Aviation: Combining network synergies and competition —
the Commission’s approval of the LH-AuA Alliance

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1. Introduction

The liberalisation of the European air transport market during the 1990s has triggered a process of consolidation in the European airline industry. Apart from mergers, airline alliances play an important role in this consolidation process. They can produce benefits by extending networks and improving efficiency. However, they can also restrict competition on certain markets, in particular on routes between hubs of the alliance partners. When assessing such alliances under its competition rules, the Commission therefore has to weigh the benefits in terms of network synergies against the potential losses arising from the reduction in competition. In order to minimise the latter, often remedies are imposed on the alliance partners. This has been done, for instance, in the case of the co-operation between Lufthansa and SAS and in the case of the tripartite Joint Venture Agreement between bmi British Midland, Lufthansa and SAS (1). Experience has shown, however, that for various reasons new entry is difficult to achieve.

In 1999, Austrian Airlines (AuA) decided to join the STAR alliance (2). As a key step in this regard, it concluded a co-operation agreement with Lufthansa which was notified to the European Commission on 10 December 1999 under Council Regulation 3975/87. AuA and Lufthansa (hereinafter ‘The Parties’) applied for an exemption under Article 81 (3) of the EC Treaty and Article 53 (3) of the EEA Agreement. As the co-operation agreement created a number of serious competition concerns, in May 2001 the European Commission sent the Parties a Statement-of-Objections in which it pointed out its intention to prohibit the agreement. The Commission was concerned that the Parties would eliminate competition on a large part of the Austrian — German air passenger market. Subsequent negotiations with the Parties led to a significant remedy package. During a thorough ‘market test’ (3) the Commission could assure itself that on the basis of these undertakings a number of airlines are willing to enter the market concerned. On this basis, on 5 July 2002 the Commission granted the Parties a six year exemption (4).

2. The co-operation agreement

The Parties envisage to build a lasting alliance by creating an integrated air traffic system which is built on a close co-operation in commercial activities, marketing and operational activities (5). The aim is to improve the use of the Parties’ respective hubs in Frankfurt, Munich and Vienna. A framework agreement sets out the main features of the co-operation. In addition, both companies have concluded a number of more concrete implementation agreements. A ‘Special Pro Rate Agreement’ (SPA) defines their joint pricing policy. The Parties establish an integrated transport system world-wide, with joint network planning, a joint pricing policy and joint budgeting. This includes reciprocal access to frequent-flyer programmes, code sharing, harmonisation of service levels, and integration of data processing. In information technology the Parties combine their systems in areas like flight data, reservation systems, ticketing, inventory, etc. By agreeing to joint use of airport facilities for passenger clearance, they hope to offer a smooth transfer to their customers.

The network arrangement, which started with the summer season in April 2000, comprises passenger transport, maintenance, airport facilities and ground handling. The most far-reaching cooperation has been established for the bilateral

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2. ‘STAR’ is a world-wide alliance of airlines, built on bilateral agreements between the various partners. Its members include United Airlines, All Nippon Airways, Lufthansa, LOT, SAS, Air Canada, AuA and bmi British Midland.
3. A Notice pursuant to Article 16 (3) of Regulation (EC) 3875/87, which contained a full description of the commitments made by the Parties, was published on 14 December 2001.
5. A summary of the co-operation was published on 11 July 2000 in the Official Journal of the European Communities. Comments from interested parties were received from a large number of competitors, trade unions, travel agencies and ground handling service providers.
traffic between Austria and Germany with the conclusion of a so-called 'neighbourhood agreement'. The latter creates a joint-venture for traffic between Germany and Austria, which includes the sharing of profit and losses.

3. The relevant market

In the passenger transport market, customers demand a transport service between a point-of-origin and a point-of-destination under certain conditions such as timing and quality of service. This transport service can be carried out by different transport modes (air, rail, road or sea) or a combination thereof. To establish the relevant market in air transport, the Commission has developed the so-called point-of-origin / point-of-destination (O&D) pair approach. According to this approach, every O&D pair should be considered to be a separate market from the customer’s point of view. The Commission further distinguishes ‘time-sensitive’ and ‘non-time-sensitive’ customers. The former wish to reach their destination in the shortest possible time, they are not flexible in terms of time of departure/arrival and they need to have the option of changing their reservation at short notice. Non-time-sensitive customers, on the other hand, are more price-sensitive and accept longer journey times. Finally, a distinction can be drawn between O&D (point-to-point) passengers and transfer passengers, who take connecting flights.

For the purpose of assessing the Parties’ co-operation, in its decision the Commission distinguished three categories of passenger air transport service within the EEA:

(i) services between Austria and Germany;
(ii) services between Austria or Germany and a third EEA country (e.g. Frankfurt-Rome);
(iii) services between two third EEA countries (e.g. London-Rome).

As competition concerns arose in particular as regards the neighbourhood agreement, i.e. traffic between Austria and Germany, the following analysis focuses on the first category.

Based on the O&D approach, the Commission considered whether, apart from taking direct flights between Austria and Germany, passengers would have alternatives due to indirect flights, other transport modes or overlapping catchment areas of different airports. Whether such alternatives exist depends on a number of factors. One important issue in this regard is the extra travelling time required. There exists a correlation between the extra time a traveller is willing to spend using an indirect flight or another transport means and the overall travelling time. Given the short distance, the travelling time of direct flights between Austria and Germany is very short. As a result, O&D (point-to-point) passengers are unlikely to accept significant extra time when using alternative transport means.

As set out in detail in the decision, the Commission comes to the conclusion that indirect flights offer an alternative to direct ones for only a few non-time-sensitive travellers. It is therefore concluded that the Parties’ direct flights between the two countries are not put under competitive pressure from indirect flights offered by competitors. Similarly, it is found that overlapping catchment areas of two or more airports offer an alternative only to a very limited number of passengers. With regard to alternative transport modes, the Commission considers that road and rail only offer an alternative for non-time-sensitive passengers on a limited number of short-haul routes between Austria and Germany. This view is confirmed by a price comparison. A comparison of a business-class air ticket with a first-class rail ticket and an Air-PEX ticket with a second-class rail ticket reveals that on the routes in question air travel in general is more than twice as expensive as travelling by train or car. This indicates that passengers choose the transport mode on the basis of other criteria than the price (for instance travelling time). If these transport modes were in price competition, one would expect prices to converge or, if prices of alternative transport modes were too low for airlines to match, no air transport to be offered.

4. The Commission’s assessment of the co-operation agreement

At the time of the notification in 1999, direct flights were offered on 33 routes between Austria and Germany. Only one route was not operated by

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1. Generally speaking, business travellers are more time-sensitive than leisure travellers and tend to book fully flexible tickets. The second group of passengers are not time-sensitive but pay more attention to the price. These passengers accept longer journey times and may choose indirect flights if they are less expensive than direct ones.

2. For instance, passengers from the Western region of ‘Voralberg’ live in the overlapping catchment areas of Zürich and Innsbruck. They therefore may have the choice between flights offered by the Parties and those offered by Swiss / Crossair.

3. According to data provided by the parties, only about 2-3% of the airline passengers who travel between Austria and Germany live in overlapping catchment areas.

4. For example, on the Munich-Salzburg, Munich-Linz and Munich-Vienna routes.
the Parties. (1) In terms of both the number of total flights and total passenger numbers, the Parties had a combined market share of 100% on 27 of the 33 routes between Austria and Germany. These 27 routes accounted for more than 90% of total traffic between the two countries. Thus, the Parties are by far the strongest competitors on the Austrian-German air transport market.

Even though, with the conclusion of the co-operation agreement, the Parties together had a market share of 100% on all routes of importance in terms of passenger numbers, they continued to face competition in respect of the important category of transfer passengers. Unlike O&D passengers, transfer passengers have a wider choice of flights, with the result that there is greater competitive pressure on the Parties as regards such customers. Long-haul travellers have the choice of various European hubs and may therefore benefit from competition (2).

This is not the case for O&D passengers and regional transfer passengers flying locally between Austria and Germany. For all major routes between Austria and Germany, the category of O&D passengers and regional transfer passengers forms a significant customer market. Given that indirect flights and alternative transport modes in most cases do not offer an alternative, after the establishing of the joint venture, this important customer group depended entirely on the Parties.

Example of the Vienna-Frankfurt route

As an illustration, one may consider the, in terms of passengers, most important route between Austria and Germany. It connects the most important hubs both of AuA and Lufthansa. In 1999, on the route Vienna — Frankfurt there were 560,000 passengers and the parties offered 10 daily flights. A large proportion of all passengers were either point-to-point passengers or regional transfer passengers. By creating the joint-venture, the Parties obtained a 100% market share for direct flights on this route. These passengers did not have a choice but to fly with the Parties.

While the joint-venture eliminated all actual competition on this market, the Commission concluded that considerable entry barriers also restrict severely potential competition. Such entry barriers arise due to:

(a) At least the Frankfurt airport is very congested and new entrants find it almost impossible to obtain slots at peak times.

(b) Together, the Parties operate a relatively high number of frequencies. This makes it more difficult for new entrants to establish themselves on the market with additional flights.

(c) More than half of all passengers are transfer passengers. New entrants on routes between Austrian and German hubs must therefore attract regional and international transfer passengers in order to fill capacity. However, as the Parties develop a joint network, their flights fill most slots which feed flights from and to their hubs.

(d) The pooling of frequent-flyer programmes strengthens the Parties’ position on the market, in particular on the market segment for business customers. A joint frequent-flyer programme constitutes an important entry barrier for airlines which do not have comparable programmes.

(e) A large proportion of total tickets sold on a specific route are tied to a specific airline because of corporate customer deals and other reasons. Thus, new entrants can actually compete on price for only a small proportion of customers (3).

(f) The Parties operate with relatively low load factors on routes between Austria and Germany. They thus have sufficient capacity on these routes to react quickly to price changes which could result from a new competitor entering the market.

Other bilateral routes

As regards other routes between Austria and Germany, the reasoning is similar. On routes with fewer passengers, the above-mentioned entry barriers have even greater weight. As demand for flights on these routes is lower, an entrant is obliged to obtain a higher share of total passengers on the route in order to break even.

It was therefore concluded that by entering into the co-operation agreement, the Parties have eliminated competition as regards the market for time-sensitive and non-time-sensitive O&D passengers.

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(1) Rheintalflug operated 86 flights between Vienna and Friedrichshafen. However, Rheintalflug was taken over by AuA in 2001.

(2) For example, to fly from Vienna to the United States, a passenger may fly direct, or indirect via Frankfurt, Amsterdam, Paris, London, etc. He or she would thus have the choice of several competing airlines.

(3) Small carriers find it difficult to offer similar deals to potential large customers as they cannot offer a similar range of network services (high frequencies, well-connected flights at hub airports, etc.).
and regional transfer passengers on most routes between Austria and Germany.

5. The exemption decision

As this agreement affects passenger traffic between Member States, it has an impact on trade between Member States. The effect is appreciable. It was therefore concluded that the co-operation agreement is caught by Article 81 (1).

However, in its analysis under Article 81 (3) the Commission comes to the conclusion that the agreement generates efficiency gains. Apart from the bilateral traffic, the Parties’ networks largely complement one another. While AuA has focused on medium-haul routes in Europe, especially central and eastern Europe, Lufthansa has focused much more on long-haul services. The merger of these complementary networks results in important synergistic effects and attractive connections for consumers. The co-ordination and extension of the Parties’ scheduled networks creates a more efficient network and, in particular, improves connections with Eastern European cities (1). Consumers benefit from a wider choice of air transport services to more destinations, better connections and convenient scheduling and seamless travel. Consumers also benefit from a wider choice of direct flights between the two countries (2) and connections to Eastern European destinations in particular.

However, the Commission was not convinced that the co-operation agreement allows consumers to share the benefits of the expected cost savings, e.g. through lower prices. Conditions therefore had to be imposed to ensure that competition is not eliminated. Moreover, given that the joint-venture actually eliminates competition on almost all routes between both Member States for O&D traffic, the Commission considered that the threat of potential competition would not be sufficient. It was willing to grant an exemption only after it could assure itself that, as a result of the commitments made by the Parties, there would be actual new entry in the market.

Remedies

The conditions imposed in the decision aim to reduce the above-mentioned entry barriers and to encourage inter-modal competition. Given the serious effects on competition, in comparison to previous decisions, the Commission imposed a number of new remedies on the Parties, in particular the price reduction mechanism, the obligation to enter into Special Prorate Agreements and inter-modal agreements. The market test has shown that the remedy package offers new competitors the possibility to enter the market and to compete effectively. In particular with regard to the envisaged divestiture of slots and the price reduction mechanism, the Parties were willing to make a significant effort to alleviate the Commission’s competition concerns.

The Parties are required to make slots available to a new entrant for a route chosen by it up to a maximum of 40% of the slots the Parties operated on the route in question at the time of the notification (3). The number of slots offered exceeds significantly the number of slots which the new entrants have asked for. This remedy therefore allows entrants to expand services in the future and / or new competitors to enter the market.

The price reduction mechanism is a new remedy which has not been used in previous cases. It aims to protect the interests of consumers flying on lighter routes (in terms of passenger numbers). Many of these routes are of limited attraction to potential competitors. The Parties are thus required to apply any price cuts that they introduce on routes subject to competition to three other Austrian-German routes on which they do not face competition. The Parties have some discretion when it comes to choosing these three other routes. As a side effect, this condition affords new entrants some protection from predatory pricing by the Parties by making the costs of price dumping significantly higher for the Parties.

Predation is furthermore made difficult by the frequency freeze which, during the initial start-up period, prevents new entrants being squeezed out by the Parties putting additional capacity on the market. The Blocked Space offers entrants more

(1) The establishment of a more comprehensive European network produces cost savings for the Parties through an increase in traffic throughout the network, improved network connection, better planning of frequencies, a higher load factor and improved organisation of sales systems and ground-handling services. The Parties also expect to make cost savings by jointly developing new sales channels (e-ticketing).

(2) As a result of the co-operation agreement, frequencies have increased in bilateral traffic on the routes Frankfurt-Klagenfurt, Munich-Graz, Frankfurt-Innsbruck and Vienna-Nürnberg and new connections have been added between Graz-Stuttgart and Vienna-Friedrichshafen.

(3) In addition, they must make ‘technical slots’ available to a new entrant from a third country to position aircraft at the beginning or end of operations.
flexibility by creating the opportunity to increase the number of frequencies offered to their customers without operating additional aircraft themselves. This increases the attractiveness of their services for time-sensitive customers. The new competitors’ participation in the Parties’ Frequent Flyer Programmes abolishes an incentive for (business) customers to choose the incumbent airline.

Given the high share of transfer passengers, it is also important for a new entrant to obtain access to the market of transfer passengers. To this end, it can conclude an interline agreement with Lufthansa/AUA that, at its request, includes a Special Prorate Agreement. The terms of such a SPA must correspond to the terms entered into by the Parties with their alliance partners or other carriers in connection with the route concerned.

The offer to enter into inter-modal agreements is also a new remedy. Fostering inter-modal competition is one of the priorities of the Community’s transport policy. Such a remedy is important for short-haul routes between Germany and Austria where railway operators could compete with the Parties at least with regard to non-time sensitive customers.

Given the various conditions and the duration of the exemption, the Parties must provide the Commission with information on a regular basis to show that they are complying with the conditions.

6. Conclusions

Given that the joint venture establishes a monopoly for direct flights on most routes between Austria and Germany, competition can only prevail if newcomers enter the market. In the past, however, this has proven to be difficult to ensure. Also with respect to the Austrian-German market, the market test carried out by the Commission showed that other EEA airlines initially were not interested. Large airlines endeavour to develop their networks around their respective hubs. Consequently, other major European airlines would probably operate on the Austrian-German routes only if they developed a second hub to which these routes could be connected. This, however, does not seem to be an option for the foreseeable future. On the other hand, the market is also not attractive to low-cost carriers which considered the numerous barriers to entry to be an insurmountable hurdle.

Nevertheless, and in spite of the dramatic downturn in the air transport market following the terrorist attacks of 11 September, the remedies seem to be sufficient to attract newcomers. In the meantime three airlines have already entered, as the Parties offered to apply the remedies even before the entry into force of the Commission’s decision. On this basis, since 5 November 2001 Adria Airways operates twice a day on the most important route Vienna — Frankfurt. Air Alp flies daily on the route Vienna — Stuttgart and Welcome Air has entered the route Innsbruck — Hannover. Two other entrants from Eastern and Central European countries have confirmed their willingness to enter the market once demand in air transport picks up.

Most importantly, however, after the Commission published the remedies in detail in December 2001, an Austrian investment group has decided to create a new regional carrier. Styrian Airways has been set up to operate specifically on routes between Austria and Germany. It is envisaged that Styrian Airways starts operating on four routes between Graz and four German cities and on another four routes between other Austrian cities and Germany in the winter season 2002/2003.

On this basis the Commission was willing to exempt the co-operation agreement under Article 81 (3) until 31 December 2005. In its decision, the Commission points out explicitly that the fact that there are several new entrants is an important factor allowing the Commission to grant this exemption (1). Should this situation change, the Commission might be obliged to revoke or amend the exemption pursuant to Article 6(3)(a) of Regulation (EEC) No 3975/87.

(1) The Commission took note that, as regards entrants from non-EEA countries, Austria and Germany agreed to grant traffic rights to such carriers if they wish to operate on routes between the two countries.