3. The Commission's approach towards global airline alliances — some evolving assessment principles

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I. Introduction

The number of international airline alliances and similar forms of co-operation agreements has increased in recent years and significantly impacts on the play of competition within today's airline industry. This process of economic repositioning in the air transport sector is likely to accelerate as a consequence of the recent Court's ruling in the 'open skies' cases. (1) The expected changes in the regulatory framework, in particular the elimination of the nationality clauses, will increase the possibilities for European airlines to restructure their business by engaging in further alliance, merger and acquisition activity, while the Commission will have to make sure that these developments take place in accordance with competition law. (2)

Today the Commission takes a broadly positive approach to international airline alliances. Alliances can bring benefits to the economy as a whole from efficiency-triggered cost savings, as well as to consumers as a result of service improvements such as new seamless services, improved schedules or reduced fares. Nevertheless, there is a risk that these benefits will be achieved at the expense of restricting or eliminating competition in certain markets. The Commission therefore usually tries to ensure continued competition on all routes affected by alliances by imposing a set of remedies that have the effect of making new entry possible as a condition for exemption. However, where the network overlap is substantial, and economic benefits in relation to the harm to competition are rather low, prohibition of the transaction may be the only answer, in the absence of effective remedies. Although very much a case-by-case assessment, the following assessment principles — established on the basis of the most recent transatlantic alliance cases (3) — illustrate the Commission's current approach to structural airline transactions.

II. Market definition issues

The 'point of origin/point of destination' (O&D) pair approach

To establish the relevant market in air transport cases, the Commission applies the so-called 'point of origin/point of destination' (O&D) pair approach. According to this approach, every combination of a point of origin and a point of destination should be considered to be a separate market from the customer's viewpoint. (4) To establish whether there is competition on an O&D market, the Commission looks at the different transport possibilities in that market, that is, not only at the direct flights between the two airports concerned, but also other alternatives to the extent that they are substitutable to these direct flights. These alternatives may be direct flights between the airports whose respective catchment areas significantly overlap with the catchment areas of the airports concerned at each end (airport substitution), indirect flights between the airports concerned, or other means of transport such as road, train or sea (inter-modal substitution). Whether one of those alternatives is substitutable to the direct route depends on a multiplicity of factors, such as the overall travel time, frequency of services and the price of the different alternatives and can only be decided on a route-by-route basis.

The Commission also investigates whether passengers travelling on unrestricted tickets (who can travel on any flight offered by a carrier on a

(1) Cases C-466/98, C-467/98, C-468/98, C-469/98, C-471/98, C-472/98, C-475/98 and C-476/98 against the United Kingdom, *Denmark, Sweden, Finland, Belgium, Luxembourg, Austria, Germany.*

(2) Communication from the Commission on the consequences of the Court judgement of 5 November 2002 for European air transport policy (COM (2002)649).

(3) See in particular the contributions 'Commission closes investigation into *KLM/NW* and *LH/SAS/UA* alliances' and 'Investigation into air alliance between *bmi british midland* and *United Airlines* closed' in this Competition Policy Newsletter as well as 'The proposed *British Airways-American Airlines* alliance' in Competition Policy Newsletter 2002, No. 2, p. 28. In a detailed review of the Commission's emerging policy regarding airline alliances and mergers see J. Stragier speech, European Air Law Association, Zurich, 9 November 2001.

(4) See in particular Case 66/86 *Ahmed Saeed Flugreisen* [1989] ECR 803 and Commission decision of 11.08.1999 in Case COMP M. 2041 *KLM/Alitalia*.

given city-pair) are in a different market to passengers with restricted tickets (who are restricted to travelling on the flights specified on their ticket). In the past, these two groups of passengers have been rather labelled 'time-sensitive' and 'non-time-sensitive'. In practice, what enables airlines to separate these two groups is less the extent of their preference for short journey times than the extent of their preference for schedule flexibility. Time-sensitive passengers are prepared to pay more to ensure they will always be able to travel on the most convenient flight. Whereas in cases concerning *intra-European* routes this distinction has led to the definition of separate markets, in *transatlantic* cases it has never been necessary to argue on the basis of this distinction, since the alliance partners usually had similar shares of both the unrestricted and the overall markets.

Network competition and network markets

Network carriers, operating a so-called hub-and-spoke system, usually argue that the market definition used in air transport should take into account that the airline industry is characterised by network competition among airlines alliances. This reference to network competition represents a supply side perspective and highlights the key drivers of those carriers` business model rather than the customer needs to be served. Imagine a consumer wishes to fly from a concrete point of origin to a certain point of destination. If no choice between airlines on this particular O&D pair exists, the consumer may find little comfort in the fact that airlines compete world-wide in the development of their respective networks. Thus, while the emphasis on network competition reflects the supply side considerations, from a demand side driven market definition perspective it is justified to analyse the effects of the co-operation primarily under the O&D pairs approach. Network competition issues as such are still not sufficient to require changes to the established market definition approach followed by the Commission. However certain network phenomena such as the competition effects resulting from frequent flyer programs, corporate customer deals or the possibly limited interlining access of third carriers to feeder traffic may have to be considered as 'market entry barriers' in the context of assessing the alliance partners` market power on the routes concerned. Nevertheless, it should also be noted that the Commission's approach at least implicitly recognises notions of network competition by accepting that certain indirect routings via competing hub-airports may be substitutable with direct long-haul flights.

The evolution of the Commission's market definition

Initially the Commission was of the opinion that for time-sensitive passengers indirect flights were generally not substitutable for non-stop flights on long-haul routes, since — other things being equal — indirect flights are considered as less attractive. Intensive market investigations in the alliances cases *Lufthansa/United Airlines/SAS, KLM/NorthWest* as well as in the merger case *United Airlines/US Airways* however have indicated that indirect flights — depending on a number of factors such as airline preference, price, schedule, availability of direct flights — have to be seen as (at least as potential) suitable alternatives to non-stop services on long haul routes. ([1]) In *United Airlines/US Airways* it was concluded that indirect routings may constitute a competitive alternative to non-stop-services if they are marketed as connecting flights on the city-pair concerned on the CRS; are operated on a daily basis and cause only a limited extension of the trip duration. ([2]) In the recently closed transatlantic airline cases, where the routes concerned showed a corresponding pattern, the Commission followed a similar approach and concluded that indirect flights, under certain conditions, appear to exert a sufficient competitive constraint on non-stop long-haul services. Conversely the Commission needs to assure that the competitive conditions on markets, where one party offers a direct service and the other a competitive indirect service, will not be substantially affected by the alliance.

As regards *intra-European* routes the Commission maintained in its recent *Lufthansa/AuA* decision its established practice that indirect flights are not able to put sufficient competitive constraints on short-haul direct flights. ([3]) The situation may however be different — depending on the market conditions — on certain medium-haul routes, where the Commission concluded in the *Spanair/*

([1]) The situation and market conditions however may be totally different when indirect flights involve 'back tracking'. In *BA/AA* and *bmi/United* it was concluded that on many UK-US routes only a small number of passengers choose to fly indirect and that these flights were therefore at a competitive disadvantage and as such unlikely to constrain the market behavior of the alliance on the problematic direct overlap-routes.

([2]) Case COMP/M.2041 — United Airlines / US Airways of 12.1.2001.

([3]) Commission decision of 5 July 2002 in the case COMP/37.730 — *AuA/LH*, OJ. L 242, 10.9.2002.

SAS case that indirect flights are less at a disadvantage to direct flights than on short-haul services. ([1])

III. Identification of competitively affected markets

The competitive assessment of alliances in the airline industry is complicated not only by the high number of potentially affected O&D markets but also by the network nature of the industry. In practice this may mean that competition could take place *between routes* as well as on *specific routes.* When trying to identify the markets competitively affected by an alliance, the Commission usually categorises two broad types of affected markets: *overlap* and *non-overlap* markets. The first category addresses mainly actual, the second mainly potential competition issues.

Competition assessment on overlap markets

Whereas for *intra-European* alliance cases in principle only direct-overlap markets may raise competition concerns for *long-haul traffic* the situation is insofar different as both direct and certain indirect routes may belong to the same relevant market. This makes it necessary to differentiate for the latter services into three further market overlap sub-categories: direct-direct overlap routes, direct-indirect overlap routes and indirect-indirect overlap routes. For these categories some rough assessment thresholds have been established, indicating possible competition concern on a preliminary basis. In the recently cleared airline alliance cases the Commission has only raised serious competition concerns on O&D markets where the combined market shares of the parties were higher than 50%, and in the case of direct-indirect overlaps, where in addition to the 50% threshold the increment was higher than 3%. As regards indirect-indirect overlaps, such routes are only under rather exceptional circumstances likely to raise serious competition concern, since the usually available competing direct or other indirect services via competing hubs should sufficiently constrain the alliance` market behaviour.

The competitively affected markets will be identified on the basis of these thresholds and subsequently a more detailed market analysis will be undertaken, unless market information indicates that there are already competition problems at a low market share. This ‘filter’ process allows the Commission to concentrate on the markets with the largest competition concerns and where it is likely that competition will be eliminated as a consequence of the transaction.

Competition assessment on non-overlap markets

Whereas the Commission initially considered alliance partners as potential competitors on all routes connecting destinations of the respective networks and where before the alliance at least one operating party was already present ([2]) the Commission today applies an economically realistic approach towards potential competition in the airline industry, relying on the notion of a real commercial possibility of entry. ([3]) An airline will in principle only be considered as a potential competitor on a specific route if that route is either directly linked to one of its hubs ([4]) or sufficiently frequented by local traffic to allow market entry on a point-to-point basis ([5]), while taking into account the operational requirements of the respective business models. This perspective is in principle applicable to short-haul ([6]) and long-haul routes alike, however different evaluation thresholds in terms of minimum O&D traffic, extent of necessary connecting/transfer passengers and/or relative size of hub/operational presence (e.g. international, domestic, regional hub) might be relevant. ([7]) On *long-haul* routes it might be furthermore necessary to analyse to what extent alliance partners have to be considered as potential competitors on indirect routings. However, the Commission has so far never challenged an alliance on the basis of a restriction of potential

([1]) Case COMP/M. 2672 — *SAS/Spanair* of 5.3.2002.

([2]) Commission notices published in the cases *British Airways/American Airlines* and *Lufthansa/SAS/United Airlines*, OJ C 239, 30.7.1998.

([3]) Joint cases T-374/94 etc. European Night Services and Others v. Commission [1998] ECR II-3141.

([4]) In principle airlines operating a hub-and-spoke system will not enter a route where they do not have a hub at one end, since their whole business model is based on increasing traffic through their hubs.

([5]) For example in *BA/AA* various of the routes where competition concern arose were regarded as thick routes and therefore considered as attractive enough for a point-to-point entry.

([6]) In the *SAS / Spanair* case the Commission concluded that neither *Lufthansa* nor *bmi* or *AuA* would be potential entrants on the concerned overlap route of SAS and Spanair, given the presence of other carriers, the limited number of passengers per year and the absence of hubs in Copenhagen or Madrid.

([7]) Neither definitive minimum O&D traffic thresholds, nor decisive criteria for hub-categorization have been established so far.

indirect competition, since the effect on competition there is probably only appreciable in very exceptional cases and moreover unlikely to lead to an elimination of competition. This revised approach towards potential competition assessment has not only significantly reduced the number of potentially affected overlap markets but has also inversely increased the importance of competitive indirect services as necessary competitive constraints as far as long-haul routes are concerned.

IV. Market power, entry barriers, elimination of competition and remedies

Airline alliances usually involve such a high degree of business integration (e.g. route coordination, joint-pricing, revenue-sharing, joint-marketing, …) that it ends any actual and potential competition between the parties on the affected markets. Taking further into account that alliances normally have, at least on some routes (in particular on the the hub-to-hub routes) rather high market shares, such alliance agreements are therefore usually caught by Article 81 with respect to all routes where the operation leads to an appreciable restriction of competition on the relevant markets.

Economic benefits and fair share for consumers

The Commission in principle accepts that alliances can contribute to improving the production and distribution of transport services and promote technical and economic progress. The Commission further accepts that connecting passengers can enjoy the various types of alliance benefits, such as wider choice of destinations and connections, seamless service and lower fares. It is however vital that the benefits of an alliance are passed on to the passengers. Such a conclusion is the more likely the more complementary the respective networks are and consequently the less overlap markets exist. However, more difficult is to establish the benefits to be expected for point-to-point passengers, on the routes where the parties were actual or potential competitors before. In the context of its on-going airline alliance investigations the Commission therefore puts a higher emphasis on receiving clear evidence on the expected passenger benefits (e.g. consumer pass-on in case of efficiency gains) on these routes.

Elimination of competition

Whether competition is likely to be eliminated depends — among other factors — on the market position of the alliance on the relevant markets (e.g. market share/ concentration ratio) and on the existence of significant entry barriers, hence whether the parties will enjoy market power, which allows them to act to a considerable extent independently of their competitors and customers. Although airline alliances often lead, in particular on the overlap routes to high market shares, these are as such not sufficient to conclude that significant market power exists and that competition is likely to be eliminated. This appears in the airline industry to be much more evident where high market shares come together with high entry barriers.

In airline alliance cases the Commission usually faces various types of entry barriers. The most important are

— Regulatory barriers, such as government pricing restrictions for indirect flights or the unavailability of necessary traffic rights,

— Slot shortages at congested airports,

— Increased frequencies resulting from the co-operation,

— Network effects resulting from joint frequent flyer, travel agency or corporate customer incentive schemes or reduced third carrier access to transfer passengers,

— ‘Behavioural’ barriers arising from possible predatory pricing or predatory capacity tactics

Whether market power resulting from entry barriers is likely to eliminate competition needs to be primarily established on a route-by-route analysis. Of particular competition concern are usually barriers resulting from slot shortages at congested airports, because these have the direct effect of marginalising the threat of market entry. In addition it might be also necessary to assess certain network effects across all affected routes in order to identify market power arising from the overall economic strength of an alliance at their respective hubs or vis-à-vis certain customer groups. Absent significant entry barriers the Commission analyses to what extent actual and potential competition provides sufficient constraints on the parties. If existing direct or indirect competitors have or easily can introduce or adapt sufficient capacity to accommodate even a significant additional proportion of customers currently carried by the parties, this should in principle act as a significant constraint on the alliance's competitive behaviour on those routes.

Entry barriers and remedies in the recent transatlantic alliance cases

In the *KLM/NorthWest* transatlantic case the Commission followed the above outlined economic reasoning and consequently accepted high market shares on the direct overlap routes in the absence of any further direct competition and without imposing any remedies. This was possible because the Commission did not identify any significant market entry barrier on the affected routes and therefore could conclude that the existing indirect competition should sufficiently constrain the competitive behaviour of the alliance partners. Moreover, it was accepted that there exists an important level of potential indirect competition resulting both from the possibility for competitors to commence new services and to adjust existing services by schedule adjustment.

A different market situation was present in the *Lufthansa/SAS/United Airlines* case. There the Commission identified significant regulatory and structural entry barriers which prevented new direct and indirect market entry and therefore direct and indirect flights from competing effectively on the problematic routes. The Commission came to the conclusion that absent sufficient remedies competition was likely to be eliminated on these routes. After the parties had submitted corresponding undertakings, basically slot surrender at congested airports and furthermore the German aviation authorities agreed no longer to apply certain restrictive price control measures vis-à-vis competitive indirect services, the case was cleared.

The Commission remedy approach in the recent transatlantic airline cases clearly mirrors the identified entry barriers. The more problematic the identified entry barriers are, the more significant remedies are needed to ensure that competition is not eliminated on any routes. The exact scope and content of necessary remedies on long-haul routes might be different from those usually applied on short-haul routes due to significantly different market conditions. Whereas for intra-European alliances the likely remedy approach is focused on allowing direct entry ([1]), on long-haul routes with rather limited point-to-point traffic, remedies will be designed to remove entry barriers to allow effective competition from indirect services.

Conclusion

The strong focus on market entry barriers and the existence of market power in the Commission's current airline alliances competition assessment practice is well rooted in modern competition policy and concentrates on the real market effects of alliance agreements. It has helped the Commission to apply a realistic competition assessment approach towards global alliances.

([1]) See most recent in Commission decision of July 5, 2002 in Case COMP/37.730 — *AuA/LH*.