1. INTRODUCTION - THE ISSUE

1.1 According to recent press statements made by Iain Sproat, the Minister at the Department of Trade responsible for the civil aviation industry, the United Kingdom intends to sweep away the regulatory system which has controlled domestic commercial aviation in Britain in one shape or form since the late 1930s. The objective is to be the same as in the United States, where the domestic market was deregulated in 1978. According to Iain Sproat,

"It is my clear conclusion that the increased competition that has resulted from deregulation within the United States has, in general, benefitted the airlines and, more importantly the travelling public".

The process has already started here with the recent deregulation of freight tariffs, as in the United States freight services have been deregulated in advance of scheduled passenger services.

1.2 Regarding competition in the civil aviation industry, SCC has evolved a policy stance mainly derived from participation in several licence and domestic tariff hearings since 1979. The evolution of this policy, together with the policy itself, was set out in "A Review of SCC Civil Aviation Work and Policy Development" (SP21/B1). This policy has been endorsed by both the Scottish and National Consumer Councils. In essence SCC is committed to reduced regulation and increased competition within the domestic industry as being in the consumer's interest. The only exception arises in regard to certain Scottish internal air services which are generally accepted as being socially and economically essential to the remote island communities they serve. These have come to be regarded as "life-lines" and as such considered in need of a degree of protection not necessary for ordinary commercial services.

1.3 SCC recently had to decide whether implementation of a United States style deregulation of our domestic commercial airline market was in the interests of consumers. The Council was already on record as favouring a lowering of regulation and a further opening up of our airline system to market forces and increased competition and deregulation is the natural conclusion to such a policy. With deregulation, the SCC faced its most important policy decision to date regarding not just air transport, but transport in general. The effects of freeing the airline industry from regulatory protection will be both immediate and irreversible;
the implications for users will be profound. To date SCC and other consumer bodies have been able to make policy decisions within the context of a regulated industry which permitted only evolutionary change over a fairly long time span.

1.4 However, events now are moving very quickly. What has happened to date is as follows. Recently Iain Sproat visited the United States to study domestic airline deregulation there. He returned a convert and held discussions with the Department of Trade Civil Aviation Section senior staff and specialists; with the result that they are reported to be strongly in favour of scrapping all regulation in the United Kingdom in as short a time as possible. The case for deregulation has been put before Lord Cockfield, Secretary of State for Trade. We understand that the Secretary of State has agreed in principle to deregulate the industry. It is significant that only at this stage was the Chairman of the United Kingdom regulatory body, the Civil Aviation Authority (CAA) called in and consulted. In line with the Authority's longstanding position, the reaction was a negative one; that deregulation was not needed here either for the industry or its passengers.

1.5 This is the current position. The pro and anti deregulation camps are now forming, the latter including not only CAA, but also the larger United Kingdom airlines such as British Airways. Both camps are busy quoting what is or is not in the consumer's interest but to date consumers have not spoken up directly for themselves. SCC now has a chance to do so. Two very important issues are being addressed by the Council. Firstly, whether deregulation of our domestic civil aviation industry is in the consumer interest? Secondly, what advice the Council should give to the Government on how actually to implement deregulation, so that consumer interests are safeguarded? For it seems that Government whilst clear as to its intentions, has yet to decide how to go about scrapping regulation. It has only stated that it wishes to do so without new legislation. Time is short, but the situation is ideal for consumers to influence the Secretary of State on both counts.

1.6 Deregulation will not simply result in a modified United Kingdom domestic air transport scene, it will produce a totally new scene. Deregulation on the United States model will mean radical and abrupt change; SCC is therefore supporting revolutionary change for the industry. Because of this it is important that the consumer stance is judged not simply in terms of the current situation, but from an appreciation of what the post deregulation situation is likely to be. The United Kingdom is fortunate in not having to go it alone; the United States having proceeded us. It is now five years on from American deregulation and we have the advantage of judging the results from hindsight.
1.7 Much has been written as to whether it has been successful or not. Not surprisingly many airlines, both here and in the United States, have argued that it was at best a mistake and at worst a disaster. However, American airlines who have managed to adapt after riding out the early whirlwind of change produced by deregulation, argue the opposite. The Civil Aeronautics Board (CAB) the United States equivalent of our CAA, has consistently argued that deregulation has been good both for the industry and the consumer. The exact opposite position in fact to CAB which believes that regulation should only be gradually relaxed whilst scrapping all controls is not a viable proposition. Thus consumers attempting to assess whether deregulation is in their interests are faced with conflicting and frequently partisan views. Because of this it is important that the consumer's stance is arrived at after full consideration of all the available facts evaluated not from the perspective of the industry or its regulators, but from that of the fare paying passenger.

1.8 It seems to SCC that the consumer has in fact three options. Firstly, to accept a full regulatory system. Secondly, to accept full deregulation. Thirdly, to have an element of deregulation, or liberalization, of the present system, controlled in the consumer interest. SCC itself rejected the first option and also after careful consideration, option three on liberalization. This rejection was based on current evidence (presented later in this paper) that the consumer does not and cannot control such liberalization. The Council therefore sees no alternative to option two, deregulation of the United Kingdom domestic airline system with the exception of a small number of life-line services in Scotland (and the Channel Isles).

1.9 As mentioned earlier deregulation is a complex issue which has provoked fierce arguments. Both the pro and anti lobby state firmly that they are arguing on behalf of the consumer, despite the fact that the two sets of arguments inevitably contradict each other. The truth of these conflicting claims can only be assessed by examining the airline industry and the actual history of deregulation in the United States. This paper attempts to present the facts of the situation in concise and non technical terms. Section 2 briefly describes what airline regulation actually is. Section 3 outlines what happened on and after deregulation in the United States. Section 4 sets out what similarities and differences there are between the United States and United Kingdom airline systems. Section 5 examines how deregulation could be implemented here. Having provided the factual background, section 6 sets out SCC's policy stance on deregulation adopted on 10th December 1982.
2. WHAT IS AIRLINE REGULATION?

2.1 With the current exception of the United States, all domestic airline industries throughout the world are regulated. This has been the case since the 1930's. The format of regulation differs little between countries, with the United States and the United Kingdom being until 1978, very similar. In each country the government has established a regulatory body. For the United Kingdom this is the Civil Aviation Authority, created in 1972 under the 1971 Civil Aviation Act as the successor to two previous regulators. The Authority is a Quango, to which government has delegated powers to regulate the domestic market in regard to route access and fare levels.

2.2 Our CAA issues ten year licences for route access and sets tariff levels by means of a process of airline application and public quasi-judicial hearings. On tariffs its decisions are final, on route licences an airline (but not a consumer body) has a right of appeal to the Secretary of State for Trade.

By statute (Civil Aviation Act 1980) the CAA must give equal regard to the needs of airlines and consumers. Since the 1980 Act the Economic Policy and Licensing Division of the Authority has had to develop its regulatory guidelines in consultation not only with the industry (as under the 1971 Act), but also with recognised consumer organisations such as SCC. As a result the 1980 Guidelines place a greater emphasis on competition and airline efficiency than their predecessors.

2.3 The year 1979 marked a watershed for the consumer so far as the United Kingdom domestic airline industry was concerned. The year marked the time when United Kingdom regulation changed from being almost completely managed in the interests of the industry to something like parity of consideration between it and its users; a situation which SCC helped bring about. Till 1979 the industry had been regulated under the Civil Aviation Act 1971 and its 1972 Regulations. Whilst this act set up the formal tribunal procedure of public hearings now held by the CAA, it made no provision for the Authority to consult consumer organisations alongside the industry. For example while airlines had (and still have) an absolute right of objection to another airline's applications, a right to insist that a hearing be called and a right of appeal against any CAA decision resulting from a hearing; consumer representatives had and have none of these powers.

All the CAA needed to do was merely take note of what it considered to be the consumer interest regarding fare levels and standards of service.

2.4 In 1979 SCC entered the field with the publication of "Competition and the Scottish Air Traveller" which was primarily an attack on the 1971 Act and resultant regulatory system for not allowing sufficient competition in the domestic market. Later in the same year the CAA produced its report "Domestic Air Services, a review of regulatory policy", (CAP 420) which also argued more conservatively along the lines of regulation liberalization.
In the consultation process which followed, SCC argued strongly for an extension of competition to the domestic industry, plus equality for the consumer in public hearings. Late in 1979, the Government published a new Civil Aviation Bill part of which dealt with regulation. SCC successfully campaigned to amend this bill. The resultant Civil Aviation Act 1980 gave the consumer two important new rights. Firstly, the CAA in developing regulatory policy now has to consult consumer organisations as of right and secondly, the consumer has a discretionary right to obtain airline cost and revenue information held by the Authority.

2.5 As a result of consumers gaining a degree of parity with the industry on development of regulatory policy the CAA had under the 1980 Act to draw up a new set of guidelines for hearings. These are the criteria by which the Authority by law decides whether it will allow airline route applications or not. As a result of the consultation process, SCC was able to ensure that the new guidelines were much more consumer orientated than the previous ones. These make provision for consumer needs, such as price and service competition, cost effective airlines and innovation regarding service standards and price levels. On paper at least from late 1980 the United Kingdom domestic airline regulatory policy had been liberalized and for all practical purposes industry and consumer interests were on a par. Unfortunately reality, in the form of a rather conservative minded regulator, has threatened to cancel out those consumer gains of 1979 and 1980.

2.6 In two instances, the British Midland Airways' application to compete with British Airways on Edinburgh/Glasgow-Heathrow and Cathay Pacific and British Caledonian's applications to compete with the United Kingdom flag carrier on London-Hong Kong, the Secretary of State has had to step in and over rule CAA decisions on the grounds that the Authority had not implemented the agreed policy on competition under the 1980 Guidelines, with the result that their decision was against the interests of consumers who had been denied in both instances benefits from increased choice of service and lower fares. This over cautious attitude of the Authority is probably the main reason why Government has now decided to strip it of power to control domestic fares and route licensing. The domestic market alone has been selected, because international air services are directly controlled by individual governments under separate bilateral agreements. As a result (and as the Americans found in 1978 and 1979) it is impossible for one government to act unilaterally to bring deregulation to its international services or to combat the price fixing activities of the International Air Transport Association (IATA).
2.7 Whether our Government will axe route licensing and reduce tariff regulation overnight, as happened in the United States will not be known until proposals are made public; but this is likely to be the situation. However, it is unlikely that the proposals will contain a "self destruction" clause, as in President Carter's 1978 Airline Deregulation Act. This provided for the complete winding up of CAA's counterpart, the Civil Aeronautics Board on 1st January 1985. In the United Kingdom the CAA also has responsibility for regulating airline safety, providing air traffic control facilities at larger airports, licensing pilots and aircraft and for medical checks on commercial pilots. In the United States these other regulatory duties are carried out by the Federal Aviation Administration (FAA), which is not to be wound up; although airline safety may well be deregulated in the near future by the Reagan administration.

2.8 The remaining piece of the regulatory jigsaw in the United Kingdom is the Department of Trade Civil Aviation section. This has responsibility for assisting the Secretary of State (along with the CAA) with international licensing and tariff negotiations, dealing with licensing appeals and investigation of civil aviation accidents. This is likely to remain unchanged except for the appeals system regarding domestic routes.

2.9 Three points are relevant regarding the United Kingdom regulatory structure and the role of the CAA. Firstly, directly as a result of consumer pressure, United Kingdom regulation has been liberalized over the last three years. Secondly, unfortunately consumers have not greatly benefitted from this liberalization, especially in regard to opening the industry to increased competition, due to overcaution on the part of the CAA. Thirdly, the hearings procedure is extremely time consuming and cumbersome and as a result acts against innovating airlines and their customers. An example of just how time consuming it can be is indicated by the fact that British Midland Airways and its potential Glasgow and Edinburgh users had to wait twelve months between application and hearing, a further six months between hearing and decision and then another eighteen months between appeal and final ruling by the Secretary of State. It surely should not take three years for the second and fifth busiest air routes in Europe to be opened to genuine price competition in a supposedly liberalized regulatory system.

2.10 As will be noted when deregulation in the United States is considered later, the main impetus of regulation is to protect the status quo. As a result even after a degree of liberalization, the United Kingdom domestic airline industry remains heavily regulated. The consequence has tended to be that incumbents (those airlines holding a route licence) are in a protected position and only the most determined of airline innovators persist and overcome the obstacles course presented by route and tariff regulation procedures in this country.

2.11 We now have in the United Kingdom what has been accurately described by Roy Watts, Chief Executive of British Airways, as a regulatory system of "controlled competition". Under it SCC and other consumer bodies have had some successes such as the revoking of British Airways' monopoly on both Aberdeen-London routes in 1979. However, we and innovating airlines have had as many losses, precisely because the ring is held by a regulator.
2.12 The key domestic breakthrough was opening up the two main Anglo-Scottish trunks to service and price competition; but this came only after the regulator had first argued that further competition on these routes was not in the interests of the industry and so should be denied to consumers. A further cause for concern is that whilst the consumer organisations' record has been passable for licence hearings, under the current regulatory system it is a dismal one for tariff hearings. At present, despite very full and costly public hearings airline price increases tend to go "through on the nod" and the CAA makes no attempt to relate fares to the costs of efficient airlines as against what airline costs happen to be at any point in time. In late 1982 the consumer is still faced by a protected airline industry in the United Kingdom. There has been some liberalization, but unfortunately it exists more on paper than in reality. The main stumbling block to parity of industry and its consumers has been and remains the conservatism of the United Kingdom regulator.

3. WHAT WAS UNITED STATES DEREGULATION?

3.1 The objective of the Carter administration in 1978 was to sweep away protective regulation in the interests of creating a more efficient airline industry better able to serve its customers. It certainly was an "open skies" policy, but not the "free for all" its opponents wish us to believe.

3.2 Prior to 1978 the American industry had been even more tightly regulated than United Kingdom airlines today. On the domestic scene, CAB not only controlled route access and pricing, but also bailed out insolvent airlines. During the 1950's and 60's it developed a reputation for stern paternalism. In the 1960's it actually mandated that there must be a scheduled, reliable jet service between every conceivable pair of towns in the United States at set prices. The board also attempted to keep all certificated airline companies solvent. It firmly believed that even one bankruptcy would cause institutional lenders to refuse to finance the industry. This was a level of regulation in excess of anything practised then or now in the United Kingdom.

3.3 With deregulation in 1978, the CAB was required to do a 180 degrees turn and prepare to dissolve itself in six years. The extent of its transformation as a regulator can be judged by the fact that earlier this year it deliberately precipitated Braniff, one of America's biggest carriers, into bankruptcy. It did so in the interests of open market competition, over ruling an attempt by Pan American to save the airline by a swap of 20 million dollars for access to Braniff's South American routes.

3.4 This decision by CAB needs careful consideration when consumers here assess deregulation. Not surprisingly the board was castigated by the airline lobby for Braniff's demise which was held by many to highlight the dangerous and destabilizing consequences of deregulation; the ultimate result of the "free for all". However the Reagan Administration stood firm and backed the board's decision as being in consumers' interests. For ultimately it has to be good for the consumer that deregulation strips protection from inefficient, over manned or badly managed operators. This harsh feature of deregulation will be reproduced on the United Kingdom scene.
3.5 Deregulation in the United States freed the domestic market of all route and most price controls, with the remaining price controls going at the end of 1982. As a result carriers are free to select which routes they wish to operate and to move off those considered uneconomic. Also (unlike here) carriers cannot hold a permission to operate a route and then fail to do so. Prior to deregulation many United States' carriers collected route licenses for an anti-competitive purpose, not to operate them, but simply to keep other airlines off them. This is still a feature of the present day United Kingdom market. In America, in addition to allowing easier access to all routes, deregulation has brought in a "use it or lose it" situation. An airline given permission to go on a route must do so within a very short space of time or give it up.

3.6 The short term result of deregulation in the United States was a year of considerable disruption as carriers assessed the new market conditions and reacted to them free of controls. Some airports, such as Atlanta in Georgia suddenly found airlines queuing up to operate services, others lost airlines. Some cities found they were served for the first time by jets, others that their air service was downgraded to turbo-prop aircraft; a very few communities lost their air service altogether, usually to regain it later. Some major carriers such as Delta, reacted carefully to deregulation and prospered as a result, others such as Braniff did not and suffered the consequences. On the busy routes, price competition soon became fierce with extensive discounting. This was followed by the inevitable pressure on operators to seek mergers so as to restrict price and service competition.

3.7 The United States however has strong anti-trust laws, and as a result mergers have been carefully regulated so as to keep the skies open. The latest merger refusal decision was handed down recently by CAB in regard to Western Airways and Wein Air (an Alaskan regional airline) on the grounds that this would restrict competition both in the west coast states and in Alaska.

3.8 It has to be anticipated that a similar period of disruption may be experienced here following on deregulation. As will be explained later this is not necessarily to be over feared by the consumer in the United Kingdom. The recession has complicated matters, but, following on deregulation the United States domestic market soon not so much settled down as resettled into a new pattern.

3.9 Moving up by size of routes. Socially essential services to remote rural communities, our life-line type services have not been greatly effected. The 1978 Act allowed for the fact that these could not be operated according to ordinary commercial criteria or left to market forces. Provision was made for continued subsidy where required, but more importantly for forcing airlines to continue operating these services until a successor could be found.
3.10 Moving further up the ladder, commuter airlines and their users have certainly benefitted from deregulation, despite the recession. After an initial period of acute instability with the larger airlines mainly withdrawing from the commuter network, the market adapted. New commuter airlines emerged using aircraft more suited to short haul flights than their pre-deregulation counterparts. Now despite recession, the American commuter industry is booming. The result has been more airlines, more services, lower fare increases and many more communities linked into the commuter network.

3.11 Piedmont Airlines of North Carolina is a good example of one of the main deregulation effects which the United Kingdom government hopes will be reproduced here. This is the creation of new airlines followed by their rapid and healthy development. In fact, Piedmont, like some other United States commuters has since deregulation grown rapidly into an efficient regional carrier making healthy profits despite the recession. Its 1982 returns report passengers carried, miles flown and traffic growth all up on 1981. The recent comment of their senior vice-president for marketing illustrates the contrast between many United States commuter airlines after deregulation and their regulated and loss making domestic counterparts here,

"Because our new routes and services have been so widely accepted by the public our traffic has continued to grow at a higher rate than our capacity".

3.12 Moving up to the top of the domestic market and the United States major carriers, here the picture is patchy. At this level route and price competition has been much tougher with the recession biting harder than at the commuter level. Deregulation was indeed followed as predicted by the entry and rapid expansion of small regional carriers such as Air Florida and Texas International. However, until recently all except four of the major carriers were in the red, some such as World and Pan American have been in a critical financial condition and close to bankruptcy. However, it has been mainly losses from involvement on North Atlantic services, rather than their deregulated domestic market, which were to blame for this situation.

Isolating the top level of the United States' domestic market, the picture is somewhat different. Five years on it is now possible to see which airlines have coped and prospered under deregulation despite the recession and those unable to operate without protection. Against some loss makers berating the CAB and deregulation for their fate must be placed deregulation success stories, airlines such as US Air and Midway Airlines. Deregulation in America has in fact provided a climate which whilst encouraging the birth and rapid expansion of new carriers with new service and price ideas, has not penalized existing efficient and well managed airlines such as Delta and Eastern. There is no reason to expect that the same will not be true of the United Kingdom domestic market and industry.
3.13 It is extremely difficult to disentangle the effects of United States deregulation from those of the economic recession. However, one of the main arguments in favour of United Kingdom domestic deregulation is how well many major United States airlines are weathering the recession, despite the gloom of 1981 and their appalling financial returns of the first quarter of 1982. The consensus view now emerging from America is that but for the tougher commercial discipline imposed by deregulation, many more established carriers would have followed Braniff to the wall.

3.14 The Carter administration deregulated in full knowledge of the five year economic cycle prevalent in the airline industry, with the economic upturn of 1978 and 1979, bound to be followed by a similar downturn. What had not been predicted was the ferocity of the effects of the worldwide recession when it hit the United States industry on top of its own cyclical downturn in demand and revenue. As a result by the end of 1981 all but four of the major United States carriers were in the red, with Braniff, Pan American and World Airways facing bankruptcy. The last two survived into 1982, but the first quarter of this year brought an even worse situation personified by the super-efficient Delta turning in a quarterly loss (of nearly 15 million dollars) for the first time in twenty five years.

3.15 It has since become clear that the United States industry reached an important watershed early this year. Far from deregulation having weakened and destabilized the major carriers, the reverse has been the case. Many airline executives now admit that "they are still in there fighting" precisely because deregulation had made them stand on their own feet without depending on state protection. A previous opponent of deregulation, Al Brescia, vice president of Eastern Air Lines, put it thus,

"This industry is really only three years old. At the time of deregulation we were all thrown to the wolves - but we were the wolves and the chickens, all at the same time, and we were all looking for a free lunch. We've learnt there is no free lunch."

3.16 In late 1982 it is clear that the major American carriers have successfully passed over the watershed, despite the recession. The second quarter financial results indicated the rally, lead by Delta back in the black with a 23 million dollars net profit on the quarter and Pan American having not only pulled itself back from bankruptcy but looking close to breaking even in the near future. Significantly post deregulation carriers such as US Air and Frontier, have so far remained in profit. The recession has provided the severest of tests for the United States' deregulation. Many carriers are still making losses, but the industry in general is now certain it can weather the worst. This optimism and self
reliance stands in sharp contrast to British Airways, with its huge debts and gloomy predictions for the future.

3.17  To summarize, five years on from deregulation and in the midst of its worst ever economic depression, the United States has a vigorous and viable domestic airline industry. Despite the recession many new carriers have been created. As a result of deregulation, other carriers have expanded rapidly and many of the older established carriers such as Pan American have slimmed down and become more self reliant. The American market is so large it is difficult to generalize from, but the trends are clear; greater competition in both price and service, increased consumer choice with an impetus for airlines to become cost effective in order to survive. On prices the reasoned view is that overall although prices have risen (especially since the recession deepened) their rate of increase has been less than it would have been under regulation.

3.18  The key to the consumer getting value for money, both in regard to price and service, relies on increased airline efficiency. In the United States a recent report from the Department of Transportation, "An Analysis of State Regulatory Forum", charts increases in efficiency levels of their airline industry since deregulation. These increases have been substantial, particularly for intra-state carriers, an example being crews on Boeing 737s changing from three to two. The conclusion of the report is that price competition has set proper productivity standards and all airlines are being forced to meet them. The simultaneous recession has in fact hastened the process.

3.19  One final point is relevant on the United States experience of deregulation. The Carter administration did not intend it to be confined to the home market and made energetic attempts to export it. There is not space here to describe the events which followed, but end products have been a weakened IATA, the liberalization of several United States bilateral agreements, including those with the United Kingdom and a liberalized fare structure on the North Atlantic. Given its attitude to the closed European market, the United Kingdom government will certainly use domestic deregulation in the same way, to put pressure on protectionist regimes in Europe and elsewhere to the benefit of efficient airlines and customers alike.
4. THE UNITED STATES AND UNITED KINGDOM MARKETS. SIMILARITIES AND DIFFERENCES.

4.1 Since 1978, both supporters and opponents of deregulation have made frequent comparisons between the domestic airline markets of the United States and the United Kingdom. Many such comparisons have been spurious because differences in the two markets have been ignored. Because of this the likely dangers of deregulation for British airlines and consumers have perhaps been exaggerated. However, these differences are crucially important in that they point to problems which the United Kingdom government will have to resolve to successfully deregulate here.

4.2 The first such difference is market size. The United Kingdom certainly has the largest and most vigorous airline industry in Europe, but there the similarity ends. The American market is huge being both intra-continental as well as purely domestic. We in Britain count our airlines in groups of tens, but Americans number theirs in hundreds. Because of the small size of the United Kingdom, we have only two types of routes here as against four in the American domestic market. We have what roughly equates to their short haul (sectors not usually above 200 to 300 miles) third-level and commuter routes. There is nothing here similar to the American long haul intra state and intra continental routes. This tremendous difference in scale of market has both good and bad implications for deregulating here. The bad implications are dealt with later, but the good is the rather obvious point that there is simply less here to be disrupted by deregulation and as a consequence the effects will be less dramatic and destabilizing. Also, as pointed out earlier the American industry was pitch forked from a very strictly regulated position to nearly complete deregulation literally overnight. Here, the industry will not have such a wide divide to cross. As noted there has already been some liberalization here.

4.3 A point of similarity between the two markets however, is that even under a regulatory regime both developed new airlines fairly freely. This feature is important in indicating an easy transition from a regulated to deregulated system.

4.4 By European standards our industry is a large and vigorous one. As the accompanying note illustrates, even under a regulatory regime there is already a flow of new airlines coming up and attempting to build service networks. Despite recession our industry is creating new domestic airlines, the newly formed Genair group being an example. The recent retreat of British Airways from the domestic scene has also shown that we have sufficient independent airlines ready and willing to compete for route access under deregulation. Even the weakest of the domestic routes operated by the state airline has had not one but several independents ready to take it over. British Airways has now shed over thirty domestic routes and will shortly come off others such as Inverness-Heathrow. As will be noted later there are very few routes in the United Kingdom which would risk losing an operator under a deregulated system and this includes the majority of the life-line routes in Scotland.
4.5 As in the United States there will be a problem here regarding a small number of third-level services in Scotland (and the Channel Isles). These are half a dozen or so small aircraft services, serving very remote island communities and providing their life-line link to a major Scottish city, mainly Glasgow. In Scotland, these specialist air services are operated by Loganair, (the only others are those operated by Aurigny in the Channel Isles.) However, these routes can all be safeguarded in the same manner as the provision made in the United States.

4.6 To turn now to the differences which will result in problems for the United Kingdom government. These problems are sufficiently serious that if solutions are not found the United Kingdom consumer will find the benefits of deregulation far more limited than their United States' counterparts. These differences are fourfold. They are firstly, the British Airways problem, secondly, high United Kingdom airport charges and related airport problems, thirdly, the problem of mergers and collusion between airlines, and fourthly, the question of whether our market is large enough for open competition.

4.7 To take the British Airways problem first. The United States is unusual in not having a state airline. Pan American and Trans World Airways are frequently regarded as unofficial flag carriers, but are privately owned and have no state protection. The United Kingdom has not one but two flag carriers. British Caledonian will not be a problem at deregulation, not being a public corporation in receipt of public funds. British Airways is a different proposition.

4.8 Although in retreat, British Airways still dominates the United Kingdom domestic market, with in volume terms having over half of the passengers carried on its aircraft, the majority being on the four shuttle services. It obtained its position of dominance in the United Kingdom mainly as the result of two aids, not available to the independents. Firstly, it was for many years protected from competition as the incumbent of the majority of domestic routes. Secondly, the Government whilst not directly subsidizing the corporation underwrites its massive aircraft purchase schemes and guarantees its resultant large scale debts. Whilst the route protection has been lowered, the second situation still applies. The net result of both has been to inhibit the growth of rival independent domestic airlines such as British Midland Airways and Dan-Air.

4.9. Running into a deregulation, British Airways position is an anomaly which the United States did not have to find a solution for. If it is not to be privatized, which looks increasingly the case, under deregulation the Government will need to stop underwriting British Airways' debts. This underwriting is precisely the kind of "free lunch" expectation that conditions many large airlines to rely on protection. The reason that only the state airline can run a shuttle here is simply that only it has the capacity, including aircraft necessary, for such an operation. It is significant however, that all of the new Boeing 757s coming onto shuttle in 1983 have been purchased with loans underwritten by the United Kingdom Government, a facility not available to its competitors on these routes British Midland and British Caledonian.
4.10 For deregulation to work all airlines will need to be equally treated on domestic services. As a consequence for Government to either write off British Airways' debts, or continue to underwrite them would constitute continued protectionism and regulation. However, should the Government withdraw state support from our ailing flag carrier, it is unlikely to be able to cope and adjust as did its American counterparts.

4.11 Because of this dilemma it is perhaps safe to conclude that the United Kingdom government will not in Al Brescia's terms throw the British flag carrier to the wolves until it has had time to fight its way back to financial viability. Does this really make any difference to the domestic scene in the longer term? The monopolies on all three Anglo-Scottish trunks have now been broken and in its struggle to become cost effective, British Airways is retreating from the domestic market. Deregulation should both speed up the erosion of the state airline's unhealthy domination of the domestic market and increase service and price competition on many trunk services. It is likely that because of its cost structure British Airways will continue to retreat from running conventional domestic scheduled services, including its current Highland and Islands services. As a result, unless British Airways' debts are written off, its position should not have too serious an effect on the post regulation situation for either airlines or consumers.

4.12 The second and much more serious problem is airports. Here there are many and important differences between the United States and the United Kingdom. These differences partly account for why airport user charges and hence airline costs, are considerably lower in the United States than here. Here the current structure of airport funding and charging places a considerable burden on airlines and consumers alike. This is particularly true in regard to the seven British Airports Authority (BAA) airports. It is difficult to see how the United Kingdom can bring in deregulation without radical changes in airport finance.

4.13 The subject is a complex one, but briefly airports such as BAA's Glasgow and Heathrow have high user charges because they must fund most of their future development out of capital generated by current revenue from airlines. These charges are passed directly through to the fare paying public. The result is a very high level of charges and a higher than necessary level of fares. Both factors make our domestic air travel less competitive than it should be and restricts the scope of domestic airlines' pricing policies.

By contrast, American airport funding is very different and results in some of the lowest user charges in the world. There airports fund themselves and their development from two main sources. Firstly, they raise money by the sale of bonds and terminals (to airlines), secondly they receive Federal funds derived from passenger and general taxation. There are other differences, but the main distinction can be summed up as follows. In the United States the community pays for the airport,
in the United Kingdom, the air traveller pays for it (regardless
as to how many jobs, etc, an airport such as Heathrow creates).

4.14 The Government has now asked BAA to look at ways of
raising private capital, including the bond system. However,
this is unlikely to bear fruit prior to deregulation. Given
current airport pricing policies overall, deregulation will not
produce the same boost here as in the United States until a new
structure of airport financing is introduced. Even in the short
term for government to outlaw deliberate over pricing, such as at
Heathrow, would be difficult, unless established policy in regard
to a third London airport is changed.

4.15 The BAA airports will present a further problem for airline
deregulation. Not only will airlines rightly refuse to pay the
current level of charges in a free market situation they will also
refuse to agree to the BAA's lame duck policy
in regard to subsidizing loss making Prestwick Airport out of revenue
earned from other BAA airports. The result of this being that
Aberdeen and Glasgow airlines and their passengers pay to keep Prestwick
open.

4.16 To be truly effective airline deregulation in the United Kingdom
needs to be accompanied by equally radical changes in regard to airports.
Until this is done, British airlines will not be able to fully respond to
freedom gained under deregulation and the consumer will not receive
the full price gains it could otherwise provide.

4.17 However, even having reformed airport funding and charging in
this country, another important difference in airport operating
practice will need to be changed if deregulation is not to accentuate
current consumer inconvenience resulting from timetable
problems. This is the problem of the "slot system". Under deregulation
there will need to be a system for ensuring firstly, a fair allocation
of slots (take off times) for airlines and secondly, a spread of flights
throughout the day for passengers. At present in the United Kingdom,
available slots are handled by the airlines themselves via an airline
committee at each airport. Not unnaturally these tend to be dominated
by the larger airlines, especially British Airways. The system does
not work well now and will not provide the needed rationing of flights
after deregulation.

4.18 The Americans do things differently. At the twenty two largest
airports, slot allocation is handled by a neutral body, the FAA. Since
deregulation FAA has experimented with several methods of allocation.
Selling slots was a disaster, but the current method of a "lucky dip"
system, although not without its problems, has worked fairly and ensured
small airlines are not crowded out by larger operators such as Delta.
In the United Kingdom at present, the big airlines, especially British Airways, engage in what can only be described as time-tableing wars.
The motive is purely anti-competitive, to freeze out competition and the
practice would be outlawed in the United States. It is very much against
the consumer interest and unless at deregulation our slot allocation system is
changed to something like that used in America, this anti-competitive
practice will increase.
4.19 A final postscript on the important differences between the two countries regarding airport services. In the United States air traffic controllers and their services are paid for out of Federal funds, but here once again they have to be paid for by the airlines and their customers. These costs form a significant proportion of our very high airport charges. If this situation remains unchanged, yet again the result will be lower price benefits for the consumer than under the United States system.

4.20 Moving to the third difference noted in 4.6, the problems resulting from merger and operator collusion. As in the United States, following on from initial jockeying for route access and price cutting, there will be a move here towards airline mergers, especially by those airlines not sufficiently cost effective and efficient to cope with a deregulated market. The United Kingdom, has some provision to deal with this under the Office of Fair Trading and Monopolies and Mergers Commission. However, it does not have a system whereby the CAA (unlike its counterpart) can call in all merger proposals and outlaw them if judged to be anti-competitive. The United Kingdom industry, even under regulation has a history of mergers, the most recent producing Air UK and Genair. This tendency may well be accentuated after the post deregulation market settles down and government is likely to have to make provision to deal with this problem. The present Competition Act does not provide for judging such problems as when mergers produce airline market shares across a transport network which are anti-competitive.

4.21 A more tricky problem is the matter of collusion, official or unofficial, the result of which is to restrict competition. The United States has the benefit of very strict anti-trust laws. Since deregulation CAB threatened several "Show Cause Orders" to prevent airlines acting in collusion, especially in regard to price setting and market shares. Within the smaller United Kingdom industry the danger of unofficial collusion between operators to limit the practical effects of deregulation is a very real one. It will of course be a by-product of the obvious difference in size and scale of the United States and United Kingdom markets, which was the fourth difficulty noted in 4.6.

4.22 Roy Watts, Chief Executive of British Airways, is currently arguing that deregulation can only work in an airline market which is in a state of "perfect competition".

"The effective operation of market forces depends on the existence of a state of perfect competition something that belongs more to the realm of economic theory than the real world."

He rightly points out that the American market, where several airlines of comparable size can exist, comes close to this model, but Britain does not. The argument is that even if deregulation does cut back the dominance of British Airways, our market is still not big enough to maintain open competition. The situation is perhaps not as clear cut as that, but for our smaller market he does have a point. To effectively compete for example with the British Airways' Shuttle, especially to provide price competition, an airline must be able to develop to certain size. Even for the shuttle routes, it is difficult to see them accommodating more than three operators, who will soon cutback on competition once they have obtained their market share. Perfect or open competition needs a supply of new airlines "waiting in the wings" to displace them. Here scale of market is an important factor and our market is perhaps too small to permit this to happen so freely as in the United States.
4.23 However, whilst this is true of the current situation, it will not necessarily be true for the deregulated United Kingdom market. One crucial difference will be that then no airline will feel secure. The real evil of protection, even the liberalized form currently practised in the United Kingdom, is the sense of security felt by operators when they have obtained their licence. When airlines have overcome the licensing hurdle, incumbents on routes relax, they compete, but not too hard. Hence the comment of the Chairman of BMA before taking up his licence for Glasgow-Heathrow, that BMA would not attempt to take more than 20 per cent of the market.

4.24 The situation of imperfect competition is a feature of the regulated industry. Airline executives in the United Kingdom find it difficult to conceptualize the truly competitive market. This is perhaps because the airline industry in Britain has never known anything other than a protected environment and is conditioned to it. Whilst licensing remains airlines will continue to practise unofficial collusion and market sharing, however good their intentions beforehand.

4.25 The answer to the problem of market size and imperfect competition, is stimulation of the market by removal of price and route access controls as currently practised in the United Kingdom. What exists on Glasgow-Heathrow at present is indeed imperfect competition between three airlines. The route market will be extended only so far as to give the existing operators a viable market share and then all three airlines will settle down secure in the knowledge that no other airline is likely to be able to overcome the licensing hurdle to take their place. The "cosy relationship" of what airlines define as competition will once again reappear on the route. The key to deregulation and genuine stimulation of the market is that a steady stream of airlines make their way up the domestic market and then challenge to displace those on premier routes when they can offer consumers a better product. This is the post deregulation situation in the United States with airlines having to constantly look over their shoulder, ready to fend off challenges and constantly striving to innovate and improve their service. If one prime consumer benefit of an open market has to be singled out, it must be that of the constant pressure and stimulus it exerts on airlines. It is this feature that will help to stimulate the United Kingdom market and counteract its small size and current state of imperfect competition.

4.26 Two other features of the current home market point to an expansion of scale under deregulation. Firstly, under regulation, the fatality and merger rates of small airlines has been high, probably because of limited route access slowing firms' growth. Also under regulation (and for the same reason) it has proved difficult for newcomers to develop viable networks. Freedom from controls may permit this to happen more easily.
If, as the United Kingdom Government obviously hopes, Articles 85 and 86 of the Treaty of Rome are applied to air transport, then the solution to the size limitation here will be resolved. Laker, with his unsuccessful European Skytrain initiative, clearly indicated the obvious fact that whilst the United Kingdom may not have the optimum size of domestic air market, Europe as a whole does. There is not space here to follow through events in the parallel struggle, mainly United Kingdom inspired, to "open up" Europe to competition. However, the EEC as a whole does represent one solution to Roy Watt's problem; ironically one strongly supported by British Airways.

4.27 Hence it can be seen that there are important differences between the air transport markets here and in the United States. Almost certainly the problems of British Airways, small market size, imperfect competition and mergers and airline collusion can be overcome. The vital problem of punitive airport charges is not likely to be overcome without a parallel reform of airport finance.

4.28 At the end of the day deregulation here should produce a domestic market, where on all except a very small number of non-commercial routes, there will be open access to any airline wishing to fly them. Airlines will be free at any time to pioneer new routes, new types and concepts of service; also to respond and adapt to changing patterns of consumer demand. There will be increased price competition, but limited in extent whilst airport funding remains unchanged.

4.29 Taking the airline system as it will be after deregulation, rather than now, should consumers trade off the position they have won under the 1980 Civil Aviation Act regarding participation in the regulatory structure? Deregulation will probably sweep away licence and also tariff hearings as well. However, SCC's view has always been that such participation is a second best situation and the consumer is better served if the market can exert the pressure on the airlines. Also the recession has done more than the 1980 Act and regulation to make airlines cost conscious, more efficient and more attuned to matching services to consumer need. Without it British Airways would still be grossly overmanned and dominating the domestic scene.

4.30 Any fears that deregulation will not benefit the state airline, independent airlines and air travellers, should be eased by events in the long distance coach trade since it was deregulated under the 1980 Transport Act. Open competition has not only transformed the industry, its service standards, products and pricing, it has also transformed the National Bus Company's long distance operation. This United Kingdom experience of transport deregulation has produced another spin-off, which should influence consumer reaction to airline deregulation. The coach industry has not only expanded, but higher standards and new concepts of service, have resulted in a surge of demand for new equipment, again despite the recession. British Leyland's coach division and its employees have certainly benefitted alongside coach travellers. There is no reason to believe that air deregulation will not have the same spin-off for British Aerospace and Rolls Royce.
5. HOW SHOULD THE UNITED KINGDOM DOMESTIC AIRLINE SYSTEM BE DEREGULATED?

5.1 As noted in section one, the United Kingdom Government whilst deciding to deregulate, has yet to work out how to do it. Consumers will be better served by deregulation if they can influence how it is carried through. United Kingdom air services can be divided into two kinds, those that could be profit making and those which are not likely to be profit making, with three basic route types. Firstly, there are the major trunks, routes such as Glasgow-Heathrow, with passengers carried measured in the hundreds of thousands. Secondly, there are the minor trunks, such as Inverness-Heathrow, often aptly termed "thin routes", where passengers are measured only in their tens of thousands. Finally, there are routes such as Glasgow-Barra termed third-level and usually flown by small aircraft. Here passengers are numbered in their hundreds.

5.2 Scottish services can be further divided between life-line and non life-line routes, split evenly between the minor trunks and third-level. So which of these services should be deregulated? The key to this puzzle lies in a careful differentiation between routes which are or have the potential to be profit makers and the relatively small number of routes which are unlikely to break even let alone make a profit, but are vital to the economic and social well being of certain remote rural communities. The former can be left to normal commercial operation, but not the latter which need a degree of protection.

5.3 The commercially viable route, not in need of protection must meet two minimum conditions. It must not be in receipt of subsidy and must have at least one airline ready to take it over if the incumbent withdraws. Such routes will not necessarily be making a profit at any particular time, but will be capable of covering their costs year over year. There is no reason why all such routes should not be deregulated. This would include all the major and minor trunks, including the second level Scottish life-line services. For the third-level routes, all but life-line services can be deregulated. To date regulation has not in fact been able to hold airlines on these third-level services if they felt the need to withdraw for commercial reasons and subsidy was not available. As a result Loganair withdrew from Inverness-Edinburgh in 1981 and the route is now dormant. The usual reason for withdrawal and lack of interest by other airlines, tends to be improvement of surface transport (in this particular case upgrading of the A9 trunk road).

5.4 The particularly Scottish problem is what to do about the life-line services under deregulation? A great deal of confusion surrounds this concept, which is generally applied wrongly to any island to mainland or remote area air service. It has also tended to be assumed that all life-line routes are in need of special protection; once again this is not the case in reality. What is essential for deregulation purposes is an adequate definition of the circumstances when a route (but not its incumbent airline) should be protected from the operation of market forces. The consumer has been waiting for several years for such a definition from CAA, but to date all that has been given is a list of such routes which omits the third-level life-lines.
5.5 It is self evident that for any life-line air service to be protected, the incumbent airline must provide an acceptable standard of passenger comfort and safety and a service of adequate frequency. Currently, this is achieved by conditions attached when airlines operating these services receive subsidy from public funds, whether from central government, local authority or development agency. In fact it has been one of the more reassuring features of the post-war scene that successive governments have made provision for maintaining Scotland's lifeline air services. There is no reason for such provision to be disrupted by deregulation.

5.6 The criteria in 5.7 below are intended only to establish basic guidelines which can be applied to any remote area route to see whether it meets the conditions for life-line designation. They are not intended, however, to be comprehensive or permanent criteria for three reasons. Firstly, it is obvious that with change over time different types of communities may come to need a life-line designation for their air service even though it is not required now. At present in Scotland, the need is most clear cut for islands situated at a considerable distance from the Scottish mainland with the resulting long sea journey as the only alternative to air. However it is possible to conceive of some very remote mainland communities, who may in the future come to rely on an air life-line. Secondly, changes in aircraft technology have frequently produced radical changes in air service potential. The most obvious historical example of this is the revolution in the United Kingdom domestic system produced by the introduction of jets in the 1960s. A similar transformation came to the Scottish third-level inter-island air services with the introduction of small aircraft with STOL (short take off and landing) capability, also in the 1960s. A similar technological shift forward in third-level services is underway at the moment with the introduction of small helicopter services. It must never be forgotten that current life-line routes are partly the result of historical accident and the limitations of current technology. As a consequence the guidelines' criteria must never be regarded as finite, but capable of adaptation to meet changed circumstances.

Finally, and most importantly, every remote community must have an opportunity to participate in the process of drawing up guidelines, so that their local needs are taken into account.

5.7 Keeping the qualifications of 5.4 and 5.5 in mind the commonsense criteria for deciding whether a route falls into this category would seem to be:

(i) The services are island to mainland or island to island within an island group, thus crossing a sea barrier.

(ii) The service must link the island community to a major service centre.

(iii) The service must be the primary or the only means of air transport to the mainland city for the island community.

(iv) There must be an "insurance policy" need, meaning that in an emergency alternative sea transport would be too slow to fulfil this purpose.
(v) The air service acts as a feeder life-line in that it enables the communities of the outlying islands within the three Scottish island groups (Orkney, Shetland and Outer Hebrides) to gain access to main life-line air services originating in Kirkwall, Sumburgh, Stornoway and Balivanich.

These criteria should enable a list of current Scottish life-line air services to be drawn up.

5.8 Thus a distinction can be made between life-line air services which need protection and those which can be left to ordinary commercial operation. There is no reason why the latter should not be deregulated, but retaining their life-line status in case at any time in the future they slip into the first category. The first group cannot safely be fully deregulated and are the types of routes afforded protection under the United States' deregulation legislation.

5.9 The difficulty is what kind of protection should they be afforded, other than the availability of subsidy from public funds as required over time? These tend to be specialist small aircraft services, with only a few airlines able to take them over should the incumbent withdraw. However, regulation and subsidy on the current model are not necessarily the only answer. Regulatory support for such life-lines has tended to fossilise them in a non-profit making role and to prevent the development of new third-level airlines with new service and equipment ideas which could make the services viable and not in need of protection. In the field of Scottish ferry transport, SCC has recommended that similar routes be put up for competitive tender at five yearly intervals. A similar solution would seem to be applicable to these life-line air services.

5.10 There is not the space here to argue through what is a very complex issue, but certainly the regulatory protection for the currently non-viable routes needs to be with a "light hand." For example it is vital to stimulate their development by encouraging local entrepreneurship. In Orkney a small airline has recently started up, so perhaps the future of some of these services is to be by local initiative. However, what is vital is that protection does not bar access to other operators who can provide a better service, especially if they can make them commercially viable without subsidy. All that is required for these services is "light-handed" regulation to keep existing life-line routes in being and cope with any of the commercially viable group which slide down the scale. However, this protective function needs to be matched by non-incumbent airlines being allowed easy access to these routes if they can provide a better and more cost effective service.

5.11 Finally it is taken as self evident that safety standards will not be allowed to drop after deregulation and that CAA will continue to be responsible for their maintenance. The SCC is aware that the Authority has recently shown considerable flexibility regarding matching the lowest possible cost to the operator with adequate safety standards for the passenger regarding the new third-level helicopter services within Scotland. As a consequence there would seem little need to change the current provisions. SCC is aware of current proposals by the FAA in the United States for safety deregulation (safety by objectives), but does not see a similar need within the United Kingdom.
6. **SCC POLICY FOR AIRLINE DEREGULATION**

1. The Scottish Consumer Council supports deregulation of the United Kingdom domestic air transport system.

2. The United Kingdom Government should make legislative provision for continued support for the Scottish life-line and feeder life-line air services. This provision should be along the lines set out in this paper.

3. Government should consult with local authorities and local users before deciding which air services are to be designated as life-lines.

4. Life-line route franchises should be issued for a period of five years, after which they should be subject to review and made available for competitive tender.

5. To facilitate maximum consumer benefit from deregulation, government should as a matter of urgency reform airport funding and charging procedures.

6. Current airline safety standards and procedures should continue to apply after deregulation of the United Kingdom domestic air transport system.

NOTE 1

1. The Civil Aviation Authority Official Record, which details applications by airlines for particular routes, recorded the following applications for second and third level routes in the thirteen week period 1st September to 23rd November 1982. Only applications involving destinations within the United Kingdom are recorded, and the applications are divided into two sections: one detailing applications by airlines applying for new licences, and one for airlines applying to vary a licence held by them or revoke a licence held by another airline for a particular route.

2. Airline applications for new route licences

| Welsh Airways Ltd                 | Haverford West to London (Gatwick) |
| G.B. Airways Ltd                 | London (Heathrow) to Inverness     |
| Alidair Ltd                      | Edinburgh to Manchester            |
| Midhavens Ltd                    | Cranfield to London (Heathrow)     |
| Loganair                         | Londonderry to Isle of Man and/or  |
|                                 | Blackpool                          |
| British Midland Airways Ltd.     | London (Heathrow) to Inverness     |
| Melbrea Air Ltd                  | Cardiff to Chester (Hawarden)      |
| Brymon Aviation Ltd              | City of London Stolport to         |
|                                 | Manchester                         |
| Air Ecosse Ltd                   | Edinburgh to Birmingham            |
| Lease Air Ltd                    | Cardiff and/or Bristol to          |
|                                 | London (Gatwick).                  |

During the thirteen week period there were therefore ten applications for new licences by ten different airlines. The two points which are notable from these applications are firstly that the airlines applying for these routes include three which are not well-known, and secondly that not all of the routes applied for are well-established ones. For example, the applications from Welsh Airways and Midhavens Ltd., involve new links into London. Perhaps more importantly, the application by Brymon is innovative in that it involves the use of the City of London Stolport and a new aircraft type.
3. Airline applications to revoke or vary existing licenses

Spacegrand Aviation Services Ltd  Blackpool and/or Isle of Man and/or Belfast
Air Ecosse Ltd.  Birmingham to Manchester and/or Edinburgh
Brymon Aviation Ltd.  London (Heathrow and/or Gatwick) to Plymouth and/or Newquay
Dan-Air Services Ltd.  London (Gatwick) to Aberdeen
Lease Air Ltd  Humberside and/or Norwich to Blackpool and/or Liverpool
Air Ecosse Ltd.  Dundee and/or Manchester and/or Exeter and/or Liverpool
Lease Air Ltd  Norwich and/or Humberside to Newcastle and/or Edinburgh and/or Glasgow
Lease Air Ltd  Liverpool to Newquay and/or Exeter.

There were therefore eight applications by five different airlines.