Consolidation of the EU airline industry: How the Commission kept seatbelts fastened in the 2009 airline merger wave

Lucia Bonova, Dagmara Koska, Axel Specker (1)

1. Introduction

The year 2009 was marked by a wave of mergers in the European airline industry, leading the Commission to review a number of cases, namely Iberia/Vueling/Clickair, Lufthansa/bmi, Lufthansa/SNAH (Brussels Airlines) and Lufthansa/Austrian Airlines. In all but the Lufthansa/bmi case, the Commission identified competition concerns with respect to a number of short-haul routes. To address these concerns, the parties submitted commitments in phase I (Iberia/Vueling/Clickair) and phase II (Lufthansa/SNAH (Brussels Airlines) and Lufthansa/Austrian Airlines).

In case M.5364 — Iberia/Vueling/Clickair (2), on 9 January 2009, after a phase I investigation, the Commission approved the proposed acquisition of the two Spanish low-cost airlines, Vueling and Clickair, by the Spanish flag-carrier Iberia. The Commission’s investigation found that the merger as initially notified would have restricted competition in the air transport of passengers or even led to a monopoly on seven European routes (namely Barcelona-Venice, Barcelona-Rome, Barcelona-Nice, Barcelona-Athens, Madrid-Venice, Madrid-Naples and Ibiza-Paris) as well as on twelve Spanish domestic routes (Barcelona-Málaga, Barcelona-Santiago de Compostela, Barcelona-Seville, Barcelona-Granada, Barcelona-Oviedo, Bilbao-Málaga, Bilbao-Ibiza, Bilbao-Seville, Ibiza-Seville, Ibiza-Valencia, Alicante-Ibiza and Seville-Valencia).

In case M.5403 — Lufthansa/bmi (3), the Commission examined the proposed acquisition of UK carrier British Midland (bmi) by Germany’s largest airline Lufthansa in terms of its impact on the air transport of passengers on a number of short- and long-haul routes. On many of these routes, the parties were already cooperating with each other pre-transaction by way of code-sharing, i.e. one party was actually operating the route while the other party merely marketed flights on this route. The Commission’s investigation showed that, on routes where the parties were already cooperating, the party doing the marketing was unlikely to start competing by entering the route as an operating carrier. The Commission therefore concluded that the transaction would not significantly impede effective competition on any of these routes. The same conclusion was reached for all other routes on which the parties’ activities overlapped — one reason being that the combined entity would continue to face sufficient competition on these routes. The transaction was thus approved in phase I on 14 May 2009.

As regards case M.5335 — Lufthansa/SNAH (Brussels Airlines)(4), which was conditionally approved in phase II on 22 June 2009, the in-depth investigation confirmed that the transaction would have raised competition concerns with respect to four routes: Brussels-Munich, Brussels-Hamburg, Brussels-Frankfurt, and Brussels-Zurich. On the Brussels-Frankfurt route, the Commission found that the merger would lead to a monopoly for time-sensitive passengers. It would also eliminate close competition between Lufthansa and Brussels Airlines for non-time-sensitive passengers, since the competitive pressure exercised by the train service on this route was found not to be sufficient to compensate for the loss of competition from an air carrier. As concerns the Brussels-Munich and Brussels-Hamburg routes, the merger would lead to a monopoly. On Brussels-Zurich, where Lufthansa’s subsidiary Swiss is the operating carrier and Brussels Airlines is Swiss’s code-share partner, the Commission’s investigation led to the conclusion that the merger would eliminate the significant likelihood of Brussels Airlines entering the route with own services, and potential competition between the parties would thus be lost. The transaction would, therefore, significantly impede effective competition on the Brussels-Zurich route.

On 28 August 2009, the Commission conditionally approved the notified transaction in case M.5440 — Lufthansa/Austrian Airlines (5), after the phase II investigation confirmed competition concerns on five routes: Vienna-Frankfurt, Vienna-Munich, Vienna-Stuttgart, Vienna-Cologne and Vienna-Brussels. The Commission found that Lufthansa’s subsidiary Germanwings and Austrian Airlines were the only competitors currently active on the Vienna-Stuttgart and Vienna-Cologne routes and thus the transaction would create a monopoly on these routes. Similar-

---

(1) The content of this article does not necessarily reflect the official position of the European Commission. Responsibility for the information and views expressed lies entirely with the authors.

(2) OJ C 72, 26.3.2009, p. 23.


ly, on the Vienna-Brussels route, Austrian Airlines faced competition from Brussels Airlines (which was then being acquired by Lufthansa). The transaction would therefore lead to competition concerns, given that the only remaining competitor, SkyEurope, did not exert sufficient competitive pressure on the parties and had already filed for insolvency. On the Vienna-Munich and Vienna-Frankfurt routes, the transaction would eliminate at least potential competition between the parties. Existing competitors were found not to exercise enough competitive constraint on the parties to prevent them from raising prices post-merger.

To remove the abovementioned competition concerns, the parties involved offered to transfer their slots (i.e. landing and take-off rights at specific times) at the airports where slots were found to present a barrier to entry. Slots are thus to be offered free of charge at Barcelona, Madrid and other airports (Iberia/Vueling/Clickair), Brussels, Frankfurt, Munich, Hamburg and Zurich (Lufthansa/SNAH) and Vienna, Frankfurt, Munich, Stuttgart, Cologne and Brussels (Lufthansa/Austrian Airlines). These slot remedies were complemented by ancillary remedies such as interlining, prorate and code sharing agreements, as well as access to the incumbents’ frequent flyer programmes.

The aim of this article is to discuss the Commission’s approach to market definition and the relevant counterfactual in the airline cases. We shall also examine recent developments in the way the parties’ alliance partners are treated when assessing the effects of airline mergers, and the investigative tools that have been applied by the Commission in these cases. The article also highlights the main features of the commitments made in the most recent airline mergers.

2. Market definition in airline merger cases

In airline cases, the typical distinction between product and geographic market definition is only remotely relevant, as the markets are defined on the basis of demand and supply on routes between individual city pairs, i.e. taking into account bidirectional traffic flow between point A and point B. Demand-side substitution is crucial in these cases, as passengers usually do not readily substitute destinations in response to significant non-transitory price increases. All recent airline mergers were therefore assessed on the basis of city pairs where the parties’ activities overlapped. However, the question of market definition is only a starting point when assessing the competitive effects of mergers: the Commission takes all effects of a particular transaction, including those that may go beyond the impact on individual city pairs. Thus the Commission examined the effects of the Lufthansa/Austrian Airlines merger on a bundle of flights to Central and Eastern Europe which, individually, might not have been considered a substantial part of the common market given the low number of passengers flying on these routes annually.

The Commission has traditionally assessed the impact of airline mergers on two main categories of passengers, defined in the past as time-sensitive and non time-sensitive passengers. The market investigation in the abovementioned cases provided evidence that this distinction remains important when assessing the substitutability of airports, or substitutability between passengers’ preferences for air and train services with respect to the level of service, the type of carriers (low cost vs. network carriers) and schedules. In recent cases, and in particular in the Lufthansa/SNAH (Brussels Airlines) case, the Commission conducted a detailed qualitative and quantitative analysis before concluding that the distinction remains relevant.

In principle, when dealing with short-haul routes, the Commission takes into consideration only direct services offered on a given route. An exception to this rule might be warranted if factual examination of the traffic shows that a substantial proportion of passengers travel indirectly. This is true notably in cases where a direct service allows for a one-day return trip. In these particular circumstances, the Commission recognized that indirect and direct service belong to the same market.

A further typical element investigated in airline cases is the substitutability of airports at the point of origin and destination. The aim is to determine the catchment area of adjacent airports and to establish whether customers consider air services offered from these airports as substitutes for one another. The Commission analyses this substitutability on a case-by-case basis, using qualitative and quantitative tools.

Finally, the Commission investigated substitutability between rail and air services on short-haul routes where a high-speed train is operating. This issue has arisen recently in connection with the Brussels-Frankfurt route (Lufthansa/SNAH Brussels Airlines) and the Vienna-Munich route (Lufthansa/Austrian Airlines).

(*) By way of exception, destination substitutability could be higher for holidaymakers: see COMP/M. 5141 — KLM/Martinair.

(6) Indeed, non time-sensitive passengers are more inclined to travel from secondary airports while primary airports are the only option for most time-sensitive passengers.
3. The counterfactual

Under its Horizontal Merger Guidelines, when assessing the competitive effects of a merger, the Commission compares the competitive conditions that would result from the notified merger with the conditions that would have prevailed without it — which, in most cases, means the competitive conditions at the time of the merger. However, in some circumstances, the Commission may take into account market changes that can reasonably be predicted. (1)

One of the main features of airline cases is that, quite commonly, at the time of the proposed merger there is already a network of cooperation agreements between the parties, ranging from different types of code-share agreements to common bottom-line joint ventures. Frequently, therefore, the parties have argued that, given these agreements, the transaction would not materially alter the competitive conditions already prevailing on the relevant markets.

The Commission, as a matter of principle, does not accept such an argument prima facie and is committed to investigating the merger-specific effects of each transaction, since the merger will make contractual cooperation structural and hence perpetual. The Commission therefore analyses, amongst other things, the level of actual competition between the parties as well as the likelihood of future competition between them on the routes where they were cooperating before the merger. By way of example, in the Lufthansa/bmi transaction where, before the merger, Lufthansa and bmi were code-sharing on a number of routes, the Commission concluded that the parties were not likely to enter the routes where they currently code-share with each other. (2)

However, a similar analysis of the Lufthansa/SNAH (Brussels Airlines) merger produced different results as regards the Brussels-Zurich route. Here, the Commission found that, if the merger did not go ahead, SN was the most likely entrant on this route and the transaction therefore eliminated this potential competition.

Similarly, in the Lufthansa/Austrian Airlines case, where the parties were already involved in a profit-sharing joint venture, the Commission analysed the transaction in the light of two counterfactual scenarios. One was what would happen if the transaction turned the parties’ contractual cooperation into a permanent structural link. The other was the most likely alternative counterfactual scenario if the proposed transaction did not go ahead. The Commission found that, without the merger, Austrian Airlines — which was then being privatised — was likely to be acquired by another airline, namely Air France-KLM. In this alternative counterfactual scenario, Austrian Airlines and Lufthansa were likely to terminate their joint venture and become actual competitors on the relevant routes. However, in the end, the Commission did not need to conclude on the relevant counterfactual as such conclusion would not alter its assessment of the effects of the case.

4. Treatment of alliance partners

The Commission has traditionally given its investigations a broad scope, analysing not only overlaps between the merging parties but also overlaps between one party and the other party’s alliance partner. When assessing the affected markets, the Commission used to aggregate the parties’ market shares with those of the alliance partners with which a merging party was closely cooperating.

In older merger cases, therefore, the Commission investigated not only the routes where the parties’ activities overlapped but also the routes where the services of one of the parties overlapped with those of the other party’s alliance partner. If the combined market share of the respective players was significant, these routes were considered as affected markets. In the latest cases discussed in this article, however, the Commission decided to restrict its analysis to overlaps between the merging parties and to consider other markets to be affected only if there is solid evidence that the cooperation between one merging party and a third party (its alliance partner) will be extended to the other merging party. In other words, a market is considered as affected only if there is evidence that one party will be integrated into the other party’s partnership with another airline on this market, or that competition will otherwise be reduced as a result or as a foreseeable consequence of the merger.

5. Investigation methods applied

In addition to standard investigative tools such as questionnaires sent to relevant market players (3), the Commission used several other tools. In particular, during the phase II of the Lufthansa/SNAH (Brussels Airlines) case, a customer survey was used to gather direct evidence of passenger behaviour, such as the degree of substitution between Brussels National (Zaventem) and Antwerp airports. The

(2) In that case, the Commission’s investigation did not indicate that the relevant code-share agreements would be contrary to Article 101 TFEU. The relevant counterfactual was therefore a situation in which the parties cooperate under the code-share agreements.

(3) Such as questionnaires to competing airlines and train operators, corporate customers, travel agents, consumer associations, airports, slot coordinators and Member States’ civil aviation authorities.
survey also helped measure the degree of competitive constraint exercised both between the parties and on the parties by their competitors, including train services. The survey was run by an independent contractor, selected on the basis of a call for tender, and the parties had the opportunity to comment on the relevant questions before the customer survey was launched.

In phase II of both Lufthansa/SNAH (Brussels Airlines) and Lufthansa/Austrian Airlines, the Commission also carried out a thorough econometric analysis of daily pricing data for several booking classes obtained from the parties and some of their competitors. The Commission was thus able to reconstitute monthly average net fares per class to analyze, for example, how the entry of competitors on the parties’ routes had, in the past, affected the parties’ fares. The Commission was also able to analyze the prices charged by the parties to non time-sensitive passengers (as proxied by non-flexible economy class fares) compared with their pricing to time-sensitive passengers, who primarily purchase flexible fares.

As regards potential entry, the total passenger demand on the route in question served as a starting point for assessing whether the route would economically sustain operations by an additional operating carrier. The Commission also examined the parties’ internal documents in order to assess their entry strategies both in general and for the particular routes at issue. The parties’ past entries were also analyzed to determine entry patterns on the basis of route characteristics (e.g. total demand on the route, passenger mix, connection to existing hubs/bases, profitability and yields etc.). Similar criteria were used to assess whether or not a competitor was likely to enter the route in question. To this end, the Commission also requested internal documents form third party carriers.

6. Remedies

The commitments accepted in recent cases contain a number of improvements over previous packages, reflecting the lessons the Commission has learnt from past experience with airline mergers and the way remedies were implemented in those cases. Broadly speaking, the recent commitments reduce the burden imposed on the new entrant by the slot application procedure. They also facilitate slot transfer from the parties and give the applicant more visibility in the future operation of these slots. Furthermore, the enhanced commitments are designed to encourage competitors to enter those routes where competition concerns were identified. Incentives include, for example, the prospect of obtaining grandfathering rights to slots at congested airports. Last but not least, the commitments are designed to ensure effective monitoring by the Commission.

At the core of the remedies is a commitment to give new entrants (or competitors willing to expand their existing services) slots on the routes where competition concerns were identified and where slots are scarce. The underlying rationale is to lower barriers to entry in situations where there are slot constraints at (at least) one end of the problematic route. New or existing competitors willing to enter or expand on such routes would normally find it difficult to obtain slots from the slot coordinator. Slot remedies thus aim to lower entry barriers so that entry or expansion is more likely to occur. The slots are normally offered at airports at both ends of the route (14) for a specified number of flights, i.e. daily or weekly frequencies. The number of slots made available generally corresponds to the overlap between the parties. This solution aims to replicate the competitive pressure that the parties exercised on each other before the merger.

According to the recent commitments, on short haul routes, the parties have to grant slots that are within +/- 20 minutes (15) of the time requested by the applicant and that are in line with the applicant’s business model as regards, for example, turn-around time. (16) The commitments generally do not contain any limitation on the number of slots to be released at peak hours.

The new commitments simplify the slot allocation procedure to help new entrants plan their schedules, and introduce a fast-track dispute resolution procedure that can be invoked by any slot applicant/new entrant who has reasons to believe that the parties are failing to comply with their commitments.

An important element of the most recent commitments is the prospect of obtaining grandfathering rights to the slots transferred. As a rule, slots are earmarked for the route where competition concerns were identified. However, once these slots have been used on a given route for a number of full consecutive IATA seasons (four as a rule (17)), the slot transfer becomes definitive and the new entrant is able to use these slots on any other route. In the Iberia/Vueling/Clickair case, this standard period was reduced to two full consecutive IATA seasons for applicants who request slots to operate,

(14) Unless these slots can be obtained from slot coordinators through a normal procedure.

(15) This is an improvement on previous cases where slots granted by the parties could deviate from the applicant’s request by 30 minutes; see (for example) case COMP/M.3280 — Air France / KLM.

(16) The commitments foresee that ‘arrival and departure slots shall be such as to allow for reasonable aircraft rotation taking into account the Prospective New Entrant’s business model’.

(17) However, the specificities of a case may require that this period be shortened to two IATA seasons or prolonged to six or eight IATA seasons.
from one single airport, a significant number of city pairs (15) with respect to which competition concerns have been identified. Market players regarded such grandfathering rights as an additional incentive for airlines to enter these routes. This is because slots are particularly valuable assets at some European airports where there are considerable slot constraints. Moreover, grandfathering rights to slots allow for a flexible allocation of aircraft and strengthen the viability of services offered by competitors.

Where new or existing competitors are willing to operate additional frequencies on these routes, the commitments enable these competitors to enter into special prorate and code-share agreements with the parties, allowing them to place their codes on the parties’ flights. In addition, new entrants may conclude interlining and intermodal agreements, and they may be granted access to the parties’ frequent flyer programme for their passengers. The rationale behind ancillary remedies of this kind is to ensure that the parties’ competitors have access to connecting traffic, i.e. they can fill their planes with connecting passengers and thus achieve/increase profitability for the services that they add on a given route.

The Commission market-tested each set of commitments with the customers and competitors of the respective parties and with other market participants. Most of the feedback it received was positive, i.e. respondents felt that the commitments would sufficiently facilitate entry or expansion on the remedy routes and would solve the competition concerns raised by the proposed concentrations. Furthermore, in each case, respondents to the market test expressed interest in taking up the remedy slots despite the current economic crisis. It remains to be seen how these improved remedy packages will work in practice: their full positive impact may not be felt until after the industry has recovered.

(15) If an airline operates a significant number of city pairs, it is likely to (have) set up a base at the airport.