

***Case No IV/M.967 -  
KLM / AIR UK***

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**REGULATION (EEC) No 4064/89  
MERGER PROCEDURE**

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Article 6(1)(b) NON-OPPOSITION  
Date: 22/09/1997

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## COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 22.09.1997

PUBLIC VERSION

MERGER PROCEDURE  
ARTICLE 6(1)(b) DECISION

To the notifying parties

Dear Sirs,

**Subject: Case No. IV/M.967 - KLM/AIR UK**

Notification of 21 August 1997 pursuant to Article 4 of Council Regulation N° 4064/89

1. On 21 August 1997 the Commission received the notification of a proposed concentration through which the Dutch airline company, KLM, will acquire sole control over the UK company, Air UK.

**I. THE PARTIES**

2. KLM is engaged in the European and intercontinental carriage by air of passengers and freight. The Dutch airline Transavia is controlled by KLM. KLM also has interests in other activities largely connected with the air transport sector and tourism business.
3. Air UK, which is under the sole ownership of Air UK Holdings Ltd., is principally engaged in the transport of passengers in the UK as well as between the UK and other destinations, primarily within the European Union.

**II. THE OPERATION**

4. The notified operation consists of the acquisition, from British Air Transport Holdings Limited ("BATH"), by KLM of 55% of the share capital of Air UK, and thus of sole control over Air UK.

### III. CONCENTRATION

5. According to the notification KLM has, on *ade facto* basis, enjoyed joint control over Air UK since prior to the entry into force of the Merger Regulation. According to KLM, the important role it had in Air UK's financial and commercial operations, as described below, led to UK Air being "fully dependent on KLM", to the point that Air UK would have jeopardised the financial and commercial support of KLM if it had pursued a policy on strategic matters contrary to the wishes of the latter company.
6. The relationship between KLM and Air UK goes back to the late seventies, when the first steps were taken to use Air UK as a feeder service for the KLM network. Although the relationship between the two companies deepened during the eighties, it was not until 1987 that the relationship started to take a structural form.
7. The means by which KLM's influence over Air UK was set up has to be assessed in the light of the then existing UK legislation, in particular the 1982 Civil Aviation Act, which provided that Air UK, being the holder of a UK air transport licence, had to be controlled, within the meaning of that act, by UK nationals. This requirement remained in place until, as part of the internal market program and the liberalisation of civil aviation within the common market, it was abolished on 1 January 1993.
8. In view of the constraints imposed by the UK legislation, KLM, in 1987, acquired 14,9% of the share capital of Air UK<sup>1</sup>. Following that acquisition one representative of KLM was formally appointed to the Air UK board, which in total consisted of five members. As it was not possible for KLM at that time to acquire a larger share, nor to conclude a shareholders' agreement formally providing for joint control over Air UK, the influence of KLM was achieved through a loan arrangement, in June 1988, from KLM to BATH in which [...] acted as an intermediary. In this arrangement the remaining 85,1% of the shares in Air UK was pledged as a security and KLM effectively got a call option on all those shares. The agreement stipulates the price of the shares, £ [...] mio., which is equal to the amount made available to BATH under the loan arrangement.
9. The loan arrangement and option agreement are formally constructed as two separate agreements concluded on the same date, one between BATH and [...]<sup>2</sup>, the second between [...] and KLM. It is, however, clear from the agreements that they, for the purpose of the present assessment, must be regarded as a package, setting out the total arrangement between KLM and BATH. The role of [...]<sup>3</sup>, although formally the lender and holder of the call option, is effectively limited to that of an intermediary. The loan arrangement, therefore, differs significantly from what would normally be expected in such an arrangement between a financial institution and its client.

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<sup>1</sup> In 1995, KLM increased its shareholding in Air UK from 14,9% to 45%, through the conversion of a loan given in 1992 into share capital. This increase had no effect on the legal structure described in this section.

<sup>2</sup> Business Secrets - deleted for publication

10. The fact that KLM was the true lender is shown, inter alia, by the fact that all amounts paid by [...] to BATH will be immediately advanced to the bank by KLM, that [...] will forward any repayment or interest received from BATH to KLM and by the fact that [...] according to the agreements has no responsibility for the financial condition of BATH. As to the options, the agreements gave KLM the right to require [...] to exercise the option to purchase the shares, as well as to require [...] to assign or transfer its agreement with BATH to any third party designated by KLM. Moreover, following [...] exercise of the call option, [...] could not, without the approval of KLM, offer the shares to any third party. In fact, the only alternative to offering the shares to KLM that [...] would have had would be to hold on to the shares itself. In this respect, the agreements included an incentive for [...] to offer the shares to KLM within 7 days, otherwise [...] would have to pay a penalty to KLM, in the form of a 9% interest on the outstanding part of the loan.
11. It is significant that the agreements specify that the call option is exercisable from 1 January 1993 until 1 July 1997, i.e. from the time when, following the implementation of the liberalisation of civil aviation in the common market, it would be possible for KLM to formally acquire control over Air UK in the meaning of the UK civil aviation regulations. It is also significant that the agreements provide for early exercise of the call option (at any time) if Air UK was contemplating to engage in any business substantially different from that at the time of the agreement, or if Air UK wanted to reorganise or suspend any part of its business. Finally early exercise of the call option would be possible in case of any failure of Air UK to meet its financial obligations. Such failure would be known by KLM as [...] was under an obligation to pass on financial information about Air UK to KLM.
12. The rules relating to the call option and the exercise thereof must be seen to have had two main effects. Firstly, it had the effect of reserving the Air UK shares for KLM until such time when it would be possible for it to acquire the shares. In this respect the agreements served as a basis for the continued integration of Air UK into the KLM group, which has subsequently taken place (see below). Secondly, and more importantly for the assessment of whether KLM through this arrangement acquired de facto joint control over Air UK in the meaning of the Merger Regulation, the option and loan arrangement gave KLM an immediate right to use its call option if BATH were to propose any substantial changes to Air UK's business activities.
13. Moreover, as KLM, in addition to the above-mentioned loan arrangement, in the period between June 1988 and September 1990, on several occasions provided guarantees in favour of operating costs of Air UK (aircraft leases and strip guarantees), it cannot be excluded that KLM, had it not agreed to provide these guarantees, would have been in a position to invoke the early exercise provisions relating to Air UK's failure to meet its financial obligations.
14. It follows from the above, that BATH, although being the majority holder of shares in Air UK, must have realised that had it tried to impose any significant strategic decisions relating to the operation of Air UK's business against the wishes of KLM, this could have given KLM the right to invoke its early call option if the decision proposed by BATH would have led to a substantial change to the business activities of Air UK. Moreover, an attempt by BATH to impose strategic decisions

against KLM would potentially have jeopardised the financial situation of Air UK, in which case KLM would also have had a right to invoke the early exercise provisions. The fact that KLM's continued support of Air UK had an important effect on the financial situation of Air UK is evidenced, not only by the above mentioned financial arrangements, but also by the fact that from 1988 an increasing part of Air UK's business operations has consisted of feeding passengers into the KLM network.

15. The above indication that BATH, following the June 1988 agreements, *de facto* had to take KLM's view into account when preparing the strategic decisions relating to the business of Air UK is further reinforced by the fact that, since that time, the only two people to hold the post as managing director of Air UK, prior to taking up that post, held management positions in KLM. This strongly indicates that KLM, although it did not have any formal right to appoint the managing director of Air UK, *de facto* had a decisive influence on such appointments.
16. This is consistent with KLM's submission that, on the basis of the above mentioned financial arrangements, it *de facto* had veto rights relating to all strategic decisions on the business policy of Air UK, such as budgets, business plans, major investments and appointment of senior management, and that in the period between June 1988 and KLM's exercise of the call option on 30 June 1997 no strategic decisions were taken that did not have the support of KLM, as well as of BATH.
17. It follows from the above that the situation surrounding the relationship between KLM and Air UK in 1988 has to be assessed in the light of the prohibition imposed by UK legislation on foreign nationals acquiring control over a holder of a UK air transport license. Account must also be taken of the underlying purpose of the relationship, i.e. to structure Air UK into a company which would have as one of its main objects to feed passengers into the KLM network. Taking these factors into account, the Commission has come to the conclusion that the combined effect of the loan arrangements and call options from June 1988, KLM's representation on the board of Air UK as well as in the post of managing director, and KLM's not insignificant shareholding in Air UK, was such as to make it very unlikely that BATH *de facto* could have taken important strategic decisions relating to the business of Air UK if KLM would have opposed such decisions.

Therefore, it has to be concluded that KLM, has *de facto* had important veto rights since 1988 and, thus, in all likelihood had *de facto* the possibility of exercising, jointly with BATH, decisive influence over Air UK. It has certainly had that possibility since 1 January 1993, as, following the liberalisation of civil aviation, it could then directly invoke the call option. The present operation therefore constitutes a passage from joint to sole control over Air UK.

#### **IV. COMMUNITY DIMENSION**

18. The combined aggregate worldwide turnover of the undertakings concerned exceeds ECU 5 000 million. The aggregate Community wide turnover of each party exceeds ECU 250 million. They do not achieve more than two-thirds of their turnover in one and the same Member State. The operation, therefore, has a Community dimension.

#### **V. COMPATIBILITY WITH THE COMMON MARKET**

## A. THE RELEVANT MARKETS

### a. Introduction

19. The Court of Justice has stated<sup>3</sup> and the Court of First Instance has confirmed<sup>4</sup> that in the air transport sector, the definition of the relevant market has to start from the route itself, or a bundle of routes to the extent that there is substitutability between them according to the features of each case. Furthermore, the structural conditions prevailing at airports and airport capacity must also be considered both in connection with the routes and separately. Finally the impact of an extensive or high volume network in a given geographical area<sup>5</sup> must be analysed, because competition in the air transport sector also takes place at the level of major airports as well as between networks.

The substitutability between routes depends on a number of factors such as the distance between the point of origin and the point of destination, the distance between the different airports situated on each side of the route and the number of frequencies available on each route<sup>6</sup>.

### b. The routes concerned by the operation

20. Air UK operates a number of domestic flights within the UK, while KLM does not operate on any of these routes. In addition Air UK operates a number of international flights between the UK and several European destinations, among which flights between London and Amsterdam.
21. KLM has an important international world-wide network. Within this network it operates, together with its subsidiary airline company, Transavia, flights between London and Amsterdam, like Air UK, though operating from different airports in the London area to those used by Air UK.
22. The services offered by KLM and Air UK overlap on the route between Amsterdam and Guernsey/Jersey. Until the summer of 1997 KLM was the only operator on this route, where the total number of yearly passengers is about 10.000. During the 1997 summer season Air UK has operated one weekly flight on this route. In addition, British Airways has offered seven weekly flights via Gatwick airport

However, the main overlap between KLM and Air UK is on the route between the London area, which is served by five airports (Heathrow, Gatwick, Luton, Stansted and London City) and Amsterdam, which is served by Schiphol airport.

23. In its notification, KLM has submitted that, if the airports of the London area are seen as a whole in the present case, the relevant market should also include

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<sup>3</sup> See judgment in Case 66/86 - Ahmed Saeed Flugreisen and Other v/Zentrale zur Bekämpfung unlauteren Wettbewerbs [1989] ECR 803.

<sup>4</sup> See judgment in Case 2/93 - Air France v/Commission (TAT) [1994] ECR 323.

<sup>5</sup> See also Commission Decisions of 13.09.1991 (Delta Air Lines/Pan Am), 01.10.1992 (Air France/Sabena), 27.11.1992 (British Airways/TAT), 17.02.1993 (British Airways/Dan Air), 20.07.1995 (Swissair/Sabena).

<sup>6</sup> Commission Decision of 05.10.1992 (Air France/Sabena), point 25; of 27.11.1992 (British Airways/TAT), point 19; of 17.02.1993 (British Airways/Dan Air), point 10.

all flights between the London area and the airports of Rotterdam, Eindhoven and Maastricht in the Netherlands, Antwerp and Brussels airports in Belgium and Dusseldorf in Germany.

24. However, the responses received from customers and competitors, do not support KLM's submission. Instead the responses indicated a certain degree of substitutability between the different airports of the London area, for reasons of their comparable proximity and ease of access to London. Contrarywise, a low degree of substitutability was indicated between the Amsterdam Schiphol airport and the Dutch, Belgian and German airports suggested by the KLM as substitutes (possibly with the exception of Rotterdam). In addition, some respondents indicated that a distinction could to be made between "business" passengers and "leisure" passengers, essentially characterized by the types of tickets on which passengers travel and the particular conditions attached to these, i.e. "business" passengers tend to travel mainly on full-fare flexible tickets, whether in economy or business class, and "leisure" passengers mainly on restricted economy fares, such as apex and super pex.

However, due to the fact that KLM, Air UK and the main competitors all carry passengers of both categories on the route being analyzed, and given that the investigation has not indicated that any of the above distinctions would significantly change the outcome of the present analysis the precise market definition can be left open in this case.

## B. ASSESSMENT

### a. Market Structure

25. KLM operates on the London area/Amsterdam route through Heathrow and Gatwick airports, while Air UK operates its flights on this route through Stansted and London City airports. The combined market share of KLM and Air UK on the route in 1996 was approximately [...] ([...]<sup>8</sup> + [...]<sup>9</sup>).
26. The two most important competitors on the route are British Airways, which operates through Heathrow airport and, through Cityflyer Express (a franchise of British Airways) from Gatwick, and British Midlands, which operates through Heathrow airport. The 1996 market shares of British Airways (including Cityflyer Express) and British Midlands were both between 20-25%.
27. A relatively new operator on the London area/Amsterdam route is Easy Jet, which has been operating through Luton airport since April 1996. Its market share does not exceed 5%.

### b. Assessment

28. Although the KLM group (KLM, Transavia and Air UK) will have a market share on the London area/Amsterdam route which is approximately double that of its nearest competitor, British Airways, and equal to the combined share of British Airways and British Midlands, there is no indication that the present

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<sup>7</sup> Business Secrets - between 40-50 %

<sup>8</sup> Business Secrets - between 30-40 %

<sup>9</sup> Business Secrets - between 5-15 %

operation will have any significant impact on the competitive conditions on that route.

29. As has been concluded above KLM had already prior to the present operation *de facto* joint control over Air UK since 1988. During the period since then the commercial relationship and coordination which has been gradually built up between KLM and Air UK has effectively resulted in the operational and commercial integration (code-sharing, frequent flyer programmes, sales and services support, revenue accounting system and joint use of KLM tickets) of Air UK into KLM group. As already stated, this relationship is largely explained by the feeder function provided by Air UK, which through its network of flights between different parts of Great Britain and Amsterdam have allowed passengers to transfer to KLM flights.
30. In view of the extensive commercial integration between the companies most competitors and customers have in their responses indicated that the present operation will not have any significant impact on the competitive situation on any of the routes serviced by the parties.

#### c. Conclusion

31. Given the above factors and in particular the pre-existing joint control of KLM, combined with the already close commercial integration attained between KLM and Air UK, the Commission considers that the present operation will not have a significant competitive impact on the route between the London area and Amsterdam, or on any other market.

#### C. CONCLUSION

32. In the light of the above considerations, the notified operation will neither lead to the creation nor to the strengthening of a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it.
33. For the above reasons, the Commission has decided not to oppose the notified operation and to declare it compatible with the common market and the functioning of the EEA agreement. This decision is adopted in application of Article 6.1.(b) of Council Regulation No. 4064/89.

For the Commission,