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AIRLINE COMPETITION

-- Note by the United Kingdom --

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1. Introduction

1. This paper is submitted by the United Kingdom's Competition and Markets Authority ('CMA'), the UK's lead competition and consumer authority. From 1 April 2014, the CMA came into operation taking over many functions of its predecessor bodies, the Office of Fair Trading ('OFT') and the Competition Commission ('CC').¹

2. The CMA's aim is to make markets work well for consumers, businesses and the economy. Its powers and responsibilities cover competition law enforcement, market studies and investigations, consumer protection, and merger control. In relation to the airlines sector, the CMA shares concurrent competition (but not merger control) and consumer powers with the Civil Aviation Authority ('CAA').

3. The CMA and its predecessor bodies have undertaken a portfolio of work in the airlines sector including:

- A number of airline mergers
- An abuse of dominance investigation under Chapter II of the Competition Act 1998 and/or Article 102 of the Treaty on the Functioning of the European Union (TFEU)
- A market investigation of UK Airports
- In addition, consumer enforcement action under the Enterprise Act 2002 against certain airlines concerning the display of the price of flights, regarding breaches of the Air Services Regulations (ASR),² and/or the Consumer Protection from Unfair Trading Regulations (CPRs)^{3,4} and Guidance for airlines and other businesses regarding (among other things) the presentation of flight prices.⁵

4. The CMA below reviews some of the issues raised by the OECD, drawing on its experiences in these cases. The contribution considers (I) the structure and functioning of the airline sector (II) market definition (III) mergers (IV) abuse of dominance and (V) pricing and ticket selling.

¹ The CMA was established under Part 3 of the Enterprise and Regulatory Reform Act 2013

² The ASR sets out common rules for the operation of air services in the EU. It sets out provisions relating to airline operating licences, aircraft registration and leasing, access to routes and traffic distributions rules. In addition to these requirements Article 23 of the ASR sets out the transparency requirements for the display of airfares. For more information see: Regulation (EC) No 1008/2008 of the European Parliament and of the Council of 24 September 2008 on common rules for the operation of air services in the Community OJ 1998 L293/3.

³ The Consumer Protection from Unfair Trading Regulations 2008, implementing Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market (the Unfair Commercial Practices Directive), OJ 2005 OJ L149/22. The Regulations ban certain practices, and outline that practices which are misleading, aggressive, or contrary to the requirements of professional diligence are illegal where they cause the average consumer to take a different transactional decision. See http://www.offt.gov.uk/shared_offt/business_leaflets/cpregs/oft1008.pdf

⁴ For more information go to www.offt.gov.uk/OFTwork/consumer-enforcement/consumer-enforcement-completed/card-surcharges/ and [https://www.caa.co.uk/default.aspx?catid=2600&pagetype=90&pageid=14691;](https://www.caa.co.uk/default.aspx?catid=2600&pagetype=90&pageid=14691)

⁵ <http://www.offt.gov.uk/news-and-updates/press/2013/28-13#>.

1. The structure and functioning of the airline sector

1.1 Boundaries of the airline sector

5. The UK has examined the airline sector in terms of passenger transport being distinct from freight transport.⁶ It has not undertaken any cases specific to freight. It has also examined B2B transactions, for example, in in-flight catering services.⁷

6. However, the UK has not examined airlines and airports together in any of its work on airlines or airports. For example, in its BAA airports market investigation, the CC did not consider it appropriate to define separate airport markets according to user or type of use (that is, between, for example, passenger and freight users), since it did not find sufficient evidence of price variations between these groups that were not related to costs.⁸

1.2 Parameters of competition

7. The OFT and CC have both found that airlines compete across a wide range of factors including price, actual origin/destination locations, potential origin/destination locations, in-flight service levels, frequencies of flights, capacity, airports of departure/arrival, times of departure/arrival and travel times. Moreover, other parameters relevant to competition are frequent flyer programmes, airport lounges and alliance membership (particularly at hub airports).

2. Market definition

8. The approach taken by the UK authorities to market definition in the airline sector has been relatively consistent over time. In relation to product scope for passenger air transport, the CMA and its predecessor bodies have:

- In line with European Commission decisions,⁹ taken a cautious approach and not found indirect and direct flights to be substitutes.¹⁰ They have also separately considered chartered and scheduled flights,¹¹ and business and leisure air passenger transport services¹²

⁶ For example, in *A report on the completed acquisition by Ryanair Holdings plc of a minority shareholding in Aer Lingus Group plc*, 28 August 2013

⁷ *A report on the proposed joint venture between Alpha Flight Group Limited and LSG Lufthansa Service Holding AG*, 14 March 2012

⁸ Competition Commission, *BAA airports market investigation: A report on the supply of airport services by BAA in the UK*, 19 March 2009

⁹ See for example Case M.4439 *Ryanair/Aer Lingus* (27 June 2007); Case M.3280 *Air France/KLM* (11 February 2004); In relation to scheduled and chartered flights, see Case M.2008 *AOM/Air Liberté/Air Littoral* (27 July 2000)

¹⁰ See for example *Completed acquisition by Air France finance S.A.S / City Jet Ltd of VLM Airlines N.V.*, ME/3535/08, OFT decision of 10 June 2008; *Anticipated acquisition by Flybe Group Limited of the BA Connect business of British Airways plc*, ME/2795/06, OFT decision of 20 June 2007; *Anticipated acquisition by easyJet Airline Company Limited of GB Airways Limited*, ME/3399/07, OFT decision of 24 January 2008.

¹¹ See for example *Completed acquisition by Air France finance S.A.S / City Jet Ltd of VLM Airlines N.V.*, ME/3535/08, OFT decision of 10 June 2008; and Competition Commission, *British Airways plc and CityFlyer Express Limited: A report on the proposed merger*, July 1999.

- Considered whether alternative modes of transport may fall within the same market:
 - In *Ryanair/Aer Lingus*, the CC concluded that the degree of substitutability to ferries between the UK and the Republic of Ireland was weak and that they did not fall within the same market since they involved substantially longer journey times, and there was no evidence of the airlines monitoring or reacting to the behaviour of ferry operators¹³
 - In the CC’s BAA airports market investigation,¹⁴ the CC found that other modes of transport were not in the same product market as air travel. In particular, it concluded that although rail was a realistic alternative for a high proportion of passengers on certain domestic flights, very few indicated that they would switch in response to even quite large price rises, and as such rail was not considered to fall within the relevant market.
- Noted factors including business model, brand recognition, service levels, ticket prices, and passenger journey purpose, as indicators of closeness of competition within the market, as well as looking at direct evidence of competition between airlines (such as price reactions and internal documents).

9. In airline cases, geographic and product scope are closely linked. For the UK authorities, the starting point for geographic scope has been origin and destination pairs.¹⁵ For example, in *Ryanair/Aer Lingus* the OFT identified a set of overlap corridors between groups of origin and destination airports within 100km/1-hour drive time of each other at each end.¹⁶ In that case it was not necessary to conclude on whether the set of substitutable airports was narrower (that is, closer together) than this, since it would not have affected the competitive assessment.

10. In other cases, the OFT has taken a narrower approach, noting that in general the extent to which flights from neighbouring airports may impose a competitive constraint on one another will depend on factors including the extent to which their catchments areas (that is, the distances that most passengers travel to reach them) overlap and the sensitivity of passengers to time travelled to and from the airport.¹⁷ As a result, based on demand-side factors:

¹² See for example *Completed acquisition by Air France finance S.A.S / City Jet Ltd of VLM Airlines N.V.*, ME/3535/08, OFT decision of 10 June 2008; Competition Commission: *British Airways plc and CityFlyer Express Limited: A report on the proposed merger*, July 1999. The European Commission has taken a similar approach: Case M.3280 *Air France/KLM*, 11 February 2004.

¹³ Competition Commission, *A report on the completed acquisition by Ryanair Holdings plc of a minority shareholding in Aer Lingus Group plc*, 28 August 2013, paragraphs 5.7-5.10

¹⁴ Competition Commission, *BAA airports market investigation: a report on the supply of airport services by BAA in the UK*, 19 March 2009

¹⁵ See for example *Completed acquisition by Air France finance S.A.S / City Jet Ltd of VLM Airlines N.V.*, ME/3535/08, OFT decision of 10 June 2008; Competition Commission: *British Airways plc and Cityflyer Express Limited: A report on the proposed merger*, July 1999; *Anticipated acquisition by Flybe Group Limited of the BA Connect business of British Airways plc*, ME/2795/06, OFT decision of 20 June 2007; *Anticipated acquisition by easyJet Airline Company Limited of GB Airways Limited*, ME/3399/07, OFT decision of 24 January 2008; Case M.3280 *Air France/KLM*, (11 February 2004).

¹⁶ Following the European Commission including the European Commission’s two investigations, in 2007 and 2013, into Ryanair’s bids for Aer Lingus.

¹⁷ *Completed acquisition by Air France Finance SAS/City Jet Ltd of VLM Airlines NV*, Case ME/3535/08, OFT decision of 9 May 2008; *Anticipated acquisition by Flybe Group Limited of the BA Connect business of British airways plc*, ME/2795/06, OFT decision of 20 June 2007; *Anticipated acquisition by easyJet Airline Company Limited of GB Airways Limited*, ME/3399/07, OFT decision of 24 January 2008.

- In *Flybe/BA Connect*,¹⁸ the OFT found that (because they are more sensitive to journey time and frequency) business travellers are less likely than leisure passengers to travel to neighbouring airports – such that airport to airport pairs may be the appropriate frame of reference
- In *BA/Cityflyer Express*,¹⁹ the CC found that for leisure passengers, origin-destination pairs beginning at any London airport were operating within the same market,²⁰ but that for business passengers, only certain London airports were substitutable. It made this distinction on the basis of demand-side characteristics of the airports:
 - high frequencies and service standards,
 - early morning departure and late evening return for short haul services,
 - minimal travel time; and
 - the quality of rail and road links.
- In *Air France/VLM Airlines*,²¹ the OFT reached similar conclusions, using evidence on the number of time sensitive business passengers travelling out of each London airport, the overall travel time from central London to short haul destinations via each airport, the catchment areas of each airport and the extent to which they overlap. The OFT also had evidence from internal modelling done by the parties, and from customer and competitors comments.
- The UK authorities have also considered supply side substitution. In *Air France/VLM Airlines*,²² the OFT considered the ability of airlines not operating on particular routes to use existing slot holdings and aircraft to switch from one route to another when prices on a route rise (slot flexing). In doing so it took into account the short runway length at London City Airport, which meant that only turboprop or small jets with specially trained pilots can use it; evidence that six months' planning is required for changes to be made,²³ as well as comments from third party airlines about the ease of redeploying slots, and examples of where this had previously occurred. Overall, the OFT did not find that slot redeployment was sufficiently quick or costless for it to widen the market through supply side substitution. The OFT also noted that there are major opportunity costs of slot redeployment given their scarcity at the London airports in question; in its BAA airports market investigation,²⁴ the CC also noted that the extent of competition between some airports is severely limited by a lack of capacity.²⁵

¹⁸ *Anticipated acquisition by Flybe Group Limited of the BA Connect business of British airways plc*, ME/2795/06, OFT decision of 20 June 2007

¹⁹ *British Airways plc and CityFlyer Express Limited: A report on the proposed merger* (July 1999)

²⁰ The European Commission came to a similar conclusion in relation to leisure/non-time sensitive passengers flying between London and Dublin: Ryanair/Aer Lingus Case No. M.4439 27 June 2007.

²¹ *Completed acquisition by Air France Finance SAS/City Jet Ltd of VLM Airlines NV*, Case ME/3535/08, OFT decision of 9 May 2008

²² *Completed acquisition by Air France Finance SAS/City Jet Ltd of VLM Airlines NV*, Case ME/3535/08, OFT decision of 9 May 2008

²³ To plan the route at the relevant bi-annual IATA slot conference

²⁴ Competition Commission, *BAA Airports Market Investigation, A report on the supply of airport services by BAA in the UK* (March 2009)

²⁵ Although the CC also noted that in some cases, common ownership of airports had impeded the development of new capacity

11. In terms of market definition in unilateral abuse cases, in its 2009 abuse of dominance case (*Flybe*, discussed further below),²⁶ the OFT took a very similar approach to that in previous mergers, and looked at origin and destination pairs.

3. Mergers

3.1 *Traditional/low-cost carriers*

12. The CMA published guidance says that it will consider any merger in terms of its effect on rivalry over time in the market(s) affected by it.²⁷ When assessing mergers of differentiated offerings, as may be the case with traditional and low-cost carriers, the CMA will consider how closely the merger parties compete and may analyse the change in the pricing incentives that the merger brings about.²⁸

13. In terms of airline competition the OFT and CC have both found that airlines compete across a wide range of factors (as discussed above) including price, actual origin/destination locations, potential origin/destination locations, in-flight service levels, frequencies of flights and times of departure/arrival.

14. It is therefore not clear that mergers between traditional carriers only will result in different concerns to mergers between traditional and low-cost carriers. For example, it may be the case that a traditional carrier and a low cost carrier compete closely on particular origin/destination pairs so that a merger of them would result in horizontal unilateral effects concerns. Similarly, it could be the case that two traditional carriers compete closely on price.

15. With respect to *Ryanair/Aer Lingus*, Ryanair is a low-cost airline and Aer Lingus is described as a ‘value carrier’ in that it is not a full service traditional carrier but nor is it a low-cost airline. It flies to central locations and has entered into a number of codeshare and interline agreements. Despite the differences in business models and offerings the CC found that Ryanair and Aer Lingus were close, direct and potential competitors (that is, they provided a threat of entry to each other on routes where one was not present).²⁹ In that case the CC found that the merger could be expected to give rise to a substantial lessening of competition in air passenger services between Great Britain and the Republic of Ireland.³⁰

3.2 *Theories of harm*

16. UK competition agencies have explored horizontal unilateral effects theories of harm using relatively orthodox pricing incentive analysis on direct competition on overlapping routes (for example, *Flybe/BA Connect*³¹; *Air France/VLM Airlines*³²) and by examining an airline’s ability and incentive to use its shareholding to weaken its rival (*Ryanair/Aer Lingus*³³).

²⁶ Competition Act 1998 No Grounds for Action (Decision No. MPINF-PSWA001 – 04) Alleged abuse of a dominant position by Flybe Limited

²⁷ *Merger Assessment Guidelines*, paragraph 4.1.3

²⁸ *Merger Assessment Guidelines*, paragraph 5.4.6

²⁹ *A report on the completed acquisition by Ryanair Holdings plc of a minority shareholding in Aer Lingus Group plc*, 28 August 2013, paragraph 5.31

³⁰ *A report on the completed acquisition by Ryanair Holdings plc of a minority shareholding in Aer Lingus Group plc*, 28 August 2013, paragraph 7.188

³¹ *Anticipated acquisition by Flybe Group Limited of the BA Connect business of British Airways plc*, OFT decision 7 February 2007.

17. Moreover, the UK has also assessed vertical issues. In *Air France/VLM Airlines* the OFT analysed whether the merger would give Air France the ability and incentive to foreclose a rival provider of passenger handling services at London City Airport. In that case the OFT did not find that the merger would lead to foreclosure of a rival.

18. Both the OFT and CC considered coordinated effects in *Ryanair/Aer Lingus*.³⁴ The CC's phase II investigation ultimately found that the merger would not lead to coordination in that instance.

3.3 *Relevant merger situation and alliances*

19. It is difficult to say whether deep alliances should be treated as a merger. In order for a relevant merger situation to arise UK merger law requires two or more enterprises to be brought under common ownership or control. There are three levels of control within the UK regime: material influence; de facto control and a controlling interest ('de jure' control).

20. Material influence is the lowest level of control and can capture minority shareholdings. Indeed, the UK's investigation of *Ryanair/Aer Lingus* was an investigation of a minority shareholding. When assessing whether an acquirer will obtain material influence over a target the CMA will examine whether it has the ability materially to influence policy of the target business, in particular the strategic direction of the target business and its ability to define and achieve its commercial objectives.³⁵

21. The UK has not to date treated alliances as a relevant merger situation.

3.4 *Sale by an airline of a slot, gate or route*

22. There have been no UK cases where a slot, gate or route has been deemed to be an 'enterprise' for the purpose of merger control. Nevertheless, under UK merger laws a part of a company or its functions may still be deemed to be an enterprise. In some cases the transfer of assets alone may be sufficient to constitute an enterprise.³⁶

3.5 *Remedies*

23. At both the first and second phase of review the CMA has a strong preference for structural remedies in merger cases.³⁷ This preference is reflected in its experience of airline mergers.

24. The remedies that the UK authorities have accepted comprise divestment of slots and parking stands (*Air France/VLM Airlines*); the relinquishing of a parking stand at Southampton Airport in order to allow a rival to enter (*Flybe/BA Connect*), and the divestment of shares (*Ryanair/Aer Lingus*). In

³² *Completed acquisition by Air France Finance SAS/City Jet Ltd of VLM Airlines NV*, Case ME/3535/08, OFT decision of 9 May 2008.

³³ *A report on the completed acquisition by Ryanair Holdings plc of a minority shareholding in Aer Lingus Group plc*, 28 August 2013

³⁴ *Completed acquisition by Ryanair Holdings plc of a minority interest in Aer Lingus Group plc*, Case ME/4694/10, OFT decision 15 June 2012; CC, *A report on the completed acquisition by Ryanair Holdings plc of a minority shareholding in Aer Lingus Group plc*, 28 August 2013

³⁵ *Mergers: Guidance on the CMA's jurisdiction and procedure*, CMA2, January 2014, paragraph 4.14

³⁶ *Mergers: Guidance on the CMA's jurisdiction and procedure*, CMA2, January 2014, paragraph 4.8

³⁷ *Mergers: Guidance on the CMA's jurisdiction and procedure*, CMA2, January 2014, paragraph 8.4 and *Merger Remedies: Competition Commission Guidelines*, CC8 adopted by the CMA, paragraphs 1.8 and 2.4

Ryanair/Aer Lingus the CC also supplemented the divestment of shares remedy with a behavioural remedy that Ryanair would not seek or accept board representation with respect to Aer Lingus or acquire further shares in Aer Lingus (unless competition clearance was given).

25. The UK has not undertaken any ex post evaluation of airline merger remedies.

3.6 Efficiencies

26. In *Flybe/BA Connect* the parties submitted that the merger would lead to consumer benefits via lower fares (by moving to a low cost airline model) but since the claims were unsubstantiated they were dismissed. Efficiencies have not been raised or examined in other UK merger cases in this sector.

4. Abuse of dominance

27. In relation to abuse of dominance, the OFT has recent experience in the airline sector. It carried out an abuse of dominance³⁸ investigation in 2009 concerning an allegation of predatory entry by Flybe on the Newquay to London Gatwick route, in competition with a smaller airline's operations (Air South West ('ASW')). The OFT decided that it did not have sufficient evidence to support a finding that Flybe's conduct amounted to predation which was designed to undermine ASW's operations at Plymouth Airport and eliminate ASW as a competitor on Flybe's other routes. Therefore, the OFT concluded that it had no grounds to take action against Flybe.

28. The case involved some novel issues. First, the OFT considered that Flybe was not dominant on a relevant market covering the route where it had entered and was only dominant on two other routes. Consequently, to support a finding of related market abuse it was necessary to show that the routes where Flybe was dominant and the route where it entered were sufficiently linked. In making this assessment, the OFT considered both whether Flybe was capable of eliminating ASW without it being replaced by another airline and whether it had the incentive to do so.

29. Further, the assessment of profit sacrifice was made difficult by factors specific to the airline sector. While Flybe had incurred substantial avoidable losses on entering the Newquay to London Gatwick route, the OFT found evidence that that it was common for airlines to incur losses in their first years of operation on a new route and that Flybe had incurred similar substantial losses on other routes it had entered recently. The OFT therefore considered that the evidence of the losses that Flybe had incurred on the Newquay to London Gatwick route was insufficient to conclude that Flybe's entry marked a departure from normal competition.

5. Pricing and ticket selling

30. When buying airline tickets, there are potentially many elements of the total price that a particular consumer will pay. This could include taxes, 'airport surcharges', fees for luggage, fees for check-in at the airport, booking fees, or fees relating to the payment methods used. The CMA and CAA have, through their consumer enforcement and guidance work, looked in detail at how airlines and other ticket sellers present the different components of their prices, and how this can affect competition.

31. Computerised reservation systems have undoubtedly made price comparisons easier and enabled passengers to utilise price comparison websites in their searching. This has lowered search costs to the benefit of consumers and strengthened competition between airlines. Nevertheless, none of the OFT, CC or CMA has to date examined the role of computerised reservation systems in the role of airline competition.

³⁸ Under Chapter 2 of the Competition Act 1998

32. There is extensive research evidence on how the presentation of prices, or ‘price framing’ can affect the decisions that consumers make, and affect competition as a result. Particularly relevant to airline pricing, the OFT has investigated the effects of:

- ‘partitioned drip pricing’, where parts of the price are revealed only late in the shopping process;³⁹ and
- ‘partitioned pricing’ where parts of the price are presented separately, but at the same time, rather than (or as well as) being presented as an overall total.⁴⁰

33. OFT research found that both these price frames lead consumers to make:

- Search errors. The OFT’s experiment found that partitioned ‘drip’ pricing led to reduced shopping around and higher sales at the first shop visited.⁴¹ Search errors were also found for partitioned pricing (when the total cost was not displayed with the partitions), although less so than with drip pricing.⁴² There is a large academic literature showing that the effect of reduced search is weaker incentives for sellers to discount, weaker competition, and higher prices overall⁴³
- Purchasing errors. The OFT’s experiment found that partitioned ‘drip’ pricing leads to roughly 14 per cent more purchasing errors (where the consumer buys less or more than is optimal), than is the case with straightforward unit pricing.⁴⁴ Even when all the price components are presented to the consumer at the same time these errors can occur (though to a lesser extent).

34. Overall the OFT found that changes in the transparency and clarity of price partitions and the total price of a product or service have a significant impact on consumer decisions and welfare even when all the price components are presented to the consumer at the same time. Other research has found that partitioned pricing makes consumers: have higher purchase intentions (be more willing to buy); more likely to buy, likely to pay more; less likely to shop around; recall a lower price than they actually paid; and happier with the price they paid.⁴⁵

³⁹ OFT1291, *Advertising of Prices*, (2010) commissioned and collected evidence about five price frames: partitioned ‘drip’ pricing, time-limited offers, reference pricing, complex pricing and baiting sales. <http://www.of.gov.uk/OFTwork/markets-work/advertising-prices/#.U0-UWunNvct>.

⁴⁰ OFT extended its earlier study, to include partitioned (but not drip) pricing, in OFT1501 *Partitioned Pricing Research* (2013) http://www.of.gov.uk/shared_of/economic_research/OFT1501.pdf

⁴¹ OFT1291, 2010, *Advertising of Prices* and paragraphs 5.33 and 5.34 of OFT1226, 2010, *The impact of price frames on consumer decision making*.

⁴² This was the ‘two partitions no total frame’ in which the price was split into two partitions but the total cost was not displayed (for example, £7 + £3). See paragraph 1.26 of OFT1501.

⁴³ For example, Stigler, G. J. (1961): ‘The Economics of Information,’ *Journal of Political Economy*; Diamond, P. A. (1971) ‘A Model of Price Adjustment,’ *Journal of Economic Theory*.

⁴⁴ See Table 5.4 of OFT1226, 2010 *The impact of price frames on consumer decision making*.

⁴⁵ Lee, Y. H. and Han, C. Y. (2002), ‘Partitioned Pricing in Advertising: Effects on Brand and Retailer Attitudes’, *Marketing Letters*; Morwitz, V. G., Greenlead, A. and Johnson, E. J. (1998), Divide and Prosper: Consumers’ Reactions to Partitioned Prices, *Journal of Marketing Research*; Lynch and Thomas K. Srull (1982), ‘Memory and Attentional Factors in Consumers Choice: Concepts and Research Methods,’ *Journal of Consumer Research*; Hossain Tanjim & Morgan John (2006). “...Plus Shipping and Handling: Revenue (Non) Equivalence in Field Experiments on eBay,” [The B.E. Journal of Economic Analysis & Policy](http://www.bepress.com/bejournal/vol10/iss1/art1); Xia, L. & Monroe, K. B. (2004). Price partitioning on the internet. *Journal of*

35. The likely reasons for these results, outlined in the psychology and economics literature are that:

- consumers who have chosen to proceed beyond the initial price, feel a sense of ownership. This means that when the price subsequently rises the consumer still purchases, because to do otherwise would be seen as a loss⁴⁶
- consumers want to behave consistently with their previous actions, so once they have committed to the purchase by proceeding beyond the initial price they are likely to continue with the purchase because to do otherwise would be inconsistent⁴⁷
- consumers use simplifying strategies to deal with mathematical operations,⁴⁸ including ‘ignoring strategies’, and anchoring to certain pieces of information.⁴⁹ As a result consumers may not properly take additional parts of the price into account,⁵⁰ which can lead to consumers believing the price of the good or service is lower than it actually is.⁵¹

36. As well as these behavioural impacts, price framing can lead to a direct increase in search costs.⁵² For example, the separation of parts of the price can increase the cost of consumers collecting information about different firms' offers - three-quarters of respondents in a survey by the OFT said that the addition of optional charges makes comparing prices more difficult.⁵³

37. The above influences mean that, in the context of airlines, partitioned and drip pricing can lead to direct consumer harm through consumers buying different or additional flights to those they would have purchased without partitioned pricing, and paying more for those flights. It can lead to indirect harm through the distortion and weakening of competition, and attendant higher prices, that result from consumer errors and reduced search. Their effects may be worsened by other aspects of purchasing an

Interactive Marketing; Lichtenstein, Donald R., Peter H. Bloch, and William C. Black (1988), ‘*Correlates of Price Acceptability*,’ *Journal of Consumer Research*; Monroe, Kent B. (1971), ‘*Measuring Price Thresholds by Psychophysics and Latitudes of Acceptance*,’ *Journal of Marketing Research*, 8 (November), 460-64; (1973), ‘*Buyers’ Subjective Perceptions of Price*,’ *Journal of Marketing Research*

⁴⁶ See Kahneman, D., Knetsch, J. L. and Thaler, R. H. (1990), ‘*Experimental Tests of the Endowment Effect and Coase Theorem*,’ *The Journal of Political Economy*

⁴⁷ See Cialdini R. B. (1999) *Of tricks and tumors: some little-recognized costs of dishonest use of effective social influence*. *Psychology and Marketing*

⁴⁸ Johnson, Eric J., John W. Payne and James R. Bettman (1988), ‘*Information Displays and Preference Reversals*,’ *Organisational Behaviour and human Decision Process*’

⁴⁹ See Morwitz, V. G., Greenlead, A. and Johnson, E. J. (1998), *Divide and Prosper: Consumers’ Reactions to Partitioned Prices*, *Journal of Marketing Research*; Tversky, A., & Kahneman, D. (1974). *Judgment under uncertainty: Heuristics and biases*. Science; Yadav, Manjit S. (1994), ‘*How Buyers Evaluate Product bundles: A Model of Anchoring and Adjustment*,’ *Journal of Consumer Research*

⁵⁰ Stiving, Mark and Russell S. Winer (1997), ‘*An Empirical Analysis of Price Endings With Scanner Data*,’ *Journal of Consumer Research*

⁵¹ See OFT1501B (2012) *Partitioned Pricing Research: The economics of partitioned pricing*; Morwitz, V.G., Greenleaf, E., Shalev, E and Johnson, E. (2009), ‘*The Price does not Include Additional Taxes, Fees and Surcharges: A Review of Research on Partitioned Pricing*’, working paper, Department of Marketing, New York University.

⁵² For a discussion of how individual firms can have an incentive to increase search costs, see Ellison, G. and Wolitzky, A. (2012) ‘*A search cost model of obfuscation*’, *RAND Journal of Economics*

⁵³ See OFT1291, (2010), *Advertising of Prices*.

airline ticket, such as time pressured sales (since prices change frequently),⁵⁴ and the fact that customers may already have been attracted to a website by a low-price flight which has only very limited availability, before viewing a higher-priced flight.⁵⁵ In culmination these factors may distort competition to favour those airlines who use these practices over those who do not.

38. However, in specific circumstances, and in particular where the additional fee is truly optional, price partitioning can help consumers, and promote competition:

- One reason to charge a fee that is distinct from the headline price is to discourage consumers from choosing options that cost the airline money – as with fees for luggage or airport check-in – and at the same time allow those who do not choose the option to share the benefits from the lower cost
- A second motivation for charging a separate fee for a service is if it can be a way to split consumers into different groups, and offer the lowest possible fare to those that who are on the lowest budget or price sensitive for other reasons. In this way, price sensitive customers pay the marginal (variable) cost of their place on the flight, plus a small share of the fixed costs of running the flight, while less price sensitive customers cover their own variable costs, plus a higher proportion of the fixed costs. Consumers overall can benefit because the pricing structure can make a business viable that would not be possible with flat rate fees.

39. Bearing in mind both the harm, and potential benefits, from partitioned pricing, and the evidence that drip pricing has the potential to be more harmful than partitioned pricing, the OFT and CAA have taken the approach⁵⁶ that, to avoid what they consider to be breaches of the Air Services Regulation or the Consumer Protection from Unfair Trading Regulations (CPRs):⁵⁷

- For price elements which are compulsory for all consumers, and payable per flight, such as taxes, and some booking or payment fees (which may be imposed by the airline or by ticket agents or price comparison sites): these fees should be included in the headline price. This includes charges for the use of debit cards – the most common and widely available payment method in use in the UK.

⁵⁴ See Chapter 8 of OFT1291, 2010, *Advertising of Prices*; also OFT1312 *Consumer Contracts Market Study*, Annexe F, for evidence on the effects of time limited sales and time pressure <http://www.oft.gov.uk/OFTwork/markets-work/consumer-contracts;jsessionid=D8C5B48E6FFF0D30BBA671F1E2E60B65#.U2yZ8ulZrcs>

⁵⁵ One price frame previously studied by the OFT is ‘baiting sales’ where only a limited number of products are available at the discount price and consumers may ultimately purchase a full priced product. This is because having been attracted to a store due to the offer a consumer may feel a sense of ownership. This means that even though the offer is no longer available they are likely to purchase the product at a higher price or an alternative. See Chapter 5 of OFT1291, 2010, *Advertising of Prices*. In relation to airlines, see page 119 of [OFT 1226, 2010, *The impact of price frames on consumer decision making*](http://www.oft.gov.uk/OFTwork/markets-work/consumer-contracts;jsessionid=D8C5B48E6FFF0D30BBA671F1E2E60B65#.U2yZ8ulZrcs)

⁵⁶ For more information see <http://www.oft.gov.uk/OFTwork/consultations/travel-agents-guidance/#.U2yIFrtZrcs> and <http://www.caa.co.uk/application.aspx?catid=33&pagetype=65&appid=11&mode=detail&id=5460>

⁵⁷ The Consumer Protection from Unfair Trading Regulations 2008, implementing the Unfair Commercial Practices directive 2005/29/EC, bans certain practices, and outlines that practices which are misleading, aggressive, or contrary to the requirements of professional diligence are illegal where they cause the average consumer to take a different transactional decision. See http://www.oft.gov.uk/shared_of/business_leaflets/cpregs/oft1008.pdf

- Price elements which are compulsory for all consumers, but which were payable per transaction, such as some booking or payment fees: an appropriate proportion of these fees should be included in the headline price, depending on the number of flights searched for (for example, half the fee if a return flight was searched)
- Price elements which are optional, and may be payable per flight or per transaction, such as fees for checking in at the airport, or insurance: should be offered on an opt-in basis, and their cost should be clearly displayed or available via a link at the start of the booking process, or if offered on an opt-out basis should be included in the headline price displayed. In the specific case of credit card charges (which are optional since debit cards can be used without charge), these should be clearly set out early in the booking process and also relate to the cost incurred by the business in administering that payment⁵⁸
- A breakdown of the price should also be available
- To aid price comparison, the CAA also publishes tables of airport fees, and of optional airline services – these have been well received by travel buyers and travel agents.⁵⁹

⁵⁸ In line with the Consumer Protection (Payment Surcharges) Regulations 2012

⁵⁹ http://www.caa.co.uk/docs/2200/Comparing_airline_charges.pdf