New developments in the aviation sector

Consolidation and competition: recent competition cases

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Following the completion of the Internal Market in air transport in 1997, the European aviation sector is going through a period of rapid change. However, while liberalization of the Internal Market has been accomplished, air traffic with third countries is still heavily restricted. The so-called Chicago System establishes a rigid and fragmented international framework based on national bilateralism. Moreover, until very recently, the European Commission did not have the enforcement powers to apply effectively its anti-trust rules on such markets (see below). The system of bilateralism prevented consolidation in the industry, as merging entities faced the risk of losing traffic rights for services to third countries. The Open Skies judgements of the European Court (1) are likely to change this situation, as it declared nationality clauses in agreements between Member States and the US to be illegal (2). Member States cannot any longer designate only the national flag carrier to fly to third countries.

The liberalization process has already triggered a process of consolidation and restructuring in the European aviation sector. Larger airlines have reacted by establishing hub-and-spoke systems, concentrating traffic on their respective hubs. This allows them to improve capacity utilization due to better feeder services, and to reduce cost by bundling airport services. Furthermore, they aim to extend their respective networks through alliance agreements. The recent Open Skies judgement has now paved as well for European mergers. The recent Air France / KLM merger is a first step in this direction.

The Commission has recently taken three decisions in the aviation sector, as presented below. In two alliance cases it granted an exemption for six years for agreements between British Airways and Iberia (3) and between Air France and Alitalia (4) pursuant to Regulation 3975/87 (5). In February 2004, the Commission also cleared, based on Article 6(2) of Council Regulation (EEC) No 4064/89, the merger between Air France and KLM which will create the largest airline group in Europe (6). These three decisions were taken subject to a number of commitments which are binding on the Parties.

Even if each case must be assessed on its own merits and every situation tends to be different, the remedies proposed in those three cases are similar. Their main objective is to lower barriers to entry to allow new competing services to be operated on markets where the agreement would have eliminated competition. In the last few years, the Commission has been adjusting its remedy approach towards making actual entry of new competitors more likely.

(1) Judgement of 5 November 2002 in the 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 and Germany.
(2) The nationality clauses is bilateral agreements concluded between some Member States and the US provide that the US may withhold or revoke operating permission from a carrier if it is not substantially owned and effectively controlled by either state or its nationals.
(3) See IP/03/1703 of 10 December 2003 (case COMP/D2/38479, BA/Iberia/GB Airways). GB Airways is a British Airways franchisee. The exemption is granted until 12 September 2009.
(4) See Commission Decision of 7 April 2004 relating to a proceeding under Article 81 of the EC Treaty. A public version of this decision in English, French and German (only the English text is authentic) is available for information on DG COMP’s website at http://europa.eu.int/comm/competition/index_en.html (case COMP/D2/38284 Air France/Alitalia). Also see IP/04/AirFrance of 7 April 2004. The exemption is granted until 11 November 2007.
(6) See Commission Decision of 11 February 2004 declaring a concentration to be compatible with the common market (case n° IV/M.3280 Air France/KLM) according to Council Regulation (EEC) No 4064/89.)
Market definition

In line with its well established policy in the air transport sector, as supported by case law (1), in all three cases the Commission applied its point-of-origin / point-of-destination pair (O&D) approach. According to that approach, every combination of point-of-origin and point-of-destination should be considered to be a separate market from the customer's point of view. Network carriers operating the above-mentioned hub-and-spoke system, however, consider that the O&D approach fails to capture the nature and the extent of competition which now occurs on a network basis.

The issue of network competition is addressed explicitly in these decisions. The Commission acknowledges that, from the business model of network carriers, network competition is relevant from a supply side perspective (2). However, from the demand side, arguably the network approach is of little relevance to the individual consumer. If confronted with high prices due to a monopoly on a particular O&D pair, a passenger may find little comfort in the fact that airlines compete worldwide in the development of their respective networks. Even in the case of corporate customers, who negotiate discounts with airlines and receive typically a bulk of services, the market investigations did not confirm that this customer group has a particular concern with a possible effect on network competition. Finally, network carriers represent only one, if important, part of the industry. Low cost point-to-point operators and many regional carriers instead tend to agree with the O&D approach (3).

Airport substitutability

In certain cases passengers may have the choice between different airports. If the catchment areas overlap sufficiently such airports may be considered to be substitutable on a given city pair. For instance, the results of the market test in the BA / Iberia alliance case confirm that, for journeys between Spain and London, all London airports are part of the market for price-sensitive passengers. However, as regards time-sensitive passengers the results are less clear-cut, i.e. a majority of Heathrow/Gatwick business passengers would not accept to switch over airports in Luton and Stansted for flights between London and Spain. Likely, in Air France/Alitalia it was concluded that Beauvais-Tillé is not substitutable to Paris-Orly and Paris-Charles de Gaulle for time-sensitive passengers.

The issue of airport substitutability is also important with regard to slot related remedies. In that case, the principles of proportionality and effectiveness of the remedy have to be taken into account. In principle, if airports are considered to be substitutable from the demand side, the alliance partners may have the choice in which airport they wish to offer slots to new entrants. However, at the same time the offered remedy has to be effective. If potential entrants can demonstrate that, due to a different level of cost or their already existing operations, they can only operate from a specific airport, this choice may be restricted. In that case the principle of proportionality requires that the restrictions imposed on the parties do not go further than what is necessary to address the competition concerns. This can only be judged on a case by case basis.

For instance, in the Air France / Alitalia decision, the Commission considered that, from the demand side for point-to-point traffic, the Paris airports Charles de Gaulle (CDG) and Orly are substitutable. However, in order to ensure the effectiveness of the remedies proposed and applying the principle of proportionality, it was agreed with the parties that, under certain conditions (4) slots should be surrendered at Orly to competitors which already offer services on the affected routes out of this airport. This would allow to strengthen already existing competitors on the affected city pairs. By way of contrast, in

(2) When defining a relevant product market, the Commission first considers demand substitution. The competitive constraint arising from supply side substitutability is normally only considered in the market definition when it has an immediate and effective impact on the relevant product market (see Commission Notice on the definition of the relevant market for the purposes of Community Competition law, OJ C 372).
(4) In Air France/Alitalia, a competitor is entitled to obtain slots at Orly if it already operates flights on an affected route out of Orly and if it has all its scheduled flights serving Paris operated out of this airport.
the Air France / KLM decision, at the time of the merger, no competitors operated on the affected city pairs. In order to allow for effective entry, the parties agreed that entrants could choose at which Paris airport to pick up the slots, without any conditions attached.

Affected markets

As pointed out above, the lack of effective enforcement powers implied that the analysis of competitive impact of the two alliance agreements was limited to intra EU traffic. By way of contrast, the Air France / KLM merger was investigated under the merger regulation which allows the Commission to look also at traffic between the Community and third countries.

In its investigation of the alliance between Air France and Alitalia the Commission concluded that the co-operation eliminates competition on seven O&D pairs (1). Similarly, in the case of BA/Iberia five routes between London and Spain (2) were affected. In its assessment, as well as with regard to the remedies, the Commission took into account that on many of these routes the parties already face competition (3).

However, the existing competitors do not currently offer a service sufficient to compete efficiently against the parties’ scheduled services, in particular to attract time- sensitive passengers. Those passengers would notably require a higher number of daily frequencies to consider switching from the alliance partners to these competitors (4). In its investigation of the Air France / KLM merger, the Commission took into account the existing agreement between Air France and Alitalia. It concluded that, irrespective of the actual relationship between KLM and Alitalia, the merger would eliminate any incentive to compete between the merged entity and Alitalia. For that reason the merger eliminates competition between KLM and Air France on the Dutch-French bundle of city pairs as well as between the merged entity and Alitalia on all city pairs between The Netherlands and Italy. As a result, it was concluded that the merger would affect nine intra-European routes (5). As regards intercontinental traffic the Commission accepted the parties’ submission that, under certain conditions, indirect flights offer a competitive service to direct ones. However, it found that such indirect competition can be significantly hampered by government intervention. This applies in particular to price regulation for indirect services (6). It concluded that the merger eliminates competition on five intercontinental routes (7).

Commitments

With a view to address the Commission’s concerns, the parties offered a large number of commitments (8). In the case of the two alliance agreements, the main purpose of such commitments has been to strengthen already existing competitors. Due to the lack of available slots at airports, these competitors were not in a position to increase their operations and to offer a viable service in particular to time-sensitive customers. The main remedy therefore has been that the parties offer additional slots to such competitors.

As some of these routes are attractive to new entrants, it cannot be excluded that demand for slots will exceed the total number of slots offered by the parties. Some priority rules therefore had to be established. The Commission considers that it is more effective to add frequencies to an existing service than to start a new service from scratch on a particular city pair. In addition, in terms of competition, it is considered that a competitor offering a package of flights per day will have more chance to compete efficiently against the parties than

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(2) Madrid, Barcelona, Bilbao, Valencia and Seville.

(3) Several competitors operate or have initiated competing services since the date of the notification on several routes between France and Italy (Paris-Rome, Paris-Milan, Paris-Venice and Paris-Naples) and the UK and Spain (London-Madrid, London-Barcelona, London-Bilbao) respectively.

(4) Either the number of daily frequencies offered by the competitors is too low to provide sufficient ticket and departure flexibility for business passengers or the competitors are offering services out of secondary airports - like many low cost carriers - prolonging total travel time to a level that is not accepted by most business passengers.


(6) Some Member States still have legislation enabling them to oppose the fares offered by the indirect service provider(s) [e.g. BA operating Paris-London-Atlanta] when the latter undercut the fares of the direct service provider(s) [e.g. Air France operating Paris-Atlanta].

(7) Amsterdam – New York, Atlanta and Lagos, as well as Paris – Detroit and Lagos.

(8) Apart from the slot related commitments discussed here, depending on the case, commitments also comprise issues like frequency freeze, block-space, Frequent-Flyer, inter-lining and inter-modal agreements, as well as price regulation.
several competitors each offering only a limited number of flights. If demand exceeds supply of additional slots, preference is therefore given to competitors who are already established on a particular city pair. Similar considerations also apply for the slot release under the commitments of the Air France / KLM merger.

To some extent, commitments offered under the merger exceed those offered in the alliance cases. This reflects the different market situations and takes into account that the clearance of the merger is given for an unlimited period of time whereas the exemption decision is delivered for only six years. As a result, for instance, in the case of the merger the surrender of slots is for an unlimited duration, compared with six years for the alliances. Moreover, in the case of the merger, the slot release becomes a slot divestiture. In order to take into account concerns raised with regard to hub dominance, slots released by the parties and which are not any longer used by an entrant on a particular city pair will eventually go back into the slot pool of the airport. As there exist particular competition concerns, an innovative approach was chosen for the city pair Amsterdam - Paris. In order to make entry more attractive, under certain conditions an entrant could even obtain the grandfather rights for the slots offered by the parties.

With regard to long-haul services to third countries (1), the Commission's entire analysis hinges on the assumption that indirect flights would offer competitive constraints for direct ones. As this is put into doubt by the above-mentioned price regulation, a crucial condition for clearing the merger are the French and Dutch governments' declarations that they will refrain from any intervention into the price setting of indirect services on a large number of long-haul city pairs. Moreover, the Commission obtained assurances from the respective governments that they would give traffic rights to other carriers wishing to stop over in Amsterdam or Paris en route to the United States or other non-EU destinations.

(1) Note that in both alliances cases the Commission has not taken a decision as regards EU-third country routes.
New enforcement tools to tackle long haul routes: finally the King got a throne

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On 26 February 2004 the Council adopted Regulation (EC) No 411/2004 (1) amending two existing regulations in the air transport sector (2) and Regulation (EC) No 1/2003. (3) In spite of the very technical provisions contained in this Regulation, the essence of it is that Regulation (EC) No 1/2003 will apply also to air transport between the European Community and third countries (or long haul routes). It further broadens the scope of the Council enabling block exemption Regulation allowing the Commission to issue block exemption Regulations on certain listed air transport activities affecting also the long haul routes.

Until the adoption of this Regulation the Commission acted like a King without a throne in the field of air transport to third countries. Although there was no doubt that the competition rules applied also to the long haul routes (4), the Commission lacked the effective enforcement powers in this field. Indeed, the assessment of international alliances such as Star, Wings and Skyteam obliged the Commission to separate procedurally the intra-Community routes from the third country routes, which led to an unsatisfactory patchwork scenario. This was further accentuated by the fact that the Merger Regulation does not make this difference and therefore, when assessing mergers in the air transport field such as the recent Air France/KLM merger, the Commission also assessed the impact of the merger on long haul routes.

Therefore, the application of Regulation (EC) 1/2003 to all air transport, irrespective of the routes involved, finally brings air transport under the general framework of competition enforcement.

The Regulation entered into force on 1 May 2004 together with the modernization package.

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(2) Regulation (EEC) No 3975/87 laying down the procedure for the application of the EC competition rules in the air transport sector and Regulation (EEC) No 3976/87 on the application of Article 85(3) of the Treaty to certain categories of agreements and concerted practices in the air transport sector.
(3) For an extensive explanation of the Proposal and its background, see the article of Monique Negenman, “Commission proposes effective enforcement rules for air transport between the Community and third countries”, Competition Policy Newsletter 2003, number 2, page 12.