Aviation: European liberalisation, 1986-2002

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This note traces the developments in the liberalisation of the air transport market within the European Union between 1986 and 2002. Further information on the internal market in aviation is available on the European Commission website.

Notes on other aviation issues, including the 'Open Skies' agreement between the EU and the United States, are available on the Aviation topical pages of the Parliament website; information on EU institutional and legislative terms can be found in HC Library standard note SN/IA/3689.

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1 Legislation

1.1 Background

In June 1992 the European Council of Ministers agreed the Third Aviation Liberalisation Package. The Third Package was the culmination of a gradual process of liberalisation of the Community air transport market to which Member States committed themselves in 1986. The decision to create a single market in aviation formed part of the move to a single internal market across the whole range of economic activity, as embodied in the Single European Act.

As its name suggests, there were two earlier packages of aviation liberalisation, the First Package, adopted in December 1987, and the Second Package, adopted in July 1990. Before that time the intra-Community market was governed by bilateral agreements between Member States. These tended to rigidly control route entry and capacity and often allowed airlines to pool their revenues. Many international routes were single designation, so that only one airline of each country was permitted to operate. Fares were almost entirely set by agreement between the airlines under the auspices of IATA: indeed using IATA was a formal requirement of a number of bilateral agreements. There were, however, a few exceptions to these restrictive agreements where the governments themselves had agreed to be more liberal. The first liberal air service agreements in Europe were signed by the UK and the Benelux countries in 1985 and began to bring down fares and introduce competition. This was a model for the First Package which was introduced by the British Presidency of the European Council in 1986.

The European Commission's efforts to develop a Common Air Transport Policy before 1987 can be summarised as follows:

> The Commission has, over the years, taken several initiatives aimed at securing the re-organisation and adaptation of the air transport sector in Europe so that the Community can realise the advantages which its important position in world-wide civil aviation - in terms of size of fleet, potential market and commercially strategic hubs should command.
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> In its first Memorandum the Commission set out to stimulate dialogue in the Community and among its institutions by proposing ideas for possible action aimed at the harmonious development of civil aviation in the whole of the Community. This was followed in 1980 by a Commission proposal on inter-regional air services which was adopted by the Council in 1983. Although this Directive had limited effect, it was nevertheless important since, for the first time, air traffic rights were created at Community level, in addition to those agreed bilaterally between governments by way of Air Services Agreements (ASAs).
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> The Commission presented a second Memorandum on Civil Aviation in March 1984. The purpose of this Memorandum was to develop and expand on the objectives of the Commission's 1979 memorandum in the light of developments which had occurred and to make specific proposals situated within an overall framework for a Community air transport policy.
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> In December 1987, the Council took the first important step towards the creation of a common air transport policy for the EEC with the adoption of a package of legislative

> measures on aviation. These measures were based on the Commission's proposals in Civil Aviation Memorandum N° 2.[1]

1.2 First Package, December 1987

In 1983 the Council adopted Directive 83/416/EEC to liberalise some inter-regional air services in the Community, but Member States still insisted on a number of restrictive conditions. This was followed by a more general package of measures, the First Aviation Liberalisation Package, agreed in December 1987. The First Package essentially left the bilateral framework in place but relaxed some restrictions. It removed 'single designation' provisions so that any number of airlines were able to operate on the major international routes in the Community; overrode the insistence of a number of Member States that their national airline be given a fifty per cent share of the market; removed most capacity restrictions; gave airlines automatic but limited right to operate 'fifth freedom' services linking points in the territories of two or more other Member States; and removed the ability of Member States to block proposals for economic low fares. The relevant legislative instruments were as follows:

- Regulation 3975/87/EEC set down the procedure for the application of the rules on competition to undertakings in the air transport sector;
- Regulation 3976/87/EEC set out how Article 85(3) of the EC Treaty would apply to certain categories of agreements and concerted practices in the air transport sector;
- Directive 87/601/EEC provided rules on fares for scheduled air services between Member States; and
- Decision 87/602 set down rules on the sharing of passenger capacity between air carriers on scheduled services between Member States and on access for air carriers to scheduled air service routes between Member States.

As a result of the First Package a number of smaller airlines were enabled to enter some of the more important intra-Community routes or to provide the capacity and charge the fares that they wished. These included existing airlines such as British Midland and Hamburg Airlines and new entrants such as Air Europe and Ryanair. Aer Lingus established a fifth freedom service on routes from Dublin to Manchester and on to other points such as Amsterdam, Paris and Copenhagen.[2]

However, the First Package was time-limited and included a requirement that it be revised by 1990 and further measures adopted in 1992. A 1989 Communication from the European Commission summarised the position as follows:

> Although the package of December 1987 constitutes a sound foundation on which to build a comprehensive common air transport policy, it has to be regarded only as a first phase. It was specifically stated in both the directive on fares and the decision on capacity sharing and market access that the Council would decide on their revision by 30 June 1990, on the basis of Commission proposals to be submitted by 1 November 1989. It was also stated that, in view of the completion of the internal market in air

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1 COM(89) 373 final, 8 September 1989, pp2-3

2 for more information on low cost airlines, see HC Library standard note SN/BT/3024

transport by 1992, the Council would adopt further measures of liberalisation at the end of the three year period covered by the first package.[3]

1.3 Second Package, July 1990

The Second Aviation Liberalisation Package, agreed in July 1990, comprised three Council regulations on fares, market access and the application of Article 85 of the EC Treaty. It built on the First Package by introducing an element of 'double disapproval' for fares under which a fare set by an airline for a route between Member States would be permitted unless both States disapproved it; this applied to applications for increases in fares above five per cent. The Second Package also opened up routes between almost all European Community airports; relaxed restrictions on fifth freedom services; and eased restrictions on multiple designation of airlines on particular routes. A report by the House of Commons Transport Select Committee, published in December 1991 explained the changes in the Second Package in the following terms:

> The "Second Package" of three Council Regulations on fares, market access and the application of Article 85 of the Treaty of Rome was agreed by the Council in June 1990 and built on the first set of measures. It introduced an element of "double disapproval" into fares setting, opened up routes between almost all European Community airports, relaxed restrictions on fifth freedom services within the Community and eased the restrictions on multiple designation of airlines on particular routes.
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> Under "double disapproval", a fare set by an airline for a route between Member States is permitted unless both States disapprove it. At present, on most routes, fares can be blocked by the governments of either State connected by the route. From 1January 1993 full double disapproval will apply and airlines will be able to charge the fares they consider appropriate unless the fare has been disapproved by both States. In the Department of Transport's view, the new system will remove barriers to the introduction of cheaper fares and allow airlines to respond to the market more freely.
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> The proposals on market access and capacity sharing 3 refer to the adoption of "further measures including cabotage ... by 30 June 1992" and contain a commitment, in Article 3(2), to adopt '(for implementation not later than 1 July 1992 ... rules governing licensing of air carriers and route licensing." This would oblige a Member State to grant an operating licence to any carrier in that State, without discrimination, provided that it met the necessary technical and financial standards.
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> Although the details have still to be worked out, the commitment to apply uniform criteria in deciding whether to grant operating licences to airlines marks an important step towards the goal of ensuring that Member States do not give undue preference to their "flag carriers". In addition, the Commission aims to make it easier for airlines to offer new services on existing routes. To this end, the thresholds' for multiple designation are to be lowered to 100,000 passengers from 1992. At the same time, the Commission proposes a gradual reduction of capacity controls on routes between Members States. The complete abolition of both bi-lateral capacity sharing and multiple designation thresholds is envisaged for 1 January 1993.[4]

The relevant legislative instruments were as follows:

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3 op cit., COM(89) 373 final, p3

4 Transport Committee, *Developments in European Community Air Transport Policy* (first report of session 1991-92), HC 147, 18 December 1991, paras 3-6; see also: HL Select Committee on the European Communities, *Civil Aviation: A Free market by 1992?* (sixteenth report of session 1989-90), HL Paper 63, 5 June 1990, paras 4-9

- Regulation 2342/90/EEC provided rules on fares for scheduled air services, revoking Directive 87/601/EEC;

- Regulation 2343/90/EEC set down access for air carriers to scheduled intra-Community air service routes and rules on the sharing of passenger capacity between air carriers on scheduled air services between Member States, revoking Decision 87/602/EEC; and

- Regulation 2344/90/EEC amended to Regulation 3976/87/EEC on the application of Article 85(3) of the EC treaty to certain categories of agreements and concerted practices in the air transport sector.

In January 1991 the UK Government complained to the European Commission about a number of fares charged by airlines during 1990. At the end of November 1991, the Commission ruled that some 40 fares were excessively high but those fares remained in place and airlines were not required to refund money to passengers.

1.4 Third Package, June 1992

It is only with the Third Aviation Liberalisation Package that a substantially liberalised internal Community market was achieved. The Commission set out its intentions in a September 1991 Communication:

> Three proposals are [made] namely
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> a. Licensing of air carriers
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> b. Market access
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> c. Air fares and rates
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> In order to establish a clear legal situation these three proposals will cover all types of civil aviation. This means for example that air cargo has been incorporated In these texts.
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> [...]
>
> a. Licensing of air carriers [...]
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> Due to basic characteristics of the International aviation system, requirements on Community ownership, control and location are required. An air carrier must be owned and effectively control led by a majority of Community nationals and the majority of the board must consist of such nationals [...] It is [however] desirable to introduce a possibility to conclude more liberal agreements with third countries on a mutually beneficial basis, without prejudice to international commitments [...]
>
> The Commission has opted for a set of simple but clear economic and financial standards defining acceptable levels below which a licence should not be granted or maintained [...]
>
> The Commission has very carefully examined the need for linking operating licences to different types or scopes of economic activity (i.e. scheduled, non-scheduled, regional, etc.) These studies have led the Commission to the conclusion to abstain, apart from somewhat less strict rules for carriers operating with very small aircraft, from proposing specific rules for specific types of air carriers [...]
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> b. Market access [...]

[A] possibility already exists to protect an airline on a new route for up to 2 years and to Introduce a public service obligation for a limited period. These provisions should be retained and, where necessary, developed further. 5th freedom traffic rights are still limited but should in accordance with Council commitments be passenger flights and air cargo [...]

It would seem clear that any air carrier which has been licensed by a Member State must have an equal opportunity to be given a route licence and it would be illogical that multiple designation thresholds (if they are retained) would only be used for incoming air carriers and not also with respect to the country of origin as well.

It may be argued, however, that air carriers operating on routes not covered by public service requirements or rules on the protection of new services operated with small aircraft need to some extent to be protected against new entrants [...] The Commission has ... reached the conclusion that further safeguards In addition to already protected areas would - at the end - most probably turn out to be counter-productive because It would stifle the normal competitive effects of market forces [...] Instead of proposing separate rules to protect these services the Commission has decided to propose a redefinition of the rules related to public services requirements [...]

c. Air Fares and rates [...]

The Commission ... proposes that when normal competitive conditions have been established in civil aviation then pricing must be free. The present set of proposals needs a certain time to take effect but after three years this should be the case except where special conditions exist such as congestion and it is therefore proposed that free pricing should be introduced in 1996 for scheduled air services. The present situation of free pricing for non scheduled air services and air cargo should not be modified [...]

[Where] the Commission [is called upon] to examine fares if requested by a Member state ... It is proposed to restrict the possibility of submitting an air fare for examination by the Commission to fully flexible fares being charged on routes on which. for one reason or another. competition is limited. This will restrict the use of safeguards to be added to a double-disapproval system to situations where this system would not work well because of insufficient competition. It is also proposed that an air fare which has been submitted for examination by the Commission shaII not be suspended but wiII remain in force during the examination [...]

d. A specific Issue - Non-scheduled air services [...]

The Commission is of the opinion that a strong case for establishing two sets of rules does not exist. It has therefore decided to propose to Integrate the different air transport modes. This means in particular to attach basically the same rules on fares (With specific provisions for IT-fares), market access and operating licences to all air carriers.[5]

The Regulations comprising the Third Package had direct effect in law but certain changes had to be made to UK legislation where these conflicted with the provisions in the Regulations. The relevant legislative instruments were as follows:

- Regulation 2407/92/EC (the Licensing of Air Carriers Regulation) provided for common specifications and criteria for the licensing of carriers and the provision of a Community air transport certificate with effect from 1 January 1993. Included in the Regulation was a statutory requirement for air carriers to hold insurance to cover

[5] COM(91) 275 final, 18 September 1991, pp7-18

liability in case of accidents in respect of passengers, luggage, cargo, mail and third parties. Governments are not allowed to discriminate between airlines seeking licences to establish themselves on their territory other than for technical or economic reasons such as solvency of financial viability. Any airline which meets common safety, nationality and fitness criteria is entitled to an operating licence anywhere in the Community. The restrictions on charter airlines and limits on the number of 'seat only' sales are abolished. Separate rules apply for airlines operating light aircraft;

- Regulation 2408/92/EC (the Route Access Regulation) set out the rules on access for Community air carriers to intra-Community air routes. From 1 January 1993 airlines would have full access to all routes between Member States and the right to offer services between airports in two other Member States, the so-called seventh freedom of the air. Full, unrestricted access to all routes within the Community commenced on 1 April 1997 for both scheduled and charter services, the eighth freedom of the air (also called 'consecutive cabotage'). Article 6 provided safeguards for new inter-regional services and Article 10 prevented capacity limitations except for environmental and/or air traffic reasons;

- Regulation 2409/92/EC (the Fares Approval Regulation) set down further rules on fares and rates for air services; that from 1 January 1993 airlines would be able to set their own fares on services both within and between Member States subject to the safeguards against unfair pricing (including notification to the Commission);

- Regulation 2410/92/EC amended Regulation 3875/87/EEC regarding the procedure for the application of the rules on competition to undertakings in the air transport sector; and

- Regulation 2411/92/EC amended Regulation 3936/87/EEC on the application of Article 85(3) of the EC Treaty to certain categories of agreements and concerted practices in the air transport sector.

The Licensing of Air Carriers Regulation, the Route Access Regulation and the Fares Approval Regulation were repealed in 2008 and their provisions recast in a single Air Services Regulation (ASR) (Regulation 1008/2008/EC), which came into force on 1 November 2008. Some aspects of the Regulation required secondary legislation to fully implement them in the UK. Chapters I to III of the ASR were implemented by *The Operation of Air Services in the Community Regulations* (SI 2009/41) which came into force on 26 January 2009.

The 2009 Regulations sought as far as possible to replicate arrangements for UK implementation and enforcement of the Third Package by setting out the role of the CAA in issuing, suspending and revoking airline operating licences - including a right of appeal to the Secretary of State against CAA's decisions; the roles of the CAA and Secretary of State in approving aircraft leasing arrangements; the duties of the Secretary of State in relation to Public Service Obligations (PSOs); the powers for the Secretary of State to require airlines with an operating licence issued by the CAA to provide information in certain circumstances; and offences and criminal penalties relating to the above. In March 2010 the Labour Government published a further consultation on a second UK implementing regulation for the ASR, to establish a new enforcement regime for the pricing provisions of Chapter IV of the

ASR and to amend the 2009 Regulations to include a right of appeal against certain decisions on aircraft leasing by the CAA and Secretary of State.[6]

2 State aid, including Public Service Obligations (PSOs)

Competition can be restricted not only by businesses but also by governments, if they grant public subsidies to businesses. For this reason, the EC Treaty in principle prohibits any form of State aid that is likely to distort intra-Community competition, on the grounds that it is incompatible with the common market. However, an absolute ban would be untenable, so the Treaty provides for a number of exceptions to the principle prohibiting aid.[7] Subsidies for airlines take various forms, including operational grants, direct subsidies and indirect financial assistance. Examples include capital injections, debt write-offs, fare subsidies, and favourable tax treatments, as well as less visible forms of state support which nonetheless favour national airlines.

In February 1994, a report was published by Comité des Sages (on behalf of the European airline industry, and sponsored by the Commission). The background to this report was the wave of capital injections and State aid cases submitted for approval to the Commission. The Committee attributed this to the disappearance of traditional forms of regulatory protection and the financial strains within the airline industry. The report rejected any rolling-back of the deregulation already underway and recommended that state-owned airlines should be prepared for eventual privatisation. The Committee felt, however, that one last dose of State aid might be needed to put the industry back on its feet.[8]

In June 1994 the Commission published its response to the report. It recognised the importance of applying the Market Economy Investor Principle (MEIP)[9] to air transport, to bring an end to financial injections that were not consistent with commercial practice, although they recognised rather reluctantly that 'one last chance' restructuring aid might be given in certain circumstances.[10] In late 1994, the Commission adopted revised Guidelines on the application of the state aid rules in the aviation sector. The Guidelines applied a number of principles to Commission decisions on State aid, including:

- the aid must form part of a global restructuring programme, to enable the airline once more to become viable without additional aid;
- any airline that has benefited from aid, would not be authorised to receive further financial assistance, except in exceptional and unforeseen circumstances beyond the airlines' control;
- provision must if necessary be made for reductions in capacity;

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6 DfT, *The EC Air Services Regulation: consultation on pricing enforcement regime and leasing appeals*, 15 March 2010 [this closes on 7 June 2010]

7 for details of how the rules apply, as set out in Articles 87-89 of the EC Treaty, see: EP factsheet, *State aid*, August 2006 [EN 3.3.3]

8 Comité des Sages, *Expanding horizons: civil aviation in Europe, an action programme for the future*, January 1994 [a copy of this report is available on request from the House of Commons Library]

9 the essence of the MEIP is that when a public authority invests in an enterprise on terms and in conditions which would be acceptable to a private investor operating under normal market economy conditions, the investment is not a State aid; for a fuller explanation, see: "The Market Economy Investor Principle", *EC Competition policy newsletter*, June 2002

10 COM(94) 218 final, 1 June 1994, paras 41-42

- under no circumstances should the aid or the related programme aim to increase capacity to the detriment of other transporters in the European Economic Area (EEA);

- a government must not embroil itself in the management of an airline for non-commercial reasons;

- the aid must only be used to fulfil the restructuring programme and must not be disproportionate in relation to the needs of this programme, the airline must refrain from acquiring shares in other transport companies;

- the ends to which the aid is put and the manner of its use, must in no way be contrary to competition, nor prejudicial to the implementation of EU regulations for liberalisation (notably the Third Package); and

- the aid must be transparent and subject to control.[11]

Where aid takes the form of a financial injection it is normally subject to an investigation under Article 88(2) of the EC Treaty. States are meant to inform the Commission in advance, under Article 88(3).[12] Prior to September 11 there were a few notable cases, such as:

- **Aer Lingus:** The Irish Government formally notified the Commission in August 1993 of its intention to inject I£175 million into Aer Lingus a part of a restructuring plan aimed at reviving its loss making national airline. The Commission approved the aid in December 1993 subject to a number of conditions including conditions on capacity – the first time that such had been attached to the approval of State aid.

- **TAP:** In January 1994, the Portuguese Government applied to the Commission for approval to give TAP Esc180 billion (£710 million) in the form of borrowing guarantees and tax exemptions in order to finance a restructuring plan involving 2,500 job losses (from a total of 9,600 employees). The Commission decided in July 1994 to allow the aid, subject to conditions, including the abolition of tax advantages, payment in tranches subject to the achievement of operating results for each year, and a ban on investment in other airlines.

- **Olympic:** The Commission published its initial assessment of the Greek Government's application for approval to give Dr371 billion (£995 million) in association with a restructuring plan for Olympic in March 1994. The Commission decided to allow the aid in July 1994, subject to a number of conditions, including that Olympic should not act as price leader on Athens-Stockholm and Athens-London and that the exemption of the Greek islands from the EC Market Access rules should be lifted in June 1998.

- **Air France:** The French Government notified the Commission in March 1994 of its intention to provide FF20 billion (£2.4 billion) of aid to Air France over a three-year period in connection with a rather lenient restructuring plan. The Commission opened proceedings in June 1994 and a number of states (including the UK) submitted comments, as did a number of UK and European airlines. In the light of these comments, the French Government made a number of commitments about the conduct of Air France during the restructuring period (1994-97). The Commission

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[11] OJ No C 350, 10 December 1994

[12] at the time when the following cases occurred, these provisions were contained in Article 93 of the Treaty

decided to allow the aid (the largest ever in the transport sector) in July 1994, subject to these undertakings and a number of minor conditions. In May 1997 a group of six European airlines (British Airways, TAT, SAS, KLM, Air UK and Eurolair) launched a challenge in the European Court of Justice to the Commission's decision. The Court ruled in favour of the airlines on 25 June 1998. On 22 July the Commission confirmed its 1994 decision - though it provided more detailed arguments on the two points raised by the Court: Air France's purchase of new planes and the competitive situation of Air France on routes outside the European Economic Area (EEA), in particular its transatlantic routes.[13]

- **Iberia:** In January 1996 the Commission approved the immediate payment of Pta87 billion (£460 million) to Iberia and left the door open for a further payment of Pta20 billion (£106 million) in 1997. The Commission held that payments were compatible with the MEIP and did not therefore constitute State aid.

- **Alitalia:** The Commission announced in October 1996 an investigation into the restructuring plans of Alitalia because of concerns that a L3,000 billion (£1.3 billion) capital injection breached the State aid rules. Neil Kinnock, then EU Transport Commissioner, rejected the restructuring plans in April 1997 on the grounds that it involved an injection of public funds without sufficient guarantee of a viable return. The Commission criticised the plan for failing to cut unit labour costs and reduce routes. Alitalia proposed a new restructuring plan in July 1997 and the capital injection was reduced and some conditions attached. In February 1998 the Commission decided not to reopen its inquiry into the way Alitalia was using its authorised aid following assurances from the Italian Government. The authorities undertook to ensure that Alitalia abide by the conditions laid down in July 1997.

Following the terrorist attacks in the United States on September 11 2001 the Commission announced that it considered that aid to the aviation industry to compensate for the losses directly resulting from the terrorist attacks was permissible. Specifically, the Commission would give favourable consideration to measures to compensate airlines for losses resulting directly from the four-day closure of American airspace and it would examine the assumption of the additional costs of insurance for a maximum period of one month and the temporary continuation of intervention by Member States until the end of 2001 should the need for such cover persist, on condition that this does not place the airlines in a more favourable position than prior to the withdrawal of their insurance cover.[14]

The UK Government offered £40 million to compensate airlines for losses arising directly from the September 11 terrorist attacks.[15] Compensation under the scheme covered lost revenue over the period during which airspace was closed. It also compensated for additional costs incurred during that period, such as (but not limited to) airport and airspace charges, costs incurred in transporting passengers from their diverted destination to their intended destination, additional operating costs of diverted aircraft and additional crew costs. The Government notified the European Commission that the package was in conformity with Commission guidelines on State aid. In addition, the Government underwrote, on a temporary basis, third party war risk insurance for UK airlines and service providers to the

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13 European Commission press notice, "Commission confirms its position on aid to Air France", 22 July 1998

14 European Commission press notice, "Terrorist attacks: emergency measures for air transport", 10 October 2001

15 HC Deb 13 December 2001, cc1013-14W

airline industry. This was first announced on 21 September 2001 and was extended on a monthly basis thereafter.

The Belgian Government provided a one-month bridging loan of €125 million to Sabena and the French Government made a grant of some €55 million in emergency aid to French airlines. In Switzerland a complex financial package was put together in the wake of the collapse of Swissair, which included some €650 million of direct aid from the Swiss federal and Canton Governments.[16]

Another strand of State aid is the Route Development Fund (RDF), as outlined a European Commission communication in December 2005.[17] A Scottish RDF was established in November 2002 supporting 32 routes. The UK RDF has two elements – one for Wales and one for the North East of England.

As for public service obligations (PSOs), Article 4 the Route Access Regulation harmonised the procedures for ensuring the operation of lifeline air routes. The PSO provides the basis on which non-commercial but socially and economically necessary air services can be subsidised by national or local authorities, notwithstanding the single market. This has since been replaced by the provisions in Article 16 of the Air Services Regulation (see section 1.4, above). Articles 16(1) to 16(3) state:

> A Member State, following consultations with the other Member States concerned and after having informed the Commission, the airports concerned and air carriers operating on the route, may impose a public service obligation in respect of scheduled air services between an airport in the Community and an airport serving a peripheral or development region in its territory or on a thin route to any airport on its territory any such route being considered vital for the economic and social development of the region which the airport serves. That obligation shall be imposed only to the extent necessary to ensure on that route the minimum provision of scheduled air services satisfying fixed standards of continuity, regularity, pricing or minimum capacity, which air carriers would not assume if they were solely considering their commercial interest. The fixed standards imposed on the route subject to that public service obligation shall be set in a transparent and non-discriminatory way.
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> In instances where other modes of transport cannot ensure an uninterrupted service with at least two daily frequencies, the Member States concerned may include in the public service obligation the requirement that any Community air carrier intending to operate the route gives a guarantee that it will operate the route for a certain period, to be specified, in accordance with the other terms of the public service obligation.
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> The necessity and the adequacy of an envisaged public service obligation shall be assessed by the Member State(s) having regard to:
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> (a) the proportionality between the envisaged obligation and the economic development needs of the region concerned;
>
> (b) the possibility of having recourse to other modes of transport and the ability of such modes to meet the transport needs under consideration, in particular when existing rail services serve the envisaged route with a travel time of less than three hours and with sufficient frequencies, connections and suitable timings;
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> (c) the air fares and conditions which can be quoted to users;

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16 HC Deb 12 February 2002, cc222-23W

17 2005/C 312/01, 9 December 2005

(d) the combined effect of all air carriers operating or intending to operate on the route.

There are three airlines in the UK in receipt of PSOs; they operate 26 services in Scotland and Wales.[18]

3 Airport slot allocation

Information on airport slot allocation after 2002 can be found in HC Library standard note SN/BT/488, available on the Parliament website.

It was widely recognised that for the full benefits of the liberalisation of air transport to be realised, the system of allocating airport runway slots at EU airports would have to be revised. The then Transport Secretary, John MacGregor, announced in October 1992 that the UK was using its Presidency to work for a Regulation to allow new airlines access to slots.[19]

It was agreed in 1992 that changes in the allocation of runway slots would have to be tackled at community level if the benefits of liberalisation of air transport were to be realised. Regulation 95/93/EEC ('the Slot Allocation Regulation'), as amended by Regulation 894/2002/EC and 793/2004/EC, was implemented in the UK by the *Airport Slot Allocation Regulations 1993* (SI 1993/1067) and came into effect in May 1993. It is based on the IATA rules but with some amendments. It applies to all airports that have been designated as 'fully co-ordinated', i.e. those airports where there is insufficient capacity to meet demand. The Regulation was extended to include airports in Norway and Sweden in August 1993 and in July 1994 to airports in Austria, Finland and Iceland. In the UK only London Heathrow, Gatwick, Stansted, London City and Manchester are co-ordinated airports.[20] The system for allocating time slots at other airports is based on the IATA system for non-EU airports.

The Slot Allocation Regulation required the formation of a co-ordination committee at co-ordinated airports. Member States were given discretion on whether to establish committees for their co-ordinated airports. Membership of the co-ordination committees includes airlines, the airport operator, air traffic control, and general and business aviation representatives. All airlines using the airport can be represented on the committee but votes are weighted by the number of slots an airline has at the airport. The role of the co-ordination committee is, *inter alia*, to advise the co-ordinator on matters such as increasing airport capacity, methods for monitoring the use of allocated slots, local guidelines etc. The co-ordination committee can also deal with any complaints on the allocation of slots. The Regulation was innovative in that it insisted on the co-ordinator in charge of sharing out the slots being independent of Government, airlines and airport management.

The main provisions of the Regulation which affected the practical arrangements for slot allocation were:

- recognition of the long established principle of 'grandfather rights' under which an airline holding and using a slot in one summer season or winter season has first claim on that slot in the next equivalent season;

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18 a list of these routes is available on the European Commission website

19 DoT press notice, "EC must tackle airport slot allocation", 21 October 1992

20 London City was designated as a co-ordinated airport in 2009 following two rounds of consultation by the Government; the document outlining the Ministerial decision is available on the DfT website

- recognition of the secondary rules established by IATA including the period of use of a slot and re-timings of existing slots for specific reasons which are given priority over completely new slot demands;

- the creation of a slot pool into which are placed newly created slots (through increases in hourly scheduling limits); slots returned either voluntarily or under the 'use it or lose it' condition and slots otherwise unclaimed under grandfather rights or the IATA secondary rules;

- allocation of fifty per cent of the pool slots to new entrants[21] unless they request less; and

- a requirement that airlines must use their slots for at least 80 per cent of the period for which they are held or, subject to certain specified exceptions, the slots are withdrawn and placed in the pool.

In the UK the airport authority has the ultimate statutory authority for the allocation of slots at the airport under the *Airports Act 1986*. Airport Co-ordination Limited (ACL) is the airport co-ordinator at the UK's major airports; it is an independent company owned by nine major UK airlines, both scheduled and charter.

A CAA report in 1993 found that early indications were that airlines were releasing unwanted slots rather sooner than they might have done in order to avoid the slot being formally withdrawn under the 'use-it-or-lose-it' condition.[22] New entrants at London Heathrow had been able to take advantage of newly-created slots which had been placed in the pool but only for services on 'thinner' routes where competition was absent. A CAA report on the first five years of the single aviation market found that airport congestion at some of the EU's most congested airports had worsened over the five years since the introduction of the single market. The position was most stark at London Heathrow and Gatwick, Frankfurt, and Dusseldorf. The report made the point that it is on the densest routes where market entry would be most likely to occur and competition would be most likely to flourish were it not constrained by route congestion.[23]

The Slot Allocation Regulation placed a duty on the European Commission to report to the European Parliament on the Regulation's effects three years after its entry into force and to place a proposal for the continuation or revision of the Regulation before the European Council by 1 January 1996. This deadline was missed and there was reported disagreement in the Commission about the possible trading of airport slots. The UK Government put forward a suggestion to the Commission that a revised system should adopt a market-based approach to slot allocation, with the auctioning of newly-created and recycled slots, and legitimised and transparent trading of slots between air carriers.[24] According to press reports, however, only a minority of Member States backed the idea of slot trading: twelve Member States and all the big airports were said to oppose the idea.[25] In June 2001 the European Commission eventually published a proposal for a limited revision of the Slot Allocation Regulation[26] followed by an amended version for consultation in November 2002.

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21 defined in Article 2 of the Regulation

22 CAA, *Slot allocation: a proposal for Europe's airports* (CAP 644), February 1995

23 CAA, *The Single European Aviation Market,: the first five years* (CAP 685), June 1998, para 182

24 HL Deb 23 April 2001, cc18-19WA

25 "EU trims plans for air 'slot' changes", *Financial Times*, 23 May 2001

26 COM(2001) 335 final, 20 June 2001

On occasion, it is deemed necessary for the rules surrounding the 'use it or lose it' requirements of the Regulation to be suspended. The rule (mentioned above) states that if an airline fails to use its slots for 80 per cent of the time they are returned to the pool to be reallocated by the coordinator to other airlines, amongst which new entrants to an airport have priority.

The European Commission proposed a temporary suspension of the rule following the September 11 terrorist attacks on the United States and the subsequent impact of those attacks on the airline industry. This would essentially treat the slots allocated for the summer 2001 and winter 2001-02 seasons as if they had grandfather status, meaning that less than 80 per cent usage would not lead to the slots being removed from an airline.[27] This was legislated for in Regulation 894/2002/EC.

4 The impact of liberalisation

In October 1996 the European Commission published a communication on the impact of the Third Package, only three years after the measures had first been implemented and six months before 'full cabotage' would be complete. The Commission concluded that liberalisation had happened "in a progressive way and without major upsets" and there had been no 'big bang': "there has been no spectacular reduction in the fares, nor any dramatic disappearance of the more important carriers, nor a substantial penetration of the domestic markets by foreign competitors". However, the Commission concluded that "effects of this process, although slow, are nevertheless quite clear and it is satisfactory to note that in the end almost all operators have made use of the new possibilities offered by the third package":

> For example, when the third package was introduced there were 490 routes, there are now approximately 520. This increase contrasts with the situation which prevailed in the United States. 30% of the Community routes are served by two operators and 6% by three operators or more. It should be noted that out of the 64% of routes operated as a monopoly a large number of them have low levels of traffic and are of no interest to most other carriers. Furthermore a certain number of the other routes experience real competition from neighbouring routes, from charter services or from other modes of transport. One of most interesting developments certainly is the fact that the number of operators, on a significant number of domestic routes, passed from one to two. Moreover, the dominant carrier's market share often fell to the advantage of the second carrier. The possibilities of access to the market have been used: there' arc now 30 routes operated on a 5th freedom basis as opposed to 14 in January 1993; routes operated with cabotage traffic grew from 0 in 1993 to 20 today. The public service obligations have been used on a hundred routes in Ireland, Sweden, the United Kingdom, Portugal, France and Norway.
>
> Capacity increased but did not reduce the load factors in an unacceptable way.
>
> It is certainly in respect of the creation of new airlines that market dynamics have been most visible. Over the three years 800 licences has been granted, the majority going to small operators : 80 companies has been created, for the most part private companies, while 60 have disappeared. Increased competition from the charter companies on regular routes should also be highlighted. More important, new entrants appeared on the markets of the United Kingdom, France, Germany, Denmark, Ireland, Spain, Italy, Greece, Austria and Belgium. Their entry into the market - has often contributed to a fall in the fares.

[27] COM (2002) 7 final, 11 January 2002

> The downside of liberalisation is that the fall in air fares has been felt only on the routes where competition has been fully realised i.e. where more than two airlines operate. Certain categories of fares have fallen significantly on routes such as Barcelona/Madrid, UK/Ireland, Paris/London, certain domestic routes in Germany, in France, in Italy, in UK and in Belgium towards a number of European destinations. In general, the structure of the fares on scheduled flights remains complex and sometimes seems non-transparent thus preventing the users from benefiting from the competition.
>
> If the third package has been implemented in 1993 and 1994 because of the economic recession, the pace has accelerated since 1995 and 1996 and results are encouraging. However, it is clear that, if the "foundations" of liberalization have been well established, much still remains to be done to make it a complete success.[28]

In 1998 the CAA published a report on the first five years of the single aviation market.[29] This was followed by a further communication by the European Commission in 1999.[30]

The CAA report found that the liberalisation of European aviation had resulted in a substantial increase in competition, although this could be undermined by the growth in airline alliances and by airport congestion. While the single market had not led to a reduction in the number of European airlines, one reason for this was the inability of major airlines to exploit long-haul traffic rights out of other Member States due to the absence of EU-wide aviation agreements with third countries. The share of national carriers of international routes was 80 per cent, down from 90 per cent in 1992. It found that the effects of deregulation in aviation were analogous to those in other markets. It had brought steady growth to smaller and medium-sized airlines and a consequent fall in the market share of the national carriers. On routes where significant new entry had occurred air fares usually fell. This, however, had not been true on routes where national carriers retained their monopolies. Overall, national carriers' dominance of scheduled flights had fallen from 80 per cent in 1992 to 70 per cent in 1997 but in some domestic markets this share had fallen from 75 per cent to 60 per cent.[31]

The Commission's 1999 communication stated that, whilst the increasingly competitive aviation environment had brought benefits to consumers, some of the responses by the airlines to this environment could undermine these benefits, such as:

> The proliferation of tariffs, over-booking, the availability of seats at the most publicised promotion, fare, the growth in FFP's [frequent flyer programmes] code-sharing and airline alliances, can all make it harder for consumers to compare competing offers. As competition increases, market transparency needs to be assured, if consumer confidence is to be maintained. A competitive and efficient air transport market depends as much on well-informed consumers, in a position to make rational choices, as efficient providers. The recent initiatives on denied boarding and computerised reservation systems have gone someway to address these issues. The Commission has also commissioned a study to examine the information' passengers need to make rational choices.[32]

The Commission also indicated that it was investigating the regulatory and commercial barriers restraining the complete development of competition in the aviation single market.

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28 COM(96) 514 final, 22 October 1996, pp1-2
29 op cit., *The Single European Aviation Market,: the first five years*
30 COM(1999) 182 final, 20 May 1999
31 op cit., *The Single European Aviation Market,: the first five years*, summary
32 op cit., COM(1999) 182 final, p18

Part of this was the commissioning of a study which found that there was an overall consensus that the regulatory regime was working well, albeit with the following concerns (in order of priority):

> Access to slots/airport capacity problems: this seems to be the single, most important barrier, especially for airlines seeking to compete "head-to-head" with the flag carriers. Barriers arise from the functioning of the slot pool and the slot allocation', mechanism [...]
>
> Loyalty schemes: they comprise both frequent flyer programmes (FFPs) and corporate discounts, but the majority of airlines' concerns relate to FFPs. The effectiveness of FFPs stems from the asymmetry between the interest of the corporate traveller, who enjoys the FFP benefits, and the employer, who pays for the ticket. The key barriers reside in the fact that FFPs favour airlines with large networks, which offer travellers greater chances to accumulate and use FFPs points. In contrast there is little scope 'for small and medium carriers to operate such schemes, because their networks are too small to make them attractive [...]
>
> Differences in regulatory environment: several of the interviewed airlines are concerned about the attitude of national authorities in some Member States towards emerging competition in particular in the areas of slot allocation, negotiation of bilateral agreements covering access to non EU markets, award of Public Service Obligation (PSO) contracts and other special 'situations requiring. ad hoc decisions.
>
> Ground handling charges and quality: most of the airlines complain about the high cost and low quality of ground handling services.[33]

[33] ibid., pp19-20