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ABSTRACT

In recent years there has been a steady erosion of the anti-competitive regulatory environment which was established in international aviation after the war. This briefing document outlines the history of IATA in fixing international air fares and the advantages claimed to be derived from it.

The benefits claimed from IATA fare fixing are questionable. A number of alternatives to IATA such as zones of competition in air fares, licensing of non-IATA airlines, the deregulation of airline ticket retailing, charter airlines, and discounting are examined. These markets account for approximately thirty million air passenger per year in the United Kingdom.

The costs of IATA price fixing include the loss of regulatory authority and influence from governments to airlines, reduced airline efficiency due to price collusion, inefficient airports, neglect of the consumer interest, losses of tourist revenues, and increased costs to the traded goods sectors.

The Civil Aviation Authority should require that airlines submit their tariffs independently of the deliberations of IATA on fares. In this way the regulatory authority should establish a programme of promoting price competition between airlines.

1. THE ROLE OF IATA IN INTERNATIONAL AIR FARE NEGOTIATIONS

While international aviation agreements require that fares charged are agreed by governments, in practice the negotiations are carried on by airlines using the machinery of IATA.

Origins and operation

The Chicago Conference of 1944, which established the basis for the regulation of international aviation in the postwar era, agreed that international rates should be negotiated multilaterally, either through carrier conferences subject to government approval or through direct government control. IATA was established in 1945 as an association of airlines. The US Civil Aeronautics Board approved its tariff-setting activities in 1946, thus providing its carriers with an exemption from US antitrust laws.

While the original intention was to establish tariff setting as a function of governments, this has been delegated to IATA in most bilateral air service agreements. The tariffs are negotiated through IATA and then submitted to governments. In Europe, for example, the European Agreement on the Procedures for the Establishment of Tariffs for Scheduled Air Services (1967) requires carriers to agree tariffs among themselves, using the machinery of IATA where possible. The agreed tariffs are then submitted to the respective governments for approval. The Report of the House of Lords Select Committee on the European Communities on European Air Fares states that 'European governments, with the exception of the United Kingdom, generally endorse without question the tariffs agreed by their carriers through IATA' (1980, p.viii).

The COMPASS Report, prepared for the European Civil Aviation Conference (ECAC) in 1981, confirms the findings of the House of Lords Committee. 'Up to now, the practice has been for most governments to refuse to approve fares which its own airlines do not agree with or which have not been agreed in IATA (whether those fares were submitted by an IATA member or non-member airline)' (1981, p.11).

Scope of the agreement

The agreements between airlines typically cover the fares, the conditions attached to the fares, the class and variety of services to be provided, the capacity to be provided by each airline, and the schedules to be operated. In addition, notes the COMPASS Report, airlines 'enter into inter-airline commercial agreements which formalize the above arrangements and also provide for each airline to act as the other's agent for other aspects such as baggage and cargo handling, reservations and ticket sales, and also for pooling and sharing the revenue obtained from the operation of routes.'

COMPASS states that 'such agreements between producers are a logical consequence of the operating conditions created for airlines by governments. While airlines are required to agree prices, while national shares of many markets are fixed in advance by governments, and while only one airline from each bilateral partner state is permitted to operate on most intra-European routes, it will invariably be convenient for many to seek such forms of co-operation.'

2. THE CASE FOR THE DEFENCE

The advantages of the IATA tariff-setting machinery

Several arguments are produced in favour of the existing system.

1.**Administrative:** The costs of establishing tariffs are borne by the airlines, thus reducing the administrative role of governments in determining fares.

2.**Innovation:** New fares which are uneconomic are unlikely to be introduced.

3.**Tariff co-ordination:** The use of the IATA multilateral machinery is likely to prevent the development of anomalies between neighbouring routes.

4.**Cost-related fares:** Multilateral fare negotiations may prevent excessive cross-subsidization between routes because airlines are reluctant to participate indirectly in support of other airlines unprofitable routes.

5.**Airline profitability:** The use of IATA tariff-setting machinery benefits airlines. In many countries these carriers are government-owned and have successfully promoted their interests as the national interest. The profitability of these airlines reduces any possible requirements for subsidies from governments.

6.**National prestige:** The use of IATA machinery protects governments which, as a matter of policy, wish to maintain and expand their airline networks for prestige or cultural purposes.

The IATA case against zones of competition

The COMPASS Report recommends zones of competition instead of the IATA fare-fixing approach. The claimed advantages for the IATA system are examined later. IATA's objections to zones of competition or flexibility in airline tariffs are examined first.

In its response to the zones of flexibility proposed in the EEC Memorandum No. 2, IATA makes the following defence of its role in fixing international air tariffs.

'Commonality': The IATA system has an underlying basis of 'commonality' - a uniformity of the principles and procedures followed by airlines and governments. At the government level, this is due to the pattern of air transport bilaterals supported multilaterally by recommendations of ICAO and regional civil aviation bodies, and at the airline level, it is due to the general use of the multilateral IATA pricing mechanism. That 'commonality', says IATA, has resulted in generally clear-cut roles for governments and airlines in price development. It provides a basis for tariff structures accepted on a worldwide basis and most importantly, applicable within the worldwide system (IATA comments on EEC Civil Aviation Memorandum No.2, 1984, p.7).

Zones of flexibility could well jeopardize that 'commonality', according to IATA:

(a) geographically, by introducing the possibility of different principles and procedures between pairs of governments and between that 'community' and the rest of the world; and

(b) structurally, as airlines and governments develop unco-ordinated bilateral policies on matters such as the definitions of different types of fares, and on conditions covering reference fares, zone limits, zone types, etc. 'The potential exists for increased complexity in tariff development and for growing inter-vention in commercial issues which is likely to increase over time with the need for regular adjustment of fares and zones - as is clearly evident on the North Atlantic'(Ibid.,p.7).

3. CONSUMER CRITICISM OF IATA FARE FIXING

The case for IATA fare fixing has attracted many critics. General consumer criticisms of the system are strong.

'It is the opinion of the International Organization of Consumers Unions that IATA has become a mechanism for the elimination of competition in air fares. That being so, it must be ensured that the system of fixing fares is more responsive to the consumer interest. It should be subjected to the cartel rules that are commonly accepted in other fields of business and, particularly, provision should be made for the disclosure of more information about fare structure and and for public hearings on the establishment of rates, with an opportunity for the presentation of the consumer position with respect to rate questions' (IOCU,1970).

These criticisms are echoed in the 1985 report on air fares by BEUC, the Bureau of European Consumers Unions. Calling for the application of the EEC Competition rules to apply to air transport, BEUC stresses the following faults in the present air transport system in Europe:

(a) high air fares at the expense of the ordinary passenger;

(b) low fares which are available are tied up with restrictions so as to limit their use;

(c) market dominations of state airlines based on outdated concepts of national sovereignty;

(d) a cartel fare-fixing system; and

(e) policy domination by state airlines whose plans are rubber-stamped by governments (BEUC, 1985).

The BEUC report will be available in the autumn of 1985. It supports a long series of criticisms of price fixing in international aviation from the House of Lords Select Committee, the Air Transport Users Committee, The Institute of Economic Affairs, and the Adam Smith Institute.

4. ARE THE CLAIMED BENEFITS FROM IATA FARE FIXING WORTHWHILE?

The claimed benefits from IATA fare-fixing were taken from the COMPASS Report. In dealing with these points we can address them in the same order.

1. **The administrative savings** to government from having airlines take on the role of tariff fixing is probably small. In Britain in 1982/3 only 1.5 per cent of the 7,256 staff of the Civil Aviation Authority worked in the economic regulation division. The regulatory staff to passenger ratio is one regulator per half million passengers.

While in some small countries there may be a shortage of expertise outside the national airline to run an efficient independent regulatory agency, the cost of such an agency need not be large. On the other hand, the costs to the economy as a whole from allowing the national airline to determine air fare policy could be large in terms of lost tourism revenue, lost business traffic, and a smaller aviation sector than in an open market. Governments which lack an independent source of information on aviation matters will normally tend to accept the fares proposed by the airlines.

2. **Innovation** is likely to be less under the IATA system since new fares and products have to be agreed between airlines.

3. **Tariff co-ordination:** The IATA case is that the use of IATA machinery on a multilateral basis is likely to prevent the development of anomalies between neighbouring routes. However, such anomalies are inevitable where adjoining countries have different policy approaches to aviation (we examine some of these different approaches in aviation policy later). Under the liberal Anglo-Dutch bilateral agreement of 1984 the fare from London to Maastricht fell much lower than the fares to Dusseldorf and Brussels where the administrations had different aviation policies. The use of multilateral tariff co-ordination machinery within IATA would have left the air traveller between Britain and the Netherlands worse off.

4. **Cost-related fares:** The IATA case is that multilateral fare negotiations may prevent excessive cross-subsidization because airlines are reluctant to participate indirectly in supporting other airlines' unprofitable routes. This point is not obvious from the operation of IATA. If airline A wants to charge more on a trunk route in order to cross-subsidize some thin routes, then the agreed fare will generate supernormal profits for its partner airline on the trunk route. There is no incentive for airline B to support a fare closer to that which might emerge in an open market.

5. **Airline profitability** may be enhanced by IATA in the short run by setting fares above an open market. In the longer run, however, the absence of price competition between those in the market, the ban on new entrants to the market, and the lack of an

external involvement in the setting of tariffs is likely to cause costs to rise, thus eroding the initial impact of setting fares through IATA.

6. National prestige: IATA states that this may be enhanced by allowing airlines to survive which might not be able to do so in an open market. By protecting such airlines from competition, the IATA fare-fixing arrangements may obscure the costs to an economy as a whole of this way of furthering national prestige. A further disadvantage of this method of increasing national prestige is that when fares are set above the open market level, half of the increase in revenue will accrue to the foreign carrier on the route in a typical bilateral agreement.

The alternative for a country wishing to enhance its prestige in this way is an explicit subsidy from public funds. This informs the public of the cost of the policy and would facilitate a more informed debate on the issue.

7. 'Commonality': This point is made by IATA in opposing EEC Memorandum No. 2. IATA states that because the same principles influence fare-fixing worldwide, this establishes clearly defined roles for airlines and governments throughout the world. Zones of competition, it is argued, would place commonality at risk, and cause complexity in tariff development.

Airline fares should be market led in competition between airlines and the services bought in by airlines. Passengers require cheap point to point transportation. They should not be prevented from having this by a commonality which would require their fares to be kept artificially high in common with those charged under high fare liberal bilateral agreements.

5. ALTERNATIVES TO IATA FARE FIXING

ECAC and EEC zones of price competition

ECAC (1981) examined methods of introducing a zone of freedom from the regulation of airline tariffs. The fares proposed by airlines and approved by governments would be reference tariffs about which there would be zones within which airlines could make a commercial judgement on the fares they wished to charge. The fares would be filed with governments for notification purposes only (The Compass Report, p.56). In its Civil Aviation Memorandum No.2, commenting on the reference tariff and zones of reasonableness proposal, the EEC stated that 'it seems to the Commission that this concept has considerable merit in the Community context' (1984,p.31).

The Anglo-Dutch bilateral agreement

The lack of progress in liberalizing aviation at EEC level brought a return to an emphasis on bilateral negotiations in 1984. The Anglo-Dutch agreement, which came into force in the summer of 1984, reduced substantially the role of IATA in deciding air fares between the two countries.

Under the agreement, all airlines in Britain and the Netherlands have the right to fly between the two countries at fares to be determined by the country of origin. Decisions on frequency and capacity are made by the airlines, and airlines are free to match tariffs set by competing airlines. The virtual elimination of controls on route entry and the arrival of many non-IATA airlines on the route thus limits the applicability of IATA tariff fixing compared to routes where entry is rigidly controlled and fares are subject to the approval of both governments and both sets of airlines. The initial nine months of operation of the agreement saw an 16% increase in traffic between the countries compared to a 10% increase in traffic between Britain and Europe as a whole. There had been no growth in air travel between the countries over the eight years 1976-83.

In the first year of operation of the agreement, ten new services were introduced. Three new services by Dutch carriers and one by a British carrier have been approved, and nineteen further applications are being considered. This is a level of market entry unprecendented under the IATA system and dilutes markedly the power of the IATA member airlines to influence fares on the Anglo-Dutch routes.

The Anglo-Dutch agreement was further liberalized in June 1985. Airlines of either country are now free to combine services to more than one point in the othercountry or to link such services to a second point in another European country. These provisions will increase the attractiveness of market entry on the Anglo-Dutch routes.

Under the 1985 agreement, airlines are allowed to implement tariffs unless both governments express their disapproval. Previously the tariffs had been subject to the approval of the country of origin. The most widely publicized aspect of the 1984 Anglo-Dutch agreement was the availability of a £49 return fare between London and Amsterdam. The 1985 review of the agreement notes that the availability of the fare averaged around 2,000 seats per week.

In early 1985 the Virgin Airways from Gatwick to Maastricht was £25. The one-way fares on the adjoining IATA-priced routes to Brussels and Dusseldorf were £77 and £80 respectively.

Australian deregulation of airline ticket retailing

The Australian government is proposing to deregulate airline ticket retailing. IATA fares would then have the status of recommended retail prices. According to a report by alex McWhirter in the June 1985 edition of Business Traveller, this move will be opposed by IATA on the basis that IATA confers benefits to Australians interlining between a number of carriers. The move is opposed by Lufthansa, a staunchly conservative airline.

Interlining arrangements are not part of the fare-fixing role of IATA. The benefit from these arrangements depends on the ratio of interlining to point-to-point travellers and those who use a single carrier per journey. It is unlikely that there would be no other provision for interlining passengers in the absence of IATA fare fixing.

McWhirter finds that 'the truth is that Australia has been an (unofficial) open market place for some time now. All the Trade Practices Commision is doing is to give the present situation the rubber stamp of approval'(the Trade Practices Commision is the body which recommended the deregulation of the retail ticket market). In the May edition of Business Traveller, the marketing manager of Qantas stated that 'We have a published fare structure, but it is only used as a benchmark, with airlines discounting heavily depending on the quality of the product and its market demand.'

US/ECAC Zones of Price Competition

In 1978, the Civil Aeronautics Board instituted a review of IATA traffic conferences. In 1980, the Board reported that 'the traffic conferences had substantially reduced competition in air transportation to and from the United States'. Nevertheless, it found that approval and immunity for two years from the effective date of the final order were required 'to accommodate international comity and foreign policy considerations and to allow time to examine whether certain transportation benefits such as interlining, could be attained via multilateral rate setting' (1984, p.44).

Fares between Europe and the United States are now set according to the US-ECAC Memorandum of Understanding of 1982. This sets fare zones within which airlines are free to decide their own fares. The CAB Report states that 'the ECAC Memorandum of Understanding provides, amongst other things, that the signatory nations will neither prevent nor require any carrier's participation in multilateral tariff co-ordination.'

The US/ECAC zones of competition are a compromise between the wish of the US to export its domestic deregulation policy and the more traditional approach of countries such as Germany and France. The US had intended to apply its full anti-trust policies to the member airlines of IATA. This approach was dropped 'in order to accommodate international comity and foreign policy considerations' following objections by many European governments.

Discounting

The discounting of airline tickets has become commonplace in recent years. It provides a safeguard against the establishment of IATA fares which are too high to attract the revenues required by the airlines. The 1979 Annual Report of the Air Transport Users Committee stated that 'the system can therefore be regarded as being of benefit both to the airlines and their users and the committee is in favour of legalizing the selling of bulk fares for general resale by all travel agents.' In 1980, an estimated five million tickets were marketed in Britain at less than IATA tariffs. The Committee noted that 'almost all the world's airlines engage in unofficial discounting.' In 1982, the Committee repeated its earlier calls for government action that would make discounted tickets available to all.

Cheapies and Charters

In 1983, the Civil Aviation Authority defined a tour operator 'cheapie' as 'convenient popular term covering packages which are offered to individual members of the public and which include minimal accommodation so that, while meeting the formal requirement to offer a ground package, the arrangement effectively offers a flight alone.'

Of the 44 million passengers travelling from British airports in 1982, 36.9% were on charter services. The relaxation of accommodation requirements attached to these tickets makes them close to discounted airline tickets referred to above. The major charter markets from Britain (with the charter market share) are as follows: Canary Islands(96%), Spain(87%), Greece(82%), Portugal(70%), and Yugoslavia(69%).

Internal UK deregulation - the 1985 evidence

Between April 1984 and the end of March 1985 passenger numbers between Belfast and London increased by 25% to over 900,000. This resulted from a degree of market entry and price competition which could not occur under the IATA system. The applicability of the changes on London-Belfast to international routes depends in the first instance on the policy stance adopted by our international partners in aviation. Nonetheless, the results of liberalization on London-Belfast are striking.

Prior to April 1984, British Airways had a monopoly on the Heathrow to Belfast service. British Midland operated a Belfast-Gatwick service. In 1983, the market was 700,000 passengers per year with a BA share of over ninety per cent.

From April 1984, British Midland was permitted to compete directly with British Airways on the Belfast-Heathrow route. Dan-Air, which has a hub at Gatwick, took over the Belfast-Gatwick services.

Fares have declined under competition. Services have improved as BA introduced its 'Super Shuttle' service to respond to competition. The loss of traffic by BA has been minimal. Dan-Air has increased the Gatwick passengers to over 100,000. British Midland has attracted over 150,000 passengers to its new service. The growth of traffic on the route is a striking reminder of the impact on the economy as a whole from adopting a more competitive approach to aviation in Europe.

LIBERAL MARKETS - A SUMMARY

In addition to discounted tickets and tour operator 'cheapies', IATA fare decisions are also undermined by governments taking a stronger line in rejecting IATA recommended fares and allocating routes to non-IATA airlines. There are two major examples of this - the North Atlantic policies of the US government and the Anglo-Dutch agreement of 1984. These cover about nine million passengers. Together with five million discounted tickets and sixteen million charter passengers, we have about thirty million air passengers at British airports each year who are travelling outside the IATA fare fixing arrangements.

6. THE CASE FOR LEAVING THE IATA FARE FIXING SYSTEM

Problems of collusion

The IATA fare fixing arrangements transfer to airlines the implementation of much of the function of governments in setting air fares. This has a number of potential dangers of inefficiency.

1. Consumer interests will tend to be neglected.

2. Since the number of airlines in most airline markets is limited to one per country, it will be easy for airlines to collude to set prices higher than in an open market.

3. Price collusion and restricted market entry will reduce incentives to efficiency.

4. It is likely that price collusion between airlines will lead to other non-competitive agreements between airlines in areas such as passenger and baggage handling, reservations, ticket sales, and revenue pooling.

5. Price collusion promotes non-price competition between airlines. Differentiation of similar aircraft and competition on the basis of services such as in-flight meals and drinks impose higher operating costs on airlines, building in the tendency to maintain higher fares.

6. Price collusion between airlines has caused 'knock-on' effects leading to inefficiency in services provided at airports. In Europe, for example, there is no price competition on most routes between airlines. Airports can thus pass on increases in their charges to the airlines in the knowledge that both carriers on a route will in turn be able to pass on the increase to consumers in the same way. This contributes to the disparity between airport charges in Europe and North America.

General competition policy

The price fixing arrangements that apply to airlines are unusual in the context of general government policy towards industry. To the case against collusion can therefore be added the facts that:

7. Price collusion is not normally allowed in the wider industrial sector of most economies. An exemption in the case of aviation is undesirable. The historical exemption from anti-trust legislation is a result of peculiar postwar circumstances and has no economic rationale.

8. Aviation is a normal contestable market just like those for butchers, bakers, and candlestick makers (as the Edwards Committee reminds us). While market entry remains restricted,

governments should retain control over the rates charged. Without free market entry, government participation in fares control is still required.

A strategy for reform

One route that would eventually remove the problems of collusion includes the following steps.

Where governments have up to now taken the decisions reached by the airlines without question, the partial perspectives of the airlines should be recognized and air fares regulated in the interests of consumers as well as producers.

Since the United Kingdom already has an independent authority which arbitrates on air fares, in the shape of the Civil Aviation Authority, it should insist that fare submissions are notprepared by carriers in collusion.

Future fare increases submitted to the Civil Aviation Authority should be filed without reference to the applications of other carriers and based on the cost schedule of each airline rather than joint or compromise applications agreed at an IATA tariff conference.

The proposal to leave the IATA fare-fixing system is a logical development given that two in every three international passengers at UK airports are travelling on services to which the IATA price fixing does not apply. These flights include charters, discounted tickets, and those travelling to the US and Netherlands with whom we have liberal bilateral agreements.

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