preamble, is to "provide for appropriate procedures, decision-making powers and penalties to ensure compliance with the prohibitions laid down in Articles 85(1) and 86", but the scope of this Regulation is limited to "international air transport between Community airports."²³ The aim of Council Regulation 3976/87, on the other hand, is to make provision for the exemptions recognised in Article 85(3) to be applied to air transport "to ensure increased competition should be effected gradually so as to provide time for the air transport sector to adapt".²⁴ Both Council Directive 87/601 and Council Decision 87/602 have since been replaced by measures adopted under the second phase of the liberalisation programme.

Second Phase of Liberalisation

The second set of liberalisation measures comprised of the following:

- Council Regulation 2342/90 - fares on scheduled air services;²⁵
- Council Regulation 2343/90 - access for air carriers to and sharing of passenger capacity between air carriers on scheduled air services and routes between Member States;²⁶
- Council Regulation 2344/90 - amending Council Regulation 3976/87 relating to the powers of the Commission to grant block exemptions.²⁷

While also revoking Council Directive 87/601, the basic aim of Council Regulation 2342/90 was to introduce greater flexibility in the setting of

18 OJ [1987] L374/1.

19 OJ [1987] L374/9.

20 OJ [1987] L374/12.

21 OJ [1987] L374/19.

22 Council Regulation 3975/87: amended by Council Regulation 1284/91. OJ [1991] L122/2 and Council Regulation 2410/92. OJ [1992] L240/18.

Council Regulation 3976/87: amended by Council Regulation 2344/90. OJ [1990] L217/15 and Council Regulation 2411/92. OJ [1992] L240/19.

23 Article 1(2).

24 Preamble.

25 OJ [1990] L217/1.

26 OJ [1990] L217/8.

27 OJ [1990] L217/15.

scheduled fares by airlines with minimal interference from the Government. This greater freedom, however, was subject to a number of criteria such as the requirement that fares must reasonably related to the airline's "long-term fully allocated relevant costs, while taking into account the need for satisfactory return on capital and for an adequate cost margin to ensure a satisfactory safety standard."²⁸ Council Regulation 2343/90, on the other hand, revoked Council Decision 87/602 and aimed "to stimulate the development of the Community air transport sector" by increased market access through the liberalisation of restrictions on the exercise of traffic rights and the removal of capacity restrictions.²⁹ In particular, it introduced fifth-freedom rights between Member States provided they were exercised as an extension or preliminary to a service originating or terminating in the Member State in which the carrier was registered; for instance, a UK registered carrier operating a Copenhagen-London-Paris service. Hence, in one respect, the Copenhagen-London sector might be the preliminary service to the London-Paris service, while in another, the London-Paris sector may be the extension of the Copenhagen-London service. Although the measures contain in the second package went some way towards a greater liberalisation of Community air transport, they were steeped in exemptions and conditions before a particular "liberalising concept" was triggered, and fell far short of the slightly more radical proposals put forward by the Commission.³⁰

In the intervening period between the first and second phases of the liberalisation programme, a judicial development of considerable significance took place. The ECJ had been asked by the Bundesgerichtshof for a preliminary ruling on the applicability of the competition rules to extra-Community air transport, that is to say, air transport beyond the Community.³¹ The facts concerned airline tickets which were being sold in Germany and which undercut (severely in some cases) the tariffs approved by the German authorities usually agreed internationally. The circuitous manner by which the purchase and re-sale of the tickets were made involved the defendants in the case purchasing such tickets outside Germany at a rate locally applicable, which by virtue of the differences in foreign currency exchange rendered such a venture attractive. This ticket, however, was issued for a fifth-freedom journey via Germany; that is, for instance, Turkey-Germany-Canada. The journey of interest was that between Germany and Canada. The Court found that since Council Regulation 3975/87 expressly related to international air transport between Community airports, the inference had to be drawn that domestic air transport and air transport to and from airports in non-member countries were outside its scope but were nevertheless subject to the transitional provisions in Articles 88 and 89.³² That being the case, agreements, decisions or concerted practices of such a nature could only be void under Article 85(2) if either the national authorities or the Commission had ruled that the prohibition in Article 85(1) applied.

28 Article 3(1).

29 Preamble.

30 COM(89) 373.

31 *Ahmed Saeed, supra.*

32 See Case 209-213/84. *Ministère Public v. Asjes* [1986] 3 CMLR 173.

Although this inference was in a sense obvious, the Court went further by drawing the limits of that principle in terms of its territorial application. It held that *only Article 85* was subject to the territorial distinction drawn for the application of Article 88, Article 89 and Council Regulation 3975/87. That is to say, where domestic or extra-Community air transport was in question, the applicability of Article 85 depended on the exercise of the powers conferred on the national authorities and the Commission pursuant to Articles 88 and 89. *The same, however, could not be said of Article 86.* Article 86 did not embrace the territorial distinction for its application. Therefore, it applied to all forms of air transport, whether domestic, intra-Community or extra-Community. The basis for this distinction, according to the Court, stemmed from the fact that Article 85 enabled exemptions to be granted through decisions taken by the relevant authorities or the Commission by virtue of Article 85(3).

In contrast, no exemption may be granted, in any manner whatsoever, in respect of abuse of a dominant position [Article 86]; such abuse is simply prohibited by the Treaty and it is for the competent authorities or the Commission as the case may be, to act on that prohibition within the limits of their powers.³³

Therefore, Article 86 was directly applicable to air transport.

The resulting complication, backed by the fear that the application of Article 85 may not be as uniform as it could possibly be in respect of the territorial difference in air transport, moved the Commission to propose without success an amendment to expand the scope of Council Regulation 3975/87 to include domestic and extra-Community air transport together with enabling powers to grant exemptions for these services.³⁴

Third Phase of Liberalisation

By far, the third package of measures in 1992 was the most significant as it represented the final stage in the process of air transport liberalisation. Its significance was also in the manner and extent to which changes have been required to align the system of administrative regulation for air transport in the UK. While previous liberalisation measures have also required alterations to the regulatory policies and practices of the CAA on matters such as fares and capacity, these have been minimal since the CAA have for many years deregulated fares and capacity subject to the regulatory oversight of anti-competitive behaviour. One of the most significant changes have been the re-classification of the types of air transport licences granted by the CAA to operators. In the past, an air transport licence would usually be issued to cover both the authorisation for operating an aircraft and the services on a particular route. With the introduction of the common licensing criteria for airlines based in the Community, the CAA now grants operating licences, route licences and air transport licences. This classification is uniquely required in the case of the UK since the CAA has been given the responsibility of licensing airlines based in the Channel Islands and the Isle of Man, which are not member countries of the EC. These will be addressed further in due course.

33 *Ahmed Saeed*, p.134.

34 See COM(89) 417.

The measures contained in the third package are comprised of the following

- Council Regulation 2407/92 - licensing of air carriers,³⁵
- Council Regulation 2408/92 - access for Community air carriers to intra-Community routes;³⁶
- Council Regulation 2409/92 - fares and rates for air services³⁷

Common Licensing Criteria

The central aim of Council Regulation 2407/92 is to introduce the right of Community undertakings to an operating licence without discrimination on the basis of nationality. The grant of an operating licence is dependent on certain criteria being satisfied, though if these are so satisfied, there will be no discretion for deciding whether it ought to be granted. These criteria are namely that the undertaking has:

- its principal place of business and, if any, its registered office in the Member State to which the application has been made;
- as its main occupation air transport in isolation or in combination with other air transport related activities;
- financial competence;
- managerial competence in cases where "the competent authorities of a Member State require, for the purpose of issuing an operating licence, proof that the persons who will continuously and effectively manage the operations of the undertaking are of good repute or that they have not been declared bankrupt";
- a valid Air Operator's Certificate (AOC) which has been issued to represent compliance with safety standards.

Such an operating licence, however, does not confer any right of access to routes nor markets. An operating licence in this sense is only a licence for "entry into the profession". A route authorisation, unless automatically granted under Council Regulation 2408/92, will continue to be necessary.

The introduction of a Community Operating Licence without the right of access to specific routes implies that an undertaking needs to have in its possession an Operating Licence as well as a route authorisation of some form. As both authorisations were previously contained in the Air Transport Licence issued by the CAA, it now has to differentiate more clearly the operating and the route authorisation. Accordingly, the CAA will now grant an Operating Licence to an applicant who satisfies the licensing criteria of the Community and a Route Licence to an applicant to operate specific routes which are not covered by Council Regulation 2408/92 on market access. These are primarily routes involving international services beyond the Community since the Regulation has created a general right of access to Community routes including domestic routes within a Member State since April 1, 1997. In essence, an air transport service must possess:

35 OJ [1992] L240/1.

36 OJ [1992] L240/8.

37 OJ [1992] L240/15.

- an Operating Licence and a right under Council Regulation 2408/92 for access to specific routes, or,
- an Operating Licence and a Route Licence. It matters not that the carrier does not or has no intention to operate the routes covered Council Regulation 2408/92, but it must still satisfy the licensing criteria for the grant of an Operating Licence.

These authorisations, however, relate to Community carriers. Carriers from the Channel Islands and the Isle of Man are not affected, neither are the routes to these places. In respect of these carriers and routes, the CAA continues to maintain the grant of Air Transport Licences. If, however, the carrier intending to serve on such routes is UK-registered, a Route Licence will be issued instead, since by virtue of the UK registration the carrier would have been granted an Operating Licence under Council Regulation 2407/92. But given that the substance of the economic regulatory policy under the liberalisation programme are not radically different from the policies pursued by the CAA for many years, and on which Community policy on air transport liberalisation has largely been modelled, the impact of these measures on carriers licensed by the CAA has therefore not been as significant as one might have imagined. The same may not be true of other Community carriers. Indeed, the CAA saw little point in maintaining the difference between the airlines it licenses and proposed in 1993 that the provisions of the third package of measures should be similarly extended to Channel Islands and Isle of Man carriers and to the routes serving these destinations.³⁸

Market Access

The primary aim of Council Regulation 2408/92 is to confer an automatic right on Community air carriers who will have been granted an Operating Licence in the first instance,³⁹ to exercise the traffic rights which they have been granted on routes within the Community. A Member State could not, therefore, refuse access by a Community carrier onto a route or market which it has been granted the necessary traffic rights to operate. This, however, is no more than a general principle. Much like previous liberalisation measures, this Regulation is also full of exemptions, some of which are transitional in nature, while others are not of a permanent nature. These exemptions have given rise to a number of important cases where Member States have refused a Community carrier to exercise its traffic rights, some of which have shed an important light on the progress of securing a truly liberalised air transport market; at the same time too, they provide national authorities responsible for route authorisation with principles by which the provisions of the Regulation may be applied.

The exemptions in the Regulation may be conveniently classified into the following: *transitional exemptions*, *infrastructural exemptions*, and *public policy exemptions*.

³⁸ Decision 3/93.

³⁹ Article 2(b) defines a "Community air carrier" as: "an air carrier with a valid operating licence granted by a Member State in accordance with Council Regulation 2407/92".

(a) Transitional Exemptions

- cabotage services - before April 1, 1997, a Member State need not grant cabotage traffic rights within its territory to Community carriers licensed by another Member State unless the cabotage service was an extension or preliminary service to the originating or terminating service in its State of registration.
- domestic services - before April 1, 1997, a Member State may regulate access to routes within its territory for carriers licensed by it under Council Regulation 2407/92 provided it was free from discrimination on the grounds of nationality and carrier identity. :
- exclusive concession - in cases where an exclusive concession had been granted by law or contract to operate domestic routes and in relation to which other forms of transport could not ensure the adequate and uninterrupted service, the concession was permitted to continue for a period of three years from the time the Regulation entered into force or the expiry date of the concession whichever was the earlier.

It is clear that these exemptions have now expired. The most significant of these has been the expiry of the right of Member States to regulate entry into its domestic routes by a Community carrier licensed by another Member State in accordance with Council Regulation 2407/92. It marks a very significant departure from the tradition of protecting domestic markets that has been built and practised for so many years, but it is also a reflection of the unique nature of the Community legal system.

(b) Infrastructural Exemptions

- airport systems - Member States are given the discretion to regulate the access of Community air carriers on the basis that air traffic needs to be distributed between airports in an airport system but without discrimination on grounds of nationality nor identity of carrier.⁴⁰ The rules relating to such distribution must accord with the requirement of transparency, typically through their publication.
- environment - Member States retain the discretion to regulate access to airports which suffer from congestion or environmental problems by imposing conditions limiting the exercise of the traffic rights or indeed refusing the exercise of such rights, particularly in circumstances when "other modes of transport can provide satisfactory levels of service". Regulating access on such a basis requires Member States to observe the non-discriminatory rule as well as ensuring that it does not unduly affect the objectives of the Regulation nor distort competition. This would ensure a degree of proportionality between the means used and the ends. In all cases, however, such restrictions cannot exceed a period of three years.

⁴⁰ An airport system consists of "two or more airports grouped together as serving the same city or conurbation": Article 2(m). These include, for instance, London, Paris and Rome.

(c) Public Policy Exemptions

- public service obligation - this may be imposed in respect of scheduled air services serving peripheral regions or operating on a thin domestic route to a regional destination to ensure the "adequate provision of scheduled air services satisfying fixed standards of continuity, regularity, capacity and pricing, which standards air carriers would not assume if they were solely considering their commercial interest". These routes, however, need to be vital for the economic well-being of the region. An example is the decision of the CAA to designate the Glasgow-Tiree, Glasgow-Barra and Glasgow-Cambeltown routes as a matter of such obligation.⁴¹
- regional services - Member States may refuse permission to another air carrier to operate on a new regional route which a carrier licensed by it has started to operate with an aircraft of no more than 80 seats and which capacity does not exceed 30,000 seats per annum, unless that other carrier proposes to operate using an aircraft of not more than 80 seats or ensuring that if a larger aircraft was used, no more than 80 seats are sold for that journey. This exemption can be applied only for a maximum period of two years.

The provisions of the Regulation are by no means always free from complications; nor indeed, complied with. These are made more acute by the availability of a wide range of exemptions that may be called upon to justify refusal for the exercise of air traffic rights. In 1994, for instance, the French authorities refused permission for TAT European Airlines⁴² to operate into Paris(Orly) from London(Gatwick) which TAT claimed it was entitled to under Council Regulation 2408/92. Its complaint was made on the basis that the restriction of London-Paris services only to Charles de Gaulle airport (CDG) had no objective reasons since French domestic services were permitted to operate into both Orly and CDG. In addition, TAT argued that Orly was also served by international services with fifth-freedom rights, for example, London(Heathrow)-Paris(Orly)-Karachi by Pakistan International Airline. It claimed that neither the airport distribution rules nor congestion could be invoked since TAT already had in its possession the necessary slots to operate on that route. The French Government referred to its Decree on the distribution of intra-Community air traffic within the Paris airport system and to the long-term objectives of its airport policy for establishing CDG as the "gateway to Europe" and Orly as the "gateway to Paris". The decision of the Commission reasoned that the Decree adopted by the French Government was not in accordance with the requirement of non-discrimination. In particular, it stated that the Decree "discriminated against Community carriers other than those established in France, and, to a lesser extent, other than Greek, Portuguese and Spanish carriers as regards the operation of French domestic routes". Furthermore, the Commission could not find any justification in the allocation of intra-Community traffic solely to CDG since "many extra-

⁺¹ (1996) OJ C387/6 and (1996) OJ C387/7.
⁺² TAT is part-owned by BA.

Community international services, including medium-haul services, are operated concurrently at Orly and CDG airports by French or by non-Community airlines."⁴³

No more than one month later, TAT filed another complaint against the French authorities claiming on this occasion that the refusal to license TAT on the Paris(Orly)-Marseille and the Paris(Orly)-Toulouse routes was an infringement of Council Regulation 2408/92 and also the 1990 Agreement struck between the Commission, the French Government and the Air France Group when the latter took over UTA, which until then had been an independent long-haul carrier. The French authorities justified its decision on the ground that the routes in question were the subject of an exclusive concession granted to Air Inter in accordance with Article 5 of the Regulation. The Commission eventually upheld the complaint of TAT stating that the decision to refuse a licence to TAT was discriminatory, and the concept of discrimination under the Regulation had a two-fold meaning, namely, nationality and identity of carrier. The Commission referred to the policy reason to distinguish between nationality and identity stating that the absence of discrimination on the ground of nationality was insufficient to achieve a fully integrated market for air transport since the structure of Community air transport does not always allow for nationality nor ownership to be identified readily. Hence the need for a principle of non-discrimination on the basis of carrier identity which would aim to prevent a Member State from withholding the traffic rights granted to "a limited number of other carriers who are or can be precisely identified to operate the same service on comparable terms". This discrimination may result either directly from the measure taken or may be ascertained indirectly from the *de facto* circumstances. In that case, the Commission reasoned that the exclusive concession granted to Air Inter in respect of Paris(Orly)-Marseille and Paris(Orly)-Toulouse could not come within the scope of Article 5 since Article 5 was designed to ensure the continued provision of adequate transport services and where there was no other way of uninterrupted travelling between two points in the same Member State. Where, however, one of these points fell within an airport system, the exclusive concession must relate to the entire airport system, and not to particular airport within it. Thus, restricting the Paris(Orly)-Marseille and Paris(Orly)-Toulouse routes to Air Inter but at the same time allowing TAT to operate Paris(CDG)-Marseille and Paris(CDG)-Toulouse could not mean an exclusive right to Air Inter. And since Article 5 gave effect to exclusive concessions which were in force only at the time the Regulation came into effect (January 1, 1993), Air Inter did not have an exclusive concession in respect of Paris-Marseille on the ground that an Agreement of 1985 gave UTA and Air Afrique the permission to operate on that route, nor in respect of Paris-Toulouse since the Agreement of 1990 provided for the expiry of its exclusive rights on March 1, 1992.⁴⁴

⁴³ Case VII/AMA/II/93, OJ [1994] L127/22. An appeal has been lodged against the decision: Case C-203/94, OJ [1994] C254/6.

⁴⁴ Case VII/AMA/IV/93, OJ [1994] L127/32. Both France and Air Inter appealed against the decision: Case C-174/94, OJ [1994] C218/16 and Case T-260/94, OJ [1994] C275/28.

A year earlier, the Commission had handed down a condemnation in respect of the refusal by the French authorities to authorise Viva Air's application to operate a Paris(CDG)-Madrid service, prominently against its own airports policy to develop and expand CDG airport into a European gateway and hub by gradually transferring intra-Community services from Orly airport⁴⁵. The catalogue of difficulties involving the French authorities under this Regulation was further extended with the disputes involving BA⁴⁶ and Air UK⁴⁷ who were also refused access to Paris(Orly), and again involving Lauda Air (Austria) which was considered under the new European Economic Area rules.⁴⁸

While these cases may have been a minor distraction to the process of liberalisation, they are instructive of the difficulties that surround the exposure of a previously protected sector to competition. The ability to enforce strictly the regulatory provisions is, therefore, as much a cause for concern as is the desire to do so. The disparities in the regulatory policies of Member States are ironically too obvious to put a big question mark over the real process of liberalisation. Free of bilateral restrictions, the CAA has consistently sought to license routes liberally to promote competing services for the benefit of users. The same cannot always be said of all other Member States. Although it would be stating the obvious that access to routes has and will continue to be regulated to some extent even if only by the use of exemptions, the crucial difference lies in the disparity between these route licensing policies and their underlying philosophy. A regulatory presumption of liberal licensing contrasts markedly to an approach whereby a case has to be argued for a route licence to be granted, as was the case with the CAA in its earlier years.

In the sense that the market access Regulation seeks to liberalise access to intra-Community routes, it bears little difference to the long-standing policy of the CAA of liberal access. Indeed, as noted above, the CAA went as far as to propose an extension of the liberalisation measures to Channel Islands and Isle of Man carriers and routes which were outside their scope of application. Its proposal sought, first of all, to abolish the regulatory distinction between scheduled and charter services on these routes, and to extend a similar degree of freedom to these carriers to serve any UK route as if they were UK-registered airlines and also to extend the application of the fares Regulation to such routes. Although no serious objections were raised at the hearing, the point was made by several airlines that abolishing the scheduled/charter distinction would give existing charter operators an advantage by virtue of the fact that new operators do not enjoy the benefit of any established standard relative to past performance. The CAA's response to this concern indicated that,

these were unlikely to be of great significance given both the way in which it has treated applications for charter services and the transparently liberal policies towards Channel Islands

⁴⁵ Case VII/AMA/I/93. OJ [1993] L140/51.

⁴⁶ See *The Times* (12 May 1994).

⁴⁷ *The Times* (9 May 1994).

⁴⁸ *Financial Times* (14 October 1994).

services...Implicit in its proposal therefore was the assumption that it would grant liberally further applications
It reasoned further that it "could not ignore the changes which had taken place within the EC or the broad sweep of developing Government policy towards airline competition."⁴⁹

In the procedural sense, the market access measures have isolated further the incidence of public hearings in route licensing, at least in respect of intra-Community routes. Although consistency in policy application and gradual deregulation over the years have contributed to the rarity of licensing hearings, it is evident that the liberalisation of access to Community routes will reinforce that effect. This, as stated earlier, is not necessarily a bad thing since the hearings are often dominated by legal representatives who seek not so much as to contribute to the wider development of air transport policy, but to exalt the art of legal argument and semantical prestidigitation. Indeed, the CAA has no particular wish to see the revival of undue hearings for the purposes of route licensing. Hearings will of course continue to be essential in cases of alleged anti-competitive behaviour in respect of routes not falling within the scope of the Regulation. The drawbacks of the lack of hearings for cases of alleged anti-competitive behaviour on those routes covered by the Regulation have already been referred to earlier and are explored further below.

Capacity

While no specific Regulation has been adopted for the liberalisation of capacity, Article 10 of Council Regulation 2408/92 removes any capacity limitations on routes covered by the Regulation. A remedial power is, however, vested in the Commission to impose limitations to stabilise capacity where there has been a "serious financial damage". The regulation of capacity has not been actively pursued by the CAA for some years although there may be occasions when the enforced reduction of capacity has been necessary, in particular where there are bilateral restrictions or where there has been a significant change in the traffic density of the route. For example, the restrictions in the bilateral agreement between the UK and Japan required the CAA to condition the licence of BA so that it had to operate a prescribed number of frequencies,⁵⁰ as was the case relating to the London(Heathrow)-Beirut services in which capacity had to be distributed between BA and British Mediterranean Airways.⁵¹ The general policy, however, remains one in which the decisions of airlines in respect of capacity ought to be shaped by market forces, not regulatory prescription.

The remedial power of the Commission is more of a protective measure rather than an anti-competitive instrument with which it could be used to prevent excess capacity with predatory characteristics. While anti-competitive behaviour may be dealt with under Article 85 and Article 86 of the Treaty of Rome, the remedial power is all but a covert expression of the protectionist tendency in respect of airline interests, though not necessarily, *rather than* user

49 Decision 3/93.
50 Decision 1/91.
51 Decision 2/94.

interests. Financial damage envisaged by the provision may arise in two circumstances: excess capacity with predatory or anti-competitive intent or excess capacity as a result of significant changes in market conditions. In a case where an anti-competitive behaviour has been alleged, powers of the Commission under Council Regulation 3975/87 to apply Article 85 and Article 86 can be invoked and if necessary dealt with under the expedited procedure⁵² This is an antitrust rather than an economic regulatory intervention. Where financial damage is imminent or has been caused by a significant reduction in demand, the interplay of demand and supply of the market system will accordingly inform, or indeed should have informed, the airline concerned to either withdraw the service or reduce the capacity or frequency to meet the lower level of demand in accordance with its commercial judgement. Of course, an exception must be made in respect of services which are operated as part of a public service obligation, although this argument pales into insignificance if the central tenet of a public service obligation, duly compensated for, is taken into account. Further, an exception to this argument can also be made of unforeseen circumstances such as war or emergencies. Unless these limited conditions exist, serious financial damage is *prima facie* insufficient to justify economic regulatory intervention. Although liberalisation is far from deregulation, it is a contradiction of the liberalisation policy to enable intervention on the basis of, *inter alia*, the "capacity utilization achieved" by the airlines.

Fares

The regulation of fares have not been actively pursued by the CAA for over a decade. Its recommendation to the Government for the deregulation of domestic fares was duly endorsed in 1984.⁵³ Filing of fares continue to be necessary, however, if only to maintain regulatory oversight against anti-competitive behaviour. Fares on international routes are largely prescribed by bilateral agreements unless a mutual agreement to allow competition in fares has been achieved. In these respects, Council Regulation 2409/92 which seeks to facilitate the determination of fares "freely by market forces" is little more than a formality for UK domestic air transport.

The fares Regulation makes provision for Member States to regulate fares in two circumstances. First, where a fare is "excessively high to the disadvantage of users in relation to the long term fully-allocated relevant costs of the air carrier including a satisfactory return on capital", the Member State concerned may withdraw that fare. Secondly, a Member State has the discretion to prevent further fare decreases "when market forces have led to sustained downward development of air fares deviating significantly from ordinary seasonal pricing movements and resulting in widespread losses among all air carriers concerned" but only as regards the services in question. Regulatory intervention on the basis of excessively high fares in the light of the fares structure for the route concerned resembles the policy of the CAA to intervene where these amounted to an exploitation of market power, and in any event, it

52 Commission Regulation 4261/88, OJ [1988] L376/10.

53 *Airline Competition Policy* (Cmnd.9366, 1984).

is specifically justified on the ground that they disadvantage the users. The intervention provided in the Regulation when fares are decreasing is a less straightforward issue. It resembles to a limited extent the policy of the CAA on predatory practices by lowering fares so significantly, although this is clearly an antitrust response to the behaviour. It would therefore appear that such cases are more appropriately dealt with under the antitrust provisions of Articles 85 and 86. Preventing further downward spiral of fares, which all the more so has not been directly justified by user interests, is an economic regulatory action to adjust the appropriate level of fares against the flow of market forces, and is not a sufficient justification.

Community Policy on Air Transport Competition: A Critique

The liberalisation measures have, in no small way, heralded a new and arguably challenging era for Community air transport. The changes they have introduced are by no means familiar to many Member States who have never embraced any form of liberal air transport policy prior to the arrival of these measures. For the UK, while many aspects of these measures are in essence a confirmation of the regulatory policy pursued for many years, others have affected it in more fundamental ways both in substantive and procedural terms. Licensing of air transport may not be a new means of securing the attainment of a particular objective; indeed it stretches back to 1960 when the ATLB was first created. But the types of licences have had to be re-classified. Policy review has had to be effected to consider the extension of Community policy to Channel Island and Isle of Man routes which the CAA cannot be impervious to. Regulatory objectives have also assumed a fresh emphasis. Even more significant has been the transfer of regulatory responsibility for anti-competitive behaviour to the Commission in respect of the routes covered by the market access Regulation. The drawback of this development lies in the absence of open, public hearings for determining allegations of anti-competitive behaviour. Whatever may be the imperfections of an adversarial hearing, the likelihood of establishing the truth or falsity of the anti-competitive behaviour claim is far greater than a closed hearing.⁵⁴ The trappings of a court-room and the confrontational characteristic of a *lis inter partes* hearing go a long way towards preventing the sort of legal vacuum which frequently troubles an *ex parte* hearing. Although the expertise of national competition authorities and the Commission in antitrust policing need not be seriously doubted, there remains the question of whether, between them, they form the most appropriate institution disposed to air transport competition policy development to the exclusion of the regulatory agencies entrusted with the task for so many years including the CAA.⁵⁵ Opportunities

54 Interview with the Director of the Economic Regulation Group, CAA, 2 February 1995.

55 The CAA has an agreement with the OFT in airline competition cases to "work together using their differing but complementary knowledge and expertise so as to handle competition issues in the airline sector in the most effective way...Now however the Authority no longer has the ability to restrict or condition airlines' licences on routes within the Community and thus in practice redress for anti-competitive behaviour can be implemented only through the powers of the

though these measures may have promised, much is still to be desired. Some of these fundamental policy concerns are explored below.

The Dilemma of Interests: The Means and The Ends

One of the most fundamental misgivings of Community air transport policy is the lack of prioritisation of the stated objectives. This, as it must seem in due course, is the root-cause of the difficulties towards a coherent establishment of air transport policy. In its first Communication to the Council, the Commission spelt out in the Memorandum four objectives of a Community air transport policy:

- users: the availability of a network of efficient services at prices as low as possible without discrimination;
- airlines: financial soundness of airlines, a diminution of costs and higher productivity;
- staff: safeguarding interests of airline workers for social progress and eliminating barriers to free movement;
- public: improving the conditions of life.⁵⁶

No measure of preference has been built into the set of objectives. User interests are by no means a primary objective as may be contrasted with the *Statement of Policies on Route and Air Transport Licensing* of the CAA.⁵⁷ Other interests are ranked as of equal importance with user interests. Indeed, the Communication paid a special regard to the interests of airlines in respect of their financial soundness and their workers when it sought to explain the objectives further. Community air transport policy in this respect represents a stark reversal in policy direction for the UK since for well over a decade interests of the users have been given priority over the interests of the other participants in the regulatory complex.⁵⁸

Justification of this policy approach by reference to the Treaty, particularly Article 2 and Article 3, is not readily supported by the language of the Treaty itself. The Memorandum of the Commission stated that,

[T]he general objectives of Article 2 should be applied for air transport as an economic sector in itself and result in a harmonious development of this activity in the whole of the Community. However, since air transport, like other modes of transport, falls within Article 3 it is clear that development of an air transport policy should take into account also the other aims announced in the interest of the Community in general...such as industrial policy...regional policy... energy policy and environment....⁵⁹

Commission or, as appropriate, the OFT under national competition law...It is important to establish which cases if any would be most appropriately handled at national level and which by the Commission": CAA, *Airline Competition in the Single European Market*, CAP 623 (1993), paras.296-301.

56 *Contribution of the European Communities to the Development of Air Transport Services*, Bull. EC Supp.5/79, para.15.

57 CAP 620 (1993).

58 See Civil Aviation Act 1980.

59 Bull. EC Supp.5/79, para.11.

While it would clearly be inappropriate to disregard other policy aims of the Community, they cannot however override nor fetter the discretion of the Community in developing an air transport policy. But it is also true that the Community institutions have not been expressly mandated by the Treaty to accord equal importance to the interests of users, airlines and others. Article 2 does no more than to set out the tasks of the Community to promote a harmonious development of economic activities in order to ensure "a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the States". Article 3 on the other hand sets out the specific tasks of the Community including the development of a common transport policy. Both Articles do not preclude the prioritisation of air transport policy objectives, and this can therefore be achieved over time through the use of its regulatory discretion either by publishing policy statements or developing a set of principles from the case-law.

As the discussion on state aids and mergers below will indicate, the interests of users have not featured as prime concern in the decisions of the Council and the Commission. Most illustrative of the actions of the Council for present purposes is evident in the liberalisation measures adopted. Although logic dictates that the process of liberalisation must be gradual to enable satisfactory adaptation by Community carriers to competitive forces, this justification cannot be applied indiscriminately to all aspects of economic regulation. In particular, the Commission and Member States have often been conferred with remedial powers to ensure the survival of Community carriers, even perhaps in the blatant wake of inefficiency or anti-competitiveness. It is a supreme irony for a liberalisation policy to protect the inefficient by holding out a stick without the carrot. A useful example is the remedial powers of Member States under Article 6 of Council Regulation 2409/92 to prohibit further downward spiral of air fares in dire market circumstances. The purpose of this provision seems two-fold in the most obvious sense: to protect the interests of carriers⁶⁰ and the interests of users indirectly by ensuring that services continue to be viable. The preamble to the Regulation states that,

it is appropriate to complement price freedom with adequate safeguards for the interests of consumers and industry.

It is clear that the safeguards in this Regulation, specifically under Article 6, were not intended to correct anti-competitive practices in fares since such practices would be dealt with under Article 85 and Article 86 which enforcement the Commission has been authorised by Council Regulation 3975/87, or by the national authorities according to their national antitrust laws. It cannot therefore be argued that the safeguard provided in Article 6 had been designed to prevent anti-competitive practices.

⁶⁰ Indeed, an answer to a European parliamentary question was provided by Commissioner Abel Matutes that one aim of the safeguards is "to protect airlines if an obvious state of crisis is provoked by a fares war between all carriers": [1994] 4 CMLR 28.

Nevertheless, it is entirely possible to submit the argument that the safeguard against the downward spiral of fares is to ensure that airlines are not driven to the brink of collapse by a "price-war" so that ultimately it is the interests of users which will be adversely prejudiced. However, the plausibility of this argument pales into insignificance if the realities of air transport economics are put into perspective. In the first place, the argument assumes the total withdrawal of services by all airlines on the route simply on the basis of non-profitability. In practice, however, this is unlikely to happen. The point will come when one or perhaps even two airlines will be left to operate the services without the vigour of the competition *ex ante*. This absence of competition will then enable the remaining airline or airlines to raise the fares to their 'normal' level to reflect the proper allocation of costs. This latter adjustment cannot be regarded as excessive pricing to the disadvantage of users since it is a proper allocation of costs with relevant provision for a satisfactory return on capital. It can only be regarded as excessive pricing if the fares *during* the period of downward spiral were still priced above costs so that the latter adjustment was simply to inflate the margins further, but in which case the regulatory intervention to prevent the downward spiral when fares were still above costs must amount to an artificial determination of fares contrary to the idea that fares should be set freely by market forces, and consequently amounts to the protection of possibly inefficient airlines. In any event, excessive pricing can be dealt with in two ways. First, if the new pricing was excessive as a result of an abuse of a dominant position, that can be dealt with under Article 86 or the relevant national antitrust laws. Secondly, barring the constraints on competition noted in the previous chapter, excessive pricing by one airline will in practice accelerate a lower level of entry barrier so that other airlines will begin to introduce competing services with differential, often smaller, margins between fares and costs: this is the essence of the theory of market contestability. At any rate, the difficulties of infrastructural constraints are not as significant in such cases since the competition *ex ante* necessarily implies that these limitations did not apply then. Thus, providing that there has not been pricing below cost with predatory intent, which at any rate will be considered as an antitrust case, the loss arising from the continued provision of the services when fares are spiralling downwards must be seen as a voluntary commercial decision, albeit an irrational one. Commercial irrationality on its own, however, cannot suffice for regulatory intervention. Article 6 safeguard against the downward spiral of fares underscores the intent of Community air transport policy to further the interests of airlines, possibly at the expense of user interests. Indeed, it has been explained elsewhere that this provision was inserted specifically to protect the Mediterranean airlines who were vulnerable to the low fares of the charter airlines.⁶¹ Although there is nothing inherently inappropriate about protecting the interests of airlines, the argument is such that a competitive system envisaged by the Treaty and the liberalisation measures, and which puts airline interests ahead of user interests, results in a mismatch of means and ends by putting the cart before the horse. It distorts the theory of critical market contestability which is a precondition of effective competition.

61 See F.de Coninck, *European Air Law* (Institute of Air Transport, Paris, 1992), p.70.

Without a clear prioritisation of the objectives, policy development for Community air transport runs the risk of mismatching its objectives and the means by which they can be achieved. Community policy, hitherto, assumes competition as a means by which the objectives can be furthered⁶² It is, however, not clear as to whether competition represents a cast-iron or a flexible means which use will be in accordance with the prevailing economic conditions. While it has identified how airline interests may be promoted,⁶³ the policy is less clear as to how competition as a policy instrument will be applied to secure the interests of users.

State Aids: A Barrier to Competition

The issue of state aids has persistently plagued the efforts of achieving a truly single European market for air transport. State aids are not prohibited *per se*. The Treaty of Rome provides in Article 92 and Article 93 that while aids are in principle incompatible with the common market, there are circumstances in which they may be accepted. Article 92(1) states,

Save as otherwise provided in this Treaty, any aid granted by a Member State through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, shall, in so far as it affects trade between Member States be incompatible with the common market.

This is a provision of considerable width. Aids which *are* or *may be* compatible with the common market are set out in Article 92(2) and (3) respectively, and they include aid with a social character, aid designed to promote or facilitate economic development or the execution of an important project of common European interest.

State aids are not confined solely to capital handouts or equity contributions which are tangible. The forms of aid which the Commission has recognised range from loans to guarantees, subsidies to tax exemptions. The concern with state aids in air transport is not so much the principle of aid in itself, but rather with the potential distortion of competition intended by the liberalisation programme; for it is a policy weakness to put in train a process of liberalisation but at the same time permitting unlimited access to financial assistance for some but not others. The concern is particularly acute in air transport given the virtual dominance of State ownership in all but two national airlines in the EEA. Except for BA and Icelandair, all other Member States maintain one or another form of financial stake in their national airline.

62 See *Impact of the Third Package of Air Transport Liberalization Measures*, COM(96) 514.

63 *Contribution of the European Communities to the Development of Air Transport Services*, Bull. EC Supp.5/79.

Table 8.1 Ownership of Flag Carriers as in 1996

Flag Carrier	Country	State Ownership
Aer Lingus	Ireland	100%
Air France	France	94.2%
Alitalia	Italy	86.4%
Austrian Airlines	Austria	51.9%
British Airways	United Kingdom	0%
Finnair	Finland	60.7%
Iberia	Spain	99.8%
Icelandair	Iceland	0%
KLM	Netherlands	38.2%
Lufthansa	Germany	35.68%
Luxair	Luxembourg	23.11%
Olympic	Greece	100%
Sabena	Belgium	33.8%
SAS	Sweden	50% of 42.85%
	Denmark	50% of 28.57%
	Norway	50% of 28.57%
TAP	Portugal	100%

Source: *Association of European Airlines Yearbook 1996*⁶⁴

It is therefore reasonable to assume that publicly owned national airlines effectively have unlimited access to financial assistance while privately owned airlines need to secure the confidence of investors in the market place in order to have access to financial assistance. The disparity in access potentially prevents fair competition. In the light of this concern and the need to enforce the rules on state aids more vigorously, the Commission issued guidelines indicating its intended approach with respect to air transport state aids. These were first set out in its second Memorandum to the Council in 1984.⁶⁵

The language of Article 92 is such that the approach of the Commission is limited to one which embraces a presumption that state aids are in general prohibited unless they can be properly justified; for otherwise, "any increase in competition between airlines could result in the financing of such competition out of state aid."⁶⁶ Hence, the guidelines formulated by the Commission reflect to a large extent this presumption. Stated briefly, the guidelines to be drawn upon when assessing state aids are as follows:

- state aids justified on the basis of attaining national objectives will not be regarded as sufficient to satisfy the requirement of compatibility in the Treaty;
- assessments of state aids will also depend on the economic situation of the air transport industry in the Community;
- while recognising that the economic conditions of the industry tend to fluctuate, aids may be authorised in cases where an airline is suffering "serious financial difficulties", subject to a number of conditions. First,

⁶⁴ The ownership share does not take into account those which are held by public sector institutions or airlines of another State.

⁶⁵ COM(84) 72.

⁶⁶ *Ibid.*, para.2.

the aid must form part of a restructuring programme so that the airline can within a reasonably short time begin to operate without further aid. Secondly, the aid must not result in a transfer of the airline's difficulties to other parts of the Community. For example, the aid cannot be used to finance a particular route on which there is intense competition. Thirdly, there has to be transparency to ensure the proper application of the aid;

- where the aid is also designed for regional development, objectives of the Community relating to regional development will be referred to accordingly;
- state aids intended for the operation of domestic routes will be accepted in general since they are not likely to be prohibited by terms of Article 92;
- state aids will not be assessed in such a manner that will place "Community carriers at a competitive disadvantage with carriers from third countries, who are either subsidised or otherwise benefit from preferential treatment".⁶⁷

Since then, the Commission has published a number of documents consolidating its statements of policy on State aids⁶⁸ including a comprehensive evaluation report.⁶⁹

A central tenet of the Commission's policy to ensure neutrality in the treatment of publicly owned and privately owned enterprises when applying the state aids rules and its own guidelines, is the *Market Economy Investor Principle* (MEIP) designed principally to enable it and Member States to assess whether the aid granted would have been secured by a private enterprise from its investors. This principle, however, involves a notoriously difficult value judgement. Officials would in essence be acting as a surrogate for private investors attempting to guess objectively whether the aid was equivalent to an ordinary commercial transaction between the owner and the undertaking. In practical terms, this cannot be a satisfactory substitute for a true market test; but it is the better of two evils. State ownership in Community airlines are not likely to disappear altogether in the foreseeable future in spite of the commitment by some Member States to privatise their national airline, for instance, Germany, France and Portugal. Rules for state aids must therefore continue to be in place. Indeed the Commission has implicitly acknowledged that the issue of state aids in general is a particularly thorny one, and will persist to be so.

[I]t is not the aim of the Commission in the future, just as it has not been in the past, to replace the investor's judgement. Any requests for extra finance naturally calls for public undertakings and public authorities, just as it does for private undertakings and the private providers of finance, to analyse the risk and the likely outcome of the project. In turn, the Commission realises that this analysis of risk requires public undertakings, like private

67 *Ibid.*, Annex IV, para.52.

68 E.g. *Application of Articles 92 and 93 to State Aids in the Aviation Sector*, (1994) OJ C350/5.

69 *Report on the Evaluation of Aid Schemes Established in Favour of Community Air Carriers*, SEC(92) 431.

undertakings, to exercise entrepreneurial skills, which by the very nature of the problem implies a wide margin of judgement on the part of the investor. Within that wide margin the exercise of judgement by the investor cannot be regarded as involving state aid...Only where there are no objective grounds to reasonably expect that an investment will give an adequate rate of return that would be acceptable to a private investor in a comparable private undertaking operating under normal market conditions, is state aid involved even when this is financed wholly or partially by public funds.⁷⁰

Ironically, however, the lack of vigour on the part of the Commission in applying its own guidelines is by no means undetectable. Several cases are instructive of this point.⁷¹ In particular, the Commission ruled compatible a capital injection of FF20bn into Air France in 1994 on the basis that the latter's restructuring plan was aimed to return it to financial and economic viability.⁷² This decision came following two earlier decisions authorising a FF5.8bn aid to Air France in 1991 on the footing that under the MEIP, it would not have been unreasonable for a private investor to make a similar investment. That conclusion was based on a number of observations, in particular the deterioration of Air France's financial position and global structure principally as a result of the Gulf War, but also of the take-over of UTA and of other related financial charges. The Commission was also influenced by the *Contrat de plan* which it felt promised good long-term prospects for its overall structure.⁷³ This proved to be misguided eventually. In spite of that injection, the Commission was driven to recognise explicitly in 1994 involving yet another injection, that "Air France's situation has continued to worsen".⁷⁴

In 1991, the Commission again authorised the aid granted to Sabena even though "in view of the accumulated debts and the costs of the restructuring programme, no investor apart from the State would at present be prepared to take part in the restructuring programme of Sabena."⁷⁵ Nevertheless, it authorised the aid on the basis of Article 92(3)(c) to promote the development of a certain economic activity subject to several undertakings including the abstention from granting further aid, the re-orientation of Sabena's operations towards greater commercialisation, and the finding of an industrial partner to co-operate in the restructuring programme. A similar application of the derogation in Article 92(3)(c) from the rules on State aids was made in respect of the £175 million equity injection into Aer Lingus which, according to the Commission, no investor would provide. The development of economic

70 OJ [1991] C273/2. para.27. in respect of public undertakings in the manufacturing sector.

71 E.g. see *Olympia Airways*, OJ [1994] L273/22; *TAP*, OJ [1994] L279/29.

72 OJ [1994] L254/73.

73 See Twenty-first Competition Policy Report 1991. p.179 and Twenty-second Competition Policy Report 1992. p.269.

74 OJ [1994] C334/7 and the subsequent ruling against this particular aid: OJ [1994] L258/28.

75 Commission Decision 91/555, OJ [1991] L300/48. at p.50.

activities in that case took the form of the aid's contribution to the Irish-EC and Irish-US links and a genuine programme of restructuring.⁷⁶ These authorisations have not been without difficulties and have led the CAA to make the following observation.

The Commission has set out a list of issues to which it would have regard in considering whether injections of equity constitute aid. It is however by no means apparent from its written decisions that it has applied its own guidelines with equal rigour.⁷⁷

More recently, the Commission authorised the capital injection of Ptas 120bn into Iberia, on the ground that the injection was not an aid in the sense prohibited by the Treaty since the equity contribution would have been made by a private investor given the same set of circumstances. Therefore, the question of whether the aid should be authorised under one of the exemptions provided did not arise.⁷⁸ These are but a number of key cases in a very controversial area of Community law on air transport competition. Though there is yet to emerge a clearer set of principles on these cases, it is already evident at the same time that State aids in air transport is increasingly becoming juridified as a result of the readiness of to seek the sanctions or protection of the law and the courts.⁷⁹

It is equally difficult to rationalise the guideline of the Commission on state aids designed to support the operation of domestic routes. These could only be approved if they do not "affect trade between Member States". The claim to being "favourably disposed" towards such aids must nevertheless be seen in the light of the decisions of the ECJ on the meaning of "trade between Member States" as regards Articles 85 and 86. The Court has pronounced that, even in circumstances appearing to be limited purely to a domestic setting, their very nature could have,

the effect of reinforcing the compartmentalization of markets on a national basis, thereby holding up the economic interpenetration which the Treaty is designed to bring about...⁸⁰

The effect on trade between Member States is, however, subject to a *de minimis* rule, that it must affect trade to *an appreciable extent*. This was first enunciated by the ECJ in *Volk v Vervaecke*.⁸¹

Community air transport policy cannot develop in a state of delusion. Like it or not, State ownership in national airlines will remain in one form or another. The

76 Case N557/93. OJ [1993] C291/4 and Commission Decision 94/118. OJ [1994] L54/30.

77 CAP 623, para.255.

78 Commission Decision 96/278. [1996] OJ L104/25.

79 E.g. Case C-174/94. *France v Commission* [1994] OJ C227/31; Case T-394/94. *British Midland Airways v Commission* [1994] OJ C392/14; Case T-16/96. *Cityflyer Express v Commission* [1996] OJ C108/11. See also J.Goh. *European Air Transport Law and Competition* (John Wiley, Chichester: 1997). chs.11-13.

80 Case 8/72. *Vereeniging van Cementhandelaren v Commission* [1972] ECR 977. at p.991. See also Case 126/80. *Salonia v Poidoman* [1981] ECR 1563 and Case 246/86. *Belasco v Commission* [1991] 4 CMLR 96, and the decision of the Commission in *MELDOC*. OJ [1986] L348/50.

81 Case 5/69. [1969] ECR 295.

policy on state aids must be cast accordingly.⁸² A greater part of the problem lies in the way in which objectives of the air transport policy have been compromised. Assessments of state aids are usually made in the light of the airline interests, with remote consideration given to user interests, if at all. The pre-dominance of airline interests readily generates a sympathetic propensity to approve aids which design cannot be clearly distinguished either as a genuine commercial transaction between owner and undertaking or aid in the prohibited sense. By contrast, if state aids were examined with the public interest foremost in mind, then this objective criterion would dictate the prohibition of aids which were either contrary or likely to affect the public interest adversely. The effect of this crucial difference is most conspicuous in a comparison between the regulatory objective of the CAA which regards user interests as a prime concern and the overall Community policy which regards user interests as no more important than other objectives. The liberal licensing regime and the multi-airline competition policy pursued for so many years by the CAA, and indeed the aims of the single European air transport market, will stand precariously alongside a less than rigorous structure of state aids enforcement. The competitive environment which the privately owned airlines have fostered and endured in will lose its equilibrium if other national airlines were better placed to receive aid from their national governments.

Airline Mergers: A Tradition of Collusion

Much like everything else in air transport, the Treaty has also been silent on mergers between airlines. A clear remit to intervene in merger cases did not arise until 1989 with the passing of the Merger Control Regulation 4064/89, sixteen years after it was first drafted.⁸³ A number of airline merger cases had by then been determined, namely the take-over of B.Cal by BA and of UTA and Air Inter by Air France. The regulation of mergers has never been a part of the CAA's responsibility, although clearly it is disposed to use its regulatory powers to deal with such cases through the conditioning of the licences it grants. Its policy as regards mergers are set out in paragraph 10 of the *Statement of Policies on Route and Air Transport Licensing* which states that while an acquisition by one airline of another together with its routes mergers may have neutral or beneficial effects in terms of the statutory objectives, it could also lead to a reduction in competition. Where this was the case, the CAA would give no preference simply on the grounds of incumbency on the routes in question. In reaching its decisions, the CAA would have regard in particular to the maintenance of a competitive environment.⁸⁴

The attitude of the CAA towards Community take-overs is stated in *Airline Competition in the Single European Market*.

82 It is interesting in this regard to note the resolution of the Council in response to the Communication from the Commission on the way forward for European civil aviation which urges the Commission to adopt a closer scrutiny of State aids cases in air transport. See Council Resolution, OJ [1994] C309/2 and COM(94) 218.

83 OJ [1989] L395/1. See N.Nugent, *The Government and Politics of the European Community* (Macmillan, Basingstoke: 2nd. edn., 1991), p.307.

84 CAP 620.

The mergers most obviously damaging to competition will be those where the airlines concerned operate networks which overlap substantially. In such cases any benefits of scope are likely to accrue to the airline in terms of increased market power and not to users through reduced costs. Given the existing structure of the air transport industry in the Community, this would be most likely to occur where a national carrier acquired a smaller competitor based in the same country. In these circumstances the airline being acquired is likely to be one of only a few able to start or maintain competing operations. Thus the result of simply accepting such mergers, or alternatively of doing so with only token conditions attached, would normally be to reinforce the dominance of the flag carrier concerned in its national market and at its major airport or airports. This will be especially detrimental to competition where the airport or airports concerned are, or are likely to become full. Normally therefore such mergers should not be permitted or at least, if genuinely unavoidable, they should be conditioned in a way which will substantially eradicate the negative impact for competition.⁸⁵

Both policy statements are a crystal clear reflection of the decision of the CAA following the take-over of B.Cal by BA, which resulted, *inter alia*, in several important undertakings given by BA to the MMC. The decision of the CAA in respect of the applications for route licences surrendered by BA after the take-over has already been discussed in previous chapters.⁸⁶ The real significance of this take-over lies also in the additional intervention by the Commission.

Prior to 1989, Community regulation of airline mergers were dealt with principally under Article 85, and Article 86 where the take-over also constitutes an abuse of dominant position.⁸⁷ The advent of Merger Control Regulation 4064/89 gave specific powers to the Commission to investigate mergers with a "Community dimension".⁸⁸ Mergers with a Community dimension are characterised by the following criteria:

- where the aggregate world-wide turnover of all the undertakings concerned is in excess of ECU 2500 million,
- where the aggregate turnover of all the undertakings concerned is in excess of ECU 100 million in each of at least three Member States,
- where the aggregate turnover of each of at least two undertakings concerned is in excess of ECU 25 million in each of at least three Member States, and

85 CAP 623, para.243.

86 See Decision 7/88.

87 See e.g. Case 43/85, *ANCIDES v Commission* [1988] ECR 3131.

88 OJ [1989] L395/1. Article 1(2). See J.Goh, *European Air Transport Law and Competition* (John Wiley, Chichester: 1997), ch.5 and the important contribution of the House of Commons Transport Select Committee to the debate on the inadequacies of the "Community dimension" concept: *Developments in European Community Air Transport Policy* (First Report), HC 147 (1991-92).

- where the aggregate Community-wide turnover of each of at least two of the undertakings concerned is in excess of ECU 100 million.⁸⁹
- Mergers without a Community dimension will therefore be dealt with by national authorities of Member States in accordance with the principle of subsidiarity, particularly in respect of cases where "each of the undertakings concerned achieves more than two-thirds of its aggregate Community-wide turnover within one and the same Member State."

Ironically, however, the vigour with which the merger control Regulation should have been applied has been less apparent than the period prior to its enactment. To date, the most significant intervention is still the first investigation in 1988 into the BA-B.Cal merger where a number of substantial undertakings were extracted from BA, in addition to those already given to the MMC, so as to "create stronger opportunities for new competitors to emerge, by improving substantially the prospects for other carriers to be licensed on a number of former B.Cal European routes, by limiting the merged airline's share of slots at Gatwick airport and by ensuring that the merger does not lead to constraints on slots at Heathrow airport."⁹⁰ Substantial undertakings were also extracted from the Air France Group when it took over the long-haul independent airline, UTA, and the domestic airline, Air Inter, in 1990. An agreement was struck between the Commission, the French Government and Air France which promised greater market access and competition with a measure of preference given to airlines outside the Air France Group. In spite of the substantial undertakings, which included the designation of another French airline "to serve eight routes accounting for more than half of domestic traffic", the misgivings with this merger eventually became apparent.⁹¹ The disputes relating to the constraints at Paris(Orly) and the series of State aids to Air France amply testify, not only to the failure to restructure or rationalise, but also to the realities of airline mergers between a national carrier and a smaller, independent carrier.

A number of important airline merger cases have now emerged since mergers were brought within the scope of the Regulation. The first was the take-over of certain Pan Am assets by Delta, specifically the operations of Pan Am at London(Heathrow) and Frankfurt where the latter operated a hub. While the merger met the threshold laid down in the Regulation and therefore qualified for investigation, the Commission concluded that its assessment of the relevant market share of Delta was not significant given in particular the strength of prevailing competition in the transatlantic sector. This conclusion was reached in spite of its finding that the merger would give Delta the largest share of the transatlantic traffic.⁹²

89 As amended by Council Regulation 1310/97. OJ [1997] L180/1: corrigendum [1997] OJ L199/69.

90 Press Release ISEC/7/88 (10 March 1988): see also [1988] 4 CMLR 238.

91 Twentieth Competition Policy Report 1990, pp.90-91.

92 Case IV/M.130. [1992] 5 CMLR M56.

Likewise, two years later, the Commission approved the joint venture proposal between Air France and Sabena.⁹³ Sabena, it will be recalled, had given an undertaking in 1991 to the Commission that, as a condition for the provision of State aid, it will seek to co-operate with an industrial partner as part of its restructuring programme. Whether, at the end of the day, the proposal was a joint venture agreement or effectively a merger, the difference would only be a matter of degree. In the end, the Commission concluded that the proposal was a joint venture through which Air France and Sabena could co-operate to utilise "all the synergies identified between the two partners" given that Air France acquired no more than a joint control with the Belgian State over Sabena. A joint control, according to the Commission, "does not have the object or effect of co-ordinating the competitive behaviour of enterprises which remain independent" and therefore not a concentration. This conclusion was made in the face of the finding that Air France would have a holding of 37.58% in the capital Sabena (through a newly formed company, Finacta) and "a certain preponderance in such management" through its express consent of the appointment of Sabena's chairman. While the proposal was accompanied by some important undertakings, primarily relating to greater access by competing airlines, some were subject to a "trigger mechanism" such as when a certain threshold has been achieved. For example, the Commission found that the merger would give them 81% of the Brussels/Paris-Ankara traffic and 54% of the Brussels/Paris-Budapest traffic.⁹⁴ The undertaking was to allow multiple designation so that competing services could be provided. The Commission added, however, that,

given the relatively small volume of traffic on these routes and the need for a minimum number of passengers to ensure operation of the connections, multiple designation will be put into effect only when a threshold of 100,000 passengers annually on each of them is attained.

It is clear that such a prescription is an affront to the concept of competition and the making of decisions according to commercial judgement. Whether there should be the provision of competing services ought to be a decision resting with the competitors in accordance with the level of traffic demand. A decision to provide such services with low traffic demand, and which therefore runs the risk of making losses, is clearly an irrational commercial decision but one which should be sustained by the competing airline. On the other hand, if the competing services represent good value for money with a high quality in-flight service, users would be provided with a choice of products. A corollary of this condition is to support the provision of services which may perhaps be inefficient and thus highly unlikely to meet the expectations of users. The fear with multiple designation is clearly excess capacity leading probably to lower profitability or even losses. Multiple designation, however, particularly in the immediate aftermath of some liberalisation exercise, will almost always lead to excess capacity. This is borne out in the experience of the US deregulation and

93 Case IV/M.157. [1994] 5 CMLR M1.

94 1990 figures.

the observations of the CAA in its decisions⁹⁵ But inherent in the concept of liberalisation is the process of rationalisation. A point will be reached where the competing airlines will have to re-examine the capacity mounted on the route and, if so required, reduce the level of capacity according to the level of traffic demand; or a point where the additional capacity will have stimulated sufficient traffic growth to sustain existing capacity levels in accordance with the 'S' curve concept. Clearly though, the argument on multiple designation must also take into account the restrictions which often come with bilateral agreements. In this case, however, their relevance would have been insignificant if an enforced reduction in their frequency or capacity was made a condition of the merger, as was the approach taken in the BA-B.Cal merger. This would circumvent any bilateral restrictions on capacity. To set a threshold (of 100,000 passengers) for triggering multiple designation is, as it must clearly seem in this case, an artificial, if not arbitrary, prescription amounting to an undue protection of national carriers at the expense of user interests.

This partnership proved later to be less than successful and led to the withdrawal of Air France. As a result of this, Swiss Air acquired a 49.5% equity holding in Sabena although there serious reservations about the question of ownership and effective control. In the final analysis, the Commission decided that the structure of the equity participation and senior management did result in Swiss Air having a majority or effective control of Sabena, though the Commission also accepted that the agreement appeared to be a transitional solution until existing ownership and control restrictions were lifted on a reciprocal basis by the Community and Switzerland.⁹⁶

Between 1992 and 1993, the Commission also approved expressly or impliedly a number of mergers involving BA. The first was the acquisition of the French domestic carrier, TAT.⁹⁷ This was then followed by a decision of the Commission, in the light of the intervention by the Belgian Government under Article 22 of the Regulation, to refuse to intervene in the take-over of Dan Air by BA in 1992 on the basis that the case did not have a Community dimension.⁹⁸ This take-over and the decision of the Commission is unique in more than one respect. First, a subsequent challenge by Air France against this decision was dismissed by the Court of First Instance.⁹⁹ Secondly, BMA and Virgin applied for judicial review against the decision of the Secretary of State for refusing in the public interest to refer the matter to the MMC. This application was rejected in due course by the High Court. An appeal against the decision was taken to the Court of Appeal which was eventually dismissed on the ground that the Secretary of State was under no obligation to consider Article 86 in the exercise of his discretion whether or not to refer the matter to

95 See CAA, *Deregulation of Air Transport: A Perspective on the Experience in the United States*, CAA Paper 84009 (1984) and CAA, *Competition on the Main Domestic Trunk Routes*, CAA Paper 87005 (1987). See also Decision 1/94.

96 Commission Decision 95/404, [1995] OJ L239/19.

97 Case IV/M.259, OJ [1992] C326/16.

98 Case IV/M.278, OJ [1993] C68/5.

99 Case T-3/93, OJ [1994] C132/12.

the MMC ¹⁰⁰ This is odd since the ECJ has said in *Ahmed Saeed* that Article 86 was directly applicable in Member States ¹⁰¹ Thirdly and perhaps more strikingly, the take-over and the lack of any investigation prompted the Chairman of the CAA to remark that "the Government's approval of BA's acquisition of Dan Air without an MMC inquiry into the competition consequences will not make it easier for the UK to argue for a strong competition policy within the EC."¹⁰²

It would be an insult to intelligence to rehearse at length the widely accepted view that a programme of liberalisation or deregulation will undoubtedly lead to a greater consolidation of resources.¹⁰³ Whether that takes the form of mergers, joint ventures, alliances or code-sharing, it does not matter. The US programme of airline deregulation has had its share of the experience. Numerous code-sharing agreements and the increasing globalisation of services suggest that international air transport has not been spared either. And it must come as no surprise that this trend has infiltrated Community air transport too.¹⁰⁴ While some mergers will have a beneficial effect, others, however will tend to produce anti-competitive effects. It is therefore critical that merger laws are applied vigorously if the experience of the US deregulation is anything to go by, taking into account as a matter of course the difference in market structure and the balance of effects. Or else, greater consolidation will lead to greater dominance by the bigger airlines probably at the expense of competing services. Even the "guru" of deregulation, and the architect of the US airline deregulation programme, Professor Alfred Kahn, was driven to observe that,

No one counted on the muscle of the big carriers, which protected their own market and devoured most smaller entrants. Their biggest weapons were the computerised reservation systems, lifeline of travel agents....¹⁰⁵

The regulation of mergers in the UK is a highly politicised process; a role which the CAA has no more than a limited part to play. Community mergers law, however, has provided a fresh opportunity to re-mould the regulatory approach towards mergers, and no less in airline mergers, though much must depend on the manner in which the mergers law are applied. This would require a re-casting of the mergers policy. For instance, the CAA counselled against the belief that,

it is only by further growth through merger or acquisition between themselves that the Community's largest national airlines can hope to compete with the biggest carriers from the US and the Far East, and that only by softening substantially normal requirements of competition policy will such airlines emerge. The underlying proposition is that the need to facilitate the growth through merger and acquisition of the Community's

100 *R v Secretary of State for Trade and Industry ex p Airlines of Britain & Virgin Atlantic Airways*. *The Independent*, (8 December 1992).

101 *Ahmed Saeed*, *supra*.

102 CAA, *Annual Report 1992-93*.

103 See e.g. CAP 623, paras.230-250.

104 E.g. SAS/British Midland, KLM/Air UK, BA/Deutsche BA.

105 *Independent on Sunday-Business Supplement* (13 January 1991).

largest airlines is now so strong as to make it worthwhile sacrificing some of the benefits of choice and competition which were the object of the liberalisation in the Third Package.¹⁰⁶

Fostering competition with large non-Community carriers through the process mergers cannot, therefore, always be the appropriate approach. On the contrary, as the success of Virgin competing amongst the biggest carriers in the world including BA, American Airlines, United Airlines, Japan Air Lines (JAL) and All Nippon Airways (ANA) has shown, a strong Community competition policy is a pre-requisite for global competition in air transport. A balanced, pragmatic approach to furthering the interests of Community air transport should instead be in place. The CAA continued,

While ensuring that the Community has some airlines capable of competing effectively in major international markets is not the principal objective of mergers policy, it is reasonable that proper regard should be paid to it. The case however will need to be made on detail and not simply on broad arguments about size.¹⁰⁷

In many respects, therefore, the general presumption adopted by the Comité des Sages is ironic for it shifts the onus on the regulatory policy to establish a case against the presumed beneficial effects of a merger. In its recommendations to the Commission, it stated that,

Recognising the overall potential advantages of alliances and mergers for users and operators, and the resulting demise of the national flag carrier concept, the European Commission should, in principle, look favourably on such arrangements. Competition authorities should only object if it can clearly be shown that an aim of the arrangement is to create a dominant position within the Community or within a significant regional market in the context of a merger, or if the resulting outcome is an insufficient number of competitors deemed essential to preserve effective competition in Europe.¹⁰⁸

The flaw with such a presumption lies in the failure to recognise the different effects as between different forms of mergers. It would be difficult, for instance, to see how a merger between two largest Community flag carriers could be consistent with an strong competition policy. To shift the balance of proof onto the regulatory apparatus to disprove the beneficial effects of such mergers (if any at all) seems a blatant paddle against the current. Similarly, in a case where for instance a major flag carrier takes a large shareholding in a smaller carrier in the same Member State or country,

this will very often reduce the prospects for future competition, both because of the direct effects where networks overlap and because of the negative signals given to actual or prospective competitors.¹⁰⁹

Other cases may, however, have a neutral or beneficial effect. The regulation of mergers must therefore have a proper regard for their practical effects and in

106 CAP 623. para.234.

107 *Ibid.*, para.235.

108 *Expanding Horizons* (1994). p.22.

109 CAP 623. para.325.

accordance with the interests of users. It is the lack of prioritising the latter as a primary concern which will, if it has not already, marked difference from the regulatory policy pursued by the CAA.

Evaluation of The Liberalisation Programme

The liberalisation programme for Community air transport began over a decade ago, and despite the abolition of the right of Member States to regulate domestic and cabotage services in April 1997, there has been no seismic changes which were anticipated by some. This was the thrust of the Commission's evaluation, *Impact of the Third Package of Liberalization Measures*, which was published in 1996.¹¹⁰ Indeed, the explosion which took place in the US following its deregulation, in the form of new entrants, did not happen in the European market. On the contrary, the growth of new entrants, particularly low-cost carriers, has been gradual; some of course have disappeared as a result of the intensity of competition such as World Airlines which operated the London(City)-Amsterdam service. The growth of these new carriers has also led to an increase in the number of routes served.

The telling story is revealed by the evaluation on the changes to the fare structures as a result of the liberalisation measures; changes in fares are generally accepted as the most effective measure of competition. First of all, the Commission found that 94% of all Community routes were operated on a monopoly or duopoly basis, while only 6% of the routes had three or more carriers. On further analysis, fares on the monopoly and duopoly routes had in fact risen, while those operated by at least three carriers had fallen. The Commission found that the liberalisation programme had not brought about a dramatic reduction in fares. Apart from promotional fares on which competition has been the fiercest, but which are usually accompanied by numerous restrictions, other fare categories have risen in particular the premium fares for first and business class. Although the Commission offered no conclusive evidence for these developments, it is clear from its report that infrastructural limitations were the most formidable barrier for new entrants or established carriers to compete with the incumbents.

Conclusions

The effect of Community law on the UK since its accession in 1972 has unquestionably been significant in many respects. The changes necessitated or brought about by the "incoming tide" of Community legislation to bring about "an ever closer union among the peoples of Europe" have been far-reaching. Progress in the air transport sector, while largely unaddressed by the Treaty, has taken on a new dimension since the first set of liberalisation measures were adopted in 1987. This chapter has charted the principal effects of Community policy and legislation on the way in which air transport has been regulated under

110 COM(96) 514.

the auspices of the CAA. While some of the changes have in one sense represented a catalyst for a review of the regulatory policy pursued by the CAA, others, however, have raised difficult questions. The regulatory policy of the CAA is not set in stone; nor should it be. Policy review, and the subsequent change, cannot, therefore, be seen as a bad thing in itself. This, as has been noted, is the view of the CAA in respect of its competitive multi-airline policy to further the interests of users. It has stated in numerous decisions that it remains open to persuasion that the competitive multi-airline policy is no longer an appropriate means for the attainment of the statutory objective, but until such time, it will continue to adopt the view that the interests of users would be best served by a number of efficient and profitable airlines competing to provide services. Although the liberalisation measures adopted under the third package have, for instance, required a technical re-classification of the licences granted by the CAA, the more difficult issue, it must seem, lies with the re-orientation of the regulatory policy of the CAA which has been founded on competition and user interests.

The loss of discretion and the consequential demise of hearings for granting Operating and certain Route licences is of less concern to the CAA than the removal of its jurisdiction over anti-competitive practices in a number of respects. In particular, the system of public hearings for licensing has largely been altered by the policies of the CAA and their application. Its fears are specifically related to the manner in which anti-competitive practices by airlines are policed. Hitherto, the CAA has invoked its regulatory powers (in co-operation with the OFT) to determine allegations of anti-competitive behaviour, and if so found, to condition the licence held by the airline operator. It views the system of hearings for such cases as a highly important and useful way in which the truth can be ascertained. Clearly though, Community air transport policy has heralded a new era for the skies of Europe in no uncertain terms. Few can doubt that; neither does the CAA. The issue is not so much about the distribution of powers but the proper regulation air transport competition. Success of the policy, therefore, depends quintessentially on a stricter enforcement of antitrust laws and regulations than has been the case in the aftermath of the deregulation in the US. The value of the lesson from the US, while cannot be overrated, is considerable in this regard towards policy development in the Community. This is the substance of the theory of regulated competition. Where liberalisation takes place, the regulatory emphasis will shift from economic regulation to antitrust regulation. But this presumes that the conditions of sustainable competition have been attained, that is the relevant market may be described as contestable.

As much as economic regulation requires a certain degree of match between means and ends, effective antitrust enforcement depends on a clearly defined set of policy objectives to be achieved. In certain instances, that presumes the prioritisation of objectives *a priori*, not least in respect of an industry heavily regulated and sheltered from competition in the past. The policy of the Community as expressed in the Communications of the Commission sets out the interests of the airlines and the users, among other things, as of equal concern. It should be clear that from this chapter that competition as an aim of

liberalisation cannot be achieved so long as airline interests are paramount and preferred over user interests. This argument begins on a very simple premise airlines exist for users, and not *vice versa*. Airlines are service, and almost always profit-making, organisations whose existence must depend on the demand emanating from users. Users, on the other hand, do not exist for the airlines. Dependence on air transport services is no more than a manifestation of advancement in technology; their absence would simply drive users to other slower forms of travelling. The logic of the argument suggests that airlines must accordingly respond to user-demand. Failure to do so is inimical of not only the ability to meet satisfactorily the interests of its users, but also of operational and structural efficiency which ordinarily cannot be supported. The demise of Pan Am in the wake of deregulation in the US is highly instructive in this regard. Community air transport policy must consequently be re-written to prioritise user interests as the prime concern. Painful though the exercise may suggest, as inefficient airlines will inevitably be driven to oblivion if they fail to re-organise, the argument does not, however, seek to neglect the interests of airlines nor others. These are no more than a function of user interests. Be that as it may, regulatory policies must, in some cases, have due regard to the interests of airlines in order to ensure that the substantial interests of users are met. It may be that opportunities may have to be given to smaller airlines to operate competing services at the expense of larger airlines with more extensive network so as to provide users with a choice of products whether in the form of more attractive schedule or in-flight service. By no means, however, should such a measure of preference be an immutable part of the regulatory policy since that would amount to disregarding the interests of larger airlines. Where such smaller airlines have no prospect of meeting the interests of the users, logic of the policy must dictate that they should not be licensed to operate. Of course, the provision of competing services implies a broad policy based on active competition. Competition though, is no more than a regulatory instrument for attaining the end objective. If conditions were such that a non-active competition approach was on balance appropriate to secure the interests of users, the change would only be in the means, not the end.

In the final analysis, therefore, competition is a means for procuring a maximum overlap between the interests of airlines and users; this has been described as the level of critical market contestability and represents the next best thing to perfect competition. This is because the catalogue of limitations in the air transport sector means that perfect competition is never possible. And it is only when the conditions of sustainable competition has been maximised, that economic regulatory controls can be liberalised. This is by no means the case with the liberalisation of Community air transport. Even if this was true, it is not entirely clear that the shift towards antitrust regulation has resulted in a strict application of the antitrust rules. As this thesis has argued, the absence of an austere framework of antitrust regulation runs the risk of destroying the conditions of sustainable competition and the aims of liberalisation. The experience of the US in the years after the deregulation of the sector offers an invaluable test to this claim.

CHAPTER EIGHT A COMPARATIVE PERSPECTIVE: DEREGULATION IN THE U.S.

*We thought an airplane was nothing but a marginal cost with wings
(Alfred Kahn)*

It should be no radical claim by now to state that a policy of complete deregulation often makes a strange bedfellow in air transport. This assumption is simply premised on the long-standing practice of heavy regulation in air transport. History has shown that domestic air transport has traditionally been a protected sector of the economy. This practice has been reinforced by the territorial principle embedded in the International Civil Aviation Convention 1944, which also lays down the foundation for protectionist practices in the case of international air transport. In spite of that, more recent years have seen the emergence of air transport deregulation, whether complete or partial, in a number of countries other than the US and the UK including Canada, Australia, Mexico and India. Deregulation of international air transport, that is the elimination of bilateral restrictions, is equally, albeit gradually, notable. The Netherlands, Singapore and New Zealand are examples of countries which have consistently sought to liberalise international air transport from the restrictions prescribed in bilateral agreements. No doubt, there will remain a substantial number of countries which are likely to be hostile to the notion of liberalising international air transport. Much must depend on the underlying political, economic and social assumptions of each country as to which policy means is most appropriate for attaining a set of stated objectives.

A comparative evaluation of air transport deregulation in the US will provide a useful basis for considering the regulatory approach in British air transport and the liberalisation programme in Community air transport. No doubt, there will be material differences in the market structures so that any proper comparison must take these into account. The aims of this chapter will take the shape of a historical analysis to chart the developments in the period before the US airline industry was deregulated, and more importantly, those which eventually formed the basis for the reform package. The most significant contribution of the lessons of airline deregulation in the US to the contentions of this thesis will clearly be the effects of the deregulatory policy and the corresponding responses (or the lack of) to deal with the unintended consequences of the reform initiative. These issues should provide a basis for drawing several conclusions, in particular whether the contention of this thesis that airline deregulation must be preceded by the conditions of sustainable competition, and accompanied by an effective antitrust framework can be supported.

It should be clear that the structure of the US airline industry is not similar to that of the UK, not least because public ownership of airlines is a concept alien to the system of economic organisation in the US; whether a similar claim can be made of the structure of Community air transport is an arguable issue,

though the history of Community air transport is also steeped in the public ownership tradition. In any event, it is already beyond doubt that Community air transport has been substantially liberalised and the lesson remaining from the US is whether a liberalisation policy demands at the same time an strict framework of antitrust regulation.

Pioneers of Air Transport Deregulation

The advent of air transport deregulation in the US in 1978 signified a very significant development not only in respect of the political assumptions and the New Right theory then prevailing, but also of the history of air transport regulation since the days of the New Deal instituted by Franklin Roosevelt. More interestingly, however, the system of air transport regulation was the first regulatory arrangement to be dismantled by the Ford Administration, although much of that was a matter of accident rather than a systematic policy choice. A formal system of air transport regulation in the US was first introduced in 1938 when the Civil Aeronautics Act was enacted. This took the form of the Civil Aeronautics Authority. The establishment of the Civil Aeronautics Authority, later re-named the Civil Aeronautics Board (CAB) in 1940,¹ was part of the wider programme of reform of the 1930s for economic revival. Accordingly, the objectives of the air transport regulatory system were shaped by the national objectives that reflected the broader concerns with the state of the economy. It was therefore no surprise that the objectives pointed in the direction of protection rather than free-market competition.

The New Deal and Air Transport Regulation

It was clear from the language of the governing statute that, in performing its regulatory functions, the CAB was required to have primary regard to the interests of an infant airline industry. In essence, it provided that the CAB was to have regard to the following matters as in accordance with the public interest, as well as the public convenience and necessity:

- encouragement and development of the air transport system;
- recognise and preserve the inherent advantages of, assure the highest degree safety in, and foster sound economic conditions in, air transport, and to improve relations between and co-ordinate air transport by carriers;
- promotion of adequate, economical and efficient service by air carriers at fair and reasonable charges;
- assure the sound development of air transport through competition to the extent necessary.²

The legacy of excessive competition, which not only broke the confidence of the public but which also destroyed an air transport structure and profitability, brought forth a host of questions on the appropriateness of leaving the air transport industry to the forces of the market place. In particular, a number of

1 When President Roosevelt reorganised the regulatory functions under the 1938 Act: Reorganization Plan No.4 (1940).

2 S.102, Federal Aviation Act 1958. The Civil Aeronautics Act 1938 was replaced by the 1958 Act.

developments relating to the carriage of mail by air testified to the destructive character of an unregulated regime. For instance, in 1935 the Interstate Commerce Commission was authorised to raise the rates paid to air mail carriers if the latter were earning less than a reasonable rate of return under the mail contracts. It was obvious that this system provided very few incentives for the carriers to achieve lower costs since any shortfall in profit will be met by public subsidy. Bids for these mail contracts tended naturally to be below cost with the erstwhile hope of receiving the subsidy. Absurdity reigned a number of years later when the bid of Braniff Airways at \$0.000002 per aircraft-mile for carriage between Houston and San Antonio in Texas was out-priced by Eastern Airline at \$0.000 per aircraft-mile.³ Reform was therefore wanting, and the New Deal programme provided the opportunity for doing so. In addition, of course, the enactment of the legislation in 1938 offered the Roosevelt Administration the occasion to consolidate the functions of air transport regulation which had prior to that time been divided amongst a variety of institutions, namely the Post Office (mail contracts), the Bureau of Air Commerce (safety and technical) and the Interstate Commerce Commission (rates).⁴ Divorced from the economic reality of the time in which reform was only a question of when, the external influence on the legislative proceedings of the 1938 Act had a direct bearing on the end product. In particular, the airlines ensured that they flexed their congressional sponsorship muscles and in the process ensured that,

there was little that airlines wanted to have in the new legislation but did not get. Few interest groups have ever been as overtly and uncontestably pre-eminent in legislative proceedings as the airline industry was during the congressional deliberations that led to passage of the act.⁵

The main functions of the CAB were route or entry licensing and fare regulation. Its jurisdiction, however, was limited to inter-State air transport and could not therefore regulate entry or rates of carriers providing solely intra-State services. On route control, the CAB was required to decide applications and to certify a carrier,

if it finds that the applicant is fit, willing, and able to perform such transportation properly...and that such transportation is required by the public convenience and necessity; otherwise such application shall be denied.⁶

It was the requirement of "public convenience and necessity" under the Act which provided the CAB with a considerable scope of interpretation when it came to determining whether an application was in accordance with the public interest. This discretion provided the leverage for the pursuit of either a competitive or anti-competitive policy. More significantly, it provided a virtual *carte blanche* to the CAB to shape the destiny of the US air transport system.

3 See C.Puffer, *Air Transportation* (Blakiston Co., Philadelphia: 1941), pp.245-246.

4 S.Morrison, "US Domestic Aviation" in K.Button and D.Swann (eds.), *The Age of Regulatory Reform* (Clarendon, Oxford: 1989), p.142.

5 B.Behrman, "Civil Aeronautics Board" in J.Q.Wilson (ed.), *The Politics of Regulation* (Basic Books, New York: 1980), p.84.

6 S.401(d)(1), Federal Aviation Act 1958.

As the CAB members were political appointees, namely by the President, the ways in which the width of the CAB remit could be interpreted depended to a very large extent on the temperament of members of the CAB. As shall be seen in due course, the chairmen in particular played a vital role in shaping the direction of CAB regulatory policies between restrictive, anti-competitive policies and *laissez-faire*, free market competition policies.

In respect of fare regulation, the CAB was required to have regard to the following substantive guidelines when deciding whether to approve a proposed fare:

- the effect of the fares upon the movement of traffic;
- the need for adequate and efficient transport in the public interest at the lowest cost consistent with the provision of the service;
- standards in relation to the character and quality of service to be provided;
- the inherent advantages of air transportation;
- the need of each carrier to earn sufficient revenue, under honest, economical and efficient management, to provide adequate and efficient services.⁷

Likewise, these considerations enabled the CAB to design its regulatory policies either on a competitive or anti-competitive foundation, for example, by declaring that a proposed fare was unreasonably low that it would divert traffic away from an incumbent so that the latter would not be able to earn a sufficient return to provide regular and continuous service. In the early years of the new regulatory system, and virtually throughout the four decades which followed, the CAB opted to pursue the narrower and anti-competitive dimension of its legislative mandate.

CAB Regulatory Policies

Any analysis of the CAB's early regulatory policies must be seen in the proper light of its legislative mandate; so must its criticisms. It is, however, no secret that the CAB pursued a highly anti-competitive policy during its life time. The most pronounced and one which attracted the severest of criticisms was its "route moratorium" policy in 1969. This policy, administered under the chairmanship of Secor Browne, entailed the disapproval of almost every route application and this was achieved by avoiding the system of hearings required by the Administrative Procedure Act 1946 so that after a period of time the CAB was able to claim the application as "stale". An oft-cited case is the application of World Airways submitted in 1967 (prior to the official moratorium policy) to operate between the east and west coasts with one-way fares of between \$75 and \$79; this was less than half of the lowest available fare. The CAB effectively ignored the application and when it came to consider the case in 1973, it declared the application as stale.⁸

By no means, however, was this case the exception. CAB policies and decisions on licensing applications throughout its history had been punctuated by refusals where exceptions would only be made in highly exceptional cases. Indeed, between 1938 and 1974 after which policies became more competitive,

7 S.1002(e), Federal Aviation Act 1958.

8 CAB Order 73-11-101 (1973).

the CAB refused to certify any of the 94 applications from intending-carriers to operate domestic services between major city-pairs." One commentator described the crystallisation of this policy as an "unchallenged way of life in the agency."¹⁰ In all, the protectionist policy and practice gave the air carriers, particularly incumbents which were certified at the inception of the CAB, a large measure of insulation from competition. The justification of the CAB was simply grounded in the cross-subsidisation argument that a carrier needed to make a sufficient return to ensure the adequacy and regularity of other less profitable services so as to promote the development of the air transport services network. Unless therefore an applicant could demonstrate that the application would not constitute a significant or substantial competition against existing carriers, the CAB was not disposed to depart from its established precedent. This was evident in its decision concerning an application by four carriers to operate the east-west coast service at fares which were substantially lower than those offered by the incumbents. The case centred on two crucial sets of considerations between, on the one hand, the need to ensure lowest possible public subsidy and continuity of services on un-profitable "thin routes", and on the other hand, the need of the public to have access to a choice of fare products. In the end, the CAB tilted its decision in favour of the former arguing simply that the proposed services would constitute substantial competition against the incumbents which depended on their profits from "thick routes" to subsidise the costs of providing services on less dense routes; lest they called upon the government for more subsidy.¹¹

In many ways the decision in this case characterised the restrictive foundation of its policies not only in respect of routes, but also of its philosophy towards rates. Clearly, the issue of rates or fares is not one which can be neatly separated from the question of entry since the latter must presuppose the need for remuneration. Inevitably, therefore, decisions of the CAB often provided a double-whammy for air transport competition. Since price is arguably the most effective form of competition, a policy of non-price competition provided very little incentive for the airlines, particularly incumbents, to offer lower fares by achieving greater efficiency and productivity. Users, therefore, had very little to gain. The combination of the lack of route competition and consequently price competition was perhaps the single most influential factor in the fight for deregulation in later years. By a supreme irony, and since the jurisdiction of the CAB was restricted to inter-State travel, intra-State services which were largely un-regulated provided evidence of low fares and high traffic density from competing services. Two of the most important States were Texas and California which are considered further below. These were significant to the eventual demise of the CAB particularly when they begged the question of whether CAB regulation was merely serving the interests of the airlines instead of the users. Such was the basis of the regulatory capture criticism levelled at the CAB.

9 Senate Subcommittee on Administrative Practice and Procedure. *Hearings on Civil Aeronautics Board Practices and Procedures*. 94th Cong., 1st sess. 1975. Appendix p.334.

10 Behrman. *op.cit.*, p.90.

11 *Transcontinental Coach-Type Service Case* [1951] 14 CAB Reports 720.

Although its policies leaned towards the anti-competitive, the CAB did, however, make exceptions to the general rule. For example, it granted temporary certificates to provide subsidised services to small communities which had previously not been served,¹² and certificates to supplemental carriers or charter carriers which did not pose a significant threat to the incumbents¹¹

Dawn of A New Era

The restrictive interpretation by the CAB of its statutory remit did not, however, go un-noticed. Criticisms were rife. Economists, in particular, did not believe that regulation was in the interest of efficiency and began to develop a case against CAB regulation.¹⁴ Their arguments provided an important basis for the ensuing political debate on airline deregulation. Although the case was initially lacking in empirical evidence, this was quickly overcome when it gradually emerged that passengers travelling on intra-State services were offered lower fares for comparable distances on inter-State routes which the CAB regulated. This enabled the economists to build their arguments on the significance of price competition which on CAB-regulated routes was virtually absent. And price competition was only possible if entry was open; so the argument went. The deregulation of the airline industry was, therefore, not the result of a particular cause; indeed, it resulted from the combination of a number of factors which, by the stroke of luck, happened almost simultaneously.

A Fortuitous Co-Incidence

A central tenet of the arguments put forward by the economists was the stultifying effect of CAB restrictions on route and price competition. In doing so, the regulatory agency had become the guardian of the interests of the airlines at the expense of user interests, and therefore its policies and decisions were often captured by those which the agency had been designed to regulate.¹⁵ The most evident empirical support came from the experience of intra-State air transport competition, particularly in Texas and California. Much of these economic arguments coincided with the change in 1974 of the Presidency and the decision of Senator Edward Kennedy, as chairman of the Subcommittee on Administrative Practice and Procedure of the Senate Judiciary Committee, to examine the CAB.

12 G.Eads. *The Local Service Airline Experiment* (Brookings Institution, Washington DC: 1972), pp.97-104.

13 J.H.Frederick. *Commercial Air Transportation* (Richard Irwin, Illinois: 5th edn., 1961), pp.187-191.

14 See R.Caves. *Air Transport and Its Regulators* (Harvard University Press, Mass.: 1962); L.S.Keyes. *Federal Control of Entry into Air Transportation* (Harvard University Press, Mass.: 1951); M.Levine. "Is Regulation Necessary? Californian Air Transportation and National Regulatory Policy" [1964] 74 *YLJ* 1416.

15 See e.g., M.Bernstein. *Regulating Business by Independent Commission* (Princeton University Press, Princeton: 1951) and J.Stigler. "The Theory of Economic Regulation" (1971) 2 *Bell J. Econ. and Mgt. Sci.* 3.

Political Debate

The political force behind the deregulation debate and movement was two-fold. President Ford had campaigned on the promise that he would reduce the rate of inflation (then running at an annual rate of 12%)¹⁶ and, if equipped with that mandate, would seek to identify the tasks which would achieve this goal. Chief among these was to reduce the burden imposed on business enterprises and activities by dismantling regulatory programmes. As Behrman noted,

Partly due to the lack of attractive policy options for fighting inflation and partly due to the high compatibility between the idea of trimming government regulation and Ford's conservative dislike of big government, in early October, Ford designated regulatory reform as a major element in his anti-inflation program.¹⁷

At the time the programme of regulatory reform was conceived, proceedings elsewhere were taking place in relation to the CAB, and if nothing else, they provided a basis for the Ford Administration to pick on the CAB.

Senator Kennedy had decided in June of 1974 that the Senate Subcommittee on Administrative Practice and Procedure would conduct hearings on the CAB. The question then became one of what constituted a suitable topic for inquiry. To facilitate this task and to have someone who could direct the proceedings, he appointed Stephen Breyer as the new general counsel of the Subcommittee. There is, however, no conclusive evidence to suggest any particular policy or rational reason for Kennedy to single out the CAB for examination. One commentator observed that Kennedy was "more concerned about achieving legislative success than getting short-term publicity."¹⁸ Perhaps it was also important that the CAB was the only agency at that time to have a comprehensive record of its regulatory activities including statistical data on passengers and the details of their journeys.¹⁹ Any inquiry into its activities would therefore be greatly enhanced by the ready availability of such information.

The CAB inquiry by Kennedy's Subcommittee was unique in more than one respect given the eventual outcome of the hearings was the abolition of the CAB and a deregulation of the industry. First, it did not have direct jurisdiction over the regulatory reform of aviation. By a supreme stroke of good fortune, the Kennedy Report and efforts were taken up by the Subcommittee on Aviation of the Senate Commerce, Science and Transportation Committee which had the jurisdiction to introduce regulatory reform. The Subcommittee was chaired by Senator Howard Cannon who was initially opposed to the deregulation of the industry, but became increasingly convinced of its merits over time. The most significant influence came from the testimony of John Robson (CAB chairman 1975-1977) who announced that the CAB had conducted its own study²⁰ and was recommending the reduction of its

16 "The Coming of the Tax Revolt" (1978) *Public Opinion* 30.

17 *Op.cit.*, p.103.

18 Behrman, *op.cit.*, p.100.

19 Gary Edles formerly of the CAB, interview with the author, 9 June 1994.

20 *Report of CAB Special Staff on Regulatory Reform* (1975).

regulatory powers to foster increased competition²¹ Without any shadow of doubt, this represented a profound reversal in CAB regulatory practice and shocked all parties concerned. Senator Cannon himself was seemingly taken aback to the extent that he was persuaded to embrace the idea of regulatory reform and airline competition. The combination of support from Kennedy, Cannon and the Ford Administration in endorsing regulatory reform of aviation, albeit that they disagreed on the merits of the arguments, was a crucial contribution to the eventual freeing of the industry from the regulatory constraints imposed under the 1938 Act and CAB policies.

Case-Studies

None of these efforts, however, would have gone any further if they had not had the benefit of the empirical confirmation stemming from the results of un-regulated intra-State air transport. It was generally agreed before and during the hearings that un-regulated intra-State airlines were able to offer fares which were considerably lower for comparable distances flown by CAB-regulated airlines. The most outstanding example was the case of SouthWest Airlines (SouthWest) in Texas and, Pacific SouthWest Airlines (PSA) and Air California in California. The former, which has been the success story of US deregulation, although it existed prior to 1978, provided an instrumental exemplification to the advocates of deregulation. In 1975, its one-way fares on the Dallas-Houston route were \$25.00 and \$15.00 respectively. By comparison, CAB-regulated carriers charged \$32.00 for the same route.²² Beyond Texas, CAB-regulated carriers charged an average of \$29.00 for a comparable distance of 239 miles (e.g. Los Angeles-Las Vegas).²³ Much the same was true with PSA where in 1976 a one-way flight of 350 miles between Los Angeles and San Francisco cost \$11.43 while a comparable Boston-Washington flight (399 miles) by CAB-regulated carriers cost \$24.65.²⁴ The difference in fare per mile was 3.27 cents for the former and 6.03 cents for the latter - a 45% differential.

Much of the difference between CAB-regulated and intra-State services was attributed to the restrictive policies of the CAB on entry and fares competition. The artificiality of the results obtained from such policies - imposed protection - meant that there was little in the way of incentive for airlines to reduce costs. This protection contributed significantly to the low-load of passengers carried²⁵ since the inflexibility of the route structure and expensive fares were not sufficiently attractive to entice users of other transport modes to transfer to flying. By imposing such regulatory constraints, a fundamental character of the industry had been missed. Evidence from deregulation suggests that the industry is capable of sustaining different carriers which would have a variety of management philosophies and practices. Some adopted a niche market

21 *Hearings on Regulatory Reform in Air Transportation*, 94th Cong., 2nd sess. 1976. pp.348 *et seq.*

22 Simat, Helliesen and Eichner Inc., *An Analysis of the IntraState Air Carrier Regulatory Forum* (1976), vol.1, Appendix 1.

23 Senate Subcommittee on Administrative Practice and Procedure, *Hearings on Civil Aeronautics Board Practices and Procedures*, 94th Cong., 1st sess. 1975, p.41.

24 See Levine, *op.cit.*, p.1433.

25 Simat *et.al.*, vol.2, pt.V, p.14.

approach, while others had an expansionist attitude, still, some others provided a low-cost service while others solely a premium service of first or business class travel.²⁶ Bureaucratic rate regulation which impede management initiatives by destroying the incentives to develop philosophies and practices aimed at meeting the interests of users breeds inefficiency and overlooks the ultimate interests to be served in a service-based industry. Hence, the argument of the deregulation advocates that the airline regulatory regime had failed to achieve its intended purpose.²⁷

Role of the Courts

In 1932, Mr Justice Brandeis delivered a strong dissenting judgment in *New State Ice v Liebman* which affirmed the necessity of public economic regulation when the relevant circumstances demanded it.

The need for some remedy for the evil of destructive competition, where competition existed [and] where competition did not exist, the propriety of public regulation had been proven.²⁸

Although in minority, his opinion characterised the perception then that excessive and unregulated competition was economically and socially destructive. It was also the time when government regulation to remedy the ills of free-for-all competition was a popular idea. That subsequently led to the New Deal and the proliferation of government regulatory agencies that would "save capitalism from itself".²⁹ The protective policy of the CAB was therefore not without political and economic justification. Indeed, its anti-competitive policy framework was given greater credence with two subsequent Supreme Court decisions which effect was to enlarge the procedural discretion of the CAB in the application of its policies. In *State Airlines v CAB*, the Supreme Court by a majority handed down a liberal decision in favour of CAB's unusual procedures which Reed and Frankfurter JJ. in a dissenting judgment described as "administrative absolutism".³⁰ The case concerned a complaint by State Airlines that, in an "area proceeding" where routes were consolidated, the CAB had acted unlawfully by awarding to Piedmont Aviation those routes which the latter had not in effect applied for. All Piedmont did was to submit a broadly-based application without specifying a particular route, leaving the CAB to award Piedmont any route which the CAB thought was required by public convenience and necessity. A corollary of this approach, according to State Airlines, was the manner in which the CAB had come to its decision by failing to comply with the notice-and-comment requirements so that State Airlines and others might be able to produce evidence that suggested Piedmont was not a fit

26 Air One, for instance, catered only for business passengers by operating first class cabins.

27 For example, see E.Bailey, D.Graham and D.Kaplan, *Deregulating the Airlines* (MIT Press, Mass.: 1985); A.Kahn, "Deregulation and Vested Interests: The Case of Airlines" in R.Noll and B.Owen (eds.), *The Political Economy of Deregulation: Interest Groups in the Regulatory Process* (American Enterprise Institute for Public Policy Research, Washington DC: 1983); Levine, *op.cit.*

28 285 US 262 [1932], at p.300.

29 Breyer and Stewart, *op.cit.*, p.21.

30 338 US 572 [1950].

and able carrier. In rejecting the application, the majority stated that judicial intervention would be contrary to the intention of Congress which was to leave the CAB "free to work out application procedures reasonably adapted to fair and orderly administration of its complex responsibilities."³¹ In a more ironic case in which the Supreme Court in fact decided against the CAB, the decision nevertheless fostered the CAB's pursuit of protectionist policies.³² In a contest for routes, Delta was eventually awarded a certificate to operate a number of routes. Although objections were raised against the breadth of the certificate, a final decision on the objections was not issued until after the certificate had taken effect. The effect of the final order was to ban Delta from several routes which Delta claimed was procedurally improper given that the imposition of the restrictions after the certificate had come into force was made without formal notice and hearing. The majority of the Supreme Court agreed with the contention although without prejudice to the authority of the CAB to alter certificates. However, in the circumstances of the case, the Court reasoned that,

to the extent there are uncertainties over the Board's power to alter effective certificates, there is an identifiable congressional intent that these uncertainties be resolved in favor of the certificated carrier and that the specific instructions set out in the statute should not be modified by resort to such generalities as 'administrative flexibility' and 'implied powers.'³³

Anything to the contrary would be paying less than adequate deference to the intention of the legislature. Its reasoning which clearly gave support to the protective approach of the CAB, also upheld the regulatory priority given to route security so as to provide "assurance to the carrier that its *investment* in operations would be protected".³⁴

Even so, judicial attitude is never static; so that much as perhaps the role of the courts had been deeply significant in shaping the regulatory policies of the 1930s, no less was the case in the lead up to the first comprehensive deregulation of a major national industry. The airline deregulation drive was not entirely steered by politicians and economists who together created a fertile environment for it to happen almost by chance. A number of important judicial decisions were also thrown into the centre of the airline deregulation debate in the immediate years prior to the Airline Deregulation Act 1978. The most illustrative of these was *Moss v CAB* in 1970 in which Wright J. stated that even if the Board was statutorily obliged to afford carriers sufficient revenues, that obligation cannot become a *carte blanche* allowing the Board to deal only with the carriers and disregard the other factors, such as the traveling public's interest in the lowest possible fares and high standards of service, which are also enumerated in the Act as rate-making criteria.³⁵

31 At p.576.

32 *Delta Airlines v CAB* 367 US 316 [1961].

33 At p.325.

34 At p.323 (original emphasis).

35 430 F.2d 891 [1970], at p.900.

This decision arose out of a complaint against the informal and often *ex parte* meetings between the CAB and the carriers for the setting of fares. In particular, United Air Lines (United) and others had submitted a proposal to increase fares and whilst the decision was still pending an informal meeting was held from which the applicant was excluded. Notwithstanding the latter, the CAB decided that the proposed fares were not acceptable and proceeded in the same order to indicate that it was prepared to allow a limited increase on the basis that the increase was vital to the survival of the carriers. And the increase would be permitted if it was based on a model formula set out by the CAB. Unsurprisingly therefore, the carriers withdrew their original submissions and resubmitted proposals in accordance with the formula which almost guaranteed approval. The question that arose for a substantive determination was whether the fares were effectively agency-made or carrier-made. Where a fare was to be determined by the CAB, the Federal Aviation Act 1958 required that the proposal be subject to the proper notice-and-comment procedure,³⁶ but not otherwise. Since, however, "the Board's order amounted to the prescription of rates" because it exerted the pressure to comply, the Court stated that it cannot be procedurally proper to fence out the participation of the public nor limit the scope of judicial review by claiming that the fares were carrier-made.³⁷

Although the decision was primarily concerned with the procedural obligations of the CAB, the substantive issues of rate-making criteria and hence the policy on airline competition were inevitably inseparable. By requiring that the CAB took a more open process in rate-making so that its consideration of the statutory criteria could be assessed, the Court was also fostering greater airline competition where this was possible. If, for instance, the evidence leaned toward unjustified fare increases or indeed competing services, then a decision otherwise would attract judicial condemnation on the basis of lack of substantial evidence. This was the case in *Continental Air Lines v CAB*.³⁸ The Court of Appeals of District of Columbia held in that case that the findings and recommendations of the Administrative Law Judge (ALJ) in route proceedings in favour of greater competition could only be rebutted if the CAB had substantial evidence to do so. The ALJ had, at the conclusion of the proceedings, recommended that Western Air Lines and Continental be certificated to operate non-stop services in the San Diego-Denver market. The CAB rejected the recommendation, but instead certified Western, on the combined ground that the ALJ's "forecast may be too optimistic [given] the recent lag in nation-wide traffic growth."³⁹ It argued that the proposed service by Western would adequately meet the needs of the market so that a competing service would not be "consistent with the goal of fostering sound economic conditions in air transportation."⁴⁰ The Court was unconvinced that the CAB's approach satisfied its general statutory obligation of fostering competition "as a means of enhancing the development and improvement of air transportation

36 S.403(a) and (c).

37 At p.897.

38 519 F.2d 944 [1975].

39 Order 70-4-46 (9 April 1970) at pp. 2 and 4.

40 *Ibid.*, at p.4.

service on routes generating sufficient traffic to support competing carriers"⁴¹ It refuted the argument of the CAB by remarking that the presence of an adequate service provided by a monopolistic carrier cannot override the desirability of competition contemplated by the statute where sufficient traffic existed for that would deprive the public interest of the benefits of competition.

The same Court a year later delivered another judgment which drove the airline industry towards greater competition and thus giving more support to the advocates of airline deregulation. It said in *World Airways v CAB* that the CAB had acted *ultra vires* by preventing World Airways (then a "supplemental carrier") from applying for a scheduled certificate. Although s.401(d) of the Federal Aviation Act 1958 prohibited a scheduled carrier from holding a supplemental authorisation, no limitation to the contrary existed. Accordingly, the Court surmised that if a central objective of the statute in promoting regulated competition was to be achieved, then "rigid constraints on the Board's ability to consider applications on their merits are generally disfavored."⁴²

Even if these latter decisions were not directly responsible for creating the climate of airline deregulation, they nevertheless provided an important impetus for the CAB to experiment with more liberal policies than had been pursued in the past. The most prominent member of the CAB who spearheaded this move was its own chairman, Alfred Kahn. Without fear of the legal consequences for departing from CAB precedent, "the Kahn-led CAB set out to test thoroughly the deregulatory limits of the existing law."⁴³ This contrasted significantly with the caution demonstrated by his predecessor, John Robson, who was less prepared to depart from precedent. Nonetheless, the CAB under Robson's leadership pursued a pro-competitive line by approving a new fare proposed by Texas International Airline which undercut existing fares on several routes by 50%.⁴⁴ Further approval of price competition was also evident in its decision to allow American Airlines (American), United and TransWorld Airlines (TWA) to offer up to 50% discounts on flights between New York and California.⁴⁵ When Kahn took over the chairmanship of the CAB, he decided that there was no turning back for the CAB in its competition policies which subsequently led to a new "multiple permissive entry" policy that would enable any fit, willing and able carrier to enter or exit from certain routes.⁴⁶ Oblivious to the stare of precedent and the threat of due process violation, Kahn proceeded further to administratively deregulate the industry. The success with price competition also led the CAB to adopt a policy that gave general approval to any carrier seeking to reduce fares by up to 50% of the standard fare.⁴⁷ The momentum for deregulation, inevitably, had to gather. And the final destination was the enactment of the Airline Deregulation Act 1978 (ADA).

41 519 F.2d 944 [1975]. at p.946.

42 547 F.2d 695 [1976]. at p.698.

43 Behrman, *op.cit.*, p.116.

44 CAB Order 77-2-133 (25 February 1977).

45 CAB Order 77-3-80 (15 March 1977).

46 See *Oakland Service*, CAB Order 78-4-121 (19 April 1978) and *Chicago-Midway Low Fare Case*, CAB Order 78-7-40 (12 July 1978).

47 43 *Federal Register* 16503-16512 (19 April 1978).

End Product

In more than one way, the ADA produced hardly any over-night, dramatic events. It was by then a well-established policy of the CAB that it preferred competitive solutions to regulatory interventions and as such rendered the statute no more than a statutory confirmation. The two substantive effects of the 1978 enactment took the form of a change in the declared policy for the residual regulation of the industry and a path to the "sunsetting" of the CAB. Moving away from the broad brush mandate of fostering sound economic conditions in air transportation, the new s.102(a) specifically required,

(4) The placement of maximum reliance on competitive market forces and on actual and potential competition (A) to provide the needed air transportation system, and (B) to encourage efficient and well-managed carriers to earn adequate profits and to attract capital....(9) to provide efficiency, innovation, and low prices, and to determine the variety, quality, and price of air transportation services.

In addition, the new provisions required the CAB, in its remaining functions, to encourage entry by new carriers as well as market expansion by existing carriers.

A regulatory framework which required a maximum placement on competitive solutions essentially meant that regulatory interventions by the CAB would be minimal, and that was the aim of the new policy. By the same token, mandatory reduction of regulatory intervention impliedly meant a lesser degree of protection for the regulated. Whereas carriers could previously rely on the sympathy of the CAB to ensure that their market shares were not eroded, any form of protection under the new policy would be possible only if the carriers improved and perpetuated their efficiency. Such efficiency, as the new policy envisaged, would only be possible if the idea of competitive solutions was also accompanied by a policy declaration that promoted the provision of competing services. As the new policy moved towards a pro-competitive approach, so too must the regulatory criteria applied by the CAB in issuing air transportation certificates. Prior to the passing of the ADA, the CAB was permitted to certify a carrier only if it was fit, willing and able and that the service was "required by the public convenience and necessity". The latter mandate was necessarily narrow and prevented liberal, competitive interpretations. The new s.401(d)(1) required no more than the service having to be "consistent with the public convenience and necessity". Effectively, the licensing criteria was confined to requirement of a fit, willing and able carrier.

For all that has been said about the duties of the CAB, they were merely temporary arrangements until the abolition of the CAB in 1985. In the lead up to that, the functions were either phased out gradually or transferred to the Department of Transportation or the Department of Justice. In particular, the licensing criteria of "consistent with the public convenience and necessity" was terminated in 1981.⁴⁸ A saving provision was nevertheless included so that the

⁴⁸ S.1601, Federal Aviation Act 1958.

CAB had to conduct a comprehensive review of its implementation of the Act and to report and recommend as to "whether the public interest requires continuation of the Board and its functions" beyond 1985.⁴⁹ With the benefit of history, it is evident now that this option was not exercised although it is difficult to avoid the suspicion that the assessment of the public interest would have been coloured by the membership of the CAB then. By the time of the sunset, almost every member of the CAB, led by Kahn, had been overwhelmingly persuaded of the virtues of deregulation so that it was unlikely that a conclusion to the contrary would have been reached. Clearly, however, its conclusion would have to have substance, and to a very significant extent, the immediate effects of deregulation which were largely benefits to the travelling public had an instrumental role in persuading the discontinuation of the CAB. Whether the conclusion on the requirement of the public interest, in accordance with the then prevailing and immediate effects of deregulation, was a rather short-sighted measure can only be properly examined once these immediate, and subsequent, effects have been considered in more detail.

Effects of Deregulation: A Critical Analysis

Like all new toys, airline deregulation was received with great excitement. Although the ADA was very much a statutory confirmation of the policies and work of the CAB in the 1970s, the anticipation and the culminating effect of the efforts of the deregulation advocates added much force to the coil that was already tightly wound up for release. The release brought about an immediate explosion in air travel and set the scene for substantial structural changes to the industry.

Initial Proliferation of New Carriers

The deregulation of entry control promised opportunities for new entrants and they were promptly seized upon. The number of new carriers at the onset of deregulation increased considerably although collectively they were not part of a homogeneous group in terms of the services they provided. Some were operating long-haul, inter-continental services, while others operated purely domestic services. Still others operated regional or commuter services. Since competition between a larger number of carriers potentially meant market shares of carriers would be reduced accordingly, airlines were driven to search for strategies that would present them with an edge over their competitors. Ease of entry *per se* would not therefore ensure the long-term survival of a new entrant since in particular it would be competing with other established carriers who had the benefit of scale, network and marketing economies which the new entrant did not.

While the services provided were not homogeneous, neither was the degree of competition across all the domestic routes. In particular, larger carriers with larger size aircraft began to abandon routes which were not suited to their aircraft, but which they had been required to operate under CAB regulation.

⁴⁹ S.1601(d), Federal Aviation Act 1958.

The effect of abandonment was to create more room for smaller and new carriers, with more suitable aircraft relative to the density of the market, to expand. A study by the CAA into the air services in the New York State (essentially, New York City served by JFK, La Guardia and Newark-New Jersey) indicated, for example, that American Airlines withdrew from all intra-State services by 1982. Other airlines including People Express (Newark-Buffalo and Newark-Syracuse) were able to enter and expand their intra-New York State markets.⁵⁰ Similarly, markets which could not be developed to their advantage were left un-tapped. Reno Air, for instance, began operating a point-to-point service between Reno in Nevada and Minneapolis, while the employee-owned Kiwi International Airlines seized the opportunity to operate on the New York(Newark)-Atlanta and Orlando-San Juan routes.⁵¹ In these cases, there were no established carriers in the same market to stimulate intense competition and naturally helped to alleviate the fears of new entrants who did not share the sophistication of larger carriers.

The sudden growth of carriers provided an empirical support to the theory of contestable markets conceived by William Baumol *et al* which forwards the claim that markets served by inefficient providers would precipitate the entry of competitors.⁵² The threat of such entry was therefore sufficient to ensure that the incumbent remained efficient and competitive. In the course of the Congressional debate, strong evidence was submitted that the airline industry was structurally competitive so that administrative regulation of routes and fares was an artificial constraint. The competitive structure of the industry was premised on the belief that scale economies for a new entrant was either low or insignificant so that correspondingly barriers to entry would be low. On the basis of this analysis, airline markets were therefore contestable. An incumbent or monopoly carrier would be driven to charge fares which are reasonably related to the costs of provision, or risk the competition from a new entrant willing to undercut the fares. This was very much the underlying claim of the airline deregulation advocates.

Although there is much to commend in the theory, and represents the basis on which the model of regulated competition was constructed,⁵³ the irony of the contestable markets theory rests with its ignorance of two fundamental issues. The first relates to the distinction between a *new entrant* seeking to enter the airline industry to establish an entirely new service, and an *existing carrier* seeking to enter a particular new market or to extend its services in terms of frequency. For present purposes, both of course will be seeking to establish services in competition with an incumbent. The costs of establishing competitive services by an entirely new entrant cannot be regarded as low or insignificant by any stretch of the imagination. Fixed costs are likely to be high, and these are usually "sunk costs" which are irrecoverable costs in the event of

50 CAA. *Deregulation of air transport: A Perspective on the experience in the United States*. CAA Paper 84009 (1984), Table 13.

51 CAP 623, p.165.

52 W.Baumol, J.Panzar and R.Willig. *Contestable Markets and the Theory of Industry Structure* (Harcourt Brace Jovanovich, New York: 1982).

53 See ch.2. *supra*.

failure. On the other hand, the costs facing an existing operator seeking to enter a new market or to extend an existing service are likely to be marginal at worst. In many cases, this may only involve a re-deployment of assets such as aircraft utilisation as a result of abandoning another market⁵⁴ Sunk costs would inevitably be lower.

Secondly, Baumol's theory of contestability does not take into account the effects of infrastructural constraints particularly at congested airports (including the slot-controlled airports in the US). The evidence in chapter six has already shown that these constraints are significant barriers to entry. Even if the analysis was limited to a market where no incumbent existed so that the issue of scale economies and sunk costs were ignored, a new entrant must be able to gain access to the airport and airport facilities at attractive times to secure a sustainable share of the market. The degree of difficulty must clearly depend on the combination of airports in question. The busier and more concentrated an airport, the greater are the limitations of access, and *vice versa*. A new city-pair market which utilises two small or regional airports which are less congested is not likely to present difficulties of access which are as acute as a city-pair utilising two congested airports. Furthermore, the utility of an airport slot depends very much on the ability to match movement at another airport. The success of SouthWest is partly attributed to its ability to develop and exploit its "mini-hub" at Dallas(Love Field) airport which it now dominates. The complication of establishing an entirely new service between two points with less congested airports is, first, the need to have a sufficient threshold demand for viable air services to be operated and, secondly, the ability to sustain and expand the market share given the likelihood that the population and business activities at these airports will be comparatively lower than those surrounding a major airport, unless of course it is a secondary airport within a larger city conurbation such as Chicago which is served by O'Hare and Midway airports.

Thus, while competition may have increased in individual markets, the success rate for new entrants has not been as satisfactory as initially envisaged. Indeed, an independent study by the CAA into US deregulation concluded that "the most notable feature of deregulation has been the failure rate of new entrants. The barriers to entry in air transport have proved much higher than had been suspected by those who had believed the industry to be contestable."⁵⁵ These believers included those who steered the ADA and who had then remarked that,

Critics also argue that larger carriers, such as United Airlines and TWA, will...squeeze out smaller competitors by virtue of certain economies of scale. *This claim is simply wrong...There are few, if any, economies of scale of any great importance in the airline industry.*⁵⁶

54 See e.g., CAA Decision 2/94.

55 CAP 623, p.162.

56 per Senator Howard Cannon, *Senate Debate on S.2493*, 96th Cong., 1st sess. 1978: *Legislative History of the Airline Deregulation Act of 1978*, p.407 (emphasis added).

Indeed, the guru of airline deregulation, Alfred Kahn, admitted the myopia and naivety of advocates of deregulation. He said in a recent testimony to the Californian Public Utilities Commission that,

We underestimated the ease of entry on the national level by new carriers...We underestimated the importance of economies of scale and scope.⁵⁷

Wisdom of course comes with hindsight. Contrary to the powerful case of the deregulation advocates, air transportation is clearly not an ideal candidate for Baumol's version of the theory of contestability nor perfect competition. Be that as it may, the number of airlines has increased in relative terms since 1978. But the fierce competition derived from the abolition of entry control disappeared as fast as it came and provided a strong testament to the contention that contraction in the number of new entrants would simply lead to a greater dominance by the incumbents or the emergence of so-called mega-carriers. Inevitably also, freedom of entry would precipitate an increase in frequency from carriers who seek to offer maximum opportunities to passengers of the choice of flight schedules. An increase in frequency, however, means also an increase in capacity on the route in question. If therefore the variation in capacity (increase in total aircraft seats) exceeds the variation in passenger demand (increase in total passenger volume), then the conclusion must be unfilled capacity. Unfilled capacity for any prolonged period will financially haemorrhage a carrier. Hence, those carriers which have been able to expand and establish a strong competitive force against the larger carriers have generally been those with a highly specific strategy.⁵⁸ The case of SouthWest is instructive of this point.

SouthWest is a niche carrier which adopts a policy of competing in dense markets by using a high level of service frequency. For instance, it operates 30 daily departures in each direction between Dallas and Houston, a case that is not likely to be seen in the UK nor the EC.⁵⁹ Its low-cost of operation stems from the no-frills service, the absence of interlining costs, the use of a non-unionised work force, and the non-dependence on computer reservations systems which would only be crucial with an expansive route network. Both its simple route and fleet structure ensures a high utilisation of assets and employees. While a simple route network enables the carrier to achieve a quick turnaround, therefore spending less ground and gate time, a simple fleet structure enables employees to be switched between jobs with minimal re-training. The latter is most evident in its expansion programme since 1978 when it went from 10 Boeing 737s to 142 by the year 1990. An aircraft engineer for instance would be able to tend to any of the aircraft, thereby contributing to the simplification of the employee structure. The simplicity of these enables SouthWest to boast further of its simple fare structure where passenger tickets may be obtained from vending machines.

57 Quoted in R.M.Hardaway & P.S.Dempsey. "Airlines, Airports and Antitrust: A Proposed Strategy for Enhanced Competition" (1992) 58 *Journal of Air Law and Commerce* 455 at p.456. See also A.Kahn, "Airline Deregulation: A Mixed Bag, But a Clear Success Nevertheless" (1988) 16 *Transportation Law Journal* 229

58 CAA Paper 84009, p.9.

59 CAA, *Airline Competition in the Single European Market*, CAP 623 (1993), p.167.

The significance of a low-cost structure is the means which it provides for the small carrier to compete effectively with major carriers. This has been the case with SouthWest. By contrast, UltraAir, a product of deregulation, ceased operations seven months following the introduction of the Houston-Los Angeles and Houston-New York services in 1993. Although its philosophy was also a high frequency, niche carrier, it competed without the benefit of a low-cost structure on a route which had the presence of a major carrier, Continental Airlines (Continental) which hubs in Houston.⁶⁰ Likewise, People Express which, for a number of years was the flagship of airline deregulation, began by introducing new and different concepts to airline management including purchased meals on board and a job-sharing scheme, but flew into turbulence in the mid-1980s when it expanded considerably on its route network at New York(Newark). Newark, of course, had the presence of Continental. Instead of maintaining the level of service with its expansion, People Express, unlike SouthWest, reduced its frequency overall. Furthermore, People Express purchased two other airlines (Frontier and Brit Air) in 1985 and inherited a much expanded route structure, thereby adding to the complexity of its management system.⁶¹ The competitive edge which SouthWest has over larger carriers is its low-cost structure which the sophisticated yield management systems and scale economies of these larger carriers cannot match. People Express, unfortunately, did not share that advantage. In addition, achieving a low-cost of operation enables the frequent fluctuations in external costs to be readily absorbed without necessarily causing a financial haemorrhage (e.g. fuel costs and airport charges).

Hub-and-Spokes Network

Perhaps the most discussed and documented issue of US airline deregulation has been the emergence of the hub-and-spokes system. This system of route management and operation is a highly interesting and innovative phenomenon that enables a carrier with a large network of routes to exploit and this reflects the new philosophy in airline management which seeks to place an emphasis on "each airline to develop its own coherent strategy."⁶² A hub-and-spokes operation is a system by which travel between two points is channelled through an intermediate point. Suppose the point-to-point direct travel was between A-Y-C. The number of one-way service permutations for the carrier would be three: A-Y; Y-C; A-C. Aircraft utilisation would similarly be three if we assumed simultaneous departures and the total number of airport slots required for take-off and landing would be six. Under the hub-and-spokes system, however, direct services between some points would be abandoned; all services would be channelled through the hub airport. If we suppose further that point-Y is the hub airport, the journey pattern between the three points would be the following: A-Y-C. Point-to-point direct services of A-Y and Y-C would still be maintained but the change would be the abandonment of A-C direct services

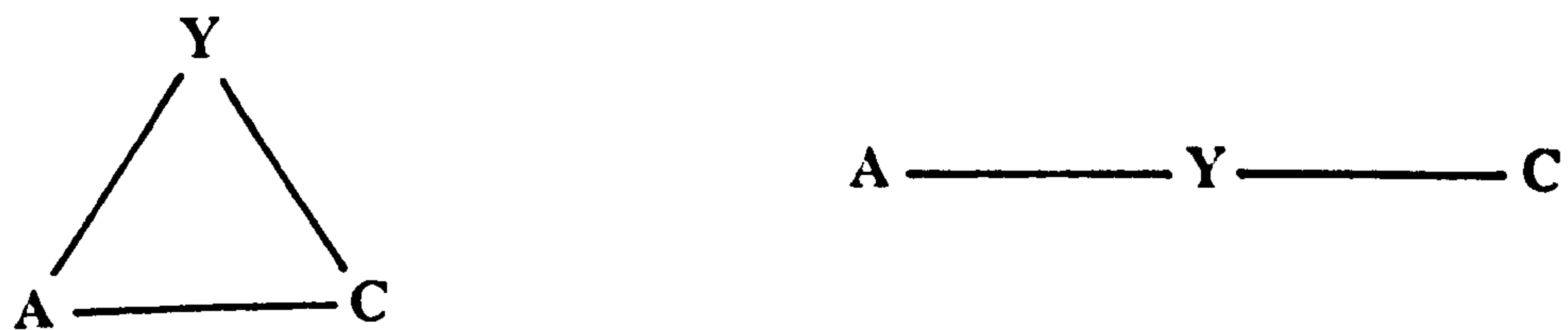
60 *Aviation Week and Space Technology* (2 August 1993).

61 People Express was subsequently taken-over by Texas International Airline which once owned Continental: *Financial Times* (16 September 1986).

62 CAA Paper 84009. p.9.

since passengers from A would now travel via Y to get to C (Figure 8.1) This additional stop may mean a longer travelling distance and time, and indeed involve a change of aircraft depending on the density of traffic between the points. Under this system, aircraft utilisation would be reduced to two while the required number of airport slots would be reduced to four. The spare aircraft and slots could therefore be used to increase frequency or to serve a new destination. In addition, by combining passengers who *would* have travelled directly between A-C and passengers *already* bound between Y-C, an airline is able to achieve a higher load factor and consequently lower its unit cost. The dominant feature in this system of route operation is point-Y which is also the hub airport. Accordingly, the theoretical strength of this system lies in the assumption that access to a hub airport is relatively unimpeded. The success of a carrier in exploiting the hub-and-spokes system must therefore mean ready access to an established airport, or an airport open to expansion, neither of which is necessarily always obtainable.

Figure 8.1



So how do passengers benefit? Why should passengers accept the inconvenience of changing aircraft and incur the extra risk of missing luggage? How can the additional travelling distance and time be justified? The first task is to dispel the misleading idea of a homogeneous class of passengers since we travel for a variety of purposes. Business passengers travel to conduct business activities. They have a less flexible schedule of travel than holiday passengers. They pay a premium to travel in comfort by flying in business or first class cabin. Leisure passengers, on the other hand, are less concerned with these factors. If, therefore, the certainty of deregulation is to benefit passengers, it is equally certain that it would not benefit all passengers. The criteria and expectations of travel for a business passenger differ considerably from a leisure passenger. If time is of essence to the former, then the hub-and-spokes system will not benefit the business passenger if the additional stop involved more time. If costs, and not time, is paramount to the holiday passenger, then the hub-and-spokes system will in all likelihood produce savings to the holiday budget since by routing passengers through the hub, the carrier will be achieving considerable economy of operations that could be passed on to the passengers.⁶³ The reciprocal effect of lower fares is the increase in air travel, *a fortiori* if the benefit is aimed at those passengers who had never contemplated travelling by air. This is considerably fostered by the greater choice of destination as a result of routes being channelled into a hub which is accessible from as many points as

63 See further S.Morrison and C.Winston. *The Economic Effects of Airline Deregulation* (Brookings Institution, Washington DC: 1986).

the number of such routes. Each additional route channelled into the hub will multiply by as many fold as the number of outward spokes from the hub, thus increasing the number of routes permutations and accruing incentives for the carrier as well as the passengers.

While it is possible that the hub-and-spokes operations may result in efficiency gains, it is also clear that the need to have access to the hub airport, and a complementary network of routes, will favour larger carriers and in particular those which have been established at the relevant airport immediately to deregulation. A good case in hand is the dominance of American Airlines and United at Chicago(O'Hare), a key airport in the US. This dominance which is a product of CAB protection over the years means that other carriers will face substantial difficulties in gaining access to the airport, much less so to provide competing services against the incumbents. In this respect, there is a significant degree of similarity with the structural problems in British air transport in that BA enjoyed a dominant position at London(Heathrow) when competition was first introduced and when it was privatised in 1987. It should also be added that this is true in respect of the national carriers in the EC and their respective airports: for example, Lufthansa at Frankfurt; Air France at Paris(Orly); Iberia at Madrid(Barajas). The stranglehold on access to key airports simply fortifies a dominant position, and is unlikely to foster more competition from new entrants unless positive regulatory actions were taken.

Product Variety: Lower Fares and Service Quality

The economic volatility of the industry stemming from external circumstances and the intense competition from new entrants ensure that carriers are user-responsive so that they continue to achieve productivity gains by relating cost to the provision of service and passing on the gains to passengers in the form of lower fares which will sustain the demand for travel by air, particularly by those who put an emphasis on the factor of cost. Demand for business or first class travel is, on the other hand, generally inelastic, and any increase in the number of travellers as a result of fare variations is unlikely to be significant. Indeed, an increase in demand would probably justify higher air fares.

Lower air fares, however, are but one form of product variety. Deregulation has also provided the carriers with incentives to offer a variety of products such as weekend travel packages, day-return travel, special up-grades to business or first class and other promotional fares. Indeed, according to a CAA study,

Promotional fares, which were discouraged by the CAB previously, now account for the majority of travel on US domestic airlines.⁶⁴

Since CAB regulation provided very little flexibility for manoeuvrability in fares, empty seats which could not be filled at the time of departure effectively constituted wastage. Economic theory states that if X-number of passengers was required to recover the fixed costs of the service, then every additional passenger was a profit to the carrier because the costs of carrying the additional passenger would only be marginal; viz., an extra meal. Deregulation therefore

64 *Ibid.*, p.3.

provided carriers with the incentive to innovate on the range of fare products to ensure optimum capacity although conditions are often attached. For instance, special, offer fares often require the passenger to include a Saturday-night stay. This assumes that inflexible travellers such as business travellers who are prepared to pay a premium would not travel during weekends. Accordingly, the benefits of deregulation are likely to be confined to travellers who would otherwise not travel by air. An important by-product of the freedom to set different fares has been the concept of yield management. This highly dynamic management tool which enables airlines to monitor demand and to respond accordingly so as to maximise yield and utilisation of assets.

The distinction in terms of deregulation benefits between business and leisure travellers is less pronounced in the case of the quality of service provided by competing carriers, particularly in-flight service, although competition in service quality was already conspicuous prior to the appearance of statutory deregulation. Inelastic premium fares paid for business or first class travel differ very little from rate regulation since the level of fares would be imposed or dictated by the absence of incentives for reduction in fares. Competition for market share must therefore turn on service quality. Kahn noted in *The Economics of Regulation* that,

In part because the doors to price competition are closed, airline companies compete very strenuously among themselves in the quality of service they offer - most notably in adopting the most modern and attractive equipment and in the frequency with which they schedule flights, but also in providing comfort, attractive hostesses, in-flight entertainment, food and drink.⁶⁵

Although the advent of deregulation enabled carriers to compete by offering different fare products, on routes which are open to substantial demand such as New York-Washington, carriers are unlikely to be tempted by the prospects of offering different fares which would, if nothing else, complicate the fare structure and multiply the sophistication of management. On the other hand, providing competitive in-flight service imposes no more than marginal demand on resources.

Even so, the ability to introduce competing services, together with fare and service variations, is conditional upon infrastructural access without which effective competition may not be possible. Entry deregulation is only one-half of the equation. Access to airport slots either at the same airport or within an airport system is the other significant half. These infrastructural difficulties are already well established, and are issues of universal concern.

Consolidation and Market Structure

Apart from route rationalisation which followed deregulation, the latter also provided a fertile ground for other forms of economic rationalisation and the most profound to have altered the face of the industry was the chain of mergers between carriers. Much of the underlying cause for the mergers has been the consequential effect of the hub-and-spokes development. Since, as suggested,

65 (1988), p.211.

dependence on the hub-and-spokes system for success requires substantial access to an airport to cater for regular departures and arrivals. by the same token it requires a certain degree dominance at the airport. The reciprocal need of the airport proprietor for long-term assurance that the airport would remain in demand is often represented by the length of the lease for access to (dis)embarkation gates at the airport as well as other airport facilities. If nothing else, the effect of the reciprocal agreement between the airport proprietor and the dominant carrier would be to reinforce the presence of the carrier at the airport, thereby excluding or limiting the access of other carriers to mount competing services. In most cases, the dominant carrier is likely to have economy of scales and network that, unless the competing carrier is of sufficient size, access to airport slots does not guarantee survival. This is borne out by the experience of smaller carriers at multi-airline hubs such as Dallas(Fort Worth) where Braniff Airways competed with the might of American Airlines and subsequently ceased operations. Similarly, Frontier Airlines which hubbed with United and Continental at Denver became a target for take-over by People Express. By contrast, competition was more sustainable between American Airlines and United at Chicago(O'Hare) which is dominated by both. The combination of size and access to infrastructural facilities is therefore vital to enable a dominant carrier to increase its frequency and capacity beyond the critical level and thereby tightening the squeeze on smaller carriers. For the smaller carrier, therefore, the tendency must be to merge to consolidate resources so as to achieve equal economy of size and access. They could also provide 'feed traffic' to the larger carriers, typically because of the types of aircraft the use which may be more suited to the nature of a particular market.

The old cliché of "if you can't beat them, join them" becomes relevant in the strategies of these other carriers. Quite apart from gaining market power by combining forces with a dominant carrier, the economic exigencies arising from structural limitations are of particular significance since even the best of strategies for effective competition will be destroyed without access to structural facilities to compete on equal par. Consequently, a merger would provide a double-whammy. An exception is of course those carriers which can exploit the opportunities offered by less dominated airports by developing them as alternative points of (dis)embarkation. SouthWest chose to develop the secondary airport of Dallas(Love Field), and provided the competition against the Houston-based Continental, for instance, on the Dallas-Houston route; Midway Airlines which developed the dilapidated Chicago(Midway) Airport. Much as the CAA has indicated that slot allocation is not part of its direct regulatory responsibility, it cannot shrink from considering the causes and effects of infrastructural limitations if its policy of liberal route licensing is to produce the benefits it was intended to. Residual regulatory intervention therefore offers a corrective measure for the inequality of opportunities

To a certain degree, the consolidation in the aftermath of deregulation was to be expected. This is already evident even within the EC as fifteen national airline markets converge into one. Given this similarity, the important issue remaining must be the way in which these mergers or alliances are dealt with. In the case

of the US. it has already been alleged that the present industry structure consisting of a few mega-carriers is the consequence of an over-liberal attitude towards mergers in the immediate years following deregulation. Dempsey claims that the "overriding and unmistakable trend" that cut across all the major deregulated sectors, not simply air transport, was "an unambiguous movement toward hefty concentration in a remarkably short time."⁶⁶ Antitrust enforcement, a responsibility transferred from the CAB to the Department of Justice, was notably absent. Indeed, the empirical evidence gathered by Dempsey demonstrated that there was no merger which did not meet the approval of the Department.⁶⁷ Although a non-interventionist stance is consistent with the fundamental aims of the free-market model where perfect competition is obtainable, the absence of a strict framework of antitrust regulation would simply precipitate the problems which called for economic regulatory intervention in the first place. Beyond a certain point, consolidation in the form of mergers takes on an anti-competitive character. Competition becomes threatened. It is entirely possible that competition between the few rather than the many would prove to be more effective, but history does not bear this out. Nowhere is more obvious than international air transport, where typically a duopoly exists; one designated carrier from each country under the bilateral agreement. By contrast, where the duopoly has been broken, fares tended to fall and quality of service tended to improve.⁶⁸ Products vary and choice is enhanced.

This evidence forms an important foundation for the claim in this thesis that any move towards the liberalisation or deregulation of air transport which assumes that the conditions of sustainable competition has been achieved, requires at the same time an effective system of antitrust regulation to ensure that the forces of competition continue and the markets remain contestable. Although the Treaty of Rome, in the form of Article 85 and Article 86, and the variety of competition measures provide the basis for antitrust enforcement, the critical issue has to be the way in which these rules are applied to ensure that any consolidation is not carried beyond the acceptable threshold of sustainable competition.

Computer Reservations Systems: Technology Gone Too Far?

The appraisal of the deregulated US airline industry would not be complete without considering the impact of computer reservation systems (CRSs) on airline competition. This is so because deregulation has required carriers to develop sophisticated reservation systems although CRSs were widely used prior to the deregulation period. In particular, the complex route structure of some carriers as a result of the hub-and-spokes system required a highly capable system which could process and store readily accessible information on destinations, flight schedules and prices. Under CAB regulation, the route structure of most carriers was relatively simple, and choice of fares was virtually

66 S.Dempsey, "The Empirical Results of Deregulation: A Decade Later and the Band Played On" (1988) 17 *Transportation Law Journal* 31, pp.43-44.

67 *Ibid.*, pp. 48-55.

68 See generally CAP 623, but especially pp.11-13.

absent. The rapid expansion following deregulation meant that without a highly developed system, the range of destinations served and fare products available could not be easily provided to the benefit of air transport users. The innovative concept of yield management would be meaningless without the data support that CRSs could provide. Consequently, carriers which could not find the economies of developing a CRS of their own either because of their size or simplicity of route structure have been forced to subscribe to a CRS which is typically owned and operated by another carrier. Clearly, this would create the danger of anti-competitive practices by the CRS-owning, for instance, by displaying flight data of its own services before that of the competitor. The real likelihood of such practices is even greater in a CRS market that is dominated by two carriers, American and United, whose systems, SABRE and APOLLO, together control about 75% of the market.⁶⁹ In addition to the anti-competitive problem of screen display discrimination, unless effective regulation is in place, such market dominance can be readily abused by overcharging subscribers to the CRS. Furthermore, systems could be operated so as to delay by a period the down-loading of information from competitors and thereby gaining a competitive edge with customers who are about to make reservations or purchase tickets on the spot. A more acute problem, for its difficulty of detection and enforcement, is the temptation by the host-airline to misuse the information received from its competitor such as schedules and fare prices.⁷⁰ These difficulties, which culminated in the bitter controversy between Braniff Airways and American Airlines led to the enactment of a statutory prohibition against misuses arising from the use of CRSs, effectively by creating a 'Chinese Wall' between airline operations and the reservation system to ensure non-discriminatory practices.⁷¹

Nevertheless, dependence on a CRS is not necessarily a pre-condition for success in the post-deregulation era. In fact the success story of US airline deregulation, that is SouthWest Airlines, does not subscribe to any CRS which consequently enables it to achieve a lower unit cost so as to be able to expand or sustain its market share as a low-cost carrier, aided by a simple route and fare structure.

CRSs are arguably an ancillary sector to the provision of air transport services. As such, the competition issues which they raise are usually outside the jurisdiction of the economic regulatory agency responsible for air transport competition. However, the competition concerns arising from the use of these sophisticated systems are real and serious, and must therefore be properly regulated. The purpose of such regulation would be to prevent or to remedy any anti-competitive behaviour. Although the CAA has not concerned itself with the competition implications of CRSs, this area is now subject to Council Regulation 3089/93.⁷² The primary aim of the Regulation is to regulate the

69 CAA Paper 84009, p.28.

70 For a further treatment of the anti-competitive problems of CRS, see *ibid.*, pp 29-30.

71 *Carrier-Owned Computer Reservations Systems* 14 CFR §255 (1984) as amended in 1988.

72 (1993) OJ L278/1. See J.Goh, *European Air Transport Law and Competition* (John Wiley, Chichester: 1997), ch.11 for a detailed examination of the Regulation

behaviour of CRS owners and operators by imposing on them certain obligations. It is clear that the combination of potential anti-competitive practices from the use of CRSs and probability of CRSs being owned by a large, dominant carrier requires regulatory oversight so that the aims of liberalisation or deregulation are not threatened.

Frequent Flyer Programmes: Fraud by Loyalty?

Frequent flyer programmes (FFPs) were first introduced by US airlines following the deregulation as a form of marketing strategy designed to promote customer loyalty. A few words need to be said of this post-deregulation novelty. FFPs are programmes which simply means the more often a passenger travels with the carrier, the better the passenger will be rewarded. They are based on a points system which increases as more flying miles are recorded by the passenger, who may redeem these points for certain rewards. The rewards may take the form of free flights, free accommodation at selected hotels, free car rental or other leisure offers. Although FFPs are designed to benefit frequent travellers, these are invariably passengers travelling for business purposes whose travel expenses are usually met by their employers - arguably a form of "business fraud". FFPs depend to a large extent on the density of the carrier's route network. The more destinations served, the more the carrier will be preferred by business passengers primarily for convenience, but secondarily for business opportunities if we accept that air transport is a strategic form of communication. By the same token, the larger the number of destinations served, the wider will be the choice of "free" destinations for the frequent flyer when mileage points are redeemed. By implication, it will be unusual for smaller carriers to develop and sustain a FFP without the support of a dense route network. Although it is possible for a group of smaller carriers to consolidate their resources and offer similar FFP attractions, it would more usual for them to sign up to an existing FFP. While a FFP affiliation falls far short of a merger by definition, there is likely to be a substantial degree of complement in the services and operations of the carriers involved. As yet, no concrete empirical evidence has emerged to suggest that competition has been adversely affected by such programmes. Even so, it is clear that they raise concerns about the potential effects on airline competition. Indeed, the European Commission has had to intervene in a number of cases to require carriers with established FFPs to provide smaller carriers with access to those programmes. This was so in its decision on the co-operation agreement between Lufthansa and SAS.⁷³

Some Reflections: Towards Re-regulation?

Airline deregulation in the US has been the most rapid and radical shift in regulatory policy both by an administrative agency and congressional action; to that extent, it remains largely unprecedented. The division in opinion as to the merits of (de)regulation is as wide today as it was when deregulation was first initiated. Nevertheless, one cannot avoid feeling the slight change in the

⁷³ Commission Decision 96/180, [1996] OJ L54/28.

direction of wind-blow, not least when the underlying theory of airline deregulation that contestability will achieve a state of perfect competition has been discredited very substantially. Both the benefits of deregulation that were envisaged and experienced have either failed to materialise or continue. The lack of foresight as to the might and responses of the carriers was an important missing link during the deregulation debate. But no one should be so naive as to suggest that the consequences could necessarily have been forecast, that ignores the inherent nature of policy formulation.

The deregulation of entry has been the single most responsible factor for much of what has happened. This is readily contrasted with the policy of partial deregulation pursued by the CAA. Quite apart from the geographic constraint on the UK to deregulate completely, the strategic reasons provide a more convincing case. Indeed, it is possible to develop a hub-and-spokes network of routes in the UK; the difference would only be a matter of degree. Economic rationales, however, dictate otherwise. Geographic size is an important component in developing a minimum threshold of scale and network economies before a hub-and-spokes system becomes viable. If an inherent requirement of a hub-and-spokes system is a reasonable collection of routes for viable operations, then this collection of routes must also depend on the relative size of the total geographic area of services provided. It is therefore unlikely that a hub-and-spokes system for domestic UK services will be a suitable concept given "not only the disparity in size but also the particular characteristics of the UK with its many thin routes and the dominance of one city, London, and one airline, British Airways";⁷⁴ this does not, however, invalidate the possibility of developing such a system for international services which to a certain extent has been the case with BA at London(Heathrow). Furthermore, the smaller the geographic size, the greater is the degree of competition from other modes of transportation and which must consequently raise the level of economies. Equally, a given geographic size has a relatively fixed volume of market capacity in the sense that the variation in domestic traffic demand between the US and the UK will be considerable on the basis of the size of the population.⁷⁵ More importantly, the strategic rationale for not deregulating entry is to prevent the excesses of a monolithic industry by blatantly ignoring the historical position of British air transport. The inequality in size and strength between BA and other airlines as a consequence of historical endowment will have little mercy for the latter if the control of entry was removed. BA's size of aircraft fleet, network of routes and possession of airport slots, all of which were transferred to it following its privatisation, would only ensure that services offered in competition with BA would achieve insignificant success even if infrastructural flexibility was assumed. Such disproportionality did not and does not exist in the US because airlines were never publicly-owned. Regulation of entry is therefore an important strategic tool for providing, not so much as equality of size and strength, but at least equality of opportunities. Unlike fares or

74 *Ibid.*, p.1.

75 For instance, domestic traffic in the US represents about 70% of total traffic while the UK and the EC are both much more dependent on international traffic: see COM(92) 434.

capacity, control of entry cannot be achieved by antitrust regulation. There is nothing anti-competitive about offering a competing service, neither is it an abuse of a dominant market position *per se*. A combination of entry regulation, based on a policy that presumes in favour of competition, and antitrust regulation of fares and capacity provides for *mutatis mutandis* a system of contestability with appropriate regulatory safeguards aimed at fostering route expansion and achieving competitive fares that would satisfy a substantial category of reasonable public demand. Competition derived from deregulation in this sense is still, but only, a means to an end. US policy on airline competition, however, is seen as an end in itself. In fact, a comment in the same vein was made by Dempsey in one of a series of critical review of US airline deregulatory policy. He argued,

In the real world, however, the task is not so much to choose between economic abstractions but to fashion an enlightened approach to bring about the positive attributes of healthy competition, which include productivity, efficiency, and a range of price and service options responsive to the demands of consumers. This must be accomplished while protecting the public against market failure.⁷⁶

It is therefore no surprise that, in just over a decade of deregulation, an agenda for regulatory reform has begun to take shape. If reform is to be effected at all, then the crucial question of which regulatory style the post-reform period should take must be addressed. Three options are possible. First, a move back to CAB-style regulation that existed prior to the ADA. Secondly, regulatory reform without reform by staying with the deregulated regime. Thirdly, regulated competition as a middle ground between CAB regulation and deregulation. No doubt, each will arouse passions of its own. CAB-style regulation cannot be an appropriate measure for the simple fact, as Kahn has summed up, that deregulation has "scrambled the eggs".⁷⁷ Deregulation, on the other hand, has already proven itself to be in excess of the degree of competition that could be regarded as healthy. The choice, it must seem, is between that of imperfect regulation and imperfect competition. This, however, would require congressional legislation, and a well-developed regulatory policy, to ensure that the excesses of bureaucracy associated with CAB-regulation and the ills of unregulated competition are avoided to the maximum extent possible. Yet, it would provide the solution, albeit imperfect in its own right, for combining the strengths of competition wherever and whenever permitted to satisfy the end objective of user interests as well as the need for regulatory oversight of anti-competitive practices which are equally destructive as excessive competition is from total deregulation.

To a considerable extent, the review of regulatory options has been superseded by a presidential commission appointed to investigate and recommend policy changes for the airline industry. Although due in part to the effects of global

76 S.Dempsey. "Airline Deregulation and Laissez-Faire Mythology: Economic Theory in Turbulence" (1990) 56 *Journal of Air Law and Commerce* 305, at p.381.

77 A.Kahn. "Airlines Invite Talk of Regulation" in *Rocky Mountain News* (July 6, 1989).

recession and in part to the excesses of competition, the urgent review was largely compelled by the deteriorating financial plight of all carriers. This task was assigned to the National Commission to Ensure A Strong Competitive Airline Industry which aimed "to question some of the most basic assumptions that have formed the foundation of policy toward this industry - and behaviour within it - for the past half century."⁷⁸ It made a number of recommendations which were shaped by three basic principles: the need for technological superiority so that infrastructural impediments to efficiency can be eliminated, the need for financial strength so that the industry can make rapid adjustments, and, the need for access to the global market by liberalising dated restrictions. On balance, the report suggested a greater interventionist role for the government and in particular the FAA, although it flatly rejected the return to regulation.

[We] do not believe the government should attempt to provide a cure through re-regulation of routes and fares. The process would be slow, cumbersome and mired in litigation and challenge, and would lack the flexibility to permit rapid response to changing conditions.⁷⁹

This reminder was made in the light of the evidence that since deregulation greater head-to-head competition on city pairs has been achieved to bring lower tariffs in real terms which would be destroyed by returning to agency regulation.

Almost every recommendation of the Commission was accepted by the Government⁸⁰ except the recommendation to set up an "airline financial advisory committee...to advise the Secretary of Transportation when an airline's financial condition poses risks to the public or to the industry."⁸¹ Such fitness regulation, however, will be made more vigorous by positively monitoring the financial position of carriers so that it creates "a strong incentive for airlines to comply with fitness requirements and to promptly correct deficiencies identified by the Department."⁸²

Conclusions

There is much to learn from the deregulatory effects, which to a large measure, have begun to emerge in Community air transport. The liberalisation programme has witnessed a sudden growth of new, low-cost carriers, although some of these have only been able to operate out of peripheral airports. Whether these carriers will have the stamina to expand further remains to be

78 National Airline Commission to Ensure A Strong Competitive Airline Industry: *Change, Challenge and Competition* (1993), introduction.

79 *Ibid.*, p.14. See also Kahn's rejection of the re-regulation idea and critical review of the National Airline Commission's Report: "Change, Challenge and Competition" (1993) *Cato Review of Business & Government* 55.

80 *The Clinton Administration's Initiative to Promote A Strong Competitive Aviation Industry: Growing To Meet Global Competition* (1994).

81 *Change, Challenge and Competition*, p.14.

82 *Clinton Administration's Initiative*, p.10. This would be carried out under the authority vested by the Federal Aviation Act, s.401(r).

seen, though it is clear from the US experience that highly specific strategies will be required if any meaningful competition with the incumbents is to be seen. In a similar way, the liberalisation programme has led to product differentiation within and between carriers, more so at the bottom end of the fare structure, that is promotional fares, rather than the top end, that is premium fares.

It is also clear that, as deregulation in the US has encountered, the liberalisation of Community air transport is beginning to see a wave of consolidating activities as airlines adjust to the new environment. The US experience has shown that antitrust enforcement must be taken seriously when liberalisation or deregulation is introduced to ensure that beyond a certain point, these consolidations do not isolate the forces of competition and in the process threaten the objective of the initiative. This is the challenge for Community air transport.

The *caveat* of this chapter is that the danger of simply grafting those experiences to other air transport markets, including the UK and the EC, must not be lost out of sight. The structure of the industry, the geographic size, and the historical traditions of these countries vary substantially and must be properly accounted for. The unsuitability of total deregulation for British air transport, including the removal of entry control, has been argued. US-style deregulation has also been rejected by the EC for Community air transport, although the practical differences are yet to be seen. Quite apart from the exemptions relating to market access, entry control is virtually non-existent, and it is not entirely clear from the previous chapter that the European Commission has been vigorously enforcing the antitrust laws. Be that as it may, an important deduction to be made is that any difference between the US-style deregulation, Community liberalisation and CAA liberal regulation is only a matter of degree. None should deny that, as market forces become more important, so does antitrust regulation.

CHAPTER NINE ADMINISTRATIVE REGULATION AND ACCOUNTABILITY

Throughout the preceding chapters, references have been made to the issue of agency regulation and accountability. Regulation, as defined in the opening chapter, constitutes a form of interference or control in the behaviour or activities of private individuals or organisations. Accordingly, the exercise of such regulatory interference must at least be rational, procedurally proper and lawful in order to justify the interference, or non-interference for that matter. In short, there must be accountability for the regulator's decisions. Administrative or agency regulation presents particular problems of accountability, ironically because of the discretion it requires to maintain its independence and the need to check the manner in which the discretion is exercised.

The solutions to an imperfect industry structure are necessarily imperfect. Regulatory policies have had to be shaped according to this structural imbalance within the confines of the statutory objectives, and more importantly, consistent with the demands of public accountability that are part of the "dialectic interplay" between the institutions of power and their legitimation.¹ As a regulatory agency, the CAA presents the classic problems of accountability in modern government seen across the range of non-departmental public bodies and beyond. Typically, these are the "smoke-screen" fashion of decision-making fortified by the lack of access to official information, and judicial preference for legal positivism that fails to adequately recognise the informal methods of communication between public authorities.²

The purpose of this chapter is therefore to chart the public law issues pertaining to administrative regulation; indeed, there would be a missing jigsaw piece in the puzzle if these broader issues were neglected. It has already been argued elsewhere that many of the developments in the modern State, including the rise of agency regulation, present a fundamental dilemma. This is because some of these are changes with which the traditional constitutional apparatus are ill-equipped to cope.³ This being the case, the use of such institutions which wield enormous amount of power is cause for concern. The question, however, should not be whether these institutions should be used at all, for it is already an accepted facet of public administration that regulatory agencies are the "fourth branch of government", to borrow a phrase from James Landis. They represent

1 R.M.Unger, *Law in Modern Society* (Free Press, New York: 1976).

2 See T.Prosser, "Towards A Critical Public Law" (1982) 9 *Journal of Law and Society* 1 and generally his *Nationalised Industries and Public Control* (Blackwell, Oxford: 1986).

3 See generally, P.Birkinshaw, *Grievances, Remedies and the Law* (Sweet & Maxwell, London: 2nd. edn., 1995) and N.D.Lewis, *Choice and the Legal Order: Rising Above Politics* (Butterworths, London: 1996).

a form of institutional response to the developments which the tripartite framework of government cannot adequately resolve. More to the point, it should be how, when and where should these institutions account for the exercise of the public power conferred upon it. More significantly, to what extent has the statutory objectives with which the agency was charged been achieved? Perceived regulatory failures must therefore be properly explained. To what extent do the criticisms generally levelled at regulatory agencies apply to the CAA, and by implication, how relevant to the CAA are the suggestions for reform. These are issues which this chapter will take up, particularly in the context of the CAA and its work in competition regulation. In assessing the role of the CAA and its accountability, it is necessary also to reflect the changes brought about by the EC liberalisation measures in air transport. By transferring national competence in air transport to Community institutions, the question arises as to how accountable are these institutions for their decisions and what accountability mechanisms exist. It needs to be asked also whether problems exist and, if so, what can be done?

Accountability and Separation of Powers

Regulatory agencies, the likes of the CAA, OFTEL, OFGAS, are often vested with functions which have traditionally been kept apart in accordance with the doctrine of separation of powers and often conferred with a wide degree of discretion to perform these functions. Although the doctrine is much more strictly observed in the US than the UK, it pays to examine it briefly vis-à-vis regulatory agencies and the role of law in checking their discretion; if nothing else, it is the bedrock of democratic accountability. As John Locke wrote in 1690,

It may be too great a temptation to humane frailty, apt to grasp at power, for the same persons who have the power of making laws, to have also in their hands the power to execute them, whereby they may exempt themselves from obedience to the laws they make, and suit the law, both in its making and execution, to their own private advantage.⁴

On this basis, the concept of agency regulation which combines the tripartite functions of legislative, executive and adjudicative, fits uncomfortably within the British democratic and constitutional structure. The exponential growth and use of administrative agencies put a strain on the traditional institutions of the State and the methods of control and accountability. The CAA which is statutorily required to formulate air transport regulatory policies, applies them in the licensing of air transport services and adjudicates disputes over licensing matters is constitutionally an awkward creature even if these functions were performed within the boundaries of a broader policy set by the government of the day. The constitutional difficulty is not simply the fusion of these functions which have traditionally been kept separate. An administrative agency which regulates the

⁴ J.Locke, *Second Treatise of Civil Government* (Blackwell, Oxford: 1946). ch.12. para.143.

activities of private sector actors (or a mixture of private and public sector actors) represents a "compenetration of the political and societal realms" and thus leading to the "progressive displacement of the state/society divide" ' In the context of the US, a member of the former CAB, Louis Hector, remarked that the combination of these functions within a single body gave rise to tasks which were inherently incompatible and difficult to perform

...my experience on the Civil Aeronautics Board has convinced me that an independent regulatory commission is not competent in these days to regulate a vital national industry in the public interest...The members of the CAB, like those of other regulatory commissions, have duties and responsibilities of policy-making, adjudication, administration and investigation which are by their very nature incompatible.⁶

No doubt, the US has a very different constitutional tradition where functions of Government are kept strictly apart. Even so, the fundamental aim remains: to keep these functions separate to ensure a satisfactory system of checks and balances. In this sense, accountability assumes special prominence. The traditional mechanisms of public accountability are typically divided into the 'political' and 'judicial'. In essence, the former means political accountability through the institution of Parliament whether directly or indirectly. But the diversity in the forms of parliamentary accountability itself means the system of select committees, the system of financial control and the system of ministerial-agency control which is ultimately subject to the constitutional requirement of ministerial responsibility. Judicial accountability is a process *ex post facto* and is potentially misleading to conceive it as a form of accountability since its concern lies not with the overall performance of the administrative agency, but the legality of the issue in dispute. Political and judicial accountability call on those institutions which have been part of the constitutional tradition for a long time and which may well be ill-suited to the demands for accountability stemming from the activities of a modern State.⁷

Parliamentary Accountability

As a nationalised industry, the CAA has no direct responsibility to Parliament, but is nevertheless indirectly accountable through the Secretary of State for policy matters. Parliamentary accountability was much more apparent at the time when the system of policy guidance was still in place. Under the 1971 Act,

5 G.Poggi, *The Development of the Modern State* (Hutchinson, London: 1978), pp.122 & 138.

6 L.J.Hector, "Problems of the CAB and the Independent Regulatory Commissions" (1960) 69 *Yale L.J.* 931.

7 I.Harden and N.Lewis, *The Noble Lie: The British Constitution and The Rule of Law* (Hutchinson, London: 1986). I make no attempt to examine the third form of financial and administrative accountability through the offices of the Comptroller and Auditor-General (C&AG) and the Parliamentary Commissioner for Administration (PCA) respectively, which deserves more detailed consideration than has hitherto been the case. Suffice it to say that both the C&AG and the PCA have demonstrated the instrumental role that they play in the accountability of non-departmental institutions. See generally, P.Birkinshaw, *Grievances, Remedies and The State*, *op.cit.* and P.Birkinshaw and N.Lewis, *When Citizens Complain* (Open University, Buckingham: 1995).

which first established the CAA and this system, s.3(3) required that all draft guidances to be "approved by a resolution of each of House of Parliament " This is of course provided Parliament with the opportunity to debate publicly and scrutinise the details of the communication between the Secretary of State and the CAA. The system was seen as a "constitutional innovation"⁸ and an effective control over the regulatory functions of the CAA as well as the general direction of the industry; an instrument which was capable of "structuring" the exercise of discretion by the CAA⁹ although its misguided use led to its abandonment subsequently.¹⁰ The CAA, however, continues to be under a statutory duty to submit its annual financial report and accounts to the Secretary of State who would then lay them before Parliament.¹¹ This requirement of laying before Parliament the annual accounts provides an opportunity for parliamentary scrutiny of the financial performance of an administrative agency, and possibly provide for a wider parliamentary debate of the air transport regulation by the CAA.

Direct accountability to Parliament, however, takes the form of select committee scrutiny. Prior to 1979, the principal jurisdiction for the regulation of civil aviation was held by the Select Committee on Nationalised Industries. With the reforms of 1979, the CAA was brought under the general jurisdiction of the Select Committee on Transport (although in some cases, the Trade and Industry Select Committee may have the jurisdiction to investigate). The Transport Select Committee (TSC), which is now part of the Department of Transport, Environment and the Regions Select Committee, has the responsibility "to examine the expenditure, administration and policy of the Department of Transport and associated public bodies".¹² In carrying out its designated role, the TSC is empowered to send for persons, papers and records, to sit notwithstanding any adjournment of the House, to adjourn from place to place and to report from time to time; it may also appoint specialist advisers either to supply information which is not readily available or to elucidate matters of complexity within the Committee's order of reference. With these added powers, the select committees generally have been able to play a more active and improved constitutional role; reports were also markedly improved in terms of quality. A critical study into the constitutional order noted that,

Given the general ineffectiveness of our parliamentary institutions and the pervading cloak of secrecy which protects the workings of the government from scrutiny, the performance of the select committee system since 1979 has been a remarkable achievement. Ministers are now subject to frequent examination, a large amount of information has been placed in the public domain, reports critical of government policy and methods of

8 H.C.Debs.814, col.1173 (29 March 1971).

9 R.Baldwin, *Regulating the Airlines* (OUP, Oxford: 1985). pp.241-243. On the structuring of discretion see K.C.Davis, *Discretionary Justice: A Preliminary Inquiry* (University of Illinois Press, Chicago: 1977), ch.4.

10 *Laker Airways v Department of Trade* [1977] 2 All ER 182.

11 S.15, Civil Aviation Act 1982, as modified by *Civil Aviation Authority (Auditing of Accounts) Order 1984*, SI 65/1984.

12 Standing Order No.130.

policy-making have been produced and have contributed to debate. Furthermore, the existence of the select committees has had effects within departments in encouraging greater rigour in policy formulation and justification.¹³

A number of the TSC's noteworthy inquiries include airline competition in 1987 and the ways that it affected British operators and the impact that it had on air services.¹⁴ The dissolution of Parliament that year meant that the inquiry could not be completed, but it stated that "this very important subject" ought to be taken up and completed by the successor Committee.¹⁵ That invitation was never taken up. In parliamentary session 1989/90, the TSC conducted one of the most comprehensive reviews of airline safety in the history of UK civil aviation.¹⁶ Among other things, a number of searching questions were put to the officials of the CAA on its policies and policy-making procedures for safety. In session 1991/92, it also carried out an inquiry into the development of air transport policy in the EC¹⁷ following a study by the House of Lords Select Committee on the EC in session 1990/91 into the issue of external relations in EC air transport.¹⁸ Whatever may have been the difficulties which pervaded the "old" select committee system, and whatever may still be the difficulties of the "new" system, parliamentary accountability remains an important forum of public policy debate and scrutiny of administrative activities in constitutional terms although for the CAA, this must now properly reflect its limited jurisdiction in the light of Community air transport law.

The Role of Courts and Accountability

Perhaps the most important issue of regulatory accountability is whether the objectives of regulation have been or are being achieved. If, in the first instance, regulatory intervention was deemed necessary to correct certain imperfections such as market imperfections or to prevent the excesses of a monopoly, then the question of whether this has been or is being achieved becomes an inescapable one. Defining regulatory success or failure is of course never an easy task. It is only natural that there will be supporters and detractors of the decisions of the regulator.

Regulators are often conferred with a wide degree of discretion. This causes problems for their accountability, but equally it must be accepted that regulatory discretion is a pre-requisite for regulatory independence. The regulator will require the independence to form a judgment of whether a particular activity or behaviour constitutes an economic regulatory offence, such as predation, and if so, whether to intervene. Even so, discretion in this sense is not the same as absolute discretion. It is not absolute because in the first instance, the regulatory discretion is over matters of fact, and not of law. Thus, its exercise must be subject to review by the courts in the case of legal errors, and may be subject to an appeal to the Secretary of State on matters of fact where the statute has

13 Harden and Lewis, *op.cit.*, p.110.

14 HC 382 (1986-87).

15 *Ibid.*, para.3.

16 *Aircraft Cabin Safety*, HC 27 (1989-90).

17 *Developments in European Community Air Transport Policy*, HC 147 (1991-92).

18 *Conduct of the Community's External Aviation Relations*, HL 39 (1990-91).

provided for this. The crucial task is therefore to reconcile between the need for regulatory discretion and the need to ensure that decisions are not only rational and fair, but are arrived at after having adopted fair procedures. The aim of this brief section is to examine the role of courts in substantive and procedural review within the context of air transport policies and decisions.¹⁹ This should provide some understanding of the extent to which the courts have a role to play in securing substantive and procedural accountability although they are by no means always so neatly separated.

Substantive accountability

This relates to the actual decision of the regulatory agency. It questions the merits of the decision, for example, whether to issue an air transport licence or whether to commence antitrust proceedings or to make a finding of antitrust infringement. Questioning the merits of a decision naturally borders on reviewing the facts of the case, a matter on which the jurisprudence of British courts is far from settled. Judicial attitude towards such cases is not entirely clear nor satisfactory.²⁰ On the one hand, these cases can be considered as appeals since they go to the merits of the case, and cannot therefore be the subject of a judicial review application. Unless an appeal procedure has been expressly provided by the statute, for example to the Secretary of State, there will be no effective redress against the perceived grievance. On the other hand, judges have shown themselves to be willing to review such cases primarily under the principle of 'Wednesbury reasonableness'.²¹ The distinction between an appeal and a review, though a long standing conflict,²² is consequently not as clear-cut as desired.

Even where such cases qualify for review, judges have traditionally been slow to intervene on the ground that Parliament intended the agency to exercise the discretion given to it, and so would be wrong for the courts to 'substitute' their version of the regulatory decision.²³ A good illustration is the application by BA to impugn the decision of the CAA to license BMA to operate a conventional scheduled service between London(Heathrow)-Belfast alongside BA's shuttle service.²⁴ This case established that the CAA had considerable latitude of discretion in the performance of its economic regulatory function. The terms of the 1982 Act were such that the CAA was able to enjoy a considerable measure of independence, and in considering the factors which it deemed as relevant to the case in question. Accordingly, the role of the courts in interfering with the exercise of this regulatory discretion was, and should be, limited. Indeed, Woolf J had indicated in that case that the courts should be even slower to intervene

19 See generally D.J.Galligan, *Due Process and Fair Procedures* (OUP, Oxford: 1996).

20 Compare *Secretary of State for Education and Science v Tameside MBC* [1977] AC 1014; *Bromley LBC v Greater London Council* [1983] 1 AC 768; *R v Ministry of Defence ex p Smith* [1996] 1 All ER 257; *R v Lord Chancellor's Department ex p Witham* [1997] 2 All ER 779.

21 *Associated Provincial Picture Houses v Wednesbury Corporation* [1948] 1 KB 223.

22 *Anisminic v Foreign Compensation Commission* [1968] 2 QB 862.

23 *R v Cambridge Health Authority ex p B* [1995] 2 All ER 129.

24 *R v CAA ex p British Airways Board* CO/943/83, QBD, Transcript of 21 September 1983.

where the appellate procedure to the Secretary of State had not been invoked. The one exception, he said, was where the application involved an important point of law in which case it might be argued that there would be advantage in the matter being considered by the court before going to the Secretary of State so as to enable "the Secretary of State to know what is the correct law to apply."

An equally relevant illustration is the judgment of Roch J. in dismissing the application of Airways International to review the decision of the CAA to license Inter European Airways to operate charter flights. He said,

In my judgment, to overturn this decision would involve a grave risk of a substantial public demand for holiday charter services going unsatisfied. In addition, it may adversely affect the employment of those pilots and cabin staff retained by Inter and deprive the airports from which Inter propose to and do now operate of revenue.²⁵

Although there is much to credit for such an analysis, it is equally plausible to construct an argument that Parliament never intended the agency to exercise its discretion in the way in which it did. A number of extra-judicial commentaries have shown that judges will not be slow to adopt an interventionist approach. In particular, Justice Laws has reasoned that,

...save as regards the Queen in Parliament, there is in principle always jurisdiction in the courts to review the decisions of public bodies...There is certainly no judicial self-constraint on the ground only that the subject-matter is politically controversial."²⁶

Even more telling, Lord Woolf has written that "if Parliament did the unthinkable, then I would say that the courts would also be required to act in a manner which would be without precedent [because] ultimately there are even limits on the supremacy on Parliament."²⁷

Procedural Fairness

Procedural review of administrative discretion tend to be more common and a more successful ground of challenge. It has its origin in the principle of natural justice, famously developed by *Ridge v Baldwin*,²⁸ although this has now been expanded to include the duty to give reasons in a limited number of circumstances,²⁹ the duty to act fairly³⁰ and a legitimate expectation to be consulted.³¹ These are collectively referred to as procedural fairness.

Much of what regulatory agencies do depends on a procedural system that is fair and rational. This may be a public hearing to determine whether a licence should be issued, varied or revoked, or a consultation exercise to gather

25 *R v CAA ex p Airways International (Cymru)* CO/839/87. QBD. Transcript of 20 May 1987.

26 Sir John Laws. "Law and Democracy" (1995) *PL* 72 at p.76.

27 Lord Woolf. "Droit Public-English Style" (1995) *PL* 57 at p.69.

28 [1964] AC 40.

29 *R v Secretary of State for the Home Department ex p Doody* [1993] 3 All ER 92.

30 *Re HK (an infant)* [1967] 2 QB 617.

31 *Council of the Civil Service Unions v Minister for Civil Service* [1985] AC 374.

evidence for the formulation of policies. The role of courts in ensuring procedural propriety for regulatory decisions is therefore an important one, all the more so in the light of criticisms against the lack of transparency in regulatory decision-making.³² Although this is an expensive way of ensuring regulatory coherence, it remains an important mechanism to check the exercise of regulatory discretion.

Conclusion

Judicial review cases against the CAA are few and far between. There is an appellate procedure to the Secretary of State, whose decisions have rarely been challenged in the courts. Baldwin's analysis reveals that airlines see little point in seeking judicial challenges because the CAA or the Secretary of State would still be empowered to make a similar decision afterwards.³³ This is what may be called the *beneficial interpretation* which refers to the incentives for avoiding a litigious attitude. Baldwin observed in his study that in addition to the difficulties of checking and balancing the exercise of authority by a multi-powered agency, there was a general reluctance in the industry to take the complaints against CAA decisions to the courts since a victory at law would achieve little if an unwanted decision might well be re-made by the CAA or by the Secretary of State.³⁴ Where a judicial decision results in the latitude of discretion being restricted, the regulator or the relevant minister is always in a position to turn to the legislature for more authority. The final result will be a circuitous exercise that is likely to cause undesirable disruptions in the regulatory process. Furthermore, the air transport industry is characterised by a closely-knitted community where protracted relationships between the parties in the industry is the quintessence of an overall efficient system of civil aviation. The confrontational requirement of an adversarial system is seen as both undesirable and damaging to the interests of the parties. Taking a dispute to court causes delay in the decision-making process of the applicant and raises uncertainties within the industry. Airline companies in particular are concerned not to create excessive publicity via the courts which may have damaging consequences such as that evidenced by the so-called "dirty tricks" campaign alleged by Virgin against BA.³⁵ Those that seek to protect the confidentiality of their trade secrets would also avoid courtroom litigation since the pre-trial proceedings of discovery may require these details to be divulged.

That said, the CAA adopts a very open procedure in making decisions, from extensive consultation on proposed policies to the giving of reasons for decisions. Procedurally, it seems difficult to impugn. Such procedural probity inevitably lends support to the merits of the substantive decision. Hence, even if the conferment of a wide regulatory discretion may have a potential for abuse,

32 *R v Director General of Gas Supply ex p Smith* CRO/1398/88, QBD. Transcript of 31 July 1988; *R v Director General of Telecommunications ex p Let's Talk (UK) Ltd* CO/77/92, QBD. Transcript of 6 April 1992.

33 See R. Baldwin, "Civil Aviation Regulation: From Tribunal to Regulatory Agency" in R. Baldwin and C. McCrudden (eds.), *Regulation and Public Law* (Weidenfeld & Nicolson, London: 1987).

34 *Ibid.*

35 J. Goh, "Fear and Loathing in the Air" (1992) 142 *NLJ* 822: 868

these procedural practices provide an important means for structuring their exercise.³⁶

From a broader perspective, it is arguable that as greater liberalisation or deregulation takes place, the role of the courts in public law and in reviewing decisions of the regulatory agency becomes correspondingly less important. This is so because regulatory interventions become less common and less necessary. This is not to say that antitrust interventions are no longer necessary. It means direct economic regulation will have evolved into a different form of regulation, but which also places a greater responsibility on the airlines to be vigilant, so that without complaints from them that their interests have been harmed, antitrust interventions become unnecessary. Judicial review of antitrust decisions is a complex area. The courts in the UK have shown a supreme reluctance to disturb the findings and decisions of the MMC and the President of the Board of Trade,³⁷ arguably on the ground that it was inappropriate for the courts to be involved in reviewing economic regulatory decisions, or that the courts lack the appreciation or capacity to construct sophisticated economic and social theories for adequate legal analysis. This may be described as the *systemic-complacent* interpretation of the role of courts in regulating public economic activities. What it suggests is simply that concentration on the niceties of jurisprudence and precedents pose a difficult barrier for the courts to produce a constructive response to the exigencies of the wider capitalist order.³⁸ The regulation of civil aviation is a complex process calling for a specialist body. Requiring a judicial institution to second guess the decisions of a specialist regulatory body would not only be a futile exercise but would inevitably strike at the *raison d'etre* of that regulatory institution. More importantly, the spasmodic *ex post* nature of judicial decisions is not an appropriate forum for policy development and coherence. Regulatory decisions frequently require the regulator to take a future view of things and to forecast future outcomes. By contrast, judicial decisions tend to focus on events of the past. However, these observations are not necessarily borne out by the experience in Community competition enforcement. There is a detectable readiness amongst Community airlines to resort to the protection of the law, primarily in judicial review proceedings against the Commission for having made a decision which allegedly infringed the rights of the litigants.³⁹ One may well argue that there is now an apparent juridification of air transport competition within the Community. This is so because problems affecting competition between European airlines were resolved in the past by negotiations and bilateral agreements between national governments, rather than judicial settlement; such bilateral or diplomatic

36 See Davis. *op.cit.*

37 E.g. *Lonrho plc v Secretary of State for Trade and Industry* [1989] 2 All ER 609; *R v Secretary of State for Trade and Industry ex p Anderson Strathclyde plc* [1983] 2 All ER 233.

38 See e.g. *Hammersmith & Fulham LBC v Secretary of State for the Environment* [1990] 3 All ER 589, pp.635-637; *Nottinghamshire CC v Secretary of State for the Environment* [1986] 1 All ER 199, pp.202-204; *Lonrho plc v Secretary of State for Trade and Industry* [1989] 2 All ER 609.

39 See generally. J.Goh, *European Air Transport Law and Competition* (John Wiley, Chichester: 1997).

processes are no longer required nor possible under the common aviation market. Instead, the new legal and economic order for Community air transport has created a new set of rights and obligations for the participants and which are enforceable in courts of law. As a result, relations within this economic sphere which were previously governed by other norms or values become juridified as the participants "turn to the legal framework in order to determine their right, duties, power and liabilities."⁴⁰

Regulatory Capture and Accountability

A major and common form of regulatory failure is widely known as 'regulatory capture'. Regulatory capture, according to the Chicago school of thought, is where the process of regulation "is acquired by the industry and is designed by and operated primarily for its benefit."⁴¹ The phenomenon of agency capture is perhaps better developed and better known in the context of administrative regulation in the US than in the UK.⁴² Even so, this is not an issue of minor consequence. Although it may be true that historically agency capture has never been a problem in the UK, the capture of other public institutions such as ministerial departments is not unknown.⁴³ As agency regulation become a more dominant feature of British public administration, it pays therefore to say a few words on the relevance or irrelevance of the capture theory.

One of the earliest analyses on the work of regulatory agencies in the US was conducted by Bernstein in the 1950s. In his analysis, a regulatory agency went through a life-cycle so that regulatory capture is the stage when the agency becomes "a captive of the regulated groups."⁴⁴ According to this life-cycle theory, an agency undergoes four stages of metamorphosis: gestation, youth, maturity and old age. He argues that the gestation stage is the period of regulatory reform under critical or near-critical conditions so that the reform results in short-term measures. At youth, the agency pursues an aggressive policy of protecting the public interest, and consequently provoking an organised opposition to its policies. As it struggles to resolve the tensions, it sinks into self-realisation that the alternative approach lies in securing the support of the regulated groups. This maturity stage is characterised by it becoming the protector of the regulated. The final stage of its life span is then spent on maintaining the *status quo* and the regulator becomes insular so that it no longer responds to wider socio-economic changes.

40 M.Loughlin, "The Restructuring of Central-Local Government Relations" in J.Jowell and D.Oliver (eds.), *The Changing Constitution* (OUP, Oxford: 2nd edn., 1994), p.278.

41 G.Stigler, "The Theory of Economic Regulation" (1971) 2 *Bell Journal of Economics and Management Science* 3.

42 See T.Prosser, *Nationalised Industries and Public Control* (Blackwell, Oxford: 1986), esp. chs.8 and 9.

43 Examples include the relationship between the Ministry of Agriculture and farmers, and indeed between the Department of Transport and the then publicly-owned, British Airways

44 M.Bernstein, *Regulating Business by Independent Commission* (Princeton University Press, Princeton: 1955).

For Posner as well as Stigler, the regulatory machinery was first designed for the benefit of the regulated and their interests. Thus, it is more specific than Bernstein's life cycle theory in it suggests a more extensive influence by the regulated during the gestation stage to design a regulatory system that was more suited to their interests.⁴⁵ Both versions explain the suggestion made by Vickers and Yarrow in their study of the BA privatisation. They argue that the incumbent airline attempted to extract an assurance from the government that prior to its sale, the government would take every step to maintain its economic strength and dominance in the industry.⁴⁶ For others such as Edelman, the process of governmental regulation is a story of symbolic politics. He maintains that "administrative acts become symbols both of protection of a wide public and of the ability of regulators to see issues from the point of view of the regulated."⁴⁷

The theory of regulatory capture is open to criticisms on several grounds. The first is the often limited scope of the theory. Stigler and Posner both assume that the primary and exclusive concern of the regulator is the user, the consumer or the general public: hence, the public interest theory. Once the regulatory agency changes its policy emphasis in favour of the regulated, it comes to be seen as captured. What the theory does not address is the possibility, deliberate or otherwise, of a combination of legislative mandates. Among these mandates may be to give a modicum of protection to the regulated groups. A common point of reference in their arguments is the protectionist policies of the CAB which were undeniably anti-competitive. The users were losing out from the lack of competition because the regulated airlines maintained a significant influence on CAB policies. Whether such influence was real or otherwise, empirical findings from which to draw a conclusion abound. The argument in principle, however, is not whether such influence existed, but the need to lend contextual relevance to the analysis so that a protectionist strategy may simply be a matter of co-incidence, and not a product of a captured agency. The CAB, along with the other regulatory agencies, was a manifestation of the promise to induce gradual economic growth, and protectionism ran through the mass of legislation consequent on the New Deal programme. The uncertainties and the discontent flowing from the Depression of the 1920s and the 1930s left the US administration with very little choice but to introduce a new regime of administrative regulation. In addition, the presidential election of 1932, required a rational political strategy to restore public confidence which had been severely damaged by the consequences of the free-market system immediately prior to the Depression. The New Deal provided the promise of economic restructuring and the regulatory protection of vital industries. In this respect, protectionist policies signify an instrument of stability, not a product of capture.⁴⁸ Likewise, for the CAA, its statutory responsibilities include "an

45 R.A.Posner, "Theories of Economic Regulation" (1974) 5 *Bell Journal of Economics and Management Science* 335.

46 J.Vickers & G.Yarrow, *Privatization: An Economic Analysis* (MIT Press, Mass.: 1988), p.343.

47 M.Edelman, *The Symbolic Uses of Politics* (University of Illinois Press, Chicago: 1964), p.189.

48 Ch.8 discussed further the legislative mandate of the CAB.

economic return to efficient operators on the sums invested in providing the services".

The theory of capture and the arguments of Stigler and Posner assume a 'monolithic' structure of the regulatory complex in which the participants have equal strengths, resources and access to information. This may be true, for instance, in the context of the US airline industry where there is no history of public ownership or monopoly. For a wider application, the theory is liable to ignore the possibility of a structurally unbalanced industry where by reason of history or legislative *diktat* one participant enjoys a decidedly dominant position. Although BA was privatised in 1987, it was so privatised with its size and assets intact which included a wide network of routes, a large fleet of aircraft including the prized Concorde and an important pool of airport slots at the popular Heathrow Airport. In this situation, other regulated participants within the regulatory complex may require the protection of regulation against market abuse, unfair exploitation or barriers to entry. Indeed, it may be necessary to give this measure of protection for the maintenance of competition, and the enhancement of user choice. In this sense, it cannot be said that tilting the balance of the policies in favour of the latter makes the regulator a captive of the regulated groups. The flexibility of the regulator in fashioning different regulatory strategies for different socio-economic climates is a self-proclaiming piece of evidence of the rise in the administrative agencies. Its resilience cannot be conveniently labelled as capture.

One of the major difficulties in administrative regulation by agency is the temperament of the responsible regulator. Although to a large extent the regulator is a political appointee of the government of the day, regulatory policies and practices will inevitably be coloured by the beliefs of the regulator. The issue is all the more acute as regards regulatory systems which have been established in accordance with loosely formulated legislative provisions requiring detailed interpretations by the regulatory agency. These concerns are not unique to public administration in the US but are equally of vital significance to British constitutional and political theory.⁴⁹ Thus, another important characteristic of regulation which the capture theory does not adequately address is the personnel involved in the regulatory process and their personal conviction which so often play an instrumental part in the shaping of regulatory strategies. In a collection of analyses on American regulation, James Wilson notes that "the movement to deregulate domestic aviation...arose not because the airlines...had changed, but because the beliefs of key political participants had changed."⁵⁰ What this observation suggests is that the success rate of capturing an agency often depends on the policy-makers within the agency.

⁴⁹ See, for instance, the controversies relating to the recent policies and decisions of the Office for Gas Supply not to cap charges for domestic gas supply: *The Guardian*, (25 May 1994) and the Office of Electricity Regulation on price review immediately following the flotation of Government shares in National Power and PowerGen: *The Times*, (9 March 1995). See also T.Prosser, "Privatisation, Regulation and Public Services" (1994) *Juridical Review* 7 and W.Hutton, *The State We're In* (Vintage, London: 1995), p.291.

⁵⁰ J.Q.Wilson (ed.), *The Politics of Regulation* (Basic Books, New York: 1980), p.384.

This is borne out in the history of CAB chairmanship from 1969 to 1977 which deserves some detailed treatment. Secor Browne (1969) and Robert Timm (1973) were among the staunchest advocates of protectionism who would not welcome the challenges of competition. The CAB was steered towards greater anti-competitiveness whenever possible including the grant of antitrust immunity to anti-competitive agreements. During his term as the chairman, Browne imposed what was known as the "moratorium" on licensing new services. It attracted severe criticisms and he subsequently resigned.

Timm in many ways was even a stronger supporter of anti-competitiveness and his approach "made himself and the CAB an easy target for critics who charged that they were protecting the airlines at the expense of the travelling public."⁵¹ At the end of his term, no effort was made to re-appoint him as chairman of the CAB. He was replaced by John Robson (1975) who favoured competition and who believed that command-and-control regulation of fares could only lead to inefficiency and higher fares. He provided every impetus that was necessary to turn around the regulatory philosophy of the CAB inherited from Browne and Timm. But Robson's mission was greatly helped by the favourable economic conditions that were then emerging. Air traffic experienced a significant growth as the public began flying again. At the same time, there was a notable decline in the operating costs of airline companies which led to more healthy profit and loss statements. The developments during Robson's leadership created a positive impression so that the politicians, the public and indeed supporters of protectionism began to have a more receptive attitude towards the CAB's new approach. The appointment of Alfred Kahn (1977) as chairman virtually sealed the fate of protectionism in American air transport, and opened a new era of experience for the industry. Kahn was in a number of ways a deeper believer than Robson in competition, and he engineered a new economic framework for the industry by introducing a number of significant reforms. His influence within the CAB was considerable. He built a great deal of enthusiasm into the work of the CAB and the idea of reducing regulatory controls was well received. But, as with Robson, Kahn's efforts were given an enormous lift by incidental developments of the time, particularly the Congressional hearing headed by Senator Edward Kennedy in the mid-1970s which eventually led to the legislative reforms in the air transport sector. Such was the variation in the personal conviction of the chairmen that it bore a significant effect on the regulatory philosophy of the CAB.

By contrast, although the CAA has been led by a stream of chairpersons over the years, it is not evident that the change in personnel has also led to a substantial shift in the policy emphasis. On the contrary, these chairpersons have consistently subscribed to the view of less regulation and more competition. Such consistency has inevitably led to a process that is less confrontational and more pragmatic. In some respects, the policy consistency has also been the result of government policy on airline competition, not only within domestic but in international air transport as well. The one significant exception was the instruction to withdraw the licence of Laker Airways in 1976. Furthermore, the

51 B. Behrman, "Civil Aeronautics Board" in *ibid.*, p.99.

way in which CAA decisions are taken, especially in licensing cases, would seem to make it difficult for any one individual to shape the policies of the institution. In the first place, such decisions are taken by a panel, typically comprising of two CAA members and an official who provides technical advice. These decisions may be taken on appeal to the Secretary of State in the light of the reasons published by the CAA. Secondly, at the time the CAA was created in 1972, there was effectively one dominant carrier in the form of British Airways Board; to speak of capture then would seem rather odd. In any event, the Civil Aviation Act of 1971 gave explicit protection to producer interests, and user interests were only second in order. With the passing of the Civil Aviation Act of 1982, there was a decided shift away from this protection of producer interests and user interests were given the same order of importance. In the absence of overwhelming evidence, to give priority to airline interests would be an obvious contradiction of the expressed legislative intent. Equally too, the creation of the Single European Aviation Market has removed a substantial part of the CAA's discretion in economic licensing cases, and put emphasis on promoting competition within the sector, though there are several misgivings under the arrangements which are explored below.

Supply of Information and Capture

Although the general theory of regulatory capture needs to be understood in the appropriate context including, it may be added, whether the regulatory official is an elected or politically-appointed member,⁵² one area of the regulatory process that is most susceptible to capture is the supply of information. Regulatory policies or decisions cannot exist in a vacuum. Information is required to make sense of them, and to a large extent this is dependent on the participants of the regulatory complex. It is this dependence for the supply information which makes the regulator vulnerable to capture since the process of supplying and the contents of the information may be used as a strategic instrument by the suppliers who seek to influence the policies or decisions of the regulator. Only information that was likely to be used to their benefit would be given while that which is likely to threaten their own interests would be withheld. For most of the time, the regulated would have more information than the regulator. Mitnick explains this "partial theory of regulatory capture" by reference to the friendship and favours relationship.

By doing the regulators 'favours' and satisfying everyday job performance needs through supplying information, the industry can ease regulators' work loads (i.e. increase their level of 'convenience') and create friendships between industry members and agency personnel. Industry control over the information needed by regulators can lead to shared regulator-industry perceptions of industry problems and appropriate solutions. Information can, of course, be supplied selectively to the

52 Elected officials who perform a regulatory function would risk their tenure in office if they chose to disregard the public interest. In order to further their political ambitions, these officials acting in the capacity of regulators will need to be responsive to the demands of the public so as to attract their votes: S.Peltzman, "Towards A More General Theory of Regulation" (1976) 19 *Journal of Law and Economics* 211.

regulators or distorted with an industry bias. Through control of information, the industry can succeed in coopting the regulators...i.e. in making the regulators perceive the regulatory task through an informational network and orientation provided by the industry.⁵³

In Baldwin's study, the independence of agency discretion could be compromised by informational capture in cases where agency decisions have to be made on the basis on information supplied by the regulated groups. This problem was exacerbated by the dominance of certain groups in formal proceedings and hence a considerable likelihood that those decisions would reflect the interests of only those supplying the information.⁵⁴ It has already been noted, however, that this difficulty is not insurmountable in the case of an agency which adopts a programme of independent research and analysis, and consultation procedures which are open and extensive. In the case of the CAA, s.69(3) of the 1982 Act requires it to consult "such persons as appears to it to be representative" before any policy statement is published. They include representatives of the civil air transport industry of the UK and the users of air transport services, organised in the form of the Air Transport Users Council (ATUC). The broad term of "representatives of the civil air transport industry" allows the CAA the discretion to conduct a wide process of consultation and therefore reduces any potential capture by the dominant interests of the industry. It would mean that the CAA will be examining information supplied by a more diverse group of participants. An effective and broader process of consultation is not only desirable to the extent that it removes the likelihood of the regulatory agency from being captured by one set of interests, but also re-asserts its constitutional legitimacy.

Decision-making at Community Level

The foregoing discussion has repeatedly argued that consultation and openness in decision-making adds probity to the decisions. However, the preceding chapters have also submitted evidence that, as a consequence of its own policies and the effects of the third liberalisation package, the number of hearings as well as consultations conducted by the CAA has been decreasing. More significantly, the effect of the third package has not only been to remove the system of hearings for air transport licensing for Community routes by virtue of the automatic rights introduced by the measures, but has also been to remove the opportunities for objections to be made against an application for a route licence, notwithstanding the fact that the CAA has itself been licensing liberally. Although total dependence on such objections is not likely to be always

53 B.Mitnick, *The Political Economy of Regulation: Creating, Designing and Removing Regulatory Forms* (Columbia University Press, Columbia: 1980), p.211.

54 Baldwin, *op.cit.* (1985), pp.219-231. He also suggested that the regulator could be captured if officials of the regulatory agency continuously identified themselves with the interests of the operators for the purposes of future employment. Further, threats which are exerted by the operators could also have a bearing on the policies or decisions of the agency.

adequate as a systematic and open method of public interest representation, in one respect, these objections are a means by which the public interest, or more specifically user interests, may be represented.

To the extent that the scope of the CAA's functions has changed, and become a matter for Community institutions, particularly the European Commission, a few words must be said of Community decision-making procedures, not so much in terms of policy formulation,⁵⁵ but in the context of air transport competition decisions, for example, route access, fares, mergers and State aids.

In terms of broader accountability, the Commission has to provide answers to questions from the European Parliament. However, there is little in the way of enforceable sanctions against an unsatisfactory account. The formal powers of the EP to dismiss the Commission exist more in theory than practical reality; in any event, any motion to dismiss the Commission must be carried by at least a two-thirds majority. The independence which the Commission enjoys in policy and decision-making processes in many ways insulates it against any specific instructions from the Council and Member States, although in reality there is a substantial degree of co-operation between the two. The absence of any real mechanism to enforce the accountability of the Commission either to the EP or the Council is compounded by the reluctance of the courts to intervene either on substantive or procedural review.

A number of Commission decisions relating to air transport have already been challenged on the ground that insufficient reasons had been given, as required by Article 190 of the Treaty. The first of these involved a judicial review application by Air France against the decisions of the Commission allowing the BA-TAT merger to proceed. Although the Court of First Instance accepted the submission of the applicant that the Commission was obliged to state the reasons for its decisions, it was not obliged to provide reasons for rejecting arguments put forward by parties to the administrative proceedings, nor indeed by third parties.⁵⁶ Added to this, the CFI has also agreed with the Commission that consultation prior to decision-making is not required unless specifically set out in legislation. In a case brought by Air France against the decision of the Commission not to investigate the merger between BA and Dan-Air, and for the lack of consultation with affected parties, the CFI had stated that

to require the Commission to go through the formality of consultation where...the provisions applicable to the matter under consideration do not impose any such consultation obligation on the institution, would oblige it to fulfil unnecessary formalities and needlessly delay the procedure.⁵⁷

The Court went to state that, in the absence of a legislative provision obliging the Commission to consult, it would be reluctant to impose such a consultation obligation which did not exist as a general principle of law.

55 For more detailed discussion on EC policy formulation procedures, see N.Nugent, *The Government and Politics of the European Community* (Macmillan, Basingstoke: 3rd. edn., 1994).

56 Case T-2/93, *Air France v Commission* [1994] ECR II-323.

57 Case T-3/93, *Air France v Commission* [1994] ECR II-121.

It is not suggested that these decisions were substantively *ultra vires*, but that procedural propriety either in the form of comprehensive reasoning or consultation to make fully informed decisions is an important safeguard against the excesses of discretionary powers; as is transparency. But a number of Commission decisions which have been impugned in the courts suggest that the record for openness is far from strikingly good.⁵⁸ This is in spite of a Council Decision and a Commission Decision relating providing access to information held by the Council and Commission.⁵⁹ Indeed, in terms of transparency and access to competition information, its approach has been described as “overly formalistic and insufficiently responsive”.⁶⁰ It should also be added that oral hearings for competition cases generally and therefore air transport competition cases are not held in public, a procedure expressly provided for by the relevant legislation.⁶¹

The Case for A Counsel on Public Interest Representation

In the light of these procedural deficits, the implication is that more can still be done to create greater openness and accountability for Commission decisions. To that end, a case has to be made for a Public Counsel on Civil Aviation charged with the responsibility of representing the public interest in air transport licensing and enforcement under the new common aviation market. While this may have the advantage of transparency on the one hand, it ensures on the other hand that all views are considered from all perspectives. But the Public Counsel is by no means a re-invention of regulatory intervention. Its role will be restricted to public interest representation, for example, in applications for operating licences, or complaints against the abuse of the exemptions under the market access Regulation, or complaints against excessively low fares or high capacity so that a policy of liberal competition can be satisfactorily reconciled with the demands for public interest protection such as exploitation or safety. Similarly, such representation should also be present in anti-competitive or abuse of a dominant position cases under the first package. This system of public interest representation is characteristic of that which obtains in the US in the shape of the Office of Aviation Enforcement and Proceedings, although it should go much further than the role of the latter.

The Office of Aviation Enforcement and Proceedings operates under the auspices of the Department of Transportation (DoT) which has the responsibility of deciding applications for operating licences under the

58 Case T-194/94, *Carvel and Guardian v Council* [1995] 3 CMLR 359; Case T-105/95, *WWF v Commission* [1997] 2 CMLR 55.

59 Respectively, Council Decision 93/731, OJ [1993] L340/43 and Commission Decision 94/90 OJ [1994] L46/58.

60 M.Levitt, “Access to the File: The Commission’s Administrative Procedures in cases under Articles 85 and 86” (1997) 34 *CMLRev* 1413.

61 Art.9(3) of Council Regulation 17/62, OJ [1959-1962 Sp. edn.] p.204 for general competition cases, and Art.12(3) of Commission Regulation 4261/88, OJ [1988] L376/10 for air transport competition cases.

deregulated regime. Despite the overall policy of the US Congress to reduce the regulation of air transport, it retained decidedly the initial and continuing requirement of fitness, so that no one may operate as an air carrier unless certified and continued to be certified by the DoT under s.401 of the Federal Aviation Act 1958. Specifically, s.401(d)(1) requires, *inter alia*, that "the applicant is fit, willing, and able to perform such transportation properly and to conform to the provisions of this Act." An application for an operating licence may be set for a public hearing, or dismissed on its merits, or decided under "simplified procedures" which provide for "adequate notice and opportunity for any interested person to file appropriate written evidence and argument but need not provide for oral evidentiary hearings". In this respect, therefore, hearings to determine an application are discretionary and normally held if it is in the public interest to do so and these are presided over by an Administrative Law Judge. The CAB remarked in 1979 that a full evidentiary examination is generally reserved "for those cases in which oral testimony and cross-examination can help resolve open questions of material determinative fact...Our basic aim is that the public interest in safe air transportation be protected *and* that, consistent with the aim, the method chosen to assess the fitness be tailored to the circumstances of each case."⁶² Where a hearing has been set, the Office of Aviation Enforcement and Proceedings will then be designated to assist the decision-maker in developing as complete an administrative record as possible for the application in question and to present "a position it believes serves the best interests of the public". In such instances the Office of Aviation Enforcement and Proceedings assumes its role as Public Counsel to represent the public interest, although public interest representation in the licensing of a new carrier has been a long-standing practice dating back to the days of the CAB. Then, public interest representation was carried out by the legal division of various bureaux within the CAB depending on the nature of the case in question. The Public Counsel role was re-organised and consolidated into one office under the auspices of the Office of Aviation Enforcement and Proceedings following the Airline Deregulation Act 1978 at which time also the remaining functions of the CAB were transferred to the DoT under the Civil Aeronautics Board Sunset Act 1984. The occasion on which the Public Counsel has played a significant role in public interest representation is amply illustrated in the first refusal of the DoT in the post-deregulation era to issue an operating authorisation to one Francisco Lorenzo on the basis that his previous experience in Eastern Air Lines and Continental Airlines had failed to demonstrate an adequate level of managerial competence and a serious lack of compliance disposition with aviation regulations.⁶³ A subsequent application for judicial review of the decision was dismissed.⁶⁴

Other basic areas of the work of the Office of Aviation Enforcement and Proceedings extend into enforcement activities, monitoring continuing fitness and compliance, and fraud enforcement. For the purposes of its submission, the Public Counsel is assisted by a team of experts who will prepare exhibits,

62 *Federal Express et. al., Midway Service* [1979] 82 CAB 980 (original emphasis).

63 Department of Transportation, *ATX Inc. Fitness Investigation*, Order 94-4-8 (5 April 1994).

64 Transcript of the Court of Appeal, District of Columbia: 16 December 1994.

analyses and provide oral as well as written testimony. Although the personnel of the Public Counsel team are officials of the DoT, a strict separation of powers and functions is observed in accordance with the rules of conduct of the DoT and the provisions of the Administrative Procedure Act 1946 when the Public Counsel role is invoked.⁶⁵

Even though the US has embarked on a system of economic deregulation since 1978, limited licensing is still in place and hearings may be held to develop as comprehensive a record as possible for the purposes of determining applications from new carriers for operating licences. It is a system by which a body of case-law may be developed to guide future licensing decisions. Hearings may also be held for cases of anti-competitive practices, employee protection and enforcement. The case for a public interest representation system in Community air transport, however, needs to go beyond applications for operating licences to include cases on route access, fares, capacity and the regulation of State aids and mergers. US airlines operate in a totally deregulated environment; Community airlines do not. Regulatory decisions as much as antitrust enforcement continue to be necessary in certain cases including of course State aids, and must accordingly have the benefit of public interest representation. And logically, representations from the Public Counsel should take place towards the close of the proceedings when the representations could also reflect the preceding submissions of other parties to the proceedings.

Representation of user interests in route licensing in the UK, though not necessarily the public interest, has often taken the form of submissions from the Air Transport Users Council (AUC) and by virtue of the fact that the CAA has a statutory obligation to further the reasonable interests of users. Indeed, it was this statutory obligation which played a part in leading the CAA to set up the AUC (then the Air Transport Users Committee) in the summer of 1973 to assist in protecting customers of British airlines.⁶⁶ Although the AUC was initially affiliated to the CAA by virtue of the joint chairmanship of both bodies, the process of giving the AUC greater independence began in 1977 with the abandonment of the joint chairmanship and culminated in more complete independence the following year. The AUC said in response to this development that it aimed "to take advantage of its freedom to say and do what it thinks best in the interests of the air traveller - including freedom to criticize the CAA."⁶⁷ Of course, the downside of such detachment from the CAA was the less ready access to information and data held by the CAA, which the AUC had previously enjoyed, to formulate comprehensive comments.⁶⁸ No such provision for representation and transparency has been made under the Community liberalisation measures. To that extent, it seems appropriate to make the case for establishing a Public Counsel on Civil Aviation; *a fortiori*, in the absence of opportunities for public hearings and consequently objections. This is not to

65 I must register my grateful thanks to Counsel Dayton Lehman Jr at the Office of Aviation Enforcement and Proceedings for his valuable assistance on these matters.

66 See Baldwin, *op.cit.* (1985), pp.221-225 for the emergence of the AUC and the evolution of its functions.

67 AUC, *Annual Report (1977-78)*, p.17

68 See Baldwin, *op.cit.* (1985), pp.223-224. But see s.84, Civil Aviation Act 1982.

suggest that the AUC should be abandoned; far from it. Quite apart from the continuing role it has to play in respect of air transport matters for which Member States still retain exclusive jurisdiction, the AUC is a member of the Federation of Air Transport User Representatives in Europe (FATURE) with whom the European Commission consults on air transport initiatives. But the FATURE is no substitute for a formal and systematic machinery of representation.

An important difference between the Public Counsel and the AUC (and indeed, the FATURE) lies in the wider remit which the Public Counsel should have by representing the public interest rather than simply user interests. It would differ from the AUC to the extent that it will become a formal part of the regulatory process to ensure a systematic method of representation in Community air transport. More importantly, it would provide for centralised representations rather than the fragmented manner in which such representations are made by representative institutions of Member States. The Commission would therefore have the benefit of expert information and representations in coming to its decisions. Although the Commission is advised at present by advisory committees in accordance with the terms of the relevant legislation, it is also clear that these committees do not have an explicit remit to represent the public interest, or user interests for that matter. That being so, it can hardly be called a system of public interest representation. At the same time, this should not preclude the development of a co-operative framework in particular for the exchange of information and opinions between the AUC, perhaps through the FATURE, and the Public Counsel. The new horizons brought about by the changes under Community law is an opportunity to re-assess the regulatory approach to provide for greater coherence and transparency. Such a system of representation would accordingly avoid the appearance that all the relevant perspectives have not been fully aired, and more particularly perhaps, to dispel any claim of "regulatory capture".

Conclusion

Time and again, the point has been made in this thesis that regulation is a second best enterprise; a species of centralisation and a process that, potentially at least, interferes with the autonomous spheres of private individuals. Thus, whether the CAA adopts a policy built on competition, or one which is biased towards protecting the incumbents, it needs to be able to justify that choice. What follows should be reasonably plain sailing; its licensing decisions on routes, on fares and on capacity should be broadly consistent with its policy. Exceptions may have to be made naturally, but only where the circumstances of the case overwhelmingly dictate. Overall, the aims of this penultimate chapter have been to chart the processes of accountability and the need to have decisions taken in the sunlight rather than moonlight. Specifically, it has sought to emphasise the paramount importance of transparency in the exercise of agency discretion so that allegations of bias, capture and all that can be readily deflected.

Accountability cannot operate in a vacuum. It has to relate to the nature of the circumstances, and as these change, so must the nature of accountability. In so far as the regulatory responsibility of the CAA is now restricted to cases where there are constraints on route entry and antitrust regulation of fares and capacity, this is a substantial, though not a complete, shift in the focus of accountability. On one level, the CAA must remain responsible for its policies including the liberal route licensing policy and the deregulated policy on fares and capacity it has adopted. On another level, by removing controls on fares and capacity, and liberalising route licensing, the CAA has effectively shifted the authority for decisions on route entry, levels of fares to charge and capacity or flight schedules to the airlines with the consequence that these airlines must assume the responsibility that comes with such decisional freedom. Ultimately, they remain accountable either to their shareholders, creditors or investors for that common purpose which they have set out to achieve (maximising investment return) and the manner in which they have sought to realise that aim (meeting user interests). Of course, the extent of this freedom must be set against the background of those difficulties which have a restrictive effect such as bilateral and infrastructural constraints.

Nevertheless, the face of domestic regulation would have changed if not for CAA's established policy of liberal route licensing or fares and capacity deregulation as a result of the three liberalisation packages adopted by the EC. To the extent that they mirror the policies of the CAA such as the deregulation of fares and capacity, the effect would have been similar in that a substantial measure of accountability will be owed by the airlines to their owners. Other than the exemptions contained in the market access Regulation, access to routes within the EC is now free and thus, in theory at least, goes further than liberal licensing. Nevertheless, the liberalisation programme has also brought with it several difficulties, some of which were examined in chapter seven. In particular, the transfer of competence in air transport competition from the CAA to the Commission must mean that any assessment of the CAA's regulatory functions and accountability must take this shift in responsibility into account. The deficits which this chapter has shown suggest that more can be done to enhance the accountability of Commission's decisions. Amongst other things, the creation of a Public Counsel for public interest representation would ensure a more systematic way of considering the public interest when determining competition cases in Community air transport; more to the point, it would open up the processes of decision-making to greater scrutiny.

CHAPTER TEN CONCLUSIONS: TOWARDS A NEW REGULATORY ERA

The industry is, and will continue to be, highly regulated throughout the world¹

Until the passing of the Civil Aviation Act 1971 that led to the establishment of the CAA, Government oversight of British civil aviation was fuelled by economic policies which were largely restrictive and steered by a succession of institutions haphazardly organised. Indeed, as Baldwin noted in 1985, "few areas of economic activity have been subjected to as many different regulatory regimes as the British civil aviation industry."² While British and US civil aviation may have enjoyed public policy parallels when civil aviation first emerged, that is, a privately owned industry left to the initiatives of the entrepreneurs, there is a much more chequered history this side of the Atlantic. If the Churchillian policy of "fly by themselves" had transcended beyond the realm of politics, the structure of British civil aviation today could have been radically different. But history tells a different story. The dominance of politics over civil aviation is considerable and real, and will undoubtedly continue to be so. The strategic importance of civil aviation and the inherent international nature of the industry that impinges on national sovereignty will always be the fundamental claims for Governmental intervention. Whatever form that intervention takes, whether by the fact of ownership or administrative regulation through the offices of a Government-established agency, is a matter of lesser import at this stage although the nature of accountability will clearly vary according to the institutional choice and design. The history of airline regulation bears ample evidence of this point. Of course, this by no means ignores the expansion of the administrative process consistent with the growth of the modern State. Only that the lack of a coherent strategy for the evolution of administrative institutions meant the subjection of British civil aviation to a myriad of advisory, regulatory and licensing bodies. By contrast, the CAB remained very much the institution it was designed to function until its abolition in 1985. In the UK, the task of regulating the airlines is today the responsibility of the CAA.

Nevertheless, the role of the CAA has changed, and changed substantially since the third package of Community liberalisation measures came into effect in 1993. Preceding chapters have shown that these changes have affected the substantive policies and procedures of the CAA, although in fairness, it should

¹ *Civil Aviation Policy* (Cmnd.4213, 1969), para.12. A number of reasons were offered: "First, there is the need for the highest standards of safety and the need to control aircraft noise. Secondly, there is the need for stability and regularity of public services. Lastly, there is the inescapable fact that international services depend upon a network of agreements reached with other countries, defining traffic rights which airlines may enjoy. The need, therefore, is to operate within this framework in such a way as to give the industry the biggest possible opportunities in the expanding world market."

² R.Baldwin, *Regulating the Airlines* (1985), p.14.

also be said that much of what is contained in the third package is a vindication of the established policies and practices of the CAA. Even so, the regulatory role of the CAA has been curtailed and effectively limited to extra-Community markets until such time as a policy on external relations in air transport has been developed by the Community. It should be added also that, quite apart from safety regulation, the CAA will continue to play an increasingly crucial role in the protection of consumers through its established Air Transport Organisers Licence (ATOL) system. Since 1973, this has been a source of protection for holiday-makers against the vagaries of the cut-throat business, where the profit margin can be as low as £5 per person. Its other remaining major task is the regulation of airports under the terms of the Airports Act 1986 where it has the role of a quasi-utility regulator, but which is outside the scope of this work. :

Administrative Regulation of Airline Competition

The aim of this thesis, established at the outset, was to examine the role of an administrative agency entrusted with the task of regulating competition. Its leading contention was to argue that competition regulation in certain economic sectors takes two principal forms, economic and antitrust regulation, but that the regulatory emphasis shifts from economic to antitrust regulation when it can be deemed that the conditions of sustainable competition have been achieved. It was submitted that this critical market contestability implies that the economic regulatory process becomes less important as market forces are relied upon more frequently to provide competitive solutions. Air transport and the CAA has been singled out given not only that little work has been done by public lawyers on the competition regulation of air transport, in particular on charting the changes to the economic regulatory policies and practices of the CAA since its inception and since the arrival of EC measures on air transport liberalisation, but also because it is an industry that possesses the characteristics to flesh out the themes of this thesis.

Regulation in the broadest sense of the term has been the subject of various analyses which were reviewed in the opening chapter including the taxonomy of regulation offered by Mitnick in *The Political Economy of Regulation*. Given its breadth, therefore, assumptions had to be made for the concept to have a more specific contextual relevance. A working definition for examining the role of the CAA was to assume regulation as a system of control of the behaviour or activities of individuals or organisations to achieve a certain end and the non-compliance of which can be enforced by way of penalties or exclusion. The generality of this formulation allows also for the regulation of non-economic behaviour such as those relating to safety or the environment. The regulation of airline competition by the CAA is essentially the imposition of a constraint on the economic behaviour of the participants in the regulated complex either by direct or indirect means. The latter may be characterised by the distinction between active and passive regulation, and in the case of the CAA is represented by the liberal licensing policy on routes or the deregulation of fares and capacity where intervention is minimal and in any event limited to cases when the realisation of the statutory objectives was threatened. In the case of

anti-competitive practices, economic regulatory interventions have also been made to resolve them through the conditioning of air transport licences. The combination of direct regulatory intervention in circumstances where the need is evident and a liberal framework to promote competition and user interests is the doctrine of *regulated competition*. This combines autonomy of decision-making on the part of the 'producers' and safeguards for 'purchasers' against exploitative actions of the producers. By fostering competition amongst airlines to serve the interests of users, the CAA aims to achieve a maximum overlap between airline and user interests, so that this mutuality would reduce the possibilities for interventions since the producers and purchasers would be sharing common objectives.

This has largely been helped by the elasticity of the statutory duties under the Civil Aviation Act 1982 which has provided the CAA with the flexibility to shape its regulatory policies and to adopt practices which give more poignancy to the doctrine of regulated competition. It has, for example, been able to deregulate fares and capacity where this has not been prohibited by bilateral agreements or Community measures. Whether competition has been generated by administrative liberalisation of route access or administrative deregulation of fares and capacity, both have required the CAA to identify the critical level of market contestability. This shift in policy emphasis and practice, however, had to be consistent with its statutory obligations so that liberalisation or deregulation could not be construed as an abdication of those obligations. Indeed, over time, Government policies have increasingly stressed the importance of competition which eventually led the Government to omit the primacy of airline interests when the 1982 legislation was passed. In part, this was also the consequence of the influence exerted by the CAA that competition would better secure the objectives of efficiency and a strong industry, an approach which gradually became apparent in its own regulatory policies and licensing case-law, and indeed borne out by the benefits which users have enjoyed either on fares, greater choice of schedules, or improved in-flight service. The preference for competitive solutions, however, is not and cannot be absolute because a competition policy cannot exist in a vacuum. It has to be a means for securing a particular end or objective and for the CAA, this has been the reasonable interests of users. The combination of competitive solutions and the common aim of the airlines and users to be satisfied by each other means regulatory interventions could be reduced to the minimum and would be invoked only when there has been a breach of these framework rules. To the extent that this is possible, Weber has described this commitment to individual autonomy and choice in consumption as characteristic of a *gesellschaftlich* model of social organisation. By postulating of user interests as a primary concern of its regulatory task, the CAA has sought to turn the private incentives of the industry into a methodology for securing its regulatory objectives. Commenting on the success of the US Securities and Exchange Commission (SEC) in regulating by incentives, McCraw said,

The heart of the regulatory system would be a careful shaping and bending of the incentives structures, so that each of the major players would voluntarily carry SEC policies.³

This was the essence of CAA economic regulatory policy and approach.

Equality between airlines, however, is not possible for reasons associated with the past. BA's historical position and the way in which it was privatised has given rise to considerable inequality of strength and opportunity, and a serious structural imbalance. Yet, to actively diminish the strength of BA as the dominant airline would be tantamount to transferring its profits to its competitors and indeed to the detriment of BA's shareholders and its competitiveness in international air transport. Without a legislative mandate, this would be constitutionally objectionable. Equality of opportunity rather than equality of size and strength would have greater compatibility with the statutory language and Government policy, though this policy has essentially required a measure of preference for smaller airlines or competitors in some cases. In particular, enforced limitations have been necessary where barriers to competition have been high either as a product of a deliberate action such as bilateral constraints or historical endowment, or market growth leading to infrastructural congestion. Much of these relate to market entry or route access and less so on fares and capacity for the latter are more amenable to deregulation subject only to anti-competitive safeguards.

Nevertheless, these are the restrictive characteristics of the airline industry which would militate against a total reliance on the theory of market contestability. They deny that the airline industry is naturally competitive. By contrast, Baumol *et.al.* had assumed in their theory of contestable markets that the airline industry was naturally competitive and consequently does not call for regulation. The difficulty with this theory for the air transport market is the number of assumptions it has to make or the number of fundamental characteristics which it has to ignore. First, sunk costs are not insignificant in the air transport market. Even if capital costs were to be ignored, the costs of wages for crew members, preparation and documentation, conversion of aircraft and depreciation in appropriate cases, are by no means negligible even though prior market analysis may have indicated that these costs could be set against the profits. Such profits, however, is dependent on whether the entry provokes a response from the incumbent. If the latter chooses to refrain from taking action, then it will either lose its market share and eventually withdraw, or remain commercially irrational by incurring losses. If the incumbent retaliates in a competitive manner, then one of three responses is possible. Either they remain in competition with each other, or the incumbents subsequently withdraws, or the new entrant exits. In both instances, there is an assumed period of *immobilisme* on the part of the incumbent so that the new entrant makes sufficient profits to make its sunk costs negligible. On the contrary, the evidence suggests that, rather than compete and risk these sunk costs, airlines would develop strategies to forge alliances with others and in doing so rationalise, if not minimise, their costs. Secondly, the theory does not address

3 See T.K.McCraw, *Prophets of Regulation* (Belknap Press, Harvard: 1985), p.187.

an industry structure which by reason of history is disproportionately balanced in favour of a particular operator such that there is no "symmetric competition". Thus, in the case of London(Heathrow) airport, for example, the congestion is unlikely to allow for any significant creation of new landing and take-off slots. To expand competition, by creating more opportunities for airline operators to compete, either new slots are created or existing slots are relinquished by an incumbent to the benefit of another in order for freedom of entry to make sense. Where an airline enjoys a dominant position, such as BA, it may be extremely difficult to secure from it a voluntary surrender of its slots to a competitor.

A third and related difficulty of the theory *vis-à-vis* air transport is its neglect of the infrastructural limitations such as the lack of runway capacity. Freedom of entry would be meaningless if the new entrant cannot have access to a take-off or landing slot at the airports as much as if it were to be denied the opportunities of attractive flight schedules. On the account of these difficulties, while deregulation may promise in theory freedom of entry and decision-making, its promise of perfect competition is less sound in practice. Market contestability would be more achievable under conditions of regulated competition in the sense developed here. This means through a process of economic regulation in the first place, maximum contestability would be sought between the producers. The aim of the process would be to turn these competing producers towards the incentives of the sector itself so as to achieve a maximum overlap between producer and purchaser interests. Thus, the need for regulatory intervention may at time be necessary to bring about this state of affairs such as by using the policy of substitution which represents a threat to the incumbent airline.

Theory of Regulated Competition

In many ways, British air transport has come a long way since air transport was first pioneered. Its history from private ownership to nationalisation over a period of seventy years or so and its return to the private sector in the 1980s has been both dynamic and varied. Importantly too, the effect of all of these fundamental changes on the regulatory landscape has not been insignificant. Over a period of about ninety years since civil aviation began, the regulatory environment has oscillated between protectionism through public ownership to competition through liberal licensing of airlines. Whether these changes have been driven by political dogma or otherwise is a matter for further debate some other time elsewhere. For now, the point has to be made that in a substantial number of those years, regulatory flexibility has proven invaluable. And, this thesis submits, will continue to be crucial. Of course, in any retrospective survey, it is always simple to be wise *ex post facto* in that the benefits derived from the deregulatory or liberal measures of the CAA, or indeed US deregulation, allows one to presume a certain degree of inevitability of the results in the choice of policy; that, for instance, "rolling back the State" whether by privatisation or deregulation to provide competition is a good in itself relative to nationalisation or command-control regulation. To assume so, would be wrong and decidedly misleading, and at the very least unsubstantiated

by the evidence in this study. Even so, the presumption seems clear that competition and choice has delivered overall benefits.

The question as posed in the opening chapters is not about whether regulation is needed, but rather one of more or less regulation and the nature of regulation. Hence, the notions of "rolling back the State" or "re-inventing government" must necessarily be qualified to the extent that it can be achieved. In the regulation of air transport, and specifically in competition, this thesis submits that the extent to which such a roll back or deregulation can be achieved must depend on a variety of factors including geographic size of the market and history. For the UK and indeed the EC, competition regulation of air transport continues to be essential regardless of whether the regulatory policy is premised on a competitive or non-competitive approach, for regulatory powers is a condition of the ability to stimulate competition or neutralise decline in circumstances when the objectives of a competitive policy are far from being achieved, or indeed to take corrective measures in cases when excessive competition is deemed as a threat to the objectives of a non-competitive policy. In any event, a competitive policy cannot guarantee competition in all cases, nor prevent anti-competitive behaviour. The licensing case-law of the CAA as well as its policy statements amply testify to this. The evidence in this thesis has demonstrated that there are constraints on the UK and the EC to adopt a deregulatory policy such as that in the US for a variety of reasons. Characteristics of the industry are such that complete economic deregulation cannot be an appropriate option. The regulation of route access, for instance, continues to be necessary in certain cases. In other areas such as fares and capacity, the constraints are less apparent and can therefore be subject to less control or regulation. But the combination of a liberal licensing policy and a deregulatory policy in limited areas is not the equivalent of complete deregulation, but rather regulated competition which seeks to balance the need for decisional autonomy and equity. The issue of international or extra-Community air transport is, however, different and will no doubt continue to be regulated substantially under the terms of bilateral agreements until such time as aviation nations recognise in practice the need for greater freedom in airline decisions and choice for users.

Whether there should be more or less regulation depends on the nature of regulatory actions in question. If economic regulatory intervention should be the exception rather the norm, which it must, the case for a vigorous framework of antitrust regulation, however, is far more cogent. For reasons which have already been considered, air transport approximates at best an oligopolistic and at worst a monopolistic industry. Of course, granted the theoretical assumptions of the contestability theory, air transport can be naturally competitive by virtue of the ease of entry. But these assumptions have been challenged, for they ignore some of the real and fundamental constraints of the industry. The trend of alliances between airlines and globalisation of services in the absence of international regulation of airline competition have enabled both large and small airlines to consolidate their position and to alter the structure of the industry in such a way as to potentially reduce competition. Some of these have been the consequences of high barriers of entry. This speaks nothing of the

acute infrastructural limitations. Even so, the analysis in this thesis of British air transport has shown that in cases where there are no infrastructural limitations, market limitations may still exist. Where such limitations exist, however, the CAA has shown that contestability can be achieved through the threat of the substitution policy. To that end, effective competition may not be conditional upon competition between many, but may equally be possible between a few so long as safeguards exist against the real risks of anti-competitive behaviour. As in the case of economic regulation, the issue is not one of whether there should be anti-trust regulation, but since the regulation of anti-competitive behaviour is necessarily *reactive*, then it must surely be one of when and in which cases should the authority be invoked.

Challenges for Community Air Transport

Re-Writing Policy Objectives

One of the shortcomings of Community air transport policy, as noted in chapter seven, is the lack of a transparent prioritisation of its objectives. Whilst the Commission identified in its first memorandum to the Council for the development of a common policy in 1979 that competition was only a means for certain ends, these ends were a combination of airline, airline employee and consumer interests. In very many ways, this reflects the statutory objectives of the Civil Aviation Act 1971 in which producer interests were given priority and user interests were no more than a set of interests subject to these other interests. But the graduation from an emphasis on producer interests to user interests in British air transport has been noted, and the rationale considered. User interests must precede airline interests for the simple fact that a modern liberal economy, or *gesellschaftlich* as Weber calls it, is conditional on autonomy of decision-making and individual choice. Choice is a derivative of competition and a vehicle for achieving allocative and productive efficiency. Hence, efficiency of operations is no more than either a by-product or pre-requisite of this policy orientation.

This policy orientation by no means represents a total disregard for the other interests within the regulatory complex identified by the Commission. In certain circumstances, it may be necessary to give a measure of preference to smaller airlines either to promote competition with an incumbent or to provide the opportunity for them to grow particularly in cases where they face high barriers to reach the minimum threshold of viability. Nevertheless, in either of these situations, the interests of users should be paramount as an end objective since by securing competition or protecting a growth opportunity, the long-term aim is to ensure choice. In other circumstances, it may be necessary to secure an enforced conditioning of a licence either by substitution or reduction of capacity. These competitive solutions are only a means to an end, the end being to promote or protect the interests of users. As such, it is not to be cast in stone. No doubt, a large part of the CAA's jurisdiction to mete out such remedies or to secure these objectives has been removed, and limited to such routes not covered by the market access Regulation. But the lessons of over two decades are highly instructive and germane to the continuing development

of Community air transport policy. Although by 1997, Community air transport could effectively be described as deregulated, prioritisation of the policy objectives remains necessary and vital for those regulatory actions that may be invoked under the measures of the liberalisation programme. Likewise, enforcement actions against anti-competitive behaviour or abuse of dominant position, and applications for State aids or merger approval will need to be assessed in the light of these prioritised objectives. This speaks nothing of the emerging forms of 'strategic alliances' in particular code-sharing and franchising, all of which demand scrupulous examination of their implications for airline competition. Of course, the mere prioritisation of objectives does not guarantee the intended end result. This calls for greater transparency and a more formal and established manner of representation in the process of decision-making than is hitherto present in the regulation of Community air transport. To this end, the case has been made in the previous chapter for a Counsel on Public Interest Representation who, as its title suggests, would represent the public interest in economic and antitrust regulation cases.

Antitrust Regulation and the Market System

The way in which Community air transport competition has been organised under the Common Air Transport Policy is clearly not consistent with a leading theme of this thesis. It is a contention of this thesis that liberalisation, or deregulation of naturally competitive sectors, should be introduced only when the conditions of sustainable competition are deemed to have been achieved. Typically, as in the case of British air transport, this requires a process of economic regulation to procure these conditions by creating equality of opportunities and greater market contestability. This is especially relevant where for reasons of historical endowment or public policy, the industry suffers from a structural imbalance. The sort of imbalance, where the national carrier acts as a dominant player, is not apparent in the US so that its decision to deregulate the industry in 1978 did not present the competition concerns raised in this thesis; competition existed *ex ante*. Even so, it is now becoming evident that the deregulation has led, or is leading, to more concentrations and an industry organised around a small number of large carriers.⁴

By contrast, British and Community air transport were unfamiliar to the idea of competition prior to the initiatives of the CAA and the liberalisation programme. Each Member State had a dominant, national flag-carrier, which usually enjoyed an elevated and protected position. The structural imbalance affecting competition was acute; some more acute than others. As this thesis has argued, to liberalise or deregulate without first removing some of the fundamental barriers stemming from such imbalance, would simply precipitate further economic regulation or the elimination of competition. It is clear that the economies of scope, scale and network enjoyed by these major carriers, whose dominance has not necessarily resulted from genuine commercial competition, have the strength and resources to out-perform new entrants. Furthermore, the question of whether of their responses to the new entrants are predatory or

⁴ S.Dempsey. "Airline Deregulation and Laissez-Faire Mythology: Economic Theory in Turbulence" (1990) 56 *Journal of Air Law and Commerce* 305.

merely competitive is one which falls within the grey penumbral area. Thus, the creation of the single European aviation market without having resolved some of these fundamental problems bears precisely the danger of enabling the dominant carriers to reinforce their dominance. The liberalisation of Community air transport was not preceded by any process of economic regulation. Competition regulation immediately took the form of antitrust regulation. It is possible to argue, however, that the liberalisation programme consisted of three phases which were designed primarily to allow airlines to adapt to the conditions of competition. But this begs two related questions. The first is whether a time span of ten years was sufficient to have created the conditions for sustainable competition given the protectionist practices of the past. More importantly, even if that was possible, the second question is whether in 1993, Community air transport can generally be described as having achieved the conditions for sustainable competition. Clearly, these are matters on which opinions will differ considerably.

It is also possible to submit the argument that the concept of liberalisation in Community air transport has been conceived differently from the traditional way in which it is understood. In the end, it is a matter of semantics. The combination of market freedom on the one hand, where airlines can choose the markets in which to operate, the fares to charge and the frequency of the services, and provisions for intervention on the other hand, is in effect a system of economic regulation in a different outfit. We have seen in chapter seven that, while competition is presumed, the final package of measures enables Member States to regulate the distribution of traffic and any substantial changes in fares and capacity which lead to serious financial damage. Quite clearly, these do not amount to a full-blown machinery of economic regulation, for they would not be adequate to deal with the exigencies of the structural problems, but they remain a source for economic regulatory interventions. To the extent that this argument is possible, it underlines the contention that economic regulation to procure the conditions of sustainable competition is an essential requisite to liberalisation and the shift towards antitrust regulation. Be that as it may, liberalising Community air transport without the certainty that these conditions of sustainable competition have been achieved to enable airlines to compete effectively and to flourish runs the risk of not realising the objectives envisaged under the liberalisation programme. Competition regulation is almost wholly dependent on the antitrust rules represented by Articles 85 and 86 and the implementing measures contained in the first liberalisation package. It is submitted that the success of the air transport liberalisation programme requires an effective and rigorous approach to antitrust regulation. Whatever may be the conditions of competition, these must be safeguarded to the maximum extent possible. The presumption must be to prohibit all practices or behaviour which are or likely to be anti-competitive. This will mean raising the threshold for approving any practice, behaviour or application between two or more undertakings to merge.

In the lead up to the Amsterdam summit of the European Council in June 1997, the Commission published an Action Plan for the full functioning of the single

market by 1 January 1999 *Completing the Single Market* contains four strategic targets for action:

- making the rules more effective;
- dealing with key market distortions;
- removing obstacles to market integration;
- delivering a single market for the benefit of all citizens.⁵

Under the plan, three categories of measures were identified. The first relates to those legislative measures which have been adopted but requires transposition or implementation by Member States. The Commission will be aiming to ensure that these are properly and promptly carried out. *Inter alia*, this includes the full implementation of liberalisation measures including those for air transport. The second set of measures relates to those which have already been proposed but the European Parliament and the Council of Ministers have not had the opportunity to consider or adopt. The third set of measures includes those which have yet to be proposed, but for which the areas for action have already been identified.

The thrust of this action plan seems to be arguing strongly for an austere approach to the implementation of the liberalisation measures accompanied by a rigorous approach to the regulation of competition by prohibiting practices or behaviour which distort or are likely to distort the market. This is by no means a guarantee, but is the next best thing to ensuring that the objectives of the single market are fully realised.

Future Role of Competition Regulation

The study of regulation and deregulation has gradually emerged as a discipline in its own right. This will no doubt continue. Choice and competition are associated notions that seem to chime well with modern centrist politics. More specifically, the tendency has been to recognise that minimal regulation or deregulation as a pre-requisite to economic growth and stability. Only 20 years ago, almost every aspect of air transport was tightly regulated. This ranged from the IATA system of fixing fares, to pooling agreements for revenues and capacity, to the contents of the sandwich for an in-flight meal. Non-compliance with these agreements, for example, the undercutting of fares would attract penalties from an IATA tribunal. So would an infringement of the in-flight catering agreements which SAS discovered when it bravely decided to serve the famous Danish salmon and caviar sandwich contrary to the world-wide agreement on in-flight catering! How so much of this has now changed; the charter market is now virtually deregulated, the US deregulated its domestic industry in 1978, the UK confidently introduced competition into a much protected industry since the 1970s, the EC now has a fully liberalised single aviation market, and Australia and New Zealand are now putting together a single aviation market between them. Indeed under Community antitrust rules, fare-fixing, revenue and capacity agreements are expressly prohibited even if airlines wanted to enter into them. This is not to say that the role of law and

⁵ See IP/97/478. 4 June 1997.

regulation has or will be diminished. It means there has been a shift in the role of law and regulation. It means relationships between individuals, between individuals and the State are cast differently.

Notwithstanding the recent change in Government, the most recent re-statement on regulatory politics is contained in several documents published by the Deregulation Initiative almost at the same time as the Deregulation and Contracting-Out Bill became law in 1994. These were *Thinking About Regulation: A Good Guide to Regulation* and *Regulation in the Balance: A Guide to Risk Assessment*.⁶ Although the thrust of these papers were concerned with 'social regulation' rather than competition regulation, it goes without saying that there are certain aspects of regulation that cannot be so readily classified nor, at least, be considered without having regard to the other. The costs of imposing stricter safety or security measures, for instance, will impact on the airlines' ability to provide competitive fares. There is no clear cut evidence when it comes down to the point, whether passengers are concerned with the maximum working hours for pilots or with low, good value fares.

Be that as it may, in the context of social regulation, the former Prime Minister has written in the Foreword of *Thinking About Regulation* that,

All regulation imposes costs on business. So there should always be a presumption against regulation unless it is strictly necessary to protect the interests of the consumer and the wider public. But in the past there has been sometimes been a tendency to go too far and impose regulatory burdens well in excess of what is really required. This damages small business, restricts market entry and stifles the innovation and growth our economy needs. The temptation to over-regulate must be restricted.

The document goes on to set out a list of guidelines on 'good' regulation which policy-makers should have regard to when considering regulatory initiatives.

- Identify the issue and keep any regulation in proportion to the problem in question.
- Keep the regulation simple and short, and aim for goal-based regulation.
- Provide flexibility within the regulatory framework by setting out the objective rather than the detailed way of ensuring regulatory compliance.
- Try to anticipate the effects on competition or trade.
- Minimise the costs of compliance.
- Integrate with any previous regulatory measures.
- Ensure that the regulation can be effectively managed and enforced.
- Ensure that the regulation will work and that its failure can be readily detected.
- Allow for enough time.⁷

⁶ Deregulation Initiative. *Thinking About Regulation: A Good Guide to Regulation* (1993) and *Regulation in the Balance: A Guide to Risk Assessment* (1993).

⁷ *Thinking About Regulation*, pp.20-21.

A number of observations are in order. First, these guidelines are an explicit affirmation that regulation is a second best enterprise. It underlines the need to avoid second guessing the decisions made in the competitive market place, a belief no longer underpinned by ideological assumptions in contemporary politics.⁸ This approach is consistent with the policies that the CAA has evolved over the years and the objectives of the single aviation market for Europe. The performance of the CAA can of course be judged retrospectively, but it is a more difficult job to pass judgment on the implementation on the single market at this stage. Nevertheless, as this thesis has argued throughout, this assertion is not the same as claiming that regulation is unnecessary. On the contrary, where there are public interest justifications for regulating, we cannot shrink away from this responsibility. More to the point, regulation should not be seen as a vehicle for preventing competition. It is as much a public policy instrument for promoting competition where there may be barriers to competition, as it is a leverage for moderating the excesses of competition.

From the public law perspective, regulation is ultimately a species of centralisation. This is not consistent with the notions of choice, autonomy and competition. Accordingly, there is much to commend in the presumption against regulation except where public policy requires. Even so, the question as to whether to regulate in the first place, or indeed to deregulate, cannot be determined entirely from the centre. This would fly in the face of the very call to deregulate or minimise regulation because regulation itself is regarded as a second best enterprise. This being so, the decision whether to regulate or deregulate needs a wider input from interested parties backed by transparent processes so that any wider participation is not seen as a simple exercise of formality. This approach to policy formulation is by no means apparent nor uniformly subscribed to by government agencies.⁹ In direct contrast, this thesis has shown from the work of the CAA that there is much to gain and little to lose from a transparent process of policy formulation, particularly in respect of its policies towards competition and the decision to deregulate domestic air transport.

Secondly, taken as a whole, these guidelines reaffirm the need to introduce an element of cost-benefit analysis into regulatory measures. This is to keep the costs of regulation, expressed in terms of compliance, monitoring and enforcement costs, in proportion to the benefits which may be derived from the regulation. This is not a novel approach; indeed, the whole process of re-

⁸ Details aside, the current Labour Government has shown no sign of their intention to abandon the general thinking behind these papers. Indeed, the setting up of the Better Regulation Unit is testimony of the willingness to continue with the deregulation initiatives and to modernise Government. Among other things, the Unit has published a comparable document setting out the principles for better regulation: accountability; relevance; transparency; targeting; consistency and proportionality.

⁹ See e.g., J.Goh and N.D.Lewis. *Private World of Government* (Centre for Socio-Legal Studies, University of Sheffield, Sheffield: 1999).

inventing government and regulatory review in the US is mounted on the cost-benefit approach.¹⁰

The theoretical assumption of the relationship between economic regulation and antitrust regulation of airline competition seems to be clear. That is to say, economic regulation remains essential where competition cannot be regarded as natural, but where it is, economic regulatory controls may liberalised or even abandoned. The economic regulatory process should become less important as solutions are sought through the market system. At this stage, the nature of competition regulation evolves into antitrust regulation. However, it is the contention of this thesis that this should be so only when the conditions of sustainable competition have been established. This is otherwise known as the critical level of market contestability.

10 Report of the National Performance Review, *Creating A Government That Works Better and Costs Less* (1993) and in particular, *Creating A Better Government That Works Better and Costs Less: Improving Regulatory Systems* (1993).

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