COMMISSION DECISION
of 22 September 1999
declaring a concentration to be incompatible with the common market and the EEA Agreement

Case No IV/M.1524 - Airtours/First Choice

(Only the English text is authentic)

(Text with EEA relevance)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community,

Having regard to the Agreement on the European Economic Area, and in particular Article 57(2)(a) thereof,

Having regard to Council Regulation (EEC) No 4064/89 of 21 December 1989 on the control of concentrations between undertakings[1], as last amended by Regulation (EC) No 1310/97[2], and in particular Article 8(3) thereof,

Having regard to the Commission's decision of 3 June 1999 to initiate proceedings in this case,

Having given the undertakings concerned the opportunity to make known their views on the objections raised by the Commission,

Having regard to the opinion of the Advisory Committee on Concentrations[3],

WHEREAS:

On 29 April 1999, the Commission received a notification of a proposed concentration pursuant to Article 4 of Regulation (EEC) No 4064/89 ('the Merger Regulation') by which Airtours plc. ('Airtours') would acquire within the meaning of Article 3(1)(b) of the Merger Regulation control of the whole of First Choice plc ('First Choice') by way of a public bid.

On 3 June 1999, the Commission decided to initiate proceedings in application of Article 6(1)(c) of the Merger Regulation.

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1 OJ L 395, 30.12.1989, p. 1; corrected version in OJ L 257, 21.9.1990, p. 13.
2 OJ L 180, 9.7.1997, p. 1.
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I. THE PARTIES AND THE OPERATION

1. Airtours is a UK company active in: tour operating, travel agencies, charter airlines, hotels and cruise ships with operations in 17 countries across Europe (notably in the United Kingdom and Ireland) and North America. First Choice is a UK company active in: tour operating, travel agencies, charter airlines, seat broking and car rental broking, mainly in the United Kingdom and Ireland, with some activities in Canada. Airtours proposes to acquire First Choice by way of a public bid.

II. CONCENTRATION

2. Airtours proposes to acquire the whole of the equity of First Choice. The notified operation therefore constitutes a concentration within the meaning of Article 3(1)(b) of the Merger Regulation.

III. COMMUNITY DIMENSION

3. The joint world-wide turnover of the undertakings concerned exceeds EUR 5 billion (EUR […]* for Airtours and EUR […]* for First Choice). Each of the undertakings has a Community wide turnover in excess of EUR 250 million (EUR […]* for Airtours and EUR […]* for First Choice), but they do not both achieve more than two-thirds of their aggregate Community-wide turnover within one and the same Member State. The notified operation therefore has a Community dimension.

IV. RELEVANT MARKETS

A. Relevant product markets

4. The parties' activities overlap mainly in the supply of leisure travel services to customers in the United Kingdom and Ireland. As well as supplying package tours and certain other holiday products, they are also both vertically integrated into upstream (airline operation) and downstream (travel agency) businesses. In previous decisions on cases in this area[4], the Commission has distinguished certain distinct product markets and these are used as the starting point for establishing the relevant markets here.

<u>Production: Tour operating</u>

5. Both parties are tour operators. Tour operators mainly supply 'package holidays', combining accommodation and possibly other services in a given (usually foreign) destination with return travel (usually by air) to and from it.

6. Package holidays have previously been found by the Commission[5] to constitute a separate market from holidays where the consumer purchases the various elements

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* Parts of this text have been edited to ensure that confidential information is not disclosed; those parts are enclosed in square brackets and marked with an asterisk.

4 For example, Commission Decision in Case No IV/M.1502 – Kuoni/First Choice, OJ C 139, 19.5.1999, p. 3, and Commission Decision in Case No IV/M.1341 – Westdeutsche Landesbank/Carlson/Thomas Cook, OJ C 102, 13.4.1999, p. 9.

5 Kuoni/First Choice case, cited in footnote 4.

individually. According to Airtours[6] and others the distinction between the two product types is becoming less marked as consumers become more familiar with holidaying abroad and thus more willing to make their own arrangements, and with the entry (following liberalisation) of low-cost scheduled airlines into the European market. Consequently, they consider, independent holidays should be regarded as a competitive constraint on package tour operators. The Commission does not accept this view.

7. The total price of an independent holiday may set an upper limit on the price that can be charged for a similar package. But it does not follow that it will act as a sufficient constraint to prevent prices for packages from rising above the competitive level. Although it may be possible for consumers to purchase the accommodation and travel elements of a package on their own account, there remain some important differences. For example, it can be difficult for consumers to make a direct comparison of prices between a package holiday and its equivalent bought as separate elements (e.g. as regards transfers to and from the airport). There are also likely to be additional search and 'transaction costs' (telephone calls, faxes/letters to the hotel and airline, arranging car hire, transfers, etc.) and risks (e.g. in taking recourse against a foreign-based hotel owner) involved in contracting separately by comparison with the 'one-stop' nature of the purchase of a package. Accordingly, the Commission does not consider that a relatively small price rise in package holidays would cause sufficient customers to substitute independent holidays to justify including independent holidays in the relevant product market for the present case[7].

8. Some packages (e.g. coach tours) involve the supply of surface transport. Other packages from the United Kingdom supply only the sea (or Channel Tunnel) crossing and the accommodation, with customers using their own cars. However, nearly 90% of all package holidays from the United Kingdom are by air[8]. Accordingly no distinction is made between product markets in regard to the transport method employed.

9. Neither Airtours nor First Choice has more than a minimal presence in UK domestic holidays. However, in the Commission's view, like that of the UK Monopolies and Mergers Commission (MMC) in its 1997 Report[9], prices of domestic holidays in the United Kingdom and Ireland do not constrain prices for foreign package holidays, given consumers' preferences in terms of climate, culture etc, as well as price levels and other factors Accordingly, domestic holidays are not considered to form part of the relevant market for the present purpose.

10. Within the foreign air package holiday market a number of further distinctions are also possible. These include distinguishing by holiday type, e.g. 'beach holidays', 'ski-ing', 'city breaks', or by destination (either on a country basis or more narrowly).

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6 Reply to Commission's Statement of Objections, at paras. 2.20-2.31.

7 The UK Monopolies and Mergers Commission (MMC) took a similar view, for similar reasons, in its investigation of the sector, 'Foreign Package Holidays', December 1997, Cmnd 3813, at p. 12, para. 2.21, ("1997 Report").

8 Notification, pages 19 and 23-25.

9 At para. 2.22.

11. Airtours considers that there is sufficient substitutability between these various elements, on both supply and demand sides, to make it unnecessary to further subdivide the package tours product market. They also point out that neither the Commission, in previous relevant cases, nor the MMC (in the 1997 Report) has so far found it necessary to do so[10].

12. However, for the reasons set out below, a somewhat narrower approach is considered to be justified in the present case in regard to distinguishing separate markets for package holidays to long-haul and short-haul destinations; the latter comprises mainly 'sun and sea' holidays[11], which are taken predominantly in the summer, and particularly in July and August.

13. Broadly, the long-haul sector is generally recognised in the travel trade as comprising all destinations that involve a flight time (from the United Kingdom) substantially in excess of three hours[12]. Thus effectively all European (mainland and islands) and North African holiday destinations, fall into the 'short-haul' category, in contrast to those in, for example, the Caribbean, the Americas or South/East Asia, where the flight times are substantially longer (typically, twice as long or more).

14. The parties, and certain of their main tour operator competitors, have a somewhat stronger presence in the short-haul sector than in the long-haul sector. In the latter (summer 1998), Airtours had 13.3% and First Choice 16.4% (total 29.7%); Thomson 14.7% and Thomas Cook 8.3%[13]. These shares are not, in themselves, indicative of the creation of a dominant position in long-haul tour operating. Moreover, the long-haul sector tends to be more fragmented than short-haul, with a large number of smaller, specialist tour operators, and some suppliers (such as Kuoni, BA Holidays, Virgin) which are part of larger groups. However, long-haul package holidays account for a relatively small proportion (around 15-20%, according to Airtours)[14] of total UK package holiday sales. Consequently, a wider product market definition, to include both long-haul and short-haul packages, would be unlikely to produce substantially different market shares and increments, although Airtours suggests that it could have some effect from the viewpoint of assessing the strength of actual and potential competitors.

15. Airtours suggests[15] that there is convergence in prices between long-haul and short-haul packages, so that, for example, a 'Disneyland' holiday in Florida has been sold at a roughly similar price to that of its 'Eurodisney' equivalent, and that in consequence, long-haul prices effectively constrain those for short-haul. However, in the Commission's view, and as more fully described below, the differences between long-haul and short-haul packages, in a variety of material respects, are

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10 Notification, in particular paras. 6.52-6.60.

11 The MMC, in its 1997 Report, table 3.3, indicates that in 1996, Spain and Greece together accounted for 5.5 million package holidays from the United Kingdom out of a total for Europe (including Turkey) of 9.5 million – or nearly 60%, with Spain alone accounting for 45%. This proportion has probably decreased since then, but Spain remains the most popular package holiday destination.

12 Notification, Section 6, and sources quoted there; flights to Eastern Mediterranean destinations or the Canary Islands may take up to around 4 hours.

13 Notification, Table 6.9, source A C Nielsen. Short-haul figures are set out in Table 1 of this Decision.

14 Notification, para. 6.64.

15 Notification, para. 6.58.

more significant, in competition terms, than their similarities, so that it is appropriate to separate them for the purposes of an assessment of the concentration.

16. Aircraft are not fully interchangeable between short-haul and long-haul operations. Certain smaller aircraft types currently in service in large numbers (e.g. B737, A320, MD 80 series) lack the range for most long-haul journeys and so cannot be used for them. Nor are all larger aircraft necessarily suitable. Some large tour operators suggested to the Commission that certain popular larger aircraft (e.g., B757) are less suitable for long-haul operations, since they lack the range for some journeys (maximum range, United Kingdom to the north-eastern US seaboard) and their single-aisle, narrow-bodied design means the cabin space is too cramped to provide adequate comfort on longer flights. Long-haul flights reduce the number of 'rotations' (each consisting of an outward and a return flight) an aircraft and its crew can make between its home base and the destination(s) in a given time period, and increase important costs such as crewing and catering. Three rotations per day are possible for many short-haul destinations, but only one for long-haul, whereas long-haul aircraft generally carry less than twice as many passengers as a short-haul one (e.g. a typical A320-series charter configuration is for around 200 passengers, that for a B767 or A330, about 350[16]). This in turn increases the number and/or the size of aircraft needed for an economically viable long-haul operation compared with a short-haul one.

17. The operating cost per passenger/mile is generally lower for larger aircraft than smaller ones, especially over longer distances. But it will not always be economical to use a larger aircraft for a short-haul journey, even where runways, airport terminal facilities etc., permit. There must be sufficient demand to fill the aircraft to a viable level, which will normally be close to the maximum, throughout the season; it costs little more to operate an aircraft with a full load than it does half-empty. This means that it is necessary for airlines to match fleet composition closely to the mix of passengers as between larger (mainly long-haul) and smaller (mainly short-haul) types. Airtours, for example, currently has in its fleet only five aircraft (A330, B767) which it regards as capable of being used for either long-haul or short-haul journeys, out of a total of 37 aircraft of all types[17].

18. All these factors will tend to decrease the scope for airlines (and vertically-integrated tour operators) to substitute between long-haul and short-haul flights, with consequent effects on prices. Moreover, although it is possible to lease aircraft on a short–term basis, charter airlines (including those of the parties) generally either own most of their aircraft or lease them on relatively long leases in order to reduce costs, maintain quality and ensure continuity of supply; according to the Commission's information, a lease of five years is typical. Accordingly, new investment (and some time) would be needed for an airline to substantially reconfigure its fleet as between long-haul and short-haul capabilities.

19. For the tour operator and the ultimate consumer, there are in addition other significant differences besides the above.

20. Long-haul holidays, although probably no longer regarded as the prerogative of the wealthy, nevertheless still have, with certain possible exceptions such as Florida, a

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16 Source: *Hot!* – Airtours' in-flight magazine, winter 1998/99.

17 Reply to Statement of Objections , p. 22, para. 2.43(iii).

more ‘exotic’ image in contrast to the relatively domesticated one presented by the typical Mediterranean resort, and accordingly appeal more to a different type of consumer (e.g. ‘singles’ or couples without children). They may also be seen as less suitable in other respects. For example, many UK foreign package holidays are taken during the peak summer holiday period (roughly, mid-July to end-August) in order to coincide with school holidays (and in some areas, factory closures); at these periods, weather conditions in some typical long-haul destinations (e.g. Florida) will be unfavourable[18].

21. The substantially longer flight time is also likely to deter some consumers from choosing a long-haul package holiday, even if it is comparable in other respects to a typical short-haul one – e.g. in terms of weather, location, price, visa and medical requirements etc. Most package holidays taken by UK customers are for a maximum of two weeks, reflecting (in contrast to much Continental European practice) the typical amount of time allowed by employers for their staff’s main annual holiday. The greater the proportion of the holiday that has to be spent in the air, the less that can be spent on the beach, and in practice there can be as much as a whole day’s difference between the total travelling times for typical long-haul and short-haul holidays. For journeys to the Americas, in particular, ‘jet-lag’ can also reduce the amount of ‘usable’ holiday time.

22. These and other differences are reflected in prices to consumers. Information provided by Airtours[19] shows that in summer 1998 the average brochure price of its long-haul holidays was some GBP […]* compared with GBP […]* for short-haul, a difference of over […]*. A comparison made for the Commission by a leading tour operator between holidays of broadly similar type (14 nights, 3-star self catering) in Florida and Spain showed the short-haul holiday to be on average about half the price of the long-haul one. Broadly similar results were shown on comparisons with Greece and the Canaries, and for ‘catered’ accommodation at these destinations (difference of around 30-40%). Moreover, there was not found to be a stable relationship between the two groups of prices over time – as would be expected if they were substitutes. For example, between 1994 and 1995, Spanish prices rose by 9% while those for Florida fell by 3%; between 1997 and 1998 the exact converse of this occurred – Florida prices rose 9%, Spanish ones fell 3%.

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18 For example, the popular ‘Lonely Planet’ travel guide makes the following comment in regard to Orlando, Florida: ‘July and August are very hot and humid with highs around 90F (33C), 95% humidity and frequent downpours.’

19 Annex 1(a) to reply of 29 June 1999 to Commission enquiry.

23. Average prices will not necessarily reflect those at the margin. However, where the differences are as large as they are here it is unlikely that a sufficient range of genuinely comparable long-haul holidays would be available at a sufficiently similar price to ensure that long-haul prices constrained those for short-haul[20].

24. Price information made available to the Commission supports the conclusion that there is only limited convergence between prices for long-haul and short-haul holidays of comparable type. Prices of some holidays at certain long-haul destinations, particularly at certain times of the year (e.g. during periods when bad weather is expected) match or come close to those at the upper end (summer peak, better quality accommodation) of the price/quality scale for short-haul ones. But it is not to be expected that this very limited overlap would suffice to constrain prices throughout the short-haul market, since the long-haul holidays concerned would not be regarded as effective substitutes – either on price or other grounds – by more than a very small proportion of customers.

25. For example, none of the long-haul holidays cited by Airtours in its reply to the Statement of Objections[21] in support of its view on this point was in the same price range as that which it supplied earlier as typical for short-haul (around GBP 485 for one week, July/August 2000, 3-star half board in Majorca[22]). The cheapest long-haul holiday in the table for July/August 1999 is GBP 849 (Thailand – which involves a flight-time of 11 hours and which at that time of year, according to Airtours' brochure, has some 23 cm of rain per month and only five hours of sunshine per day) and the cheapest at any time of year is GBP 649 (Mexico, January 2000) reflecting differences from the typical summer short-haul price of +43% and +33% respectively.

26. Similarly, in the information about long-haul holidays offered by BA Holidays, cited by Airtours[23] as showing price substitutability between long-haul and short-haul (and the consequent importance of BA as a competitor), there was only one holiday among the eight displayed that included food. All the rest were either accommodation only, and so not directly comparable with a typical short-haul package, or (in four instances) 'fly-drive' – which Airtours itself does not consider to be a 'package' holiday as normally defined[24]. The 'matching' holiday in question was 7 nights, 4-star all inclusive in St Lucia, and cost GBP 799 per person. A roughly equivalent package in Tenerife (7 nights, Barcelo Hotel Santiago, 4-star, all inclusive) is priced in the First Choice brochure at around GBP 550 during the period concerned – some 30% less. Neither would any holiday in the period concerned be suitable for families with children, since the UK school holidays are over by, at the latest, the first week in September. It is also relevant that the BA holidays in question were being offered at these prices during the 'lates' period, that is only a month or two before departure, and in consequence are likely to be offered at a discount over the brochure price used to provide the basis for

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20 This reflects the view expressed by long-haul operator Kuoni on this point at the oral hearing.

21 Table 2.6 on page 21.

22 Annex 2 to reply of 29 June 1999 to Commission enquiry.

23 BA Holidays 'world offers' poster, produced by Airtours at the oral hearing, and showing prices available in July 1999 for travel in September or October 1999.

24 Reply to Statement of Objections, p. 2, para 1.8.

comparison; a ‘late’ short-haul booking would also attract a discount, further increasing the differential.

27. In its reply to the Commission’s Statement of Objections, Airtours supplied some customer survey data in further support of its view[25]. This indicated that a substantial proportion (36%) of its sample of customers who had taken a short-haul package holiday within the last five years had also taken a long-haul one; similar proportions had considered or would consider doing so. However, it cannot be properly inferred from this – as Airtours seeks to do – that the holidays in question are true substitutes for each other. Periodic changes in personal circumstances (such as, e.g., the ‘windfall’ gains experienced by many UK building society savings-account-holders in recent years following the demutualisation and/or acquisition of their society) may allow consumers to take a more expensive (or additional) holiday in some years, but will not affect their behaviour the rest of the time. The survey data does not provide any indication of the extent to which this factor was relevant with the sample. Nor, in particular, does it provide any comparison of the prices paid for the two types of holiday.

28. For all the above reasons, therefore, the Commission considers that the relevant product market, as regards tour operation, is that for *short-haul foreign package holidays.*

Distribution: Supply of travel agency services

29. Both parties have travel agency operations in the United Kingdom (there is no overlap in Ireland.) Travel agents are retailers, supplying various services to consumers and business travellers; such as flights, either charter or scheduled, hotel and other accommodation bookings, car rental, foreign currency, travel insurance and other related services. They operate mainly through High Street shop or office premises, though some also have telephone sales operations, which are available outside normal shopping hours. Travel agents are generally remunerated by a commission from the supplier of the service concerned, whose agent they are, rather than directly by the customer for the service itself. In the case of package holidays, the agent receives a commission from the tour operator on the price of the holiday sold. All travel agents in the United Kingdom and Ireland offer the products of a range of tour operators and other suppliers amongst their range of products and services, and all the main tour operators have at least some of their own travel agencies.

30. The major tour operators (including the parties), and some small ones, also have direct sales operations, through shops, telephone call centres, or mail order, for their own products. Unlike traditional travel agency services, direct-sales operations do not permit consumers to compare the offers of different suppliers[26]. However, this distinction appears to have only limited importance, at least so far as package holidays are concerned. Integrated tour operators/agents all engage to a substantial

25 At Tables 2.4 and 2.5 and paras. 2.37-2.39.

26 The MMC, in its 1997 Report, cited in footnote 7, excluded direct sales operations and telephone sales from its market definition when considering competition between travel agents (paras. 2.24 and 4.29).

extent in 'directional selling' practices, whereby their agencies give preference to the products of the 'in-house' tour operator when selling to clients[27].

31. The Internet and teletext are also used by agents and operators to advertise availability and prices of holidays. But the actual booking and sale is, almost invariably, carried out by traditional means: through a travel agent (in person, by telephone or by mail), or direct with the tour operator (shop, telephone call centre, or mail order). Teletext is only a display system and cannot be used to make the sale. E-commerce - i.e. actual purchases via the Internet - is regarded by many agents and operators as a significant potential alternative distribution method for the future, and one which may introduce more independent distributors to the market – although established agents and operators will no doubt also develop e-commerce operations of their own. But at present it is undeveloped in the United Kingdom, even for small-value items such as books, let alone major purchases such as package holidays; consumers perceive it as risky, and it is likely to take some time to change their attitude. Its current use in the travel trade is largely confined to airline-ticket-only sales. Digital TV, about to be introduced in the United Kingdom, may eventually be developed as a selling system, but its impact is unlikely to be significant in the short term. The great majority of package tour sales (according to the notification, 81%) are still made by travel agents, and most of them (62% according to the notification) through in-person sales by shops, though the latter proportion has been declining, and direct sales by tour operators have remained static as a proportion of the total since 1993[28]. These factors suggest that for tour operators, direct distribution to the consumer (without going through an agency) is a complement to the agency sales channel rather than a substitute for it[29].

32. The relevant product market is that for travel agency services, since the parties' agencies supply the typical range of products and services, although they also play an important role in the distribution of the parties' products. On present information, however, the merger is not likely to lead to the creation or strengthening of a dominant position in travel agency services as a whole, whether or not direct sales of package holidays by tour operators, and/or distance sales (i.e. by telephone, etc.) by agents are included. In terms of numbers of outlets, the parties' combined share of the supply of travel agency services is small – around 15%[30].

33. The impact of the merger on the vertical integration of the industry – i.e. the ownership by tour operators of travel agencies and their distribution of their package holidays through them, is discussed further below (in the section on Vertical integration).

<u>Supply of airline seats</u>

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27 As, for instance, described by the MMC in its 1997 Report , at paras. 2.69-2.83.

28 The figures are for 1998, source British National Travel Survey (BNTS) as quoted at para. 6.149 of the Notification.

29 It should also be considered in this connection that while some small operators in specialist interest niches may make extensive use of direct sales, those that offer typical mass market holidays in competition with the major integrated operators are more dependent on distribution through travel agents.

30 Commission estimate, based on Form CO and MMC 1997 Report.

34. Both parties operate their own (charter) airlines: Airtours operates Airtours International, and First Choice, Air 2000. They are primarily intended for use with their own packages, though some of the seats on them are also supplied to third parties (other tour operators and brokers). Both parties also buy some seats from other airlines, both chartered and scheduled, mainly but not exclusively for incorporation into their (or others') packages.

35. Charter airlines exist primarily to serve tour operators, particularly in the most popular sectors of the foreign holiday market, and account for the great majority of seats[31] sold to tour operators for UK and Irish package tours. Their operations have a number of characteristics distinguishing them from those of scheduled airlines. Charter airlines operate (generally non-stop) between the country of origin and the airports closest to major holiday destinations. The choice of routes and the frequency of flights is dictated by demand from tour operators and charter airlines will change flying patterns to reflect changes in demand for foreign package holidays to particular destinations. Charter airlines generally expect a tour operator to buy blocks of seats for at least a holiday season.

36. The parties' market shares, and those of their main competitors, of the supply of transport services to tour operators for use in package tours are similar whether or not scheduled flights are included[32]. Scheduled flights account for a relatively small proportion (12%) of all UK package tour flights[33]. In principle, tour operators could substitute scheduled airline flights for charter flights. However, in the Commission's view, it is unlikely that prices for scheduled flights will in general constrain those for charter flights, and in consequence, scheduled flights should not be considered as part of the same product market as charter flights for the present purpose. As explained below, according to the Commission's information from airlines and tour operators, scheduled flights are not a viable substitute for charter flights for package tours to most package holiday destinations, especially short-haul ones.

37. Scheduled airlines operate a network of routes, mainly linking capital and other major cities; in consequence, they will not necessarily operate direct to the resort areas which are the tour operator's typical (short-haul) destination. (Tour operators seldom or never use indirect flights, finding them inconvenient for customers, longer, and plane-load for plane-load more expensive than direct ones.) Tour operators sometimes buy blocks of seats on scheduled flights to holiday destinations. But in the Commission's view, and broadly supported by comments from third parties, several factors make scheduled flights inadequate substitutes, from the tour operator's viewpoint, for more than a small proportion of charter flights. Indeed, according to information obtained by the Commission from a small tour operator during its investigation, scheduled seats are typically 25-30% more expensive than equivalent ones on charter flights. Consequently, they are unlikely to constrain prices for charter flights generally.

38. Seats on aircraft used for scheduled flights are usually more widely spaced than on those used on charter operations, reducing the capacity and increasing relative costs and prices. For example, typical 'economy' seat spacing on a BA flight is 31 inches,

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31 Nearly 90% according to survey data reproduced by the parties in Table 6.17 of the Notification.

32 Notification, Tables 6.17 and 6.19.

33 1998, source BNTS, reproduced in Table 6.17 of the Notification.

whereas on Airtours it can be as little as 28 inches; the difference, and other changes to layout, allowing the charter airline to carry more passengers[34]. The supply of scheduled airline seats to European destinations has certainly, as Airtours suggests, increased in recent years, notably with the entry or expansion of 'low cost' airlines in Europe – essentially, so far as the UK short-haul package holiday is concerned, Easyjet, Ryanair and the BA subsidiary Go, following liberalisation. However, the impact of this change as regards substitutability with charter flights should not be exaggerated. The range of destinations and routes served by these airlines at present is very limited. According to information provided by Airtours[35], for example, there are no services by these airlines to any Greek, Turkish, or North African destinations, or to the Canaries. Ryanair has no operations to Spain or Portugal. Easyjet's operations to the popular Spanish destinations of Barcelona and Malaga are from the relatively unpopular regional airport of Liverpool; Go's flights to Spain and Portugal are all from London Stansted rather than the more popular Gatwick, which is heavily congested. Another small scheduled airline – Debonair, based at Luton – is cited in Airtours' reply to the Statement of Objections [36] as being a useful source of capacity, especially at weekends, when its business flying sales are likely to be low. However, according to the information just mentioned, Debonair's only service to a typical short-haul package destination is to Alicante.

39. In many instances, scheduled seats may simply not be available, either at all or in appropriate numbers and at suitable times and prices, even where there are direct scheduled flights to the destination concerned[37]. Scheduled airlines are often not able to offer tour operators a whole aircraft, or more than a small proportion of the seats on it, throughout the week, and/or for a whole season[38]. Their schedules may also not permit a sufficient number of daily rotations to reduce operating costs (and hence prices to tour operators) to those of a typical charter operation. Tour operators need to acquire their capacity in bulk and ahead of time, in order to minimise costs and provide a reliable offer to customers, most of whom book well in advance. Scheduled airlines' flight schedules (and the aircraft and other resources need to operate them) however are – by definition – fixed for quite long periods at a time, and they need to offer their traditional customers, especially those with fully-flexible tickets, the possibility of a seat at relatively short notice. Failure to do so as a result of taking on substantial amounts of 'charter'-type business would damage their ability to operate a network – their primary role and the one generating most of their income.

40. Consequently, though scheduled airlines are a source of marginal capacity to tour operators, they are not likely to replace more than a small proportion of charter supply, and as a result will not fundamentally affect charter flight prices[39]. These

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34 Source: press article enclosed by Airtours in its reply of 29 June 1999 to Commission enquiry.

35 Transparency and documentation accompanying Airtours' presentation at the oral hearing, 'low-cost airlines – who flies where' (p.18).

36 Letter to Airtours from seat brokers Hunt & Palmer, appendix 5 to the reply to the Statement of Objections, and quoted at para. 3.48 of the reply.

37 According to one major tour operator, in the great majority of cases, the only direct flight available to a 'summer sun destination', especially from regional airports, will be a charter flight or, for the more popular destinations, one from a 'leisure' airline such as BA's recently-created 'Go'.

38 BA offers some whole-plane charters at weekends from UK regional airports, using aircraft not required for scheduled services at those times. This is, however, understood to be a small-scale operation, and BA has indicated that it has no plans to expand it substantially.

39 Information on relative prices supplied by Airtours at the oral hearing (paper by Professor Neven, p. 10 and Table 5) in support of its view that prices for selected scheduled and charter flights were

factors also suggest that a substantial proportion of the scheduled flying used for package tours is more of a complement to charter flying than a genuine substitute for it. This conclusion is further reinforced by the fact that many tour operators offer travel by scheduled flights, if at all, only as an extra-cost option on their packages (except for certain long-haul or 'upscale' products).

41. The major tour operators in the UK travel market are vertically integrated, each with its own charter airline. However, in line with the Commission's normal approach in these matters, self-supply is not regarded as forming part of the relevant market. The market therefore consists only of sales to (and by) third parties.

42. Accordingly, the relevant product market adopted for the purposes of the present decision as regards airline services, is that for the *supply to tour operators of seats on charter flights to short-haul destinations*.

B. Relevant geographic markets

43. The Commission has accepted in previous decisions that the markets within Europe for the supply of foreign package holidays are still essentially national in character[40]. Tour operators, even those which sell holidays in several countries, generally produce and market their packages on a national basis – i.e., for the Community, with a point of departure in, and for sale to residents of, each Member State separately. Travel agents likewise market nationally. Charter airline services can also be regarded as national in character, as they fly out of and return to their country of origin and licensing and the demand for these services arises mainly from customers resident in the country of origin.

44. There are also a number of practical obstacles which would make it difficult for consumers to book a package holiday with a tour operator or travel agent not established in their 'home' state. Relevant information and resources (e.g. brochures or booking facilities for foreign tour operators, sales points for travel agents) will not be available locally, and linguistic differences could cause communication problems. In addition, the holiday contract would normally be governed by the law of residence of the foreign tour operator or travel agent, making it more difficult for the traveller to seek redress in the event of a complaint. A further inconvenience arises from the fact that travellers would have to make their own arrangements for travel to the point of departure in the territory of the foreign tour operator or agent.

45. In the Commission's view, which third parties have in general not contradicted, narrower subdivisions, notably by airport of departure, or region, are inappropriate in the present case. Tour operators market their products nationally, without substantially differentiating them, either in price or otherwise, for consumers on a regional basis, and this is, naturally, reflected by travel agents. Consumers obviously prefer to fly from an airport that is reasonably accessible from their home, although many, especially those in the South-East or Midlands of England, will be able to reach at least one alternative departure point within a couple of hours by

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comparable, also indicates that the operator in question charged (or was charged) a supplement for the scheduled flight in each of the five instances examined.

40 For example, the Commission Decisions in the following cases: Havas Voyages/American Express (IV/M.564), OJ C 117, 12.5.1995, p. 8; Thomas Cook Group/LTU/West LB (IV/M.229), OJ C 199, 6.8.1992; West LB/Thomas Cook (IV/M.350), OJ C 216, 11.8.1993; Wagons-Lits/Carlson (IV/M.867), OJ C 202, 2.7.1997, p. 4; Westdeutsche Landesbank/Carlson/Thomas Cook (IV/M.1341), cited in footnote 4.

road. Package holiday prices generally reflect this, but are also influenced by differing cost levels for operations from the different airports. Landing fees and related factors mean that prices for departures from some of the smaller regional airports are often higher than for those from the main ‘holiday’ airports (London Gatwick and Manchester). However, the premium charged (or discount offered) is usually relatively small compared to the total holiday cost, especially when account is taken of the additional cost of the road journey to a ‘cheaper’ airport further away. This relative uniformity of pricing and cost suggests that there is a sufficient degree of overlap between the possible regional or local markets for them to be regarded for the present purpose as constituting a single, national one on the demand side, on a ‘chain of substitution’ basis.

46. On the supply side, tour operators and airlines can in general easily move planes and flights between the various airports (with the exception of Gatwick especially, where the limited availability of slots acts as a constraint).

47. These indications suggest that a further distinction of geographic markets within the United Kingdom is unnecessary for the assessment of this case. As regards Northern Ireland, the costs and other relevant features of operating and arranging flights and obtaining and supplying accommodation for consumers from Northern Ireland do not appear to differ substantially from those for the rest of the United Kingdom, and selling prices and other product characteristics are understood to be generally similar in the two areas, except that there is a wider range of destinations and other options available from the latter. The relatively small numbers of package holiday passengers (around 40 000 or 14% of the Northern Ireland total, according to one major operator) who travel to other UK airports to start their holidays appear to do so in order to avail themselves of this choice (or, for unconnected reasons, such as combining the package holiday with a visit to friends and relatives elsewhere in the United Kingdom) rather than on price grounds. The MMC 1997 Report did not make any distinction in its analysis or findings between Northern Ireland and the rest of the United Kingdom.

48. For these reasons, it is not considered necessary to define a separate geographic market for Northern Ireland in the present case.

49. The Irish market is so much smaller than the UK market (less than 5% by volume) that its inclusion or otherwise would not affect the conclusions with regard to the United Kingdom. As already mentioned, however, tour operating markets are considered as largely national due, among other reasons, to the difficulty of making cross-border purchases, and the effects of currency differences. Moreover, there are certain other differences between Ireland and the United Kingdom as regards such aspects as the structure of the industry and its evolution. Consequently, it is appropriate to regard Ireland as a separate market from the United Kingdom for the present purpose.

50. Accordingly, the relevant geographic markets for the present case, for each of the relevant product markets, are, respectively, the United Kingdom and Ireland.

V. COMPETITION ASSESSMENT

A. Introduction: Collective dominance

51. The Commission considers that on the basis of its competition analysis as set out below, the notified concentration will lead to the creation of a dominant market position in short-haul package holidays in the United Kingdom on the part, collectively, of Airtours/First Choice and the two other leading tour operators - Thomson Travel Group plc ('Thomson') and The Thomas Cook Group Limited ('Thomas Cook'). In Ireland, the Commission considers that the concentration will not lead to either a single or collective dominant position in any of the affected markets.

52. Airtours argued at the Hearing that collective dominance could be thought of as a cartel, but without an explicit cartel agreement, cartel meetings, etc. Airtours then went on to explain that such a "tacit cartel" would be unstable in the UK market for short-haul foreign package holidays because there would be no retaliatory mechanism which would prevent any of the participants in the tacit cartel from "cheating" (see paragraph 55).

53. As set out by the Commission in previous cases, and confirmed by the Court of First Instance of the European Communities most recently in the merger case Gencor/Lonrho[41], active collusive conduct of any kind is not a prerequisite for collective dominance to occur. It is sufficient that adaptation to market conditions causes an anti-competitive market outcome. As the Commission's decision in the Gencor/Lonrho case (at paragraph 140) states, a collective dominant position 'can occur where a mere adaptation by members of the oligopoly to market conditions causes anti-competitive parallel behaviour whereby the oligopoly becomes dominant. Active collusion would therefore not be required for members of the oligopoly to become dominant and to behave to an appreciable extent independently of their remaining competitors, their customers and, ultimately, the consumers'.

54. Furthermore, – contrary to the apparent view of Airtours[42] – it is not a necessary condition of collective dominance for the oligopolists always to behave *as if* there were one or more explicit agreements (e.g. to fix prices or capacity, or share the market) between them. It is sufficient that the merger makes it rational for the oligopolists, in adapting themselves to market conditions, to act – individually – in ways which will substantially reduce competition between them, and as a result of which they may act, to an appreciable extent, independently of competitors, customers and consumers.

55. In its Statement of Objections, the Commission identified[43] certain features of market structure and operation which had been identified as making anti-competitive outcomes, and in particular collective dominance, more likely. Airtours considers that, in effect, none of these indicators are present and that, furthermore, it would be impossible for the major suppliers to 'retaliate' in the event that one of them tried to win market share from the others by increasing capacity

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41 Commission Decision 97/26/EC, Case No IV/M.619 – Gencor/Lonrho, OJ L 11, 14.1. 1997, p. 30; judgment of the Court of First Instance of 25 March 1999 in Case T-102/96 *Gencor* v *Commission*, not yet published.

42 For example, as in para. 5.2, first indent, on p. 56 of their reply to the Commission's Statement of Objections: 'the allegedly collectively dominant firms must be able to reach tacit agreement to raise prices'.

43 At para. 70 ff.

and offering lower prices. However, the Commission did not suggest, nor does it consider, that all of the features have to be present and/or aggravated by the merger in order for collective dominance to arise in a given case. Nor does it regard a strict retaliation mechanism, such as that proposed by Airtours in its reply to the Statement of Objections [44], as a necessary condition for collective dominance in this case; where, as here, there are strong incentives to reduce competitive action, coercion may be unnecessary. However, in any case, as set out below, the Commission does not agree that there is no scope for retaliation in this market. Rather there is considerable scope for retaliation, which will only increase the incentives to behave in an anti-competitive parallel way.

56. In this particular case, the Commission has come to the conclusion that the substantial concentration in the market structure, the resulting increase in its already considerable transparency, and the weakened ability of the smaller tour operators, and of potential entrants to compete will make it rational for the three major players that would remain after the merger to avoid or reduce competition between them, in particular by constraining overall capacity. This does not mean that the Commission believes that there will be no competition in the market after the merger. Even in cases involving single dominance or tight cartels competition is rarely completely eliminated. In this particular case, as further discussed below, capacity is basically set prior to the selling season. A distinction, therefore, has to be made between the setting of capacity pre-season and the sale of capacity during the selling season. Constraining overall capacity in the pre-season does not exclude certain competitive actions during the selling season, for example various types of promotions. However, constraining the overall amount of capacity put onto the market ensures that the market will be kept tight. If capacity is constrained, prices and profits will be higher than otherwise, whatever competition takes place during the selling season. The Commission has reached the overall conclusion that the merger would result in a market structure which would create an incentive for the three remaining large operators to constrain capacity in this way.

44 E.g., para. 5.2, third indent.

B. The United Kingdom

Tour operation (short-haul foreign package holidays)

Introduction

57. In the Commission's view, and based on information supplied by Airtours and others, the relevant product market displays a number of characteristics which distinguish the conditions of competition in it. These are, in particular, the extent and nature of the vertical integration of the major suppliers, the extensive commercial and other links between them, and the limited scope for suppliers to make short-term output adjustments to match fluctuations in demand.

58. In the Commission's view, the merger would not lead to the creation or reinforcement of a dominant position by a single firm. However, it would lead to a situation of collective dominance in short-haul foreign package holidays[45].

Functioning of the market

General

59. Package holidays were devised partly as a way of achieving high sales volumes and reducing unit costs by allowing the tour operator to purchase the different elements (flight, catering, accommodation, etc.) in bulk, passing some of the savings on to consumers. Estimates of tour operating margins vary, but fairly low average figures - of the order of 7% (or around GBP 30 on a typical holiday price of around GBP 400) - have been cited by third parties for recent years. It should, however, be noted that vertically-integrated operators will normally also receive income, additionally, from their airline and travel agency activities, and margins on these aspects (especially airline operations) may be higher, so that the gross margins on the total operations of the integrated operators may be larger than those on their tour operation activities alone.

60. Tour operators need to operate at high levels of capacity utilisation (figures of the order of 95% or more in terms of holidays sold have been mentioned to the Commission) in order to maintain profitable short-haul operations. Matching capacity and demand is therefore critical to profitability, especially since package holidays are perishable goods - a given package loses all its value unless it is sold before its departure date.

61. Perishable-goods markets require highly flexible production and distribution systems so that supply and demand can be closely matched and 'waste' production minimised. But suppliers of package holidays are severely hampered in precisely aligning capacity and demand. They need to 'produce' (i.e. contract for the necessary flights, accommodation etc) virtually the whole of what they expect to sell a long time before it is 'consumed' (i.e. when the consumer departs for the holiday destination, or at the earliest, when the consumer pays the bulk of the price – usually around eight weeks before departure). A year or even more ahead is, according to the Commission's information, typical[46].

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45 "Collective dominance" and "oligopolistic dominance" are used as synonyms in this decision.

46 Cf. Notification, para. 6.23.

62. According to Airtours, detailed planning for the summer 2000 season (i.e. departures from May 2000) began […]*. According to Airtours, an increase of capacity of up to 10% can be contemplated until the end of […]* for the forthcoming summer season. After […]* only very minor changes are possible [47].

63. Information from the major tour operators confirms that operators' capacity plans, and the associated contracts with hoteliers and airlines, are typically fixed 12-18 months ahead of the holiday season. Some adjustments are possible after this date. However, within about 12 months of departure date, once the booking season has begun (i.e. from about the summer of 1999 for departures in summer 2000), the scope for changes is heavily constrained, due to the inflexibility of many commitments with suppliers and the problems associated with changing dates, flights, hotels, etc. of customers who have already booked.

64. Only by contracting for their expected needs well ahead of time, enabling suppliers to plan ahead, can operators obtain a sufficiently low price to attract an adequate volume of profitable sales. Tour operators accordingly need to encourage early bookings. These improve cash-flow – a substantial deposit (around GBP 100 per person, equivalent to around 25% of a typical short-haul holiday price) is paid by consumers on booking; the balance is payable (irrevocably, though operators and agents can arrange insurance as an extra-cost option) by two months in advance of departure (except, naturally, for 'late' bookings). They also reduce the risk of unsold holidays, and the consequent need for discounting, later on. Adding capacity is easier than reducing it during a season, although in some instances, e.g. where a particular resort is proving especially popular, all suitable accommodation (and/or flights to the relevant airport) will already have been reserved, at least for the peak period. But it is generally difficult for tour operators to 'unwind' their contracts, especially those for air transport, without substantial penalties. The tour operator, accordingly, bears almost all of the risk of any contracted capacity remaining unsold.

65. Faced with this limited ability to reduce output in the short-term (i.e. once the brochures are published and the selling season has started), tour operators can, for the most part, only try to restore equilibrium via the price mechanism – in other words, by discounting once it becomes clear, and to the extent, that sales of their holidays appear unlikely to match the supply for which they have contracted. The fixed costs of tour operation (mainly, the cost of the airline seat and most of the accommodation and catering costs) make up a high proportion of total costs, so that relatively high levels of discount can be applied if necessary to clear unsold stock. Reductions of up to 25% off the initial brochure price are, apparently, available on some 'late' sales – although consumers will often in such cases be required to accept the operator's choice of hotel, or even the resort, according to availability. Discounting of holidays during this 'lates' part of the selling season is accordingly a similar phenomenon to that of 'end-of-season stock clearance' sales in other retail sectors (e.g. clothing). However, the impact of discounting on 'lates' in a normal season should be seen in the context of the operator's turnover for the season; it is effectively reduced by only about 5% (25% off 25% of holidays sold). Discounts (or equivalent incentives such as 'free child' places or 'free insurance') for early

47 "Competition in the UK foreign package holiday market: An economic analysis", paper by Professor Neven prepared for Airtours and presented at the Hearing, p. 3, last paragraph.

purchase are also offered, but they are much less significant both as to the amount of the reduction (5-10% appears typical) and its impact on costs and turnover. According to one major operator, about three-quarters of all package holidays typically are sold at or close to the brochure price.

66. The fundamental rigidities in the market have important consequences for competition. They make suppliers closely dependent on each other from a strategic, as well as a short-term, viewpoint. In particular, any decision by a tour operator to try to increase market share by increasing capacity (i.e. offering more holidays for sale) will lead to a fall in prices unless competitors reduce their share by an equivalent amount by cutting capacity.

Vertical Integration

67. Tour operators throughout Europe, but especially in the United Kingdom, have become increasingly vertically-integrated, both upstream into air travel supply (charter airline operation) and downstream into retail distribution (travel agency). To date, however, there has been little integration into accommodation supply, and this appears unlikely to change in the foreseeable future, probably because to do so would, in contrast to the other two aspects, require substantial investment in a number of foreign countries, with attendant increased risks and without clear advantages in terms of cost savings.

68. Possession of a substantial ‘in-house’ charter airline operation creates a number of competitive advantages for the tour operator concerned, in addition to providing another source of income and control of a major cost element. The risk of being unable to obtain sufficient capacity is reduced. An integrated operator can also use the in-house airline to give preference to his own holidays with regard to key selling features such as the convenience of departure times (which are closely tied to the airport ‘slots’ held by airlines). At present, the extent to which the major tour operators are vertically-integrated into airline operation varies, as does the extent to which they also operate as suppliers of seats to third parties. Thomson and Airtours, for example, have large airlines and are relatively self-sufficient, selling fewer seats to third parties, and buying in fewer seats from other airlines.

69. First Choice has one of the largest charter airlines and currently sells about 30% of its airline capacity to other operators – a much greater proportion (and a larger total number) than Airtours, Thomson or Thomas Cook. First Choice buys in around 25% of its seats from other airlines (though the proportion of short-haul seats bought-in is probably smaller). More importantly, First Choice is also a major supplier of seats to independent tour operators – the third largest in 1998 after Monarch and the Caledonian/Flying Colours group. In this connection, it should also be noted that since the last-named was acquired by Thomas Cook, some rationalisation appears to be taking place, with consequent impact on third-party seat sales. According to the Commission’s information, Thomas Cook’s third party sales in summer 2000 are expected to show a decline of more than half, in numerical terms, by comparison with 1998, with adverse effects on supplies of seats to non-integrated tour operators.

70. Possession of a substantial ‘dedicated’ distribution channel, such as a chain of travel agents, produces similar benefits downstream. Most package holidays are sold through the agencies of the large groups. Although the integrated firms all handle each others’ holidays in their agencies, they all, through various

'directional selling'[48] practices, give preference to their own products. This enables them to promote their products and move their 'stock' of their own holidays more effectively, and without so much discounting, than if they relied exclusively for distribution on third parties (who would probably tend to give preference to the holidays for which they received the most commission). Discrimination in favour of the in-house product is facilitated, as the MMC pointed out in its conclusions[49], by a lack of transparency in regard to ownership links – customers are relatively unaware of which airlines, holiday brands and travel agencies are under common ownership – and other features of the distribution system. First Choice has recently begun to create an in-house agency chain, having found the lack of one an increasing handicap. The effects of the merger on competition in the distribution of package tour holidays are examined more fully below.

71. There are also a number of commercial links between the integrated companies, deriving in part from their vertical integration. The downstream links, via the use of each other's travel agency chains, have already been mentioned; these are important, since sales through third party agencies account in general for a high proportion (though not, as a rule, a majority) of the integrated operators' holiday sales[50]. In the 'lates' period it is, for example, important to have as wide a distribution as possible in order to clear any unsold stock. Upstream, they share airline capacity to some extent, both via direct purchases from each other, and through 'swaps' and consolidation arrangements whereby they maximise the efficient use of their respective fleets.

<u>Market structure</u>

Shares and increments

72. Airtours submitted various market share estimates, based on several sources, in its notification (Form CO). The only one of these to distinguish long-haul and short-haul market sectors was that from the market research firm AC Nielsen, reproduced below from Table 6.8 of the Notification. Airtours does not consider this data reliable, since it is based on returns from travel agents only, and may therefore produce a 'skewed' result. However, the Commission's own assessment of market shares for short-haul package holidays, based on a variety of sources[51], broadly confirms the overall result – giving approximately 32% for the parties combined (Airtours 21%, First Choice 11%), 27% for Thomson and 20% for Thomas Cook.

Table 1: Market shares (% by volume) in short-haul foreign package holidays from the UK, summer 1998[52]

Tour Operator	Share
Airtours	19.4

48 As defined by the MMC in its 1997 Report, this covers a variety of specific practices – such as only offering a competitor's product to a customer if an equivalent 'own' product is unavailable – cf. paras. 1.9, 7.59

49 1997 Report, paras. 2.84-2.97.

50 Figures for the parties are at para. 6.158 of the Notification.

51 Based on actual passenger carrying figures from major operators and on total market size figures from BNTS and corroborated by Civil Aviation Authority (CAA) data.

52 Shares relate to Nielsen's 'short haul beach' category.

First Choice	15.0
Combined	**34.4**
Thomson	30.7
Thomas Cook	20.4
Cosmos/Avro	2.9
Manos	1.7
Kosmar	1.7
Others	8.2
Total	100

Source: AC Nielsen

73. As can be seen from Table 1, the merger will reduce the number of substantial, integrated suppliers from four to three. The elimination of First Choice as an independent competitor is considered to be particularly significant, because (as another large tour operator has remarked) it is the last remaining 'medium-sized' player. Therefore, it will also substantially increase the gap between the larger players and the small 'fringe' ones. This polarisation of the market into large integrated companies and smaller non-integrated companies is a widely recognised trend in the industry. Indeed, according to Airtours there are two ways of doing business in this industry. Either "stay small and buy inputs or produce large volumes and integrate vertically" in the words of Professor Neven at the Hearing. The impact of this trend has been a marginalisation of the 'fringe' suppliers as a competitive force in the market. Some third parties have indicated to the Commission that in their view it is already unlikely that the 'fringe' is strong enough to offer effective competition to the major players, and that the merger would, for the reasons explained below, weaken their competitive position even further.

74. The merger of the tour operating businesses would also impact on the associated sectors of airline seat supply and distribution of package holidays as discussed more fully below.

The 'Fringe'

75. As Table 1 and the foregoing sections make clear, the relevant product market is characterised by a structure comprising, prior to the merger, four large tour operators (the two parties to the merger, plus Thomson and Thomas Cook), each vertically integrated both upstream into charter airline operation and downstream into travel agency and together accounting for the large majority of sales, plus a numerous 'fringe' of small, largely non-integrated independent tour operators and agents. The charter airline sector is more concentrated than the two downstream sectors, and self-supply is significant: there is only one substantial charter airline which sells the majority of its capacity to third parties - Monarch (which is linked to tour operator Cosmos).

76. Partly as a result of the process of consolidation and concentration of the industry by mergers and acquisitions, particularly strong since the MMC's 1997 Report was completed, there is a substantial gap between the four large operators and the rest. There are three firms (Cosmos, Manos and Kosmar) with 6% between them. Below these, none of the tour operators in the 'others' category (of which there are several

hundred[53]) has more than a 1% market share. Moreover, the majority of the latter appear to operate on a 'niche' basis, specialising in, for example, skiing, sailing, villas, short breaks, group travel, etc. In their reply to the Statement of Objections, Airtours argues that it "would be wrong to conclude that ('the independents') are confined to niche activities"[54]. The Commission has not said that the group of independents exclusively consists of niche players. On the other hand, it is clear from the membership list of, for example, the Association of Independent Tour Operators (AITO) that a substantial number of the independents are only niche players.

77. Moreover, in the Commission's view, generally supported by third parties, the ability of the 'fringe' of smaller suppliers to offer effective competition to the four large tour operators is further constrained by their small individual size and their lack of vertical integration.

78. The small size of the 'fringe' operators means, among other things, that they cannot obtain the benefits of scale and scope of the larger ones. For example, in contrast to the major operators they cannot offer a charter airline a complete planeload of passengers (except, perhaps, for a few days in the peak season). This increases the risk for the airline that it will have to operate the flight at less than optimum loading; consequently, the airline is likely to charge the small operators a higher seat price than the larger ones, to reflect this higher risk. It is possible for airlines to consolidate passengers from different operators onto a single flight, either by themselves or indirectly through the use by tour operators of a 'seat broker'[55]; but this is obviously more difficult (and thus more expensive) the more such small groups of passengers the airline or broker has to try to accommodate.

79. Recent developments have substantially reduced the choice of charter airline capacity available to the smaller tour operators, and with it, their ability to negotiate comparable prices and terms to the larger ones. The number of charter airlines has been in decline for some years. According to the Commission's information, the recent acquisition by the Thomas Cook group of Caledonian Airways and Flying Colours is leading to a further rationalisation, reducing the capacity (and in particular, its quality) available to the independent tour operators from an airline which had been a substantial supplier to them. Smaller tour operators have commented that they already face difficulty in obtaining seats at desirable times (especially weekends) and from the major tourist airports (Gatwick and Manchester). Tour operators (and airlines) have commented that they need to offer departures from both these airports in order to access the main customer centres and so provide a credible 'national' operation – otherwise their prospects for expansion beyond that of a small-scale player are slight. Other, regional airports are regarded as 'second-best' by many customers and flights from them are in some instances more expensive in view of landing charges etc. Manchester is due to open a new runway next year. However, Gatwick is acknowledged to be congested and appears likely to remain so for some years to come.

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53 The MMC 1997 Report (para. 3.20) gives the total for 1997 as about 1 000, although there has probably been some decline since then.

54 At p. 33, paragraph 3.27.

55 Seat brokers help to match supply and demand by selling to tour operators and others any 'spare' capacity which airlines wish to dispose of as surplus to their own requirements.

80. It appears that the major operators already have considerable market strength in regard to seat sales to independent operators. For example, a tour operator has commented that Monarch - the only substantial supplier to the independent sector that would remain after the merger - already tends to satisfy the needs of the major operators (who together account for over half of its third-party sales) before considering what to offer the independents, and refused even to discuss the forthcoming year's programme with the operator concerned until it had received notice of the majors' requirements.

81. Similar constraints on the ability of the 'fringe' to compete effectively against the major players exist in regard to distribution. Since most package holidays are sold through travel agents rather than direct, small operators must have access to travel agencies in order to sell their products. However, most agency branches, and all the large chains with broad national coverage, are controlled by the four large integrated tour operators[56]. For example, Airtours and First Choice have together over 1 000 of the around 7 000 branches in the United Kingdom (around 14%) , and the other two large operators have similarly extensive networks. Although nearly 40% of package tours are sold through smaller, non-integrated agencies, most of these are small, local operations with only a few branches at the most. Consequently it is essential for tour operators to obtain wide distribution coverage through the agencies of their largest competitors if they seek to expand their market share. However, the strong position held by the larger operators in distribution also allows them to discriminate against the smaller ones in a number of ways. In particular, it enables them to require the smaller operators to pay a substantially higher rate of commission – a practice established by the MMC in its 1997 Report[57]and confirmed by the Commission's enquiries to be continuing and even strengthening. It also enables them to give preference to their own products (via 'directional selling').

82. A number of small operators have expressed the concern to the Commission that these distribution arrangements place them at a further competitive disadvantage. They are dependent on their main competitors for access to distribution, and they are accordingly liable to discriminatory action in regard to such matters as commission rates, 'racking' (the extent to which their brochures are displayed on the agency's shelves – an essential aspect of marketing) and promotions, in addition to the deleterious effects of 'directional selling' and the lack of transparency over ownership. Some of these features (for example, different commission rates) may be cost-related in that selling costs may be lower for larger volumes. However, it is clear that the major tour operators, through their large agency chains, effectively control the primary 'gateway' to the retail distribution of package holidays, and this is likely to permit them to discriminate in favour of their own products and against those of an emerging competitor whenever it is rational to do so.

83. In their reply to the Statement of Objections, Airtours has argued that small operators do not have a cost disadvantage compared to larger integrated operators. In particular, they can buy seats at competitive prices and accommodation at similar prices to the large integrated operators. However, according to the investigation, there is evidence that the large suppliers buy accommodation more cheaply than the

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[56] Co-op Travel, with a 9% market share in distribution, is not integrated, but it is less significant in the South of England than in the rest of the United Kingdom.

[57] Para. 2.164. However, the MMC did not, in the circumstances prevailing at the time, find this practice to have been against the public interest.

smaller operators. […]*[58]. Furthermore, the integrated operators generally have access to cheaper seats than the non-integrated operators, who have to purchase their seats on the market - either from regular airlines or often as parts of planes rather than full plane loads. Therefore, the integrated operators have a cost advantage compared to the 'fringe' operators. However, more importantly, independent tour operators have found it increasingly difficult to find appropriate charter seats for their purposes, due to the increased vertical integration. Therefore, the fringe suppliers are constrained in expanding the number of holidays they can offer[59].

84. The 'marginalisation' of the 'fringe' of small tour operators has already occurred to a considerable extent. The four large integrated suppliers already sell between them, over 90% of all packages to mainland Spain, the Balearics, the Canaries and Tunisia, and 80% or more to all other significant 'short-haul' summer holiday destinations except Madeira and Turkey (77% each), Greece (69%) and France (33%)[60]. According to industry data (BNTS), Spain is by a large margin the most popular UK holiday destination, accounting for 27% of all holidays (all types, long and short-haul destinations) in 1998, and most such holidays (over 80%, in the case of the Balearics) were packages. According to Airtours, the independents "show a remarkable resilience...: they continue to account for around 7 million pax[61] per year...". The Commission notes that this figure includes long-haul holidays. However, it is also noted that the figure is constant in absolute terms, i.e. the independents as a group have not grown with the market. If anything, the figures of the Airtours, therefore, show the increased marginalisation of the independents as a group[62].

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58 […]*

59 On page 32 of their reply to the Statement of Objections, the parties quote Libra Holidays as an example of an independent tour operator which has expanded capacity. The Commission notes that Libra Holidays is a specialist operator. It is also noted that Libra Holidays, even with the capacity expansion, will continue to be a very small operator. However, more importantly, the Commission has not said that no new small independent tour operating companies will be established in the future. The Commission has only said that the group of independent tour operators has been and will be increasingly marginalised.

60 Source: Nielsen via Airtours.

61 Package holidays.

62 Reply to Statement of Objections, pp. 31-32.

85. Airtours has mentioned Cosmos and Virgin Sun as likely new major future competitors. Cosmos is vertically integrated with the last remaining significant independent charter airline, Monarch. Virgin Sun is the short-haul foreign package holiday business of Virgin. According to Airtours, both companies have ambitions to grow their businesses. However, in the view of the Commission, none of these companies are likely to be able to challenge the major operators in the foreseeable future. Cosmos/Monarch is, as mentioned above, strongly dependent on the majors as purchasers of seats. Moreover, Cosmos is not vertically integrated into travel agencies. As to Virgin Sun, the operations are at present very small. Virgin Sun is not vertically integrated into travel agencies either. Finally, Virgin Sun has had considerable trouble in contracting for accommodation in key short-haul destinations.

Conclusion

86. In the Commission's view, the overall effect of these factors is that, even in the absence of the notified merger, the tour operating market is one in which the smaller suppliers are not able to offer effective competition to the four large ones. Consequently, the market outcome is effectively decided by the competition between the four large integrated suppliers. This would even more be the case if the proposed merger were to go ahead.

<u>Market characteristics (oligopolistic dominance)</u>

87. As further described below, a number of characteristics, which make the market conducive to oligopolistic dominance are and will remain present in the tour-operating market after the merger[63]: for example, product homogeneity, low demand growth, low price sensitivity of demand; similar cost structures of the main suppliers, high market transparency, extensive commercial links between the major suppliers, substantial entry barriers and insignificant buyer power (consumers). In the Commission's view, the merger would, for the reasons also described below, reinforce all these characteristics with the exception of the first two, and this would contribute to the creation of a situation of collective dominance among the three large vertically-integrated players that would remain after the merger.

Product homogeneity

88. Although there are variations between different (short-haul) package holiday products, they are fundamentally similar. They all involve the 'packaging' of the two key elements (travel and accommodation) and they all depend on bulk buying – i.e. a measure of standardisation – to produce the economies of scale and scope that enable them to be marketed at a lower price than the equivalent 'bespoke' holiday (i.e. where each element is arranged and contracted for individually). This view was also set out by Airtours in the Notification, where Airtours in particular said that "The most widely sold package holidays to popular destinations are fairly

63 The characteristics listed are substantially those employed in previous Commission Decisions in Merger Regulation cases where oligopoly ('collective dominance') was an issue; see Gencor/Lonrho, cited in footnote 41, and Commission Decision 1999/152/EC in Case IV/M. 1016, Price Waterhouse/Coopers & Lybrand, OJ L 50, 26.2.1999, p. 27.

homogeneous products"[64]. The homogeneous nature of short-haul package tours is confirmed by market research which shows that about 85% of customers is influenced mainly by the price in their choice of holiday, whereas brand loyalty is of little importance[65]. This view was subsequently confirmed by competitors.

89. In the reply to the Statement of Objections, Airtours has argued that foreign package holidays are differentiated by quality of accommodation, the date of holiday and departure airport, destination country and resort, customer type and facilities available in all parts of the package. According to Airtours, the proof is the vast array of prices available. Furthermore, Airtours has argued that the market is constantly changing in important ways, e.g. there is a trend towards a decrease in the average duration of holidays and a the trend towards taking more than one holiday a year. However, the main recent trends quoted by Airtours relate to long-haul package tours, which are not part of the relevant product market[66].

90. The Commission has not said that there are no differences between different package holidays or that they are always sold at the same price. Quite clearly, for example, a five-star hotel is not the same as a three-star hotel and will under normal circumstances command a higher price. Despite such differences between different categories of short-haul foreign package holidays it is, however, also clear that short-haul foreign package holidays are today in the UK market to a large extent a standardised volume product. Evidence of this is, in particular, that the large majority of short-haul holidays are to the intermediate "three-star/self-catering" accommodation type. Furthermore, it is also noted that little differentiation is made for the air component. i.e. passengers go on the same plane, no matter whether they stay in five-star or three-star hotels. The air seat is a vital component in deciding how much capacity to put onto the market. Nevertheless, for the purpose of the present case the question is whether the differences between different categories of short-haul foreign package holidays are such that they will prevent oligopolistic dominance of Thomson, Airtours/First Choice and Thomas Cook after the merger. According to Airtours it would, because the nature of the product makes it impossible to tacitly coordinate on price and there would in any case be numerous possibilities to cheat on the tacitly agreed prices[67]. However, contrary to the view of Airtours, the Commission has come to the conclusion that the product differences will not prevent the creation of collective dominance in this case, due to the way the market functions[68].

91. As explained above, capacity is basically fixed between 12-18 months in advance of a season. The tour operators maximise profits by maximising the revenue stream on this pre-fixed capacity. This task is obviously facilitated, if capacity is kept tight by all tour operators. Indeed, in this environment, there is no need for the oligopolists to coordinate on price. This was also confirmed by the economic experts of Airtours at the Hearing, where it was said that it is unlikely that price competition will be attractive, because firms would be unable to serve the additional customers attracted

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64 Notification, p. 30, para. 6.40.

65 Notification, p. 30, paras. 6.40 and 6.41.

66 Reply to the Statement of Objections, paras. 2.10-2.19.

67 Presentation of Professor Neven and Alan Overd, Lexecon at the Hearing.

68 This is not inconsistent with statements in the Yearly Report on Competition Policy (for example, the Yearly Report, 1996). See also Commission Decision 92/553/EEC in Case IV/M.190 – Nestlé/Perrier, OJ L 356, 5.12.1992, p. 1.

by the fall in price. Consequently, they would be unable to change their market share during the season. In this industry there is, therefore, no need to coordinate on price. The crucial question is how much capacity is put onto the market. In this respect, the differences between various categories of short-haul package holidays are not significant. There is only a need to be able to monitor the overall level of capacity (number of holidays) offered by the individual integrated tour operators.

Low demand growth

92. Holidays abroad are a 'discretionary' item of consumer spending, and this increases the volatility of demand in the short term. A recent study for a major tour operator, referred to in response to the Commission's enquiries, noted a certain unpredictable volatility from year to year. It also noted that the overall average annual growth rate (3-4% over the decade) was quite low. The number of holidays abroad[69] taken by UK residents fell by some 3 million (or over 10%) between 1995 and 1996, and there were falls (smaller in size) in both 1990 and 1991 – no doubt mainly in response to general economic conditions. Demand growth for the next two years is expected to be close to zero, according to several industry estimates, but with some recovery in prospect thereafter.

93. Airtours said in their reply to the Statement of Objections that "the market for overseas holidays of all sorts continue to grow dynamically"[70]. The Commission recognises that the market for short-haul foreign package holidays is likely to continue to grow. It may also be that the market will grow somewhat faster than overall GDP growth due to increases in vacation time and general wealth. However, based on its investigation in this case, the Commission has come to the conclusion that overall growth of demand in the market for short-haul package holidays will continue to be moderate as it has been the case in the 1990s. In this respect, it is also noted as indicated by Airtours that "The huge growth in overseas holiday making in the 1970's and 1980's was originally fuelled by the increased availability of foreign package (rather than independent) holidays following the removal of statutory price and volume control on foreign package holidays imposed by the UK Government."[71]. In conclusion, the Commission finds that market growth is not likely to provide a stimulus to competition within the foreseeable future. Furthermore, for the reasons discussed above (with reference to 'the fringe'), small operators are at a competitive disadvantage compared to the integrated operators. Any market growth is, therefore, likely largely to be captured by the integrated operators, as has happened over recent years, according to Airtours' figures.

94. Airtours argued in their reply to the Statement of Objections and in the presentation at the Hearing that demand volatility adds noise to the market. This makes it harder to detect cheating and, therefore, to tacitly coordinate. The main sources of volatility according to Airtours are GDP-related volatility, exogenous shocks, changing tastes within the foreign package holiday market and changing costs (impact of low-cost airlines). The Commission does not consider either changing

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69 MMC 1997 Report, Table 3.1. The same table shows that the proportion of these which were 'package' holidays has remained relatively constant in recent years at around 55%.

70 Reply to the Statement of Objections, p. 7, para. 2.5.

71 Reply to the Statement of Objections, p 7, para. 2.6.

tastes or the impact of low cost airlines to be related to short-term demand volatility. However, these elements are both discussed elsewhere in the decision[72].

95. In the view of the Commission the business cycle (GDP related volatility) is the main cause of short-term volatility from season to season. Indeed, all the major operators indicated to the Commission that in forecasting demand for a season, the development in main macroeconomic variable such as GDP growth, the exchange rate and consumer confidence were among the most important parameters considered. However, the Commission does not find it credible that volatility due to the business cycle will make the market less conducive to collective dominance. In particular, it should be remembered that all tour operators are exposed to the business cycle and have to consider the macroeconomic development in their forecast. Therefore, it is likely that all tour operators will have similar views as to the market development. This would even more be the case, if the proposed merger were to go ahead (see section on Impact of the Merger, paragraphs 139-158).

96. As to the effect of exogenous shocks, the Commission recognises that such shocks are not normally foreseen, and therefore, cause a disruption to the planning of tour operators. Examples are terrorist attacks on tourists in Egypt or Turkey. However, it is not reasonable to argue that such exogenous shocks will make the UK market for short-haul package holidays less conducive to collective dominance. Exogenous shocks can happen in all markets[73]. They are exceptions to the market development, and will not, viewed over time, make a market less conducive to oligopolistic dominance[74].

97. In conclusion, the Commission does not consider that the volatility in demand will prevent the creation of oligopolistic dominance. On the contrary, volatility of demand makes the market more conducive to oligopolistic dominance. The reason is that the volatility demand in combination with the fact that it is easier to increase than to decrease capacity, means that it is rational for the major operators to adopt a conservative approach ("wait--and-see approach") to capacity decisions. In particular, the volatility of demand makes it rational to limit planned capacity and then add capacity later, if demand proves to be particularly strong. In this way, the suppliers protect themselves against downwards volatility in demand.

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72 Changing tastes are discussed in the section on Product Homogeneity, para. 88 ff., and the impact of low-cost airlines is discussed in the section on Supply of Airline Seats, para. 34 ff.

73 Exogenous shocks could take place in the platinum market (Gencor/Lonrho case, cited in footnote 41) for example through strikes, or in the bottled-water market, for example due to contamination of the water (Nestlé/Perrier case, cited in footnote 68). However, in neither of these markets were exogenous shocks considered to make the markets less conducive to oligopolistic dominance.

74 Indeed, if exogenous shocks became a normal feature of the market, then it is to be expected that they would be treated as endogenous variables in forecasting demand, i.e. they would be explicitly taken into account. This would reduce the disruptive impact of the shocks on capacity planning. Moreover, such events are related to some countries or destinations and will not necessarily affect the overall demand and supply as holiday makers seek other destinations and redistribute flying capacity and seek additional accommodation at other destinations.

Low price sensitivity

98. It has not been possible to obtain data which would allow a direct estimate of price elasticities in the UK market for short-haul foreign package holidays. As mentioned in the section on product market definition, there is little brand loyalty and consumers are sensitive to relatively small differences in the prices of similar holidays (to the extent that they can find them out). This shows the price is an important decision parameter in the market. However, it is also clear that people are nonetheless willing to pay a certain amount more for their holidays if prices rise generally. A study by the bank WestLB Panmure (owner of Thomas Cook) showed that in the years after 1995 tour operators had decreased capacity and thereby increased their profits, which also confirms that a collective exercise of market power could increase prices and profits. It is the supply/demand balance which determines the profitability of the market, rather than the level of sales as such. Due to the barriers to growth facing the small independent operators, this implies in particular that the integrated operators could increase the overall level of prices, if they were to behave in a parallel way. This was also confirmed by the economic experts of Airtours, who at the Hearing said that they believed that the oligopolists could increase prices, if they were to collectively exercise market power. In this respect, it should also be noted that an increase in the average price of short-haul package holidays would not have to imply an increase in the catalogue prices. It could occur in other ways. Simply creating a tighter market would, for example, lead to a reduction in the number of holidays sold at a discount in the lates period, which would lead to a higher average price.

Similar cost structures

99. There is considerable scope, in general, for economies of scale in tour operation and charter airline operation. However, the relative importance of scale reduces above a certain level. In particular, as far as charter airline operations are concerned, Professor Neven, the economic expert of Airtours, in his submission estimates that the scale economies related to fleet size are exhausted at the level of 15-20 aircraft. According to Professor Neven, this is a relatively small fleet size. This may be so compared to the large US airlines or the large European flag carriers. However, in the present market, it should be borne in mind that 15-20 aircraft would be a very substantial fleet. According to their annual reports in 1998, Airtours had a total fleet of 36 aircraft, Thomson 41 aircraft, and First Choice 25 aircraft. This was confirmed by Airtours. According to Airtours, 'once a tour operator is established and of a certain minimum size, 'scale' economies in the acquisition of aircraft seats or in-resort accommodation are relatively limited'. Above that level, airline costs are related more to 'load factors' and the number of 'rotations' (return trips) which can be made per day (three is considered optimal for short-haul) – i.e. the level of utilisation of aircraft capacity rather than its absolute size – while direct tour operating costs are related to efficient distribution and marketing (e.g. advertising/promotion costs) which, again, do not necessarily allow continuing scale economies above a certain overall size of operation.

100. The four large integrated suppliers are each sufficiently large to have achieved this minimum size. The four integrated suppliers basically have achieved the economies of scale in tour operation and charter airline operation. They fly to the same destinations, to a large extent use the same hotels, and require the same high load factors of their operations (more than 95%).

101. The Commission has accordingly come to the conclusion that the four large integrated operators basically have the same cost structures.

Transparency, interdependency and commercial links

102. In terms of transparency, a distinction has to be made between the planning period and selling season, where the catalogues have been launched. But transparency of the market is high for the four major integrated operators in both periods.

103. In the planning period, the crucial capacity decisions for the coming season are made. In reality, the capacity decision of the four major integrated operators will be transparent for each of these suppliers, for the following reasons.

104. None of the major tour operators puts out a completely new programme from one season to the next. Rather, the planning of a future season is based on sales in the previous season, increased or decreased by a forecast of the market demand for the coming season. Changes compared to the previous season are therefore incremental and the development of the programme of a tour operator is evolutionary. Consequently, simply due to past experience, tour operators know already before the planning of a season to a large extent what the offerings of the other four integrated suppliers will be for the new season.

105. Furthermore, each of the four major integrated operators will obtain a certain knowledge about the changes planned by the other integrated operators. This is due to the fact that the major operators in the planning period will be in contact with hotels for their bed stocks and be in discussions concerning seat requirements and availability with a view to obtaining or supplying seat capacity from and to one another or to agree swaps of seats and slots. Moreover, it would not be possible for the four major integrated operators, as publicly quoted companies, to keep secret any substantial capacity additions, for example through the purchase or long-term lease of new aircraft. Even for non-quoted companies this is not possible, since aircraft normally have to be contracted well in advance of entering into service. Furthermore, the airline trade press regularly publishes descriptions of the fleet composition and forthcoming changes for all airlines in the world. In addition, in view of the high degree of self supply of airline seats which is regarded as optimal for an integrated operator, a small proportionate change in the number of passengers carried would have a much greater impact on the operator's requirements of airline seats bought in from third parties in the market place. For all the above reasons, each of the four major integrated operators would know if, for example, one of the other integrated operators was planning to increase the number of passengers carried and thus the number of holidays it could offer. Each of the four integrated operators is thus well able to monitor the total amount of holidays offered by each of the others.

106. During the selling season, the most important commercial task of the tour operators is to maximise the revenue stream from the capacity which has been contracted, i.e. to sell the capacity at the highest price possible. For this purpose each of the major operators have set-up 'yield management systems'. These systems are designed to enable yields (profit margin) to be optimised at varying levels of sales across the different selling time periods (and in particular in the 'lates' period). An essential input to these systems is current information on the prices and availability of competing products from the other main operators. According to information obtained during the Commission's enquiry, these factors are closely monitored, at times on a daily basis, so that prices can be varied if necessary. The resources invested in this process are considerable (one operator has indicated around 50 staff and an annual budget of the order of GBP 2 million) – an indication of the importance attached to it. In the investigation, the Commission found that one vertically integrated tour operator, as part of its capacity planning and marketing process, routinely inputs into its own computerised market analysis system information about flight times, prices, destinations, and so forth offered by its competitors (this can be obtained from brochures, etc.). It is consequently able to determine quite precisely, as soon as brochures are published, the flight plans of those competitors and the quantity of holidays they expect to sell, which can be inferred from such factors as the number of flights to the various destinations, and the aircraft and hotels used.

107. Once catalogues have been launched, there is also almost complete transparency as to prices. In particular, most travel agents, and all the large ones, use 'VIEWDATA' – a computerised booking system which displays in real time the availability and prices of holidays supplied by participating tour operators, which includes all the large ones and some of the 'fringe'. An important effect of this, from the viewpoint of competition, is that it enables integrated tour operators to see more or less immediately if their own prices for an equivalent product diverge from those of competitors. This means that they can quickly match or otherwise set their prices relative to those of their competitors, if deemed necessary to adjust their own rate of sales. Not all discounts are shown on VIEWDATA; for example, some promotions, particularly in the early period, are made by travel agents, in particular those which are integrated with tour operators. These may be funded jointly by the agent and the operator, or by either of them alone (although in the case of the agents, their commission from the operator may be increased to reflect the cost of doing so) and are not disclosed on-screen. But given the relatively concentrated nature of the business, and the need for agencies to advertise the holidays they are promoting, it is not difficult for the larger operators to obtain good information about them.

108. In their reply to the Statement of Objections and at the Hearing Airtours said that "The heterogeneity of the product offering means detailed monitoring of price or output is not possible"[75]. They also state: "There is scope for secret price cuts. In effect no "collusive" price can be agreed for each of the prices on offer, a firm which is attempting to increase market share can do so knowing that other firms will not be able to verify whether or not the agreement has been undermined"[76]. The Commission recognises that each of the large integrated operators has virtually thousands of different prices due to the sheer size of their holiday programmes. However, the Commission has not said, and does not agree with Airtours, that it

[75] Reply to the Statement of Objections, p. 67. para. 5.52.
[76] Reply to the Statement of Objections, p. 69, para. 5.53.

would be necessary for firms to tacitly co-ordinate all these different prices in order to reach a collective dominant position. On the contrary, during the selling season, there is little incentive for any of the integrated operators to cut prices in order to gain market share, which is determined by the amount of capacity offered. Therefore, operators have no need to tacitly collude on thousands of prices. Indeed, this point was confirmed by the economic experts of Airtours: "pricing behaviour of firms after capacity has been determined is not directly relevant for joint dominance, i.e. the collective exercise of market power"[77].

109. Therefore, the Commission does not consider a very high degree of transparency of prices to be necessary for the creation of collective dominance in the present case. However, the Commission has noted that such transparency exists, at least to the extent that real-time price and availability information is available to competitors. The Commission notes that this can be important information for companies in the operation of their 'yield-management' systems and in order to ensure that their programmes sell according to the plan. In particular, it enables the major tour operators to reduce their risk, since they can see exactly how small a discount is necessary in order to sustain the desired rate of sales of their holiday stock, taking into account their competitors' prices.

110. Competition is also constrained by the ability of the main suppliers to obtain precise, up-to-date and accurate estimates of their, and their main competitors', market shares. They are aided in this by their vertical integration and their trading links with each other. According to the Commission's information, they are able to produce detailed comparative sales volume and market share information on a weekly basis at the tour operating level. This information also identifies sales by each of the main agency groups, so that, for example, each operator knows how many of its (and main competitors') holidays were sold through each chain (its own and those of competitors), and what this represents as a share of the total sales (its own and those of competitors) for that week. The figures are also expressed in terms of a comparison with the same period in the previous year.

111. In the Commission's view, the main effects of this very high degree of transparency on competition in this sector are the following.

112. As has been described above, the rigidities of the market mean that short-term actions by suppliers are aimed essentially at selling the holidays which are offered for the highest possible price, by maintaining the brochure price as far as possible and limiting discounted sales – especially those in the 'lates' period. Price adjustments and other promotional actions aim at maintaining the level of sales over the selling season so as to achieve the sale of the holidays in stock before their departure dates. Price adjustments therefore depend on the extent to which a tour operator's sales are 'on course' at any particular time rather than the prices offered by competitors as a such. The consequence of this is that if the market is oversupplied, discounting by all suppliers is the inevitable consequence, as it is always preferable to sell at a price which covers at least variable costs plus a contribution to fixed ones.

113. After the merger, particularly given the capacity rigidities and therefore risks, described earlier, of being left with unsold holidays, the high degree of transparency

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77 Paper by Professor Neven, p. 4, third line, cited in footnote 47.

will make it even more likely that the major suppliers will under-supply the market, leaving more unsatisfied demand than would be likely under a less transparent system (in which there would be more – temporary – oversupply, requiring lower prices in order to clear the products) so allowing them to raise average prices above the competitive level. The fact that in general it is, relatively speaking, easier to adjust capacity upwards rather than downwards during a season creates a further incentive to plan capacity conservatively (see paragraphs 134-135 below).

Barriers to entry

114. Airtours has suggested that entry barriers into tour operation, charter airline operation and travel agency are all insignificant, pointing to, among other things, the absence of regulatory constraints and the occurrence of entry and exit in tour operation and airline operation, and the low financial outlay required to set up a travel agency[78]. If this were the case then, even if there were an oligopolistic market structure, collective dominance could not be sustained in the long term. The MMC 1997 Report, while broadly concurring with Airtours' view, also observed that there were some barriers to growth beyond a relatively small scale[79], although it did not, in light of the circumstances prevailing at the time, make them the basis of an adverse finding.

115. Since the MMC's 1997 Report was completed, there has been substantial consolidation in the industry (some of this, apparently, prompted by what some commentators have described as the 1997 Report's 'green light' to further mergers and vertical integration). In this more concentrated market[80], any barriers to entry are likely to have a more significant impact, which in the Commission's view will increase still further if the notified operation is put into effect. To be sufficient to remove the threat of creation of a dominant position, entry must, clearly, be more than merely possible. Among other things, it must be sustainable, which, in markets such as this one, where scale is an important factor, means that it must be capable of being on, or quickly acquiring, a sufficient scale to offer a real competitive challenge to the dominant suppliers. In the Commission's view, this is unlikely to be the case here.

116. In tour operation, according to respondents to the Commission's enquiries, the primary barriers to entry/expansion are access, on reasonable terms and conditions, to airline seats and to distribution through travel agencies. As explained in the section 'Vertical Integration, paragraphs 67-71, both the agency sector and the charter airline sector are becoming increasingly controlled by the major operators, and the merger would substantially hasten this process. The perception that vertical integration is essential to survival in the long run has, for example, guided First Choice in its expansion and integration into travel agency and airline operations.

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78 Notification, paras. 6.49-6.51, 6.137-6.139 and 6.166.

79 Paras. 4.39, 4.53-4.55.

80 A comparison of the figures for all tour operating in Table 4.2 of the MMC 1997 Report and the equivalent ones in Table 6.4 of the notification suggests that the share of the four largest tour operators has increased from around 54% to over 60% in the two years from 1996-98. Since most of the acquisitions involved have been in the short-haul sector, the increase in concentration there is likely to have been even more marked.

117. It is unlikely to be viable for a small operator to match the integration of the larger ones into airline operation: they will not generate sufficient tour operation business to justify owning (or leasing) a viably-sized aircraft fleet. According to one major integrated operator, some 80% of the total costs of airline operation are scale-related. Moreover, the possession by the large incumbents, through their in-house airlines, of a stock of good-quality slots at Gatwick, in particular, gives them an advantage which smaller, non-integrated competitors cannot hope to replicate.

118. The above suggests that, even though some charter airlines might expand their capacity after the merger, in order to replace capacity rationalised by Airtours, it is unlikely that those remaining will be able to offer sufficient good quality capacity to independent tour operators to enable them to compete effectively with the major integrated suppliers.

119. As regards distribution, several smaller tour operators have commented on the increase in the commissions (now as much as double the rates of a few years ago) which they must pay in order for their holidays to be sold by the major chains, and in particular, Lunn Poly (the travel agency arm of Thomson and the current market leader). This would appear to result from the increased share of distribution (and tour operation) which the major tour operators now control, rather than from any increase in the costs of selling the holidays concerned (which may indeed have reduced as a result of increased efficiencies arising from the larger networks).

120. A former independent tour operator (who sold its business to one of the parties) indicated to the Commission that it had found further expansion beyond a market share of around 5% impossible without becoming integrated into distribution, and preferably into airline operations as well. At that level of share, an independent tour operator was beginning to reach the size where its costs would be such that it would be capable of winning substantial amounts of business from the major suppliers, rather than remaining a niche player. Consequently, it was suggested, they would find it worthwhile to increase their demands for higher commissions, etc. for distributing the new entrant's holidays, (and, at the airline level, refuse to supply seats or do so only on adverse terms) in order to prevent further growth. Eventually, it would become worthwhile for one of them to acquire the business, and so remove the threat while increasing its own share – which is what happened.

121. Airtours has argued that low cost airlines such as Ryanair and Go, the British Airways subsidiary, are now increasingly providing low cost alternatives to popular holiday destinations. In the view of the Commission, those airlines have a limited impact on the short-haul UK foreign package holiday market (see section IV.A. Relevant Product Markets, paragraph 4 ff.).

122. In the light of all these factors, the Commission considers that barriers to entry and expansion in the relevant markets are already significant, and will increase as a result of the notified operation. In particular, the Commission considers that they will be high enough to remove any realistic possibility of entry, or expansion by the independent 'fringe', being sufficient to constrain the market power of the three large suppliers that would remain after the merger.

123. Airtours has argued that the MMC concluded just two years ago that there were no significant barriers to entry in the tour operating market[81], and that "conditions of competition have not materially altered in the short period since the investigation was completed"[82]. As is evident from the above discussion, the barriers to entry into tour operation are to a large extent caused by the vertical integration of the major operators, in particular making availability of suitable air seats and distribution more difficult for independent operators. However, it is not correct that the MMC reached a different a conclusion from the Commission. In particular, the MMC recognised that vertical integration can be anti-competitive, but concluded that "At current levels (1997) of concentration in the tour operator and travel agent market, we believe that the anti-competitive effects of vertical integration are slight (1997 Report, p. 4, paragraph 1.10). The Commission finds that the conditions of competition in the market have changed significantly since 1997, in particular due to increased concentration and vertical integration.

Buyer power

124. Individual consumers have no buyer power. In some retail markets, this is counterbalanced to some extent by the existence of large, independent retailers. Such retailers do not exist in the package holiday sector in the United Kingdom[83], however, and most holidays are sold by travel agencies owned by one or other of the large operators (or the smaller ones with which they are increasingly linked through franchises or other arrangements, such as Airtours' links with the Advantage group of small agents), all of which engage in 'directional selling' in order to favour their own products[84]. Moreover, other market imperfections, such as inadequate information to consumers on the links between agencies, operators and airlines, the difficulty of comparing competing products from the limited information available in tour operators' brochures, and the 'advance', 'sight unseen' nature of holiday purchases (in contrast with the ease with which direct price and product comparisons can be made in products such as cars, furniture and electrical goods) all further limit the consumer's ability to offset any anti-competitive features on the supply side.

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81 Notification, p. 32, para. 6.49.

82 Reply to the Statement of Objections, overview section, point 3.

83 The largest independent retailer is Co-op Travel, with a share of 9%.

84 In theory, consumers could partly offset the effects of 'directional selling' etc by 'shopping around' between agencies and other sales points. But it appears they do this only to a limited extent. The MMC 1997 Report (para. 5.118) found that only about half of consumers buying a package holiday visited more than one travel agent before doing so.

125. In its reply to the Statement of Objections, Airtours argues that consumers do have buyer power due to the fact that they demand a variety of different holidays by reference to lifestyle and income, and the fact that individuals "shop around". It is, therefore, not possible for suppliers to tacitly collude on price and output. In this regard, it is first noted that the large majority of short-haul holidays offered by the integrated operators belong to the same intermediate category (see the section on Product homogeneity, paragraph 88 ff.). Second, as far as the impact of 'shopping around' by individual consumers is concerned the Commission has found (see paragraph 97 ff.) that a restriction of supply would lead to a tighter market and higher prices. 'Shopping around' by individual consumers will not change this, and in this sense individual consumers do not have countervailing buyer power, which could eliminate the effect of dominance in this case[85].

126. A submission to the Commission from the UK Consumers' Association, opposing the merger, identified many of these concerns, as well as commenting on the reduction in competition that in its view was likely to arise from the merger.

Conclusion

127. On the basis of the foregoing, in the Commission's view, the tour operating market already displays a number of characteristics which are conducive to the creation of a collective dominant position among the main players following the merger. In particular, the market characteristics are such that only the four integrated players are in reality in a position to add capacity to the market. However, they will have an incentive to add capacity in a cautious way due to the characteristics of the market. In particular, the nature of the product, the moderate growth of the market, and the level of transparency mean that capacity expansions are highly risky due to the inherent danger of creating oversupply and depressing prices. Consequently, the Commission is of the view that there is at present already some exercise of market power by the integrated operators.

Past competition

128. In recent years the main developments in the structure of the UK tour operating market have been horizontal concentration and vertical integration. The existing four vertically integrated tour operators have grown by acquisition rather than organically; a graph supplied to the Commission by Airtours of market share variations excluding acquisitions indicates relatively stable market shares for the four now vertically integrated operators over the last five years[86]. However, the recent rate of acceleration of this market consolidation, even since the publication of the MMC 1997 Report, is striking.

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85 In a tight market a tour operator confronted with a request for a lower price would simply refuse, because the tour operator would know that in all likelihood it will be possible to sell the holiday anyway.

86 At the Hearing, the economic consultant of the parties, Lexecon, argued that market shares are volatile. As evidence of that, the graph from the Notification, p. 34, para. 6.51 was reproduced at the Hearing. It should be noted that this graph includes acquisitions. If acquisitions are excluded, then there is very little movement in market shares. Therefore, there is no evidence that the underlying market shares are volatile. On the contrary, they have been relatively stable.

129. Thomson effectively started the modern UK foreign package holiday industry in the 1960s, at a time when it was the only tour operator with an in-house airline. It integrated downwards into retail distribution through the acquisition of Lunn Poly in the early 1970s. Until a UK stock market flotation in April 1998, Thomson was part of a Canadian group (the Thomson Corporation) and was not subject to constraints on its competitive behaviour arising from shareholder requirements regarding quoted companies in this sector. For many years, Thomson was the only vertically integrated tour operator in the United Kingdom, and according to the MMC 1997 Report, showed some organic growth during the period from the mid-1980s to the mid-1990s, since when it has suffered some erosion of its market share.

130. Airtours was floated on the UK stock exchange as a tour operator in the late 1980s. It established its airline in 1990 and between 1992 and 1996 spent over GBP 200 million on acquisitions, including that of the major travel agency chain Pickfords in 1992. Its strategy was based on vertical integration and growth by acquisition.

131. Thomas Cook was originally a travel retailer with a strong focus on travel-related financial services (e.g. travellers' cheques). According to the MMC 1997 Report, it was because of pressures in the financial services sector that Thomas Cook adopted a diversification strategy as a tour operator, with its acquisition of Sunworld (including an in-house charter airline) in 1996, and Flying Colours (a tour operator with in-house airline) in 1998, and the formation of a joint venture with Carlson this year, which brought in additional capacity in tour operating, and particularly travel agency and charter airlines (Caledonian). Thomas Cook has made it plain that it now considers that size is no longer its prime concern, but rather profitability.

132. First Choice (formerly Owners Abroad) is a quoted company, which started as a tour operator and acquired its in-house airline Air 2000 in 1986. It successfully defended itself against a hostile bid from Airtours in 1993. It began a policy of integration into retail distribution in 1998 (over 200 "shop equivalents" according to its 1998 annual report) in order to protect itself against the directional selling practices of the other vertically integrated operators, and to avoid the cost disadvantage of paying their commission rates and to provide the real-time feedback on market trends for the operation of a computerised yield management system (see the section on Transparency, Interdependency and Commercial Links, paragraph 101 ff.). This policy is still continuing and First Choice has stated that its policy is to establish a network of 600 shop equivalents by the end of 1999.

133. This brief description of the past and recent strategies of the four integrated tour operators indicates how dramatically the structure of the UK foreign package holiday industry has changed since the beginning of the decade as a result of horizontal and vertical integration. This consolidation has resulted in the market-share structure presented earlier, whereas as recently as 1992 (according to the MMC 1997 Report), Thomson was easily the market leader in UK foreign package holidays with 24% of the market, ahead of Airtours with 11%, First Choice with 6% and Thomas Cook with 4%.

134. The acceleration of this market consolidation process since the publication of the MMC 1997 Report (December 1997), which effectively was seen as giving the "green light" to vertical integration, is striking, particularly as far as Thomas Cook (Flying Colours, Carlson) and First Choice is concerned; it is also illustrated by the number of mid-sized operators who have been acquired by the big four. Since the end of 1997, Airtours has made four UK acquisitions (three in tour operation and one, comprising over 100 shops, in travel agency), and First Choice, eight, including two tour operators, one (Unijet) with its own airline, and the rest comprising a total of over 200 travel agency branches; Thomas Cook has acquired, besides the Caledonian airline, the airline/tour operator Flying Colours (which in 1997 had a 3% market share in tour operation) and Carlson/Inspirations (market shares of 1-3% in tour operating, and around 5% in travel agency sales). Thomson has made seven acquisitions in tour operation and one in travel agency.

135. An episode which illustrates the consequences of oversupply in the market occurred during the 1995 summer season. During the 1994 planning period, the sector indicators appeared to predict a buoyant 1995 summer season, following two years of demand growth, and operators added capacity in anticipation of a further increase in overall demand. This increase did not materialise, and all operators were left with unsold capacity, as much as 15% according to one estimate, which had to be cleared with heavy discounting. The CAA reported that the 30 largest UK operators recorded a combined pre-tax loss of GBP 10 million. First Choice, which had just re-branded itself from Owners Abroad and as a result was taking a particularly optimistic stance, declared significantly lower profits (GBP 1.3 million in 1995 down from GBP 16.3 million in 1994) as a result of the particularly heavy cost of clearing unsold stock, and in October 1995 carried out what was seen by the industry and financial sector as a "rescue" rights issue.

136. The large operators take a cautious approach to capacity planning, taking particular note of estimates of the other major operators' plans. One large supplier has indicated to the Commission that it 'has deliberately not adopted an expansionist strategy….. In doing so, it has followed the lead of [major supplier A]* and [major supplier B]* on capacity in the knowledge that limiting capacity will lead to improved margins and profits'. This approach is also illustrated by the following quotes from Chairmen's/CEO's statements in 1998 Annual Reports and other sources from major UK integrated tour operators:

Airtours:

"We remain convinced that the key to profitability in the tour operating industry remains the matching of supply and demand in the market place. It is with this in mind that we shall continue to monitor each of the markets in which we operate and where necessary to adjust our capacity accordingly" (Annual Report 1998).

First Choice:

"In line with all the major tour operators, First Choice has planned cautiously for Summer 1999 and has reduced the capacity on sale compared to Summer 1998" (Annual Report 1998).

Thomson:

"For Summer 1999, in line with other major operators, we have constrained the level of capacity in the UK market to below the equivalent 1998 level, in anticipation of more difficult market conditions" (Annual Report 1998).

Thomas Cook (Sunworld):

"Sunworld has no plans to significantly increase capacity for summer 1999 … it was time to consolidate" (*Travel Weekly,* 24 June 1998).

137. Such statements in Annual Reports seem to be particularly directed to shareholders in order to reassure them that the "1995 experience" will not be repeated. Indeed, shareholders seem to exert a "watchdog" influence against any organic expansionist strategy. When Airtours' bid for First Choice became known in April this year, an announcement by Thomson that it would defend its market-share position led to an immediate drop in Thomson's share price of 9% on the same day as the announcement, due to "fears that the company would start a price war"[87], and Thomson's management were obliged to make considerable efforts to convince institutional investors that the announcement had been misinterpreted and that they had no intention of adding capacity in the market but only of mopping up capacity which would be shed by Airtours/First Choice as a result of the merger. In this context it is also noted that Airtours, First Choice and Thomson are all publicly quoted companies[88], and according to information submitted by Airtours, about 30-40% of the shares of each of Airtours, First Choice and Thomson are held by the same group of institutional investors. Therefore, there is a large overlap between the institutional investors in Airtours, First Choice and Thomson. In the light of the episode recounted above, the Commission finds it likely that the stock market, and these institutional investors in particular, will have a disciplinary effect on the growth ambitions of any management to the extent that these ambitions may lead to capacity additions, which could depress prices, profitability and share prices. Institutional investors in the sector appear to recognise that attempts by any of the major operators to grow by seeking to add capacity and take sales from their competitors will result in lower profits for all the major operators, and they have no interest in that happening.

138. In conclusion, there is evidence that there is already a tendency towards collective dominance in the market at present (most especially as regards the setting of capacity). As far as First Choice in particular is concerned, the company has recovered strongly since 1995, but has not yet completed its retail development strategy. Absent the merger, First Choice would very probably develop quickly into a more powerful, fully integrated competitor in addition to the existing three, who have already (albeit in the case of Thomas Cook, only recently) more or less completed their vertical integration strategies. The proposed merger would eliminate First Choice as an independent competitor at this critical juncture, leaving only three vertically integrated players, with the consequences described below.

<u>Impact of the merger</u>

Increased concentration

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87 *Wall Street Journal Europe*, 23.4.1999.

88 Thomas Cook is jointly controlled by Westdeutsche Landesbank and Preussag.

139. Post-merger, the combined share of the three largest operators would be 83% on the Commission's calculation (85% according to Nielsen) compared with around 70% (either source) before it – a substantial increase in the level of concentration, especially since the fourth largest firm post-merger (Cosmos) has much less than 5%, whereas First Choice, which is currently in fourth position, is substantially larger than that. Furthermore, the Herfindahl-Hirschman index (HHI) on a conservative basis is estimated to be 1 700 pre-merger and will increase by more than 450 points to more than 2 150 as a result of the merger. Therefore, also measured on the HHI the merger will lead to a substantial increase in concentration and a very high level of concentration[89].

Loss of First Choice as supplier/distributor for the 'Fringe'

140. The integration of First Choice's airline, Air 2000, into that of Airtours and the ensuing reduction of its presence on the third-party market would leave Monarch as effectively the only substantial 'independent' supplier of airline capacity (its linked operator, Cosmos, has only a small share in tour operating). Moreover, according to the Commission's information, a substantial proportion of Monarch's 'free' capacity (i.e. the 70% or so which it does not require for intra-group use) is sold to Thomas Cook, Thomson, Airtours and First Choice. These four together account for around 80% of Monarch's third-party sales. According to some third parties small tour operators already face difficulty in obtaining adequate numbers of seats on the routes they need at attractive times, because airlines give priority to their major customers (including of course their own, in-house tour operators).

141. First Choice is currently developing its travel agency business. The proposed merger would add First Choice's 200-300 outlets (which it regards as equivalent in size to 600 ordinary shops) to the 700 of Airtours. In the absence of the merger, First Choice would be an additional possible source of distribution for the independent operators. After the merger, however, this source of actual and potential competition would be lost, and the independents would become even more reliant on the remaining three large players for their distribution. Therefore, it is to be expected that, other things being equal, the merger would further encourage the trend towards higher commissions for smaller operators (see paragraph 118 ff.). Moreover, it would remove the prospect of another substantial agency chain being created – First Choice would appear to be the only supplier likely to do this within a

89 The calculation is based on the market share data of the Commission and not AC Nielsen data.

reasonably short time, since it combines the necessary financial resources with the advantages of integration into tour operation, as well as having the incentives to do so[90].

Consequently, the removal of First Choice would further marginalise the smaller independent and non-integrated tour operators.

Increased transparency and mutual dependency

142. At present there is already a certain degree of mutual dependency between the operators in the market. This dependency is due to the impact on market conditions of the overall level of capacity put on the market for a season. This creates strong economic links between the major operators.

143. The operation will make these economic links even stronger and, therefore, increase the mutual dependency of the large operators. The merger reduces the number of competitive relationships that are possible among the major operators by half – from six to three. The more such relationships that are possible, the more competitive the market is likely to be, and conversely. In particular, the number of bilateral links to which one of the major operators would not be a party would reduce from three (for Airtours, First Choice-Thomson, First Choice-Thomas Cook and Thomson-Thomas Cook) to just one (for Airtours, that between Thomson and Thomas Cook). In this way the interdependency between the oligopolists increases significantly due to the merger. This will increase the incentive to restrict capacity because it will be much more clear to the three oligopolists that competing for market share will only result in depressed profits for all. If one of them broke ranks and sought to mop up unsatisfied demand by adding capacity, the others could be expected to react by doing likewise, creating oversupply. The profits of all would fall while the strategy of the operator which took the initiative would be frustrated. In this sense the risk of reverting to an oversupplied market will act as a deterrent for the three oligopolists to compete for market share. That the market will operate in this way is clear from the experience in 1995 and the way capacity decisions were approached in the following years (see paragraphs 134-135 ff.). The further marginalisation of the 'fringe' described in paragraphs 75-85 ff. reinforces the likelihood of this outcome.

144. Furthermore, the reduction in competitive and cooperative bilateral relationships from six to three also increases the transparency of the market. As a result, it would become much easier for one of the major suppliers to detect any attempt to disturb the market, for example, by competing for market share. The increased transparency, therefore, increases the risk that competitive actions would create oversupply, which as noted in paragraph 142 would lead to depressed profits and consequently be counter-productive.

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90 The creation of a substantial independent retail operation by a new entrant (or substantial expansion of existing independent agencies) is not considered likely for some time to come. Suitable retail sites are not cheap, and town planning and other restrictions may apply to their development. Internet and digital TV selling operations undoubtedly have great potential, but it appears to be for the longer term; one major operator has suggested that it would take 5-10 years to build a substantial retail business in the United Kingdom through these emerging technologies. See the sections on The 'fringe', paras. 75 ff., and on Barriers to Entry, paras. 113 ff.

145. This analysis was confirmed in internal documents from a leading tour operator, which suggested in its response to the Commission that if the merger goes ahead, there will be a ‘window’ of about two years during which this and another recent merger are being digested and in which it will be possible for it to acquire market share from its main competitors without increasing overall capacity, which would (it suggests) provoke a price war (it is apparently widely believed in the industry that all mergers lead to temporary losses of market share for the protagonists due to defection of some customers and suppliers as a result of elimination of duplication in their programmes). After that period, it suggests, the market will move to a stable state, and the remaining large players will be unable to take market share from one another without exposing themselves to the higher risks associated with increasing total market capacity.

146. As far as the impact of the merger on competition between the oligopolists is concerned, it should also be noted that the merger is only expected to lead to overall synergies of less than 1% of the overall costs of the combined entity. Furthermore, the cost savings mostly relate to overhead and other fixed costs. Consequently, the merger would not cause any material change in the overall cost structure of Airtours/First Choice. Therefore, changes to the cost structure would not increase the incentives to compete.

147. Consequently, the Commission has come to the conclusion that the resulting market structure will create an incentive for and make it rational for the oligopolists to restrict supply. However, as explained below, the increase in transparency also increases the possibilities for immediate retaliation, and the increased interdependency makes retaliation more likely. If, for example, one of the oligopolists decided to compete for market share, then it would effectively be targeting only two companies, whereas in the pre-merger situation, the impact of competitive actions would be more ‘diffuse’ and responses likely to be less targeted. As explained below, the Commission believes that the increased possibility of effective and timely retaliation only reinforces the likelihood that the operation would lead to collective dominance.

Arguments of Airtours: No scope for tacit coordination

148. Airtours has argued in their reply to the Statement of Objections and in the Hearing that collective dominance amounts to tacit coordination and that “tacit coordination between the large integrated firms is not likely to be feasible”[91]. According to Airtours four conditions must be fulfilled for tacit coordination to be feasible:

“– When there is little to gain from deviation and a lot to lose from being punished – i.e. when there is a small number of effective competitors

– When agreement is easy to reach and deviation can be detected – i.e. when demand is predictable and when products are homogeneous

– When effective punishment can be implemented immediately

[91] Slides from presentation of Lexecon and Professor Neven; paper of Professor Neven, cited in footnote 47.

– When punishment is not too costly for those implementing it”[92].

149. Airtours, in its arguments, drew a distinction between punishment during the season and punishment between seasons. As to punishment during a season, it claims that since capacity can only be increased marginally during a season, firms cannot be punished immediately through a large increase in capacity. Punishment could, in principle, take place through aggressive price competition, but this is unlikely to be effective because the firms which punish will be unable to serve the additional customers attracted. Therefore, the firms having deviated will hardly be punished. As to punishment in a later season, it could in principle take place through a large increase in capacity for the following season. However, this is less likely to be effective because it will inflict a lower cost due to discounting and because the association between deviation (from the tacit agreement) and punishment will be blurred[93]. Consequently, for all these reasons, tacit coordination (and therefore collective dominance by the large integrated operators) is unlikely.

150. As set out in the introductory section, the Commission does not consider that it is necessary to show that the market participants as a result of the proposed merger would behave as if there were a cartel, with a tacit rather than explicit cartel agreement (see section A. Introduction: Collective Dominance, paragraphs 51-56). In particular, it is not necessary to show that there would be a strict punishment mechanism[94]. What matters for collective dominance in the present case is whether the degree of interdependence between the oligopolists is such that it is rational for the oligopolists to restrict output, and in this sense reduce competition in such a way that a collective dominant position is created. For the reasons set out above, the Commission has come to the conclusion that this is the case for the present merger.

151. However, in this case, even on the basis of Airtours' own arguments about the punishment mechanism, it seems quite clear that there are significant possibilities to implement punishment, if one of the integrated players were to compete for market share by adding new capacity. In this respect, it should in particular be noted that the financial impact of an oversupply in the market would be such that simply the threat of reverting to such a market outcome would be a sufficient deterrent for any of the oligopolists not to attempt such a strategy. The 1995 experience is illustrative of what could happen in a capacity war.

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92 Slides from presentation of Lexecon and Professor Neven.

93 Airtours also argued that the "fringe" are effective competitors constraining the large integrated operators. For the reasons discussed earlier, the Commission does not consider that the 'fringe' constrains the large operators.

94 In the Gencor/Lonrho case, cited in footnote 41, the Commission did not argue that a specific punishment mechanism was necessary nor did the Court of First Instance in its judgment put any emphasis on this point.

152. Furthermore, the distinction Airtours makes between retaliation during a season and between seasons is not in reality that clear. The commercial links between the integrated operators allow means of retaliation such as de-racking or directionally selling against a specific competitor, which would force that competitor to sell a larger share of its holidays at discounted prices. Furthermore, there is some scope for adding capacity during a season up until February of the season. Airtours, in its reply to the Statement of Objections, indicates that capacity could be increased by up to 10%. While not changing the overall conclusion that capacity is basically fixed before the selling season, it is noted that this possibility of capacity adjustments leaves some scope for using capacity changes as a means of retaliation during a season[95]. Finally, capacity can be added between seasons. As to the link between punishment and deviation it clearly would not have to be blurred, because retaliation could simply be signalled by an operator by announcing that it was acting in response to a particular action.

153. In conclusion, the Commission, even on the basis of Airtours' own arguments, finds that there is considerable scope for retaliation both during a season and from one season to the next. This only reinforces the argument that the proposed merger would lead to the creation of an oligopolistic dominant position. More importantly though, as discussed above, the interdependencies between the oligopolists will make it rational for the oligopolists to restrict output.

Arguments of Airtours: The Eckbo-Stillman test

154. In its reply to the Statement of Objections, Airtours presented an empirical analysis called the Eckbo-Stillman test. The basic principle of the test is to analyse the reaction of share prices to major new developments. If, for example, a merger was viewed by the stock market as mainly increasing the efficiency of the merging companies, then it would be expected that the share prices of competitors would fall in reaction to the announcement of the merger, because the merger would create a more efficient competitor. If on the other hand the merger would lead to collective dominance, then it would be expected that the share prices of all companies would increase in reaction to the merger.

155. The economic consultant of Airtours, Lexecon, conducted such an analysis using the developments in the share price of Thomson. In particular, the study found that the share price of Thomson fell significantly, when the Airtours' bid for First Choice was announced. The study concluded that this is evidence that the stock market viewed the Airtours bid as pro-competitive, since, otherwise, if the merger had been seen as leading to less competition, the announcement of the bid would have led to an increase in the share price of Thomson.

156. Analysis of share prices can in some circumstances provide valuable information about the competitive impact of mergers. However, share price developments are in

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95 At the Hearing the parties argued that in previous cartel cases such as the Cement case (see Commission Decision 94/815/EC in Cases IV/33.126 and 33.322, OJ L 343, 30.12.1994, p. 1) the suppliers had kept large over-capacities and had retaliated against cheating by over-supplying the market by up to 40%. According to the parties there is no evidence that this would be the case in this market. In the view of the Commission it is not appropriate to draw a comparison with this type of cartel case. In any case, it should be noted that a 40% oversupply is not necessary for effective retaliation in the UK market for short-haul foreign package holidays.

any case only indirect evidence, since the data do not relate directly to the market concerned. Furthermore, it is also clear that share price data are often full of extraneous ‘noise’ due to many other events, which may or may not be completely unrelated to the market in questions. The presence of “noise” can be expected to be higher than normal during a period when numerous rumours about possible mergers are circulating.

157. However, the Commission has carefully considered the methodology, the data and the conclusions put forward in the study. Apart from methodological problems, the study fails in explaining all of the main movements in the share prices of Airtours, First Choice and Thomson. This means that it cannot be excluded that there could be other plausible explanations of the share price movement of Thomson than the ones put forward in the study. In particular, the fact that Thomson immediately announced plans of aggressive capacity additions at the same time as Airtours launched its bid was seen as having a tremendous negative effect on the share price of Thomson (as well as Airtours), because capacity utilisation is the crucial driver of profitability in the foreign package holiday sector. Lexecon has played down the specific reaction of Thomson in its study. However, clearly this was the key event influencing the share price of Thomson (see also the section Past Competition, paragraph 127 ff.). Accordingly, the Commission has come to the view that no reliable conclusions can be drawn from the analysis of Thomson’s share price, other than confirmation that the overall level of capacity supplied to the market is the key to profitability in this industry.

Conclusions

158. For all the above reasons, the Commission considers that the foregoing analysis of market characteristics and structure before and after the merger indicates that the notified operation would further reduce the likelihood of effective competition between the major tour operators, and also that the ‘fringe’ and new entrants would lack the strength to ensure that a competitive equilibrium would be restored. Rather, in the more concentrated market structure that would be created post-merger, the incentives for all the major suppliers to avoid engaging in such competition would be increased. The effect of this would be higher prices and profits. In other words, the operation would create a sustainable collective dominant position in the UK tour operating market comprising Airtours/First Choice, Thomson and Thomas Cook.

Supply to tour operators of seats on charter flights to short-haul destinations

159. The market structure at this level will also change following the merger.

Table 2: Market shares for the supply of charter airline seats to third parties (summer 1998)

Airline (linked tour operator)	Volume (in thousands of package holidays)	%
Airtours International (Airtours)	[…]*	[1-10]*
Air 2000 (First Choice)	[…]*	[10-20]*
COMBINED	**[…]***	**[20-30]***
Monarch (Cosmos)	[…]*	[30-40]*
Caledonian/Flying Colours/Peach (Thomas Cook)	[…]*	[20-30]*
Others (independent)	[…]*	[10-20]*
Britannia (Thomson)	[…]*	[1-10]*
Total	[3 000-4 000]*	100

Source: Airtours estimate, Table 6.21 in the notification. Specific figures for short-haul are not available, but short-haul accounts for the great majority of the *Airtours*' business and that of their main competitors.

160. In the Commission's view, and based on information obtained in the course of its enquiries, however, these figures may somewhat understate First Choice's market share, and as a result, the impact of the merger in this area.

161. Although the acquisition of First Choice's in-house airline (Air 2000) does not of itself lead to the creation of a dominant position at this level, it nevertheless has significant 'vertical' effects in that it substantially strengthens Airtours' position in tour operating.

162. A number of third parties, notably small tour operators, have expressed concern to the Commission that, after the merger, Airtours would rationalise its combined airline operations in order to adjust them relative to the merged entities requirements, in such a way that sales to third parties would be substantially reduced. Airtours has not formally announced any plans of this kind. However, […[96]]*.

163. It is important to note that figures in Table 2 include all 'third-party' sales, that is, they include sales to, and between, the major operators, as well as to independent, non-integrated tour operators. It is difficult to estimate shares for these sales, but it would appear that Monarch and First Choice currently supply a large proportion of demand from independent tour operators.

164. As described above and in earlier sections of this decision, a significant effect of the merger in this area would, in the Commission's view, be to further marginalise the 'fringe' of smaller operators, effectively confining them mostly to limited operations to less popular destinations, and specialised holiday types rather than the 'mainstream' (see section on The Fringe, paragraphs 75-85).

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96 Notification, para. 6.128.

Distribution: Supply of travel agency services

165. Airtours has provided estimates of market share in travel agency sales of inclusive tours, as follows.

Table 3: Shares of Inclusive Tour Sales by Travel Agents (1998)

Agency (group)	Share %
Going Places (Airtours)	[10-20]*
Travel Choice (First Choice)	[1-10]*
Combined	**[10-20]***
Thomas Cook (inc. Worldchoice – Carlson)	[10-20]*
Lunn Poly (Thomson)	[10-20]*
Co-op Travel	[1-10]*
Others	[30-40]*

Source: Airtours/BNTS, from table 6.23 of the notification

166. On this basis, the three large players remaining after the merger would collectively have around [50-60%]* of all agency sales of package holidays, with the next largest agency (Co-op) having a market share of around half that of the smallest integrated supplier. Airtours considers this not to be a meaningful result, partly because it does not include the [10-20%]* or so of packages which are sold by other means, notably telephone sales, whose inclusion would reduce the share of the major tour operators. However, the Commission regards the figures as broadly relevant as an indicator of market strength in package tour retail distribution, since most direct telephone sales are made through the call centres of the major tour operators. Moreover, the merger's impact would also be significant in removing First Choice as a potential competitor in distribution.

167. The addition of First Choice's tour operating business to Airtours' business in travel agency will allow Airtours to improve the efficiency of its distribution by bringing a greater volume of tour operating business 'in house'. As discussed above, it will also remove First Choice as both an actual and (more importantly, given its rapid growth) a potential competitor in distribution.

Summary

168. First Choice is the last remaining 'medium-sized' player in tour operating – the only one with potential to grow rapidly to the size of the three major suppliers. Not only is it at present a significant competitor in tour operating, but it is already vertically integrated into airline operation and it would shortly become (in the absence of any merger) a major force in travel agency, where it could threaten the leading positions of Airtours, Thomas Cook and Thomson. In summary, the merger would remove First Choice as a competitor at all three levels of the supply chain. For the following reasons, this is considered to have adverse effects on competition beyond those normally to be expected from similar increments of market shares in other cases.

169. First, as a result of the merger the market will become even more highly concentrated. Together the three oligopolists would have about 80% of the market. The remainder of the market is highly fragmented and a large part of the small operators are niche operators and not active in the main, mass-market business of the major operators.

170. Secondly, the merger would increase the interdependency and the transparency of the tour operating market by reducing the number of major players from four to three. Therefore, the number of possible competitive relationships are reduced from six to three, and the number of such relationships to which one of the major suppliers would not be a party would reduce from three to one. This is not itself decisive for the creation of collective dominance. However, the market for short-haul foreign package holidays in the United Kingdom is distinguished by the fact that capacity decisions by the major operators are crucial to the market outcome. This creates interdependency and, therefore, strong economic links between the major operators. At present, there is already a certain degree of mutual dependency between the major operators. However, the operation will make the interdependency even stronger. This will increase the incentive to restrict capacity. If one of the major operators broke ranks, there would be a risk that the others would do the same, which could have serious financial consequences if it were to lead to oversupply, as demonstrated by the 1995 experience. The risk of reverting to an oversupplied market will act as a deterrent for the oligopolists to compete for market share. In this respect the creation of collective dominance is further reinforced by the possibilities the oligopolists have to retaliate against competitive actions, for example through the extensive trading links they have with each other.

171. Thirdly, the merger would further weaken the ability of the 'fringe' to compete with the majors. Not only would Airtours have an even larger share of the tour operating market, but First Choice would be lost as a supplier of seats and as a potential distribution channel for the 'fringe' and for new entrants. The 'fringe' would, therefore, be further marginalised as a result of the merger.

172. The Commission has, therefore, come to the conclusion that the notified operation would lead to the creation of a dominant position in the market for short-haul foreign package holidays in the United Kingdom.

C. Ireland

173. The Commission has come to the conclusion, having heard Airtours, that the operation would not lead to the creation or strengthening of a single or collective dominant position on any of the affected markets in Ireland.

Tour Operation (short-haul foreign package holidays)

174. According to Airtours' estimates (objective data on the same basis as for the United Kingdom does not appear to exist), the merger would add some 7% to First Choice's current share of around 30%. Thomson's Budget operation has a share of 40%. Thomas Cook has around 7%. Only one other operator (the independent, Michael Stein, 4%) has a distinguishable market share.

175. The market share addition resulting from the operation is substantial and effectively will result in a duopolistic market structure. The Irish market is, therefore, more concentrated than the UK market. However, in contrast to the UK market, the operation will not result in the creation of either a single nor collective dominant position in the Irish tour operation market.

176. In reaching this conclusion the Commission has noted that the Irish market differs from the UK market in a number of substantial aspects. In particular, the Irish market is at the moment relatively undeveloped (only about 700 000 foreign package holidays in 1998). It is growing rapidly. According to Airtours, the market grew by 20% in 1997 and 14% in 1998, and there are prospects for considerable growth for the foreseeable future. The dynamic growth of the market will provide a greater incentive to entry and competition between the existing market participants.

177. Barriers to entry and growth are relatively low to the Irish market. The Commission, in particular, notes that vertical integration is low, which means that it is easier for new entrants to find distribution and seats of appropriate quality and attractiveness to compete effectively. A particular feature of the Irish market in this respect is that Aer Lingus makes available on an extensive scale aircraft used on scheduled routes during the week for weekend charters, and the supply does not seem to be constrained in the foreseeable future. Therefore, the proposed merger would not have the same negative impact on the fringe players or new entrants in the Irish market as in the UK market.

178. Finally, the lesser extent of vertical integration in Ireland means that there are not the extensive commercial links which are an important feature of the UK market.

Supply of seats to tour operators on charter flights to short-haul destinations

179. There is substantially less vertical integration into airline operation in Ireland than in the United Kingdom. Britannia and Air 2000 (First Choice) are currently the main charter airlines, and their shares are understood to be roughly proportionate to their shares in tour operation, but numerically smaller. There is a much greater use by tour operators of charter flights by other airlines than those owned by the main tour operators. In particular, an important source is the national carrier, Aer Lingus, which has considerable spare capacity at weekends which is sold to package tour operators. There is in any case only a small overlap since Airtours' airline presence in Ireland is small. Accordingly, the merger is not considered likely to lead to the creation or strengthening of a dominant position in airline operation in Ireland.

Distribution: Supply of travel agency services

180. As previously indicated, there is no overlap at this level in Ireland, and First Choice's share of this market is relatively small (well under 10% by number of branches, but more, possibly twice that amount, by sales.) There is, therefore, no creation or strengthening of a dominant position at this level.

VI. UNDERTAKINGS PROPOSED BY AIRTOURS

The package of undertakings

181. Airtours has submitted a package of undertakings in order to remedy the creation of a collective dominant position in the United Kingdom. The package comprises the following elements:

- Airtours undertakes to divest a tour operating business meeting the following cumulative conditions: (i) it shall be of such minimum size as, when added to the number of short-haul package holidays (if any) already offered by the purchaser, will result in the purchaser offering for sale not less than […]* short-haul package holidays ex the UK in the tour operating year 1999-2000; (ii) it shall include the […]* tour operating business […]*, and (iii) Airtours will (if requested) make available to the purchaser a […]* distribution arrangement through […]* outlets pursuant to which Airtours will make available on reasonable commission terms a guaranteed minimum percentage of racking sufficient to support and assist the development of the business of the purchaser.

- Save in circumstances where the purchaser of the tour operating business has an existing charter airline operation, Airtours undertakes to divest an airline business comprising not less than […]* aircraft, First Choice's air operator's certificate, the Air 2000 brand, a head office capable of running and maintaining the airline and appropriate slot entitlements to operate an efficient flying programme for short-haul holidays.

- Airtours undertakes to divest the […]* as conducted at the date the renewed Airtours offer for First Choice becomes unconditional in all respects.

- Airtours undertakes that in each of the three holiday years 1999/2000, 2000/2001 and 2001/2002, it will make available on aircraft forming part of the Airtours International or Air 2000 airlines such number of round trip seats to short haul package holiday destinations as corresponds to the number of such sales to independent tour operators such number of round trip seats during the holiday year 98/99. This undertaking shall cease to have effect upon completion of the sale (if the same shall take place) of the airline.

- Airtours undertakes to renegotiate the […]*.

182. The aim of the package is threefold. First, it aims at re-creating a "fourth force" in the tour operating market. According to Airtours, it will do so by creating a fourth player with 5-7% market share by selling a tour operating business of sufficient size to attain that taking into account the buyers' market share. Access to seats would be secured through the divestiture of the airline. Access to distribution would be secured by the agreement of guaranteed racking in […]* retail outlets for […]* years and the […]*.

183. Secondly, it attempts to remedy the problems of the 'fringe' operators by guaranteeing seat capacity for […]* years (if there is no airline divestment) and improve the distribution possibilities of the fringe operators.

184. Thirdly, it seeks to remove any concerns on the Irish market.

Assessment

185. The Commission has no further comment as to the impact on the Irish market, since it finds that it is unlikely that the operation will lead to the creation or strengthening of a dominant position on this market.

186. The Commission has consulted interested third parties on the undertakings. The Commission has reached the conclusion that the proposed package is insufficient to remedy the creation of a collective dominant position on the UK tour operating market.

187. As far as the small, independent tour operators are concerned, the undertaking aims to secure the availability of seats by divesting […]* and by committing to continue to supply seats to the independents. The undertaking also aims at securing distribution […]*. However, the undertaking is not likely to achieve its purpose. In particular, the agreement to continue to supply seats to independent tour operators for a period of […]* years on arms' length commercial terms is limited in time and it would be difficult to monitor and to enforce. Furthermore, […]* will not protect the small independent tour operators against directional selling in the large travel agency chains. In any case, as is clear from the assessment of the impact on competition of the proposed merger, the Commission regards the impact on the fringe to be of secondary importance for competition in the market.

188. The most important impact of the merger is the elimination of First Choice as the fourth large vertically integrated supplier. The undertaking seeks to remedy this by re-creating a 'fourth force' in the industry with a market share of about 5%.

189. Airtours has proposed to divest a tour operating business […]* as well as an airline business […]*. However, this new business would be less than one-quarter the size of the smallest of the large vertically integrated suppliers. This business would be severely handicapped by not being vertically integrated into travel agencies. The distribution agreement offered by Airtours is not sufficient to compensate for lack of vertical integration. In particular, it provides no protection against directional selling […]*. Moreover, the agreement would be difficult to monitor and enforce. In addition, the Commission has found it unlikely that such a business would have sufficient critical mass to support an airline. According to the economic expert of Airtours, 15 to 20 planes were needed to maximise the economies of scale available to an airline. It is also clear from previous industry experience (see the assessment of the impact on competition, paragraph 138 ff.) that a market share of 5% is not sufficient to have a viable vertically integrated tour operating business. Indeed the previous operators of this size have merged or been acquired in order to achieve sufficient critical mass. Finally, it is also unclear what the exact impact on the market would be, since Airtours have not identified which tour operating brands were to be sold. For all these reasons, it is unlikely that such a new business would be able to develop into a 'fourth force' in the UK tour operating market.

190. […]*.

191. […[97]]*.

192. In conclusion, the proposed undertaking would not prevent the creation of a collective dominant position. In this respect, the Commission finds the impact on the fringe of secondary importance, since it is the competition between the large integrated operators which effectively decides the market outcome. However, the undertaking is not sufficient to re-create a “fourth market force” which could provide effective competition to the large integrated suppliers to such an extent that it could be considered to replace First Choice from a competition point of view. On the contrary, it would seem that the “fourth force” proposed by Airtours would be severely handicapped in competing with the three major suppliers. The proposed undertaking, therefore, does not prevent the creation of a collective dominant position.

193. At a very late stage in the procedure (15 September 1999), Airtours proposed a new and substantially modified undertaking. Article 18(2) of Commission Regulation (EC) No 447/98 of 1 March 1998 on the notifications, time-limits and hearings provided for in Council Regulation (EEC) No 4064/89 on the control of concentrations between undertakings[98] provides that commitments intended by the parties to form the basis of a decision of compatibility pursuant to Article 8(2) of Regulation (EEC) No 4064/89 must be submitted to the Commission within three months of the decision to open proceedings, although the Commission may, in exceptional circumstances, extend that period. Airtours did not put forward any reasons which could be regarded as constituting such exceptional circumstances. In the Commission’s view, there was nothing in the new proposal which Airtours could not have included in an undertaking submitted within the three-month time-limit. Moreover, it would not have been possible, in the short time that remained before the expiry of the deadline under Article 10(3) of the Merger Regulation, for the Commission to evaluate it effectively. Further investigation would have been called for, and it would also have been necessary to seek the views of interested third-parties pursuant to Article 19(3) of the Merger Regulation.

VII. CONCLUSION

194. On the basis of the above analysis, the proposed operation would create a dominant position in the market for short-haul foreign package holidays in the United Kingdom, as a result of which competition would be significantly impeded in the common market within the meaning of Article 2(3) of the Merger Regulation.

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97 […]*

98 OJ L 61, 2.3.1998, p. 1.

HAS ADOPTED THIS DECISION:

Article 1

The concentration by which Airtours plc acquires control within the meaning of Article 3(1)(b) of the Merger Regulation of the whole of the undertaking First Choice plc is declared incompatible with the common market and with the EEA Agreement.

Article 2

This Decision is addressed to:

Airtours plc
Parkway One
Parkway Business Centre
300 Princess Road
Manchester M14 7QU
United Kingdom.

Done at Brussels, 22 September 1999

For the Commission

Mario MONTI
Member of the Commission